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RETHINKING TAX TREATIES IN A STRATEGIC WORLD WITH DISPARATE TAX SYSTEMS

*Julie Roin**

INTRODUCTION

MANY of the economic and political developments of the past twenty years have had profound implications on efforts to tax international income effectively and fairly. Though the tax treaty policy of the United States has been responsive to some of these developments,¹ other events and realities seem to have been

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¹ For example, Treasury has reacted to the growth of "treaty-shopping," or the use of intermediary companies established in tax-haven countries, both by canceling outstanding treaties with tax-haven countries and by renegotiating existing treaties to insert stringent limitation of benefits clauses. See H. David Rosenbloom, *Tax Treaty Abuse*, 15 *Law & Pol'y Int'l Bus.* 763, 793-810 (1983) (recounting history of anti-treaty-shopping actions undertaken in the 1980s). A number of commentators now believe that Treasury has overreacted to the treaty-shopping phenomenon, stripping legitimate business arrangements of treaty protection. See, e.g., *Federal Income Tax Project, American Law Institute, International Aspects of United States Income Taxation II: Proposals of the American Law Institute on United States Income Tax Treaties 166-67* (1992) [hereinafter *ALI, Tax Treaties Proposals*]; Richard O. Loengard, Jr., *A (Modest) Proposal to Reconsider the 'Limitation on Benefits' Provision of U.S. Tax Treaties*, in *Essays on International Taxation 275-86* (Herbert H. Alpert & Kees van Raad eds., 1993).

largely or completely ignored. In particular, neither Treasury nor Congress² appears to have fully considered the implications of two developments that have altered the landscape for international tax policy: decisions by many of our trading partners to adopt tax systems which integrate corporate and individual taxation,³ and the decrease in U.S. corporate tax rates.⁴ While each of these changes independently affects the incentives facing international investors, the combination of the two undercuts assumptions central to cer-

² Though the State Department is ostensibly responsible for negotiating all treaties, it has effectively delegated its responsibilities with respect to tax treaties to the more knowledgeable Treasury Department. See ALI, *Tax Treaties Proposals*, supra note 1, at 16. Tax treaties, like all other treaties, must be approved by a two-thirds vote and with the advice and consent of the Senate. See U.S. Const. art. II, § 2, cl. 2. This power has been used by the Senate to exert substantial control over treaty practices. See H. David Rosenbloom, *Current Developments in Regard to Tax Treaties*, in 2 *New York University Proceedings of the Fortieth Institute on Federal Taxation* § 31.02[2] (Nikolas Liakas ed., 1982).

³ Germany adopted a split-rate system (under which corporate income tax was levied at a lower rate on distributed than undistributed profits) in 1953. Harry G. Gourevitch, *Corporate Tax Integration: The European Experience*, 31 *Tax Law.* 65, 68 (1977). However, integration did not become widespread until after France adopted its integrated tax system in 1965. See Charles I. Kingson, *The Coherence of International Taxation*, 81 *Colum. L. Rev.* 1151, 1181-83 & n.146 (1981). Great Britain followed in 1972, see Gourevitch, supra, at 71, and Germany revised its system to correspond more closely to the French version of integration in 1976, id. at 69. By 1991, only five OECD countries provided no relief from the double taxation of dividends (Belgium, Luxembourg, the Netherlands, Switzerland and the United States). Seven provided for full integration of corporate and individual taxation through relief at the shareholder or company level (Australia, Germany, Italy, New Zealand, Greece, Norway and Turkey). Another eleven provide partial integration relief. Krister Andersson, *Implications of Integrating Corporate and Shareholder Taxes*, 50 *Tax Notes* 1523, 1526 (1991); see also *Tax Policy Aspects of Mergers and Acquisitions: Hearing Before the House Ways and Means Comm.*, 101st Cong., 1st Sess. 35-36 (1989) (statement of John G. Williams, Acting Assistant Treasury Secretary for Tax Policy), reprinted in *Daily Tax Rep. (BNA)*, May 17, 1989, at L-17, L-19 (stating that most major industrialized nations provide some relief from double taxation of dividends and listing approaches taken by different countries).

⁴ The actual amount of taxes owed by a given taxpayer depends on both the tax base and the tax rate. Rate reductions may not reduce overall tax liability if accompanied by offsetting base broadeners. The tax reforms of the 1980s and 1990s contained a mixture of base broadeners and rate reductions; as a result, the tax burdens of some corporate taxpayers have increased. The majority of corporate taxpayers, however, pay a smaller percentage of their economic income in federal income tax than they did in the 1970s. See James M. Poterba, *Why Didn't the Tax Reform Act of 1986 Raise Corporate Taxes?*, in 6 *Tax Pol'y and the Econ.* 43, 54 (James M. Poterba ed., 1992) (presenting a table showing that the average effective corporate tax rate was 44.93% in 1970 and 30.31% in 1988).

tain aspects of U.S. tax policy. Policymakers appear to have overlooked this challenge to the wisdom of current tax treaty policy.⁵

This Article attempts to explain the content and seriousness of this challenge. An analysis of the effects of U.S. treaty policy when U.S. treaty partners maintain different systems for the taxation of corporate and individual income reveals the need for a thorough reevaluation of one of our most time-honored treaty policies⁶—the desire to reduce source taxation⁷ to the lowest possible level. I argue that many of the fundamental revenue assumptions underly-

⁵ This lack of consideration extends to the scholarly literature. There have been a number of articles (some of them quite fine) on the proper method of, and mechanisms for, dividing revenues generated by the taxation of corporate profits between the country of residence and the country of source. Particular attention has been paid to the special problems posed when one of the countries imposes a classical, two-level tax on such income while the other uses an integrated method. See, e.g., Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base*, 47 *Tax L. Rev.* 565 (1992) [hereinafter *Division of the International Tax Base*]; Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 *Law & Pol'y Int'l Bus.* 461 (1978); Richard M. Bird, *International Aspects of Integration*, 28 *Nat'l Tax. J.* 302 (1975); Charles E. McClure, Jr., *International Aspects of Dividend Relief*, 7 *J. Corp. Tax'n* 137 (1980); Mitsuo Sato, *International Aspects of Integration of the Corporate and Personal Income Taxes*, 8 *Ga. J. Int'l & Comp. L.* 779 (1978). Some of the literature deals with the types of tax treaty relief that could, and should, be sought with respect to dividend income by the home countries of these foreign investors. See Ault, *Division of the International Tax Base*, *supra*, at 608. Apparently, no one has confronted the more generalized effects these integrated systems have on the taxation of transnational income and, more specifically, on their implications for the overall tax treaty policy of a tax credit country such as the United States. Only Charles Kingson, in a 1981 article, has raised some of the issues discussed in this paper when analyzing the investment incentives created by a residence country's adoption of an integrated tax system and the potential treaty-based responses by an adversely impacted source country. See Kingson, *supra* note 3, at 1210-62, 1272-75.

⁶ See Rosenbloom, *supra* note 1, at 776 n.35 (describing reduction of source taxation as the "cornerstone" of U.S. tax treaty policy); see also ALI, *Tax Treaties Proposals*, *supra* note 1, at 10 ("[I]n the past the United States and other countries have sought reductions in source-based taxes not to avoid the imposition of an excessive burden on the taxpayer but to reduce the source-based rate below the rate imposed at the residence . . ."); 1 Michael J. McIntyre, *The International Income Tax Rules of the United States § 2/E*, at 2-69 (1989 & 1990) [hereinafter McIntyre, *International Tax Rules*] (describing the prevalence of provisions reducing source taxation in U.S. tax treaties); Michael J. McIntyre, *Guidelines For Taxing International Capital Flows: The Legal Perspective*, 46 *Nat'l Tax J.* 315, 317-18 (1993) ("The usual focus of the U.S. Treasury Department in treaty negotiations, however, has been on obtaining some reduction in the foreign taxes paid by U.S. persons.").

⁷ "Source taxation" refers to the taxation of income by the country of "source"—the country in which such income is deemed "earned" under the applicable law. The competing claimant for tax dollars is the country, in which the taxpayer earning such income "resides," or the so-called "residence taxation" principle. The United States also

ing the policy of seeking reductions in source taxation are incorrect when the treaty partner is a country with an integration system, and are particularly inappropriate when the treaty partner has an imputation system.⁸ In these situations, reducing source taxation leads in fact to a unilateral sacrifice of U.S. tax revenues.

Unfortunately, none of the various options for rectifying this revenue imbalance consistent with the continuation of our treaty policy is very satisfactory. I suggest that the only justification for continuing our present tax treaty policy is as an incentive for foreigners to invest in this country. Given the likely impact of present tax policies on U.S. tax revenues, I recommend that Congress and the Treasury reconsider the wisdom of continuing to pursue source tax reductions in all instances.

It is worth noting that Congress has already expressed some displeasure with the source tax reductions effectuated by our tax treaty policy. In recent years, Congress has balked at living up to some of its self-imposed treaty obligations. It has passed several pieces of legislation that seem to have been designed to, and certainly have the effect of, clawing back source tax reductions previously agreed to by treaty. For instance, in the so-called "branch tax" legislation enacted in 1986, Congress unilaterally restricted eligibility for certain treaty benefits, thereby increasing the U.S. source tax obligations of persons affected.⁹ In 1989, Congress enacted legislation including "earnings-stripping" rules that limit deductions for interest payments to related parties in whose hands such payments are partially or fully exempt under a tax treaty.¹⁰

claims the right to tax on the basis of citizenship, so that a non-resident citizen earning income in a third country could face tax claims in three countries.

⁸ Under an imputation system, the income taxes paid by a corporation with respect to the income paid to shareholders in the form of a dividend are "imputed" to the shareholders, in whose hands they are treated both as additional dividends and as prepayments of the shareholder-level taxes due on the grossed-up amount. See *infra* notes 92-93 and accompanying text.

⁹ See Jeffrey J. Baldassari, *The Branch Profits Tax: An Analysis of Its Impact on Stockholders of U.S.-Owned Foreign Corporations and Its Interrelationship with the U.S. Network of Tax Treaties*, 20 *Case W. Res. J. Int'l L.* 643, 653 (1988); John I. Forry & Michael J.A. Karlin, 1986 Act: Overrides, Conflicts, and Interactions with U.S. Income Tax Treaties, 35 *Tax Notes* 793, 797 (1987).

¹⁰ See I.R.C. § 163(j) (West 1995). Congress strengthened the earnings-stripping rules in 1993. See Richard L. Doernberg, *The Enhancement of the Earnings-Stripping Provision*, 7 *Tax Notes Int'l* 985, 985 (1993).

These rules were intended to, and may have the effect of, imposing a source tax on income formerly protected by a treaty provision.¹¹ While these measures may not represent a complete change of heart,¹² the apparent desire on the part of Congress to tax the U.S. operations of foreign investors (often at the expense of those investors' home country treasuries) may mark the beginning of a shift in attitude towards source taxation.

While Congress' discomfort with our present tax policy may be well-founded, its recent actions with regard to source taxation are unfortunately more likely short-sighted attempts to gain tax revenue rather than a considered reevaluation of (or even intuitive response to) a previously accepted but obviously shaky policy. Congress may have acted under the hope and belief that its treaty partners would not respond to its implicit, partial revocation of U.S. treaty obligations.¹³ As anyone familiar with the paradigm of the prisoners' dilemma or theories of cartel behavior knows, a self-interested party can benefit in the short-run by cheating on its obligations when other parties to the agreement live up to their own obligations. But such strategies are likely to fail when the parties are engaged in a long-term relationship, as the United States is

¹¹ See Julie A. Roin, *Adding Insult to Injury: The "Enhancement" of Section 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 *Tax L. Rev.* 201, 221 (1994). The earnings-stripping provision differs from similar provisions maintained by many of our treaty partners in the exceptionally small amount of debt foreign-owned enterprises may incur without encountering its sanctions. See *id.* at 289 n.80. This statute has also been criticized for violating the nondiscrimination and affiliated enterprises provisions found in many tax treaties. See, e.g., Doernberg, *supra* note 10, at 987; Robert J. Misy, Jr., *An Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision?*, 8 *Int'l Tax & Bus. Law.* 171, 191 (1990).

¹² In 1984, Congress removed the withholding tax from most forms of portfolio interest paid to unrelated foreign debtors. *Deficit Reduction Act of 1984*, Pub. L. No. 98-369, § 127(a), (b), 98 Stat. 494, 648 (codified at I.R.C. §§ 871(h), 881(c)).

¹³ The partial revocations by Congress were not limited to source tax issues; in at least one instance, it reneged on a residence country obligation. The Tax Reform Act of 1986 introduced a new Alternative Minimum Tax and limited the foreign tax credits usable against this tax obligation to 90% of the amount of tax due. For a numerical example of the operation of this provision, see *infra* note 58. Congress made clear that this provision was supposed to override any obligation under a tax treaty to relieve double taxation. See *Pending Bilateral Tax Treaties and OECD Convention: Hearing Before the Senate Comm. on Foreign Relations, 101st Cong., 2d Sess. 13* (1990) (statement of Kenneth W. Gideon, Assistant Secretary of the Treasury for Tax Policy) [hereinafter *Gideon Statement*], *reprinted in* Special Supplement, *Daily Tax Rep.* (BNA), June 18, 1990, at S-4.

with its treaty partners.¹⁴ The other partner simply has too many opportunities to exact revenge for such misbehavior over the extended time period; in the language of game theory strategists, it is clear that "tit-for-tat" is also a "winning strategy" for repeat play games.¹⁵ In these situations, such a strategy would require our treaty partners to deviate similarly from their treaty obligations, eliminating not only the benefits of cheating, but also of entering into the agreement at all.¹⁶ As a result, the piecemeal strategy Congress has adopted over the past few years is likely to have negative long-term consequences.

Alternatively, Congress may be reacting to the fact that the United States is no longer overwhelmingly a "residence" country; that is, the amount of foreign investment in the United States now approaches or exceeds the amount of U.S.-owned investment in some foreign countries.¹⁷ In this light, the substitution of residence-country taxation for source-country taxation is no longer a

¹⁴ The classic prisoner's dilemma model posits a one-shot decision being made by parties who are unable to communicate with one another prior to making their decision. See Douglas G. Baird, Robert H. Gertner & Randal C. Picker, *Game Theory and the Law* 45 (1994); Robert Gibbons, *Game Theory for Applied Economists* 4 (1992). The "winning strategy" can change as these assumptions are relaxed. See Baird et al., *supra*, at 45.

¹⁵ See Baird et al., *supra* note 14, at 171 (describing tit-for-tat, one of several Nash equilibria in a given game matrix).

¹⁶ Some may argue that the above-described congressional overrides of treaty obligations are best viewed as a response by the United States to earlier violations committed by our treaty partners. An example of such a violation would be the adoption of imputation tax systems. See *infra* Part II.D. In this view, the congressional overrides represent legitimate expressions of a tit-for-tat strategy rather than unprincipled opportunism. Though I sympathize with the intuition that in many cases U.S. treaty partners may have overstepped, I find it difficult to accept that the best response is to adopt an approach that further undercuts treaties as a device for resolving international conflicts. The end result of such a process could well be the disappearance of treaties, because countries would not go to the time and trouble to negotiate a document that will be disregarded. This paper shares with some of my earlier work the assumption that explicit renegotiation of treaty terms is the preferable response to overstepping by treaty partners, even under a tit-for-tat strategy.

¹⁷ Although there is no question that the United States is a net importer of capital on a current basis, see Andersson, *supra* note 3, at 1528; H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 *Am. J. Tax Pol'y* 77, 83-84 (1991), some commentators note that the United States remains a net exporter of certain classes of capital and that international capital flows can change direction very quickly over time, see Gideon Statement, *supra* note 13, at 11; Philip D. Morrison, *Talking Past Each Other on Tax Treaty Policy and Subpart F*, 69 *Taxes* 1001, 1003 (1991).

plainly profitable exchange.¹⁸ Congress' response, however, has more the character of an unprincipled grab for undeserved tax revenues than a reasoned reconsideration of the proper approach to the taxation of international income. Moreover, the means Congress has chosen to effectuate its change of heart, unilateral overrides of its treaty obligations, are themselves objectionable.

Whatever Congress' actual motivations in this matter, this Article suggests that the discomfort with present tax policy may have a firm foundation in recent economic and political developments. Congress needs to reexamine the issue of source versus residence taxation in light of present realities rather than past misconceptions and work towards a coherent and consistent policy. Depending on the outcome of this examination, appropriate responses might be to overhaul U.S. negotiating policy for tax treaties or to amend the provisions of the Internal Revenue Code (the "Code") for the taxation of foreign-earned income to reflect more accurately (and in some instances counteract) the tax incentives and revenue effects of different tax systems.

I. INTEGRATION AND THE OPERATION OF TAX TREATY SOURCE TAX REDUCTIONS: UPSETTING THE BALANCE

The problem underlying efforts to tax income derived from international transactions¹⁹ is the likelihood of duplicative taxation. Two and sometimes three different national jurisdictions can plausibly claim the right to tax such income: the country in which the income is deemed derived,²⁰ the country in which the taxpayer resides, and the country of which the taxpayer is a citizen.²¹ If all

¹⁸ See ALI, *Tax Treaties Proposals*, *supra* note 1, at 194-95; McIntyre, *International Tax Rules*, *supra* note 6, § 2/E3, at 2-78 (1989 & 1992).

¹⁹ A transaction is an "international transaction" if some or all of the income-generating activity takes place in or is otherwise deemed to arise in a country other than the taxpayer's country of residence, or in the case of an individual U.S. citizen, the taxpayer's citizenship.

²⁰ If countries disagree as to where income was derived, a potential exists for even more tax claimants. For example, suppose that a U.S. resident earns income that under French rules would be considered French-source income and under Belgian rules would be considered Belgian-source income. In addition to the U.S. tax claim based on residence ties, both France and Belgium could assert the right to tax the income on the basis of source.

²¹ The United States is one of the only countries to assert tax claims solely on the basis of citizenship. See McIntyre, *International Tax Rules*, *supra* note 6, § 1/A, at 1-3 (1989).

those countries attempted to exact their full tax levies, few international transactions would take place; taxpayers would not be able to retain enough profits from such activities to make them economically worthwhile. Most countries have made some provision for the alleviation of duplicative taxation because of the economic importance of international transactions. But countries differ both in the form of relief or tax concessions provided²² and the mechanisms through which such relief or concessions are effected. Although some countries act unilaterally through statutes to alleviate duplicative taxation, others limit concessions to situations in which they receive something in return for their taxpayers, such as under bilateral tax treaties.²³ The United States utilizes a mixture of statutory relief²⁴ and treaty concessions.

A. The Theory Behind Source Tax Reductions: The Revenue Exchange

Though the international norm is to accord primary taxing jurisdiction to the source country rather than the taxpayer's country of residence,²⁵ most American observers prefer taxes imposed by the

Only individuals can reside in countries other than their country of citizenship. Corporations are not citizens; instead, under U.S. law, corporations are residents of the country under the laws of which they were incorporated. See I.R.C. §§ 7701(a)(4) & (5) (West 1995). Corporations become subject to two overlapping tax claims whenever they earn income outside of their country of residence.

²² There are three basic methods of compensating for duplicative tax claims among multiple jurisdictions: the credit method, where one jurisdiction credits taxes paid to another jurisdiction against the taxes due it; the exemption method, where one jurisdiction exempts from its tax base any income taxed by another jurisdiction; and the deduction method, where one jurisdiction allows the taxpayer to deduct any taxes paid to other jurisdictions when calculating its taxable income for purposes of that jurisdiction's income tax. The exemption method is regarded as the most taxpayer-friendly and the deduction method (the one utilized by the United States when coordinating taxation with sub-federal taxing units) as the least friendly. See Organisation for Economic Co-operation & Development, *Taxing Profits in a Global Economy: Domestic and International Issues* 38-39 (1991) [hereinafter OECD, *Taxing Profits*].

²³ See Adrian Ogley, *The Principles of International Tax: A Multinational Perspective* 32 (London, Intertisc Publishing, n.d.) ("[U]nilateral relief is likely to fall short of the relief afforded under the terms of a double tax agreement.").

²⁴ The Internal Revenue Code provides for a credit system, allowing U.S. citizens and residents to claim foreign taxes paid with respect to foreign source income as a credit against the U.S. income taxes due on this income. See I.R.C. §§ 901, 902 (West 1995).

²⁵ See Federal Income Tax Project, American Law Institute, *International Aspects of United States Income Taxation: Proposals on United States Taxation of Foreign Persons*

country of residence to those levied by the country of source.²⁶ Residence-country taxation is thought to be preferable because it enables greater inter-taxpayer equity.²⁷ In addition, the residence

and of the Foreign Income of United States Persons 6-7 (1987) ("Since source jurisdiction is considered primary, the right of the U.S. to tax income reasonably deemed to arise from sources within the U.S. takes precedence over the right of other countries to impose tax on the same income") [hereinafter ALL, *Foreign Persons*]; Richard L. Doernberg, *International Taxation in a Nutshell* 9-10 (2d ed. 1993) ("There is a norm of international taxation which the United States generally follows that cedes the primary taxing authority to the country of territorial connection (*i.e.* where the income is earned) and the residual taxing authority to the country of nationality or residence."); McIntyre, *International Tax Rules*, supra note 6, § 1/C, at 1-11 (1989) ("[T]he country of residence must yield primary jurisdiction to the country of source.").

²⁶ See, e.g., Gary C. Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* 14-16 (1992) (advocating residence taxation of portfolio and royalty income, but not corporate business income); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *Cornell L. Rev.* 18, 86 (1993). But see Norman Ture, *Taxing Foreign Source Income* 6-9 (Tax Foundation Government Finance Brief No. 25, 1976).

²⁷ The "equity" argument stems in part from concerns about the implementation of a progressive rate schedule when taxation is split between the country of residence and country of source. See Vito Tanzi, *Taxation in an Integrating World* 77-78 (1995); Green, supra note 26, at 29. In a progressive tax system, the tax rate increases with the taxpayer's income. When taxing jurisdiction is split between source and residence countries, the source country typically treats the income earned by the taxpayer in that country as the taxpayer's only income, and computes the applicable rate starting at the bottom of the rate schedule. The country of residence then calculates its tax imposition starting at the bottom of its rate schedule. If the residence country uses an exemption mechanism for coordinating double taxation—that is, for tax purposes it excludes a taxpayer's foreign source income—such taxpayers pay less tax than comparable domestic taxpayers with no foreign income. For example, suppose a taxpayer earns \$50,000 in Country A and \$100,000 in her country of residence, B. Assume further that in both countries, the first \$50,000 of personal income is taxed at a 15% rate, while all income above that is taxed at a 30% rate. The Country A tax would be 15% of \$50,000, or \$7,500. If Country B uses an exemption system and excludes all foreign earned income from its tax base, the Country B tax would total \$22,500. The taxpayer's tax obligations would total \$30,000—or \$7,500 less than if it had earned all of its income in either Country A or Country B.

Some exemption countries have alleviated this situation by adopting an "exemption with progression" system. These systems take foreign income into account for purposes of determining tax rates applicable to non-exempt income. Though these systems generate the "right" tax liability (*i.e.* equivalent to the liability that would have been sustained had all the income been earned in Country B) when Country A's tax on its portion of the taxpayer's income is as high as Country B's tax would have been on that amount, it provides a less complete remedy when Country A's tax rate is lower. Suppose in the example above that Country A's tax rate on the first \$50,000 was five percent. Under an "exemption with progression" system, a Country B taxpayer earning \$50,000 in Country A and \$100,000 in Country B would pay taxes of only \$32,500 (\$2,500 to Country A and \$30,000 to Country B), or \$5,000 less than if it had earned all of its income in Country B.

country is alleged to have superior administrative capabilities when it comes to assessing and auditing income taxes,²⁸ though more recent commentators have admitted that source countries may be in a preferable position when it comes to collection of taxes.²⁹ Finally, relying solely on residence-country taxation is thought to reduce opportunities for taxpayer misbehavior or strategic tax-minimizing behavior.³⁰

This conflict between the norm of source-country taxation and the perceived benefits of residence-country taxation has traditionally been ameliorated through tax treaties. In addition to establishing dispute resolution procedures for transnational taxpayers, mediating differences between the treaty partners' tax systems, and

(The taxpayer may be paying as much or more taxes than a taxpayer whose income was entirely derived in and taxed by Country A, and there are some who believe that that result is defensible. See Ture, *supra* note 26).

The provision of residual residence country taxation through a tax credit mechanism ensures in all situations that taxpayers with foreign income pay at least as much income tax as taxpayers with income derived solely from within their country of residence. Under a tax credit system, foreign income is included in a taxpayer's tax base but foreign taxes are allowed to offset the resulting tax obligation on a dollar-for-dollar basis.

²⁸ Virtually all commentators agree that while taxation levied on net income is preferable to taxation on gross income, source countries are incapable of administering a net basis tax on portfolio investment income, necessitating recourse to a gross basis tax. See, e.g., ALI, *Foreign Persons*, *supra* note 25, at 10-11; Boris I. Bittker & Lawrence Lokken, *Fundamentals of International Taxation* ¶ 66.1, at 66-3 (1991). The inferiority of the gross basis tax provides the rationale for its reduction or elimination in treaties. See Gideon Statement, *supra* note 13, at 9; Organisation for Economic Co-operation & Development Committee on Fiscal Affairs, *Model Double Taxation Convention on Income and on Capital* 108 (1977) (commentary suggesting additional treaty reduction in source tax on interest in circumstances where pass-through loan likely to avoid "obstacle to international trade"); H. David Rosenbloom, *supra* note 2, § 31.04[1], at 31-58, 31-59.

²⁹ Though some of these commentators simply want to return to source taxation, others would prefer to use source countries as a collection service because of their superior administrative capabilities. See, e.g., Hufbauer, *supra* note 26, at 14-15; McIntyre, *International Tax Rules*, *supra* note 6, § 2/E3, at 2-79; Tanzi, *supra* note 27, at 132; Donald R. Lessard & John Williamson, *The Problem and Policy Responses*, in Donald R. Lessard & John Williamson, *Capital Flight and Third World Debt* 201, 240-41 (1987).

³⁰ See Tanzi, *supra* note 27, at 98-99; Green, *supra* note 26, at 86 (describing the "move to an international system of residence-based income taxation" as the "ultimate solution" to problems with transfer pricing and financial maneuvering). This argument goes on to maintain that only in the absence of such tax-motivated behavior can worldwide efficiency in resource allocation be achieved, leading to the maximization of the world's economic pie. See 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, 27 (Assaf Razin & Joel Slemrod eds., 1990).

providing for the exchange of tax information, these bilateral agreements typically provide for reciprocal reductions in each treaty partner's source taxation of income earned by residents of the other treaty partner.³¹ Though some of these source tax reductions are intended to benefit investors through the elimination of "excessive taxation,"³² many are intended to effect a roughly neutral exchange of tax revenues between the source and residence countries.³³

The United States has traditionally been a leader in the fight for residence-country taxation. Its model treaty calls for reductions in source taxation that exceed even those advocated in the residence-tax oriented OECD model treaty.³⁴ U.S. negotiating teams, how-

³¹ See *supra* note 6.

³² For a definition of "excessive taxes," see *infra* note 45.

³³ See 2 Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* ¶ 36.2, at 316-17 (1990); McIntyre, *International Tax Rules*, *supra* note 6, § 2/E3, at 2-76 (1989 & 1993); New York State Bar Association Tax Section Committee on United States Activities of Foreign Taxpayers, *Report on Proposed United States Model Income Tax Treaty*, 23 *Harv. Int'l L.J.* 219, 264 (1983) [hereinafter *N.Y.S.B.A. Report*] (analyzing treaty reduction in withholding tax on interest as involving "primarily a question of revenue sharing between the governments"); Rosenbloom, *supra* note 2, § 31.04[1], at 31-58 ("To the extent that concessions reduce source-country taxation to the level of U.S. taxation, they benefit the investor; further reductions tend, because of the U.S. foreign tax credit system, to increase U.S. tax receipts."); Denise Bori, *Foreign Recipients of U.S. Income*, 1991, *Stat. of Income Bull.*, Summer 1994, at 34, 36 (stating that treaty reductions in U.S. tax revenues are "at least partially offset by the reductions in foreign tax credits . . . [which] serve to increase the revenue intake of the United States"). But see Gideon Statement, *supra* note 13, at 10 (noting that treaty reductions are less likely to "increase the United States share of tax on such income" due to the statutory reduction of tax rates in the 1986 tax act); ALI, *Tax Treaties Proposals*, *supra* note 1, at 10 (stating that this goal "appears to feature less prominently in present-day treaty policy").

³⁴ Compare U.S. Dept. of the Treasury, *Model Income Tax Treaty* of June 16, 1981, art. 10(2), 1 *Tax Treaties (CCH)* ¶ 211, at 10,577 (1990) [hereinafter 1981 *Model Treaty*] (withdrawn by Treasury Dept. News Release NB-1900 (July 17, 1992)) (5% to 15% source tax on dividend income, no source tax on interest or royalties) with OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (1992), art. 10-12 (5% to 15% source tax on dividend income, 10% source tax on interest, no source tax on royalties). The OECD Model Treaty is generally regarded as appropriate for developed countries with mutually offsetting residence and source interests. See ALI, *Tax Treaties Proposals*, *supra* note 1, at 220 ("What a country gives up as a source country is balanced by the benefits it receives as a residence country."); Rosenbloom, *supra* note 2, § 31.04[4], at 31-76. The United Nations model treaty, drafted for use in negotiations between developed and developing nations, allows for considerably more source taxation than either the U.S. or OECD models. See ALI, *Tax Treaties Proposals*, *supra* note 1; see generally Stanley S. Surrey, *United Nations Group of Experts and the Guidelines for Tax*

ever, have not always been able to achieve these terms in actual treaty negotiations.³⁵

The objects of efforts to reduce source taxation are actually somewhat limited. Few if any treaties reduce a source country's tax on the earnings of a full-fledged business enterprise operating within its borders to levels below those applicable to domestic enterprises. For example, if a foreign national operates a factory which produces goods sold in local markets, the profits engendered by the manufacture and sale of those goods will be taxed by the country of source at the generally prevailing rates, treaty or no treaty, though the measurement of those profits may be affected by treaty provisions.³⁶ Treaties aim to reduce the stated rate of source taxation of income earned through transactions "on the margin" of the source country's taxing jurisdiction: income earned by businesses with some but relatively insubstantial connections to the source country³⁷ and passive income paid by residents of the source country to residents of the treaty partner.³⁸ Treaties often entirely eliminate source taxation of the former and greatly reduce if not eliminate such taxation of the latter.³⁹

Treaties Between Developed and Developing Countries, 19 *Harv. Int'l L.J.* 1 (1978) (describing the development and content of the United Nations guidelines).

³⁵ See McIntyre, *International Tax Rules*, *supra* note 6, § 2/E3, at 2-78 (1989 & 1992) ("The limits [imposed by actual treaties] generally are not as low as the U.S. Model Treaty would provide."); U.S. Dept. of Treasury, Publication 901, U.S. Tax Treaties tables 1-3 (1994) [hereinafter Publication 901] (listing treaty withholding and tax rates).

³⁶ Treaties may provide such enterprises with more extensive deductions than would be allowed under local law when calculating the source country's taxable income equivalent. This can be done explicitly, through treaty provisions which expressly provide for the deductibility of certain classes of expenditures, or implicitly, through nondiscrimination provisions which require that permanent establishments and businesses owned by a resident of the treaty partner be entitled to the same deductions, and on the same conditions, as those allowed to otherwise similarly-situated domestic enterprises. See, e.g., Convention on Double Taxation: Taxes on Income, Mar. 19, 1994, U.S.-Cyprus, arts. 7, 8(3), T.I.A.S. No. 10965, at 18-20 (combining generalized nondiscrimination rules with specific rules regarding allowance of deductions for "executive and general administrative expenses" wherever incurred); Convention on Double Taxation: Taxes on Income, Aug. 6, 1982, U.S.-Austl., art. 23(1)(b), T.I.A.S. No. 10773, at 50 (nondiscrimination requirement).

³⁷ This includes both income earned in one country by businesses resident in another and without a "permanent establishment" in the source country and personal services income earned by individual residents of one treaty partner temporarily present in the source country.

³⁸ "Passive income" includes interest, dividends, rents and royalties.

³⁹ See Publication 901, *supra* note 35, tables 1-3.

A common strategy is to set statutory tax rates for the taxation of passive income earned by nonresident aliens and foreign corporations that, if enforced, would in all likelihood lead to the imposition of a higher tax burden than would be borne by a domestic investor⁴⁰ earning the same income. In the United States, for example, such income is subject to a 30% withholding tax levied on *gross* income amounts,⁴¹ while the top rate for normal domestic recipients of such income would be slightly under 40%⁴² (35% if the taxpayer is a corporation⁴³), but measured on a *net* income base. In theory, maintaining excessively high statutory rates induces other countries to enter into tax treaties; the desire to protect "their" investors from excessive taxation causes other countries to enter into negotiations with the country maintaining such rates.⁴⁴ A country's willingness to bargain down excessively high rates on passive income thus serves as a carrot to entice potential treaty partners (and as a stick to punish investors from the un-enticed). Thus, mutual reductions in excessive tax rates⁴⁵ achieved by treaty reduce both countries' source tax revenues without creating directly corresponding increases in their residence tax revenues. Some of the revenue loss associated with such reductions may, of course, be recouped through increased source taxation. The elimination of excessive source taxation makes a country more attractive to potential foreign investors; additional investment by these investors creates additional opportunities for collecting reasonable levels of source tax.⁴⁶

⁴⁰ By "domestic investor," I mean to refer to an investor domestic to the source state.

⁴¹ See I.R.C. §§ 871(a), 881(a) (West 1995).

⁴² See I.R.C. § 1(a) (West 1995).

⁴³ See I.R.C. § 11 (West 1995).

⁴⁴ See, e.g., ALI, Tax Treaties Proposals, *supra* note 1, at 13.

⁴⁵ See *id.* at 9-10. "Excessive" in this context means higher than the tax imposed on the domestic income of domestic investors by the source state.

⁴⁶ Of course, the additional investment by residents of the treaty partner may be accompanied by additional investment in the treaty partner by home country residents—investment that might otherwise have been made in the home country. As a result, looking only at the amount of additional foreign investment in the wake of a treaty probably overstates the investment and revenue gains from the treaty relationship. When viewed through a broader lens, however, reducing source taxation may have additional benefits. The economic justification for tax treaties is that reducing barriers to international movements of capital will increase the total quantum of investment and production, increasing the economic pie. See *id.* at 2 (treaties "promot[e] international commerce and contribut[e] to the optimal allocation of world resources"); Gideon Statement, *supra* note

Reductions below a "reasonable"⁴⁷ level of tax, by contrast, have generally been perceived as benefiting a foreign taxpayer's country of residence rather than the taxpayer when that residence country, like the U.S., uses a tax-credit system to ameliorate duplicative taxation.⁴⁸ Lower source taxes create fewer foreign tax credits for the taxpayer to use as an offset against its residence country income tax liability; hence, the taxpayer's post-credit residence tax liability increases.⁴⁹ Reciprocal source tax reductions of this type would ideally lead to reciprocal residence tax increases,⁵⁰ increases that

13, at 11 (treaties promote the efficient employment of capital by creating "capital export neutrality"). At the same time, no country can be guaranteed a larger—or even the same size—piece of this pie. See Ault & Bradford, *supra* note 30, at 36 (capital export neutrality policy "makes no reference to who gets what share of the world economic pie (or even of the world's tax revenues)").

⁴⁷ "Reasonable" in this context is the tax rate needed to approximate the tax liability that would have been generated under the source state's tax laws with respect to the foreign investor's income had it been earned domestically by a domestic taxpayer. Determining that "reasonable" tax rate, particularly if it may have to be effected through a tax on gross income, may present quite knotty practical problems. Note that because income tax rates vary between countries, a "reasonable" tax rate for a source country may result in a tax that is either "high" or "low" when judged according to the domestic standards of the investor's country of residence.

⁴⁸ See N.Y.S.B.A. Report, *supra* note 33, at 264; OECD, *Taxing Profits*, *supra* note 22, at 192; Rosenbloom, *supra* note 2, § 31.04[1], at 31-58.

⁴⁹ Suppose, for example, USCorp collects \$1000 in royalties from a French company for its use of valuable technological information developed by USCorp. Assume that USCorp's U.S. tax liability with respect to this \$1000 royalty would be \$200. Assume further that in the absence of a tax treaty, the French company would withhold and pay over to the French government 25% of this amount, or \$250. USCorp would be able to offset the entirety of its U.S. income tax obligation with respect to this item of income with the foreign tax credits generated by its payment of \$250 in French taxes; in fact, it would have \$50 of "excess credits." If under its tax treaty with the United States, however, France has agreed to limit its withholding tax to 5% of the gross income amount, only \$50 of French tax would be paid with respect to this income. As USCorp would now have only \$50 of foreign tax credits to offset its \$200 U.S. income tax obligation, it would have to make a \$150 tax payment to the U.S. treasury. Of the \$200 in source tax revenues sacrificed by France in the treaty, \$50 benefited the taxpayer while \$150 benefited the U.S. treasury. If the situation was reversed, that is, we analyzed the tax situation of FrenchCorp earning \$1000 in royalties from a U.S. company, we would find that of the \$250 in source tax revenues foregone by the U.S. under its treaty with France (\$250 because the statutory U.S. withholding rate on royalty income of 30% was reduced to 5%), \$100 would benefit FrenchCorp while \$150 would go to the French treasury (assuming that FrenchCorp's French tax liability on its royalty income is the same as USCorp's U.S. tax liability on its royalty income).

⁵⁰ The increases in revenue may not be perfectly identical if the treaty partners begin with different statutory tax rates (i.e., their definitions of a "reasonable" rate of tax differ).

largely offset the source tax reductions in revenue terms for the participating countries when both use tax-credit systems and have relatively equal investment flows. In short, though treaties reducing source taxation below reasonable levels change the identity of each countries' taxpayers, in theory they need not, and are not supposed to, change either the total amount of tax paid by each taxpayer nor the amount of tax collected by each country.⁵¹

The United States has found it difficult, if not impossible, to enter into treaty agreements with countries where such apparent reciprocity is unavailable due to differences in investment and revenue flows. For example, lesser-developed countries with few investors in the United States but much investment owned by U.S. enterprises balk at relinquishing source tax jurisdiction because they are unlikely to be able to enjoy anything close to offsetting residence tax increases.⁵² Nor would their source tax reductions generate additional investment by U.S. residents, since they would benefit the U.S. treasury rather than potential investors. Where investment flows are more equal, however, the expectation has been that the revenue flows engendered by treaty trades will be more equal. But is this expectation borne out in fact?

There is good reason to suspect that differences in tax systems, and specifically differences in the methods used for ameliorating the effect of international double taxation, can cause revenue disparities as significant as those caused by unequal investment flows. Furthermore, there is good reason to expect that under current conditions these revenue disparities disadvantage the United States. Instead of a roughly equivalent revenue exchange, the U.S. Treasury most likely loses more money from forgoing source taxation than it collects in additional residence taxation.

To some extent, this may always have been true. From the very beginning, the use of a tax-credit system for eliminating the threat of double taxation blunted U.S. taxpayers' incentives to use treaty provisions to reduce foreign taxes below U.S. tax rates, while for-

⁵¹ See Gideon Statement, *supra* note 13, at 12. Of course, to the extent the treaty reductions merely eliminate excessive taxation (i.e., taxes in excess of those imposed on the domestic income of domestic taxpayers in the source state), both the amount of taxes paid by transnational taxpayers and the amounts collected by the participating governments decrease.

⁵² See Kingson, *supra* note 3, at 1166-67; Rosenbloom, *supra* note 17, at 93.

foreign investors in the United States resident in countries that opted for an exemption system did not share those incentives. Recent developments, however, have probably deepened the imbalance. The spread of integration systems has accentuated the incentive for foreign taxpayers to reduce U.S. source taxation while the decrease in U.S. corporate income tax rates has made it much more unlikely that source tax concessions will produce any offsetting residence tax liability on the part of U.S. taxpayers. Why and how this is the case is detailed in the next Section.

B. The First Finger on the Scale: The Tax Credit Dilemma

It has long been recognized that Congress' decision to utilize a tax-credit system can encourage source countries to levy taxes on U.S. investors that at least match U.S. rates.⁵³ Such countries would suffer a revenue loss, and no investment gains, from impos-

⁵³ See OECD, *Taxing Profits*, supra note 22, at 193 ("a strategy followed in certain circumstances"). In a report aimed at developing countries in the process of constructing systems for the taxation of foreign investors, United Nations experts explain that "where the foreign tax credit is available, transnational corporations would be indifferent to source taxes up to the effective rate of tax in their home countries, because the source taxes are borne by the treasuries in the home countries" U.N. Centre on Transnat'l Corps., *International Income Taxation and Developing Countries* at 21, U.N. Doc. ST/CTC/56, U.N. Sales No. E.88.II.A.6 (1988). However, they also caution that these source taxes must be timed to coincide with the operation of the tax credit system; they recommend a "system of low corporate taxes and fairly high withholding taxes" as inoffensive to multinational corporations and beneficial to developing countries. *Id.* at 22. As any system employing high source taxes tends to discourage investors from exemption countries, a number of countries employ a variety of stratagems to restrict the reach of such taxes to investors from tax credit countries. See Stanley S. Surrey, *Some Foreign Tax Credit Issues in Relation to Developing Countries: Withholding Taxes on Interest Payments and Discriminatory Taxes*, in *United States Taxation and Developing Countries* 385, 399-401 (Robert Hellawell ed., 1980) (describing "a number of instances in which such discriminatory taxes have been, or are being, utilized by developing countries"). Theoretically, such "soak-up" taxes are not creditable, see Treas. Reg. § 1.901-2(c)(1) (as amended in 1991) (stating that such a tax will be considered an "income tax" eligible for credit "only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country"); in practice, this rule is not always enforced. See Kingson, supra note 3, at 1186-89 & nn. 176-77 (describing U.S. assent to discriminatory taxation effected by source countries through denials of deductions for legitimate business expenses).

Of course, when some source countries have taxes that exceed the residence country tax and a residence country allows the "blending" of foreign tax payments for tax credit purposes, see *infra* text accompanying note 63, other source countries may find it beneficial to maintain low tax rates to attract investors who would otherwise find themselves in an "excess credit" position. See U.N. Centre on Transnational Corporations, supra, at 20

ing a lower tax. What have been less discussed are the incentives provided to U.S. investors in foreign countries by such a system. They, too, lack any incentive to reduce foreign taxes if the only result is to increase their U.S. tax obligation. This does not mean that they never have an incentive to lessen their foreign tax obligations. U.S. taxpayers retain an incentive to reduce those obligations to U.S. levels. They may even have an incentive to reduce their foreign tax obligations below U.S. levels if they have another foreign investment (irreducibly) taxed at higher-than-U.S. rates.⁵⁴ Both types of reductions, however, benefit the taxpayer rather than the federal fisc. Source-tax revenues sacrificed to enable U.S. taxpayers to achieve source-tax reductions thus constitute a net loss to the U.S. treasury.

That a reduction in source tax to U.S. levels benefits only affected taxpayers and not the federal fisc follows naturally and obviously from the operation of the tax-credit system adopted by the United States. The theory underlying a tax-credit system is quite simple: although a taxpayer should not be penalized for earning income in another country by having to pay two full levels of income tax on the same item of income, a taxpayer should not be rewarded for earning income in a country with a lower tax levy than its country of residence. The basic scheme for implementing this theory is also straightforward. Since under international norms the source country's tax claim has priority over that of the residence country, the residence country treats source country taxes as a pre-payment of its own tax levy; it allows one dollar of foreign tax credit (a credit usable against residence-country income tax) for each dollar of foreign income tax paid. If the source country taxes equal or exceed the applicable residence country income tax, the taxpayer is excused from paying additional residence country taxes on the foreign-sourced income.⁵⁵ If the source-country tax is lower, the taxpayer pays the difference to the residence country. Most countries maintaining tax-credit systems impose a limit

("[E]nterprises have pressed some developing countries to reduce their taxes so that the enterprises are better able to absorb high taxes in other countries . . .").

⁵⁴ See *infra* text accompanying notes 63-70 (discussing the advantages of blending income from foreign sources with different tax rates).

⁵⁵ The taxpayer may, however, have to pay taxes under alternative minimum tax provisions. See *infra* note 58.

on the amount of foreign tax credits usable by a taxpayer to ensure that foreign taxes do not offset residence-country taxes on residence-country income.⁵⁶ In the United States, the tax credit limit for any given year is the number equal to the amount of the taxpayer's pre-credit tax liability multiplied by a fraction, the numerator of which is the amount of the taxpayer's foreign source income and the denominator of which is the taxpayer's worldwide income.⁵⁷

In sum, then, with a minor exception,⁵⁸ tax credits created by the payment of foreign source taxes⁵⁹ can be used to offset the U.S. income tax obligation generated by the receipt of the associated foreign-source income. They cannot be used to offset U.S. tax liability on U.S.-source income. Reducing foreign taxes to the level of U.S. taxes, then, should have no effect on the quantum of tax due the U.S. in its capacity as a residence country.⁶⁰ Though the amount of foreign tax credits created by the taxpayer would diminish as a result of the foreign tax reduction, the reduction would eliminate only tax credits that the taxpayer should not have been able to use to offset its U.S. tax liability.⁶¹ The amount of taxes

⁵⁶ See OECD, *Taxing Profits*, *supra* note 22, at 38; Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 Va. L. Rev. 919, 928-29 (1989).

⁵⁷ See I.R.C. § 904(a) (West 1995).

⁵⁸ Foreign tax credits can be used to offset only 90% of a taxpayer's alternate minimum tax obligation. I.R.C. § 59(a)(2)(A) (West 1995). That is, if a taxpayer's minimum tax obligation on its world-wide income totals \$100,000, it may claim only \$90,000 of foreign tax credits to offset (partially) that liability—even if it has \$100,000 in foreign tax credits after applying the general § 904 limitation (as it would if all of its income for the year comes from foreign sources). The taxpayer must pay \$10,000 of the minimum tax amount to the U.S. government, regardless of how much foreign tax it has paid on its foreign earnings. Almost by definition, however, the 90% limitation will affect only U.S. taxpayers with virtually no U.S. source income; taxpayers with substantial amounts of U.S. source income would find themselves unable to use foreign tax credits to offset that portion of their alternative minimum tax liability attributable to the U.S. source income under the regular § 904 limitations, and would meet the 10% minimum payment through payment of their alternative minimum tax liability on that U.S. source income.

⁵⁹ See I.R.C. §§ 901, 902 (West 1995) (allowing foreign tax payments to be claimed as credits against U.S. tax obligations).

⁶⁰ There may be a decrease in U.S. source-tax revenues associated with the foreign tax decrease if that decrease is obtained pursuant to a treaty arrangement. However, as discussed *supra* text accompanying notes 44-46, the revenue sacrifice resulting from a decrease in source taxation claims to "reasonable" levels should be acceptable.

⁶¹ Suppose, for example, that USCorp, a U.S. corporation, earned \$10,000 in foreign royalty income and \$90,000 of U.S. sales income in 1994. Suppose further that USCorp's

collected by the United States from these taxpayers would not increase.⁶²

pre-credit U.S. tax liability for the year would be \$35,000. Its foreign tax credit limitation for 1994 would be $\$35,000 \times 10,000/100,000$, or \$3,500. It would therefore be entitled to claim a foreign tax credit against its \$35,000 U.S. tax obligation equal to the lower of the amount of foreign taxes actually paid or \$3,500. If, in the absence of a tax treaty, the source country levied a 40% withholding tax on the royalty income, the taxpayer would be entitled to a tax credit of only \$3,500; \$500 of foreign taxes would be "wasted" and a net loss to the taxpayer. The United States would collect no tax with respect to USCorp's foreign income. If the United States had entered into a tax treaty with the source country which reduced the source tax rate to 35%, in turn reducing the amount of taxes withheld to \$3,500, the benefits of this treaty would flow to the taxpayer rather than the federal fisc. The taxpayer would still have enough foreign tax credits to offset the entirety of its U.S. income tax liability with respect to its foreign earnings.

⁶² Some have argued that despite appearances (such as that provided in the example, *supra* note 61), the U.S. Treasury does benefit from reducing foreign taxes imposed on U.S. residents to U.S. levels. The argument is that taxpayers often find ways to credit what seem to be excessive, or simply high, foreign taxes. (For a definition of a "high" foreign tax, see *supra* note 47.) Elimination of the excessive taxes reduces the amount of credits claimed, thus increasing the amount of U.S. residence tax collected. See Letter from Marcia Field, International Economist, International Taxation, Office of Tax Analysis, U.S. Dept. of Treasury to Julie A. Roin (May 26, 1995) (on file with the Virginia Law Review Association).

This argument is flawed. In the first place, if the factual predicate (that residence taxation increases as the excessive taxes are decreased) is accurate, all this proves is that treaty trades can be revenue neutral, not revenue enhancing. After all, the increase in residence revenues comes at a price—the reciprocal reduction in U.S. source taxation provided by the treaty. Though this price may well be acceptable if the U.S. source taxation is excessive, it is less justifiable if the effect is to make it easier for taxpayers to misbehave (to claim tax credits for excessive or high foreign taxes). Rather than camouflaging the problem by agreeing to a "revenue neutral" treaty, the better policy may be to try to prevent such taxpayer misbehavior in the first instance. Further, there is good reason to be suspicious of the factual predicate. Few taxpayers are in an excess credit position by exactly the amount of the foreign tax being reduced by a treaty; indeed, the 1986 corporate rate reductions left most multinational taxpayers in an excess credit position. See Morrison, *supra* note 17, at 1003. When a taxpayer is in an excess credit position, the elimination of some foreign taxes by treaty simply makes it possible for other formerly "excess" credits to be used. For example, suppose a U.S. corporate taxpayer had \$100 of foreign income from Country A on which it paid \$50 of foreign taxes, \$100 of foreign income from Country B on which it paid \$60 of foreign taxes, and \$300 of domestic income. Suppose further that this taxpayer managed to manipulate its income and expense accounts so that its § 904 limit for this foreign income was \$80 rather than the \$70 it should have been (seventy dollars is actually generous; it assumes that the taxpayer's average as well as marginal tax rate on all of its income is the maximum corporate rate of 35%). The taxpayer would be able to offset \$80 of its \$175 ($\$500 \times .35$) U.S. income tax liability with foreign tax credits, generating an after-credit tax liability of \$95. It would have \$30 of unusable or "excess" foreign tax credits. Now suppose that the United States enters into a treaty with Country A that has the effect of reducing Country A taxes to U.S. rates; that is, it decreases the taxes levied on this particular taxpayer to \$35 (at the cost of some U.S.

Reductions in source tax below U.S. levels similarly fail to benefit the U.S. government if the taxpayer can use those reductions to make formerly unusable foreign taxes usable. The operation of its tax-credit system, in particular the opportunity it provides for the "blending" of low- and high-taxed foreign income, allows taxpayers to do just that. As a result, all too often treaty reductions benefit investors in (and thus the treasuries of) high-tax source states rather than the residence country. What this means is source tax reductions are unaccompanied by significant offsetting increases in residence tax revenues.

To understand why "blending" poses a barrier to the efficacy of treaty revenue trades, one must first understand what blending is, and that requires revisiting the rules for calculating the foreign tax credit limitation. The United States calculates this limitation amount on a "world-wide" basis. This means that taxpayers can combine the income derived from all foreign countries when calculating the amount of foreign source income in the denominator of the foreign tax credit limitation fraction—and thus the amount of tax credits they may claim as an offset against their U.S. income tax liability for that year. As a consequence, a taxpayer may combine foreign-sourced income subject to relatively little or no foreign source tax due to a treaty with heavily source-taxed foreign income from a non-treaty country to generate a foreign tax credit allowance that leaves little if any room for residence country taxation. In short, through the process of blending (or "cross-crediting"), source-tax reductions provided by treaty can redound to the benefit of a taxpayer and its investments in high-tax countries rather than to the treasury of the residence country.⁶³

Blending opportunities have been substantially reduced by a refinement in the tax-credit system known as the "basket" system.

source tax reduction on Country A investors). Will the Country A decrease increase U.S. residence taxes? No—because the taxpayer will still have an \$80 § 904 limit, see *infra* text accompanying notes 71-73, and due to the hefty Country B taxes, will have paid more than \$80 in foreign taxes. Its U.S. tax liability will remain at \$95. The net result in such cases is a decrease in U.S. source taxation with no offsetting increase in residence taxation.

⁶³ The high-tax country is an indirect beneficiary of the United States' financial largesse as well, since the Treasury's willingness to cover effectively the taxpayer's excessive tax burden makes the high-tax country a more attractive investment locale, a situation which undoubtedly has some effect on marginal investment decisions. See Kingson, *supra* note 3, at 1235-36.

Though taxpayers may still combine income earned in various countries for tax credit limitation purposes, the Code requires that they separate their income into specifically defined categories or "baskets," and then compute and apply a separate tax credit limitation to each of these baskets.⁶⁴ Most income benefited by treaty source tax reductions would be included in one such basket, the passive income basket.⁶⁵ Cross-crediting or blending within this basket is made virtually impossible by a provision excluding from the basket highly taxed income of the type otherwise included in the basket.⁶⁶ As a result of this provision, passive income earned in a non-treaty country and subjected to a high source tax would be relegated to the general income basket,⁶⁷ which has been defined to include income likely to have been subjected to high source tax. Instead of being able to credit the full amount of foreign taxes paid on the highly-taxed passive income by combining it for foreign tax credit limitation purposes with low- or no-taxed passive income earned in a treaty country, the highly-taxed passive income is likely to create additional excess (and unusable) credits in the general income basket.⁶⁸

Not all treaty income, however, falls in the passive basket. One notable exception is royalty income. Though as a general rule, royalty income is considered passive income for foreign tax credit purposes, when derived in the active conduct of a trade or business⁶⁹ or when received from a related foreign company,⁷⁰ it can be

⁶⁴ See I.R.C. § 904(d) (West 1995).

⁶⁵ See I.R.C. § 904(d)(2)(A) (West 1995) (defining passive income basket).

⁶⁶ See I.R.C. § 904(d)(2)(A)(iii) (West 1995).

⁶⁷ This basket includes any income that fails to be included in a more specifically defined basket. See I.R.C. § 904(d)(1)(I) (West 1995).

⁶⁸ Recent Treasury studies show that about 75% of foreign source income is included in the general limitation category, and about 50% of that is associated with multinational corporations that are in an excess credit position. See U.S. Dept. Treasury, *International Tax Reform: An Interim Report 57-58* (Jan. 15, 1993), *reprinted in* Daily Tax Rep. Jan. 22, 1993, at L-1, L-24.

⁶⁹ The foreign tax credit limitation rules use as their definition of "passive income" the definition of "foreign personal holding company income (as defined in section 954(c))." I.R.C. § 904(d)(2)(A)(i) (West 1995). The definition of "foreign personal holding company income" specifically excludes "rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person." I.R.C. § 954(c)(2)(A) (West 1995).

⁷⁰ Such income is excluded from the definition of "personal holding company income" in certain defined circumstances, I.R.C. § 954(c)(3)(A) (West 1995), and thus from the

recharacterized as general business income—even as it continues to be treated for tax treaty purposes as passive royalty income eligible for treaty-mandated source-tax reductions. This lowly-taxed royalty income can then be blended with the highly-taxed income (including highly-taxed passive income) in the general income basket. As a result of this blending opportunity, taxpayers rather than the U.S. Treasury may reap the benefits of treaty tax reductions on royalties.

This phenomenon has not gone unnoticed; in 1993, the Clinton administration proposed placing excluded royalties in the passive basket for foreign tax credit purposes.⁷¹ This proposal was beaten back in Congress, in large part because the administration seemed to be unable to come up with a principled reason for objecting to cross-crediting in that particular context.⁷² This Article suggests just such a reason—that cross-crediting of royalty income creates a windfall for U.S. investors at the expense of the U.S. Treasury. When source tax reductions provided by tax treaties create cross-crediting opportunities for taxpayers, taxpayers may use formerly

passive income basket, see *supra* note 69, in certain specified circumstances. A broader exclusion is provided in the tax credit limitation rules, however. See I.R.C. § 904(d)(3)(C) (West 1995):

(C) *Interest, rents and royalties.*—Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent it is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation in such category.

The “general rule” provided in the regulations assigns such income to the “general limitation” basket. Treas. Reg. § 1.904-5(b) (as amended in 1992). However, more particularized rules found later in the regulations assign such income to separate categories to the extent that it is allocable to gross income of the payor falling into such separate categories. See Treas. Reg. §§ 1.904-5(c)(2)(i), 1.904-5(c)(3) (as amended in 1992).

⁷¹ See Joint Committee on Taxation Staff Summary of President Clinton’s Revenue Proposals (JCS-4-93), Released by JCT March 8, 1993, *reprinted in* Daily Tax Rep. (BNA), Mar. 9, 1993, at L-1, L-16-17; Administration’s Tax Proposals: Hearings on Foreign Tax Proposals and the Possessions Tax Credit Before the Senate Finance Comm., 103d Cong., 1st Sess. 455-59 (1993) (statement of Samuel Y. Sessions, Deputy Assistant Secretary of the Treasury for Tax Policy). Under the proposal, taxpayers would have been allowed to group all royalties together for purposes of applying the “high-tax kickoff” from the passive category. Thus, they would have been able to cross-credit high- and low-taxed royalties, some of which may have been derived in treaty countries while others were not.

⁷² See Committee on Royalty Taxation, Foreign Royalty Income: Response to Treasury Briefing Paper, 59 Tax Notes 829, 829 (1993) (attacking proposal for “fail[ing] to address why cross-crediting involving active royalties is bad, yet other cross-crediting is acceptable”).

(pre-treaty) excess tax credits to offset completely the U.S. tax liability on foreign income. As a result, the additional residence taxation that is supposed to pay for the U.S. Treasury's forgoing of its own reasonable tax claims on the U.S. source income of investors from the treaty country never materializes; treaties become a money losing proposition instead of being revenue neutral. In substance, treaties give U.S. investors a tax break through the back door. To counteract this presumably unintended effect and to preserve the revenue trades implicit in U.S. tax treaty policy, royalty income benefiting from treaty-mandated source reductions ought to be included in a basket with the fewest possible blending opportunities—if not their own separate basket. The same is true of other foreign-sourced income exempt from source taxes pursuant to treaty arrangements, such as foreign business income that is not attributable to a permanent establishment.⁷³

⁷³ Many of the newer U.S. treaties (including the 1981 U.S. model treaty) specifically allow the treaty partners to treat income sourced in the other country, but which is exempted from tax in that country under the treaty's terms, as domestic income for domestic tax purposes. See, e.g., Convention on Double Taxation: Taxes on Income, Dec. 31, 1984, U.S.-Barb., art. 23(3), T.I.A.S. No. 11090, at 38; Convention on Double Taxation: Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., art. 24(3), T.I.A.S. No. 11087, at 22 [hereinafter U.S.-Canada Convention on Double Taxation]; 1981 Model Treaty, supra note 34, art. 23(3); see generally Isenbergh, supra note 33, ¶ 42.3.2, at 436-37 (listing treaties which source income "in the country with the power to tax it" under the treaty). The United States may not be able to take advantage of such concessions because, as a constitutional matter, the federal government cannot impose taxes by treaty; all revenue bills must originate in the House of Representatives. See U.S. Const. art. 1, § 7, cl. 1; Pamela B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 *Tax L. Rev.* 1, 26 n.95 (1982). This constitutional argument is strengthened by language found in many treaties providing that "[t]he Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded . . . by the laws of either Contracting State . . ." See 1981 Model Treaty, supra note 34, at art. 1(2). Accordingly, taxpayers can always opt out of treaty rules (including sourcing rules) when to do so leads to more favorable tax results. The American Law Institute discusses one such situation, involving a U.S. corporation, X, receiving interest income from a foreigner resident in country S. Under the terms of the tax treaty between United States and S, X receives the interest free of S source tax. Under the terms of the credit article of the treaty, income is deemed to have its source in the country which has the right to tax it (which in this case would be the United States), while under U.S. tax laws, the interest income would be considered foreign source income. See I.R.C. §§ 861(a)(1), 862(a)(1) (West 1995). Since characterizing the income as having a U.S. source would decrease X's statutory foreign tax credit, the ALI writes that "the treaty rule treating the income as having a United States source can be seen as literally 'restricting' an 'allowance' accorded by domestic law." It concludes that the taxpayer should be allowed to use the more favorable Code source rule largely because under an alternate rule, "taxpayers would be

Whether such changes in tax law would actually lead to a substantial change in tax revenues is highly questionable, for doing so would simply feed into the other, deeper problem with the tax-credit system: the fact that it eliminates any impetus for taxpayers to use treaty mechanisms to lower foreign income tax exactions below U.S. levels. Since the benefits of lowering foreign tax levies below U.S. levels flow to the U.S. Treasury rather than the taxpayer,⁷⁴ taxpayers have no economic incentive to minimize foreign taxes.⁷⁵ If tax minimization requires any expenditure of resources, a rational taxpayer will decide against attempting such action. And there is little doubt that justifying tax-deductible payments to a U.S. parent company cost a foreign subsidiary. Source countries are not anxious to see their own tax bases disappear as entities operating within their borders decrease their taxable income through deductible payments to related parties; like the United States, they often discourage such transactions through legislative and regulatory action.⁷⁶ Resources often have to be expended to

required to examine all applicable treaties to ascertain whether the treaty changes the statutory source rule," thus "produc[ing] a substantial amount of complexity." See ALI, *Tax Treaties Proposals*, *supra* note 1, at 83-84. This argument is not convincing. To begin with, once one is looking up a treaty to determine whether to apply for source tax concessions, it would not seem terribly difficult to check its source rules at the same time. Further, inasmuch as the United States pays the price of the source rules in terms of lost tax revenues from foreign investors, unaccompanied by any increase in foreign investment (since the investor's home country presumably levies a substitute tax, the investor derives no tax advantage from investing in the United States), one would think it should receive some offsetting gain as a residence country. Such one-sided trades could be eliminated by a statutory change. A statutory provision re-sourcing treaty-exempted income as domestic source income (or providing a separate foreign tax credit limitation basket for such income, which would have a similar though not identical impact) should have the desired effect of producing some offsetting residence tax gain.

⁷⁴ For purposes of this discussion, a taxpayer is not regarded as having reduced its foreign taxes "below U.S. levels" until it has eliminated all of its excess foreign tax credits. A taxpayer may have an incentive to reduce some foreign tax liabilities below U.S. levels in order to create cross-crediting opportunities for other foreign tax liabilities.

⁷⁵ Indeed, Treasury is convinced that some U.S. taxpayers fail to seek enforcement of foreign tax relief pursuant to existing treaty obligations, or to follow through avenues of administrative and judicial relief for overpayments of foreign taxes, relying instead on the efficacy of U.S. foreign tax credit relief. See *U.S. Taxpayers Overpay Foreign Taxes, Then Take U.S. Credit*, IRS Official Says, *Daily Tax Rep. (BNA)*, June 10, 1993, at G-2.

⁷⁶ Taxpayers' "war[iness] of confronting the tax authorities of the foreign nations in which they operate" was cited as one reason for their failure to enforce treaty obligations under competent authority proceedings. *Id.* Taxpayers have good reason to suspect that the tax authorities would not react kindly to their claims. A number of countries, including

overcome that discouragement, in the form of legal fees, political capital, and sometimes duplicative taxation.

Nor are there any managerial incentives to reduce foreign taxes which might counterbalance these costs, at least if the reductions involve taking advantage of treaty concessions. Managers of foreign subsidiaries would find it in their self-interest to reduce foreign taxes if their companies could retain the difference between the foreign tax and U.S. tax amounts, even temporarily;⁷⁷ the company would have more money to invest, the managers would be in charge of that investment, and they would likely find some way to benefit from the resulting profits. Unfortunately for both the managers and the U.S. Treasury, the tax reductions made available through treaties rarely if ever give foreign managers the opportunity to control such low-taxed foreign income. Tax treaties reduce source tax only on income with marginal connections to the source state, and not on most types of active business income.⁷⁸ Source tax is reduced on items such as royalties paid by the foreign subsidiary to a resident of the United States (typically the parent or another related company), on interest paid to a U.S. resident, and on income earned by a company without a permanent establishment in the treaty partner's country (i.e. the income earned by the U.S. parent company, not the foreign subsidiary). The subsidiary

the United States, have enacted statutes designed to restrict the amount of treaty-favored interest paid to foreign residents by related debtors. See Roin, *supra* note 11, at 289 & n.80. Further, as the United States has tried to crack down on (alleged) transfer pricing violations by foreign-owned businesses, other countries have levied similar charges and actions against U.S.-owned businesses in retaliation. See Stanford G. Ross, *International Taxation: A 20-Year View*, 57 *Tax Notes* 945, 947 (1992) ("Japan essentially adopted new section 482 rules in response to extensive audits of Japanese companies by the United States.").

⁷⁷ There is an extensive literature detailing the benefits conferred on taxpayers by "deferral," which is the technical name accorded to the practice of minimizing foreign taxes paid on a foreign subsidiary's income. See, e.g., 2 William C. Gifford & Elisabeth A. Owens, *International Aspects of U.S. Income Taxation: Cases and Materials* 129-30 (1982); Isenbergh, *supra* note 33, at 19-20; Paul R. McDaniel & Hugh J. Ault, *Introduction to United States International Taxation* 119 (1989); Daniel J. Frisch, *The Economics of International Tax Policy*, 47 *Tax Notes* 581, 583 (1990). The time-value-of-money benefits flowing from reinvestment of foreign profits in a low-tax jurisdiction have been blamed for artificially increasing the level of foreign investment. See Frisch, *supra*. To the extent such benefits exist, they advantage the domestic shareholders of the subsidiary as well as its managers.

⁷⁸ See *supra* text accompanying notes 36-39.

may also be allowed to deduct certain expenditures which it would not be allowed to deduct under foreign law in the absence of a treaty.⁷⁹

In all but the last of these situations, the tax reduction affects only income in the hands of a U.S. taxpayer. This has two consequences. In the first place, this leaves the managers of the foreign subsidiary with no opportunities to benefit from the tax reductions; to become lightly taxed, income must be paid out to another entity, beyond the control of the foreign subsidiary's managers. Secondly, as such income has to be received by a U.S. taxpayer who is currently taxable in the United States on its world-wide income to be eligible for treaty benefits, there is no deferral, and hence no time-value-of-money benefit to be gleaned by the U.S. parent, the foreign subsidiary or the managers of either company. Even in the last situation, the allowance of additional deductions, treaties require the allowance of deductions only for expenses that have been "incurred"; they do not authorize the deduction of phantom outlays.⁸⁰ Unless source tax rates exceed 100%, an unlikely occurrence, a company's cash position cannot be improved by incurring an expense to save taxes.⁸¹ Once again, the cost of achieving the foreign tax reduction outweighs any possible benefits of that reduction to the foreign subsidiary or its manager.

In sum, though financial incentives do exist for reducing foreign taxes in some situations, those incentives disappear when the reductions involve making use of a treaty mechanism.⁸² Hence, if

⁷⁹ *Id.*

⁸⁰ See 3 J. Ross MacDonald, *Annotated Topical Guide to U.S. Income Tax Treaties* 1615 (1993).

⁸¹ It is possible, however, that the outlays will be to related companies incorporated in tax haven (low tax) jurisdictions which may be able to benefit from deferral. The viability of such schemes are limited by the subpart F rules, which require U.S. shareholders in foreign base companies to include their pro-rata share of "foreign base company income" in their own income on a current basis for purposes of calculating their U.S. income tax liability. See I.R.C. § 951 (West 1995).

⁸² There is one situation in which the U.S. parent would have an incentive to utilize tax treaty mechanisms to reduce foreign tax payments: when the income, if left in the foreign subsidiary, would be subjected to foreign tax at rates higher than U.S. rates. Particularly if the parent is in an excess credit position, these additional tax costs would go straight to its bottom line. Note that in this situation, the parent company's interests would conflict with those of the managers of the foreign company. Those managers derive no benefits from money paid over to the parent company, while they may benefit from retaining control over (even a lesser amount of) such money. Particularly since the retained money would in

the blending benefits are removed from royalty payments (or other deductible expenditures), foreign subsidiaries may well decrease the level of royalties (or other payments) paid to their U.S. parents. Though the United States can impose some counter-pressure in the form of section 482 suits, its ability to do so is severely circumscribed by revenue constraints—and adverse court opinions.⁸³ Furthermore, not all restructuring is as blatantly illegal as a transfer pricing violation; there is nothing wrong, for example, with a company deciding to market its merchandise through a foreign retail establishment rather than the independent contractor it would have used had there been tax advantages flowing from such an arrangement.

all probability increase their subsidiary's "profits" (since most treaty-favored payments would constitute deductible expenses which would decrease "profits"), the managers may resist the use of such tax-minimization devices. Whether such resistance would be effective (or if the managers could be co-opted in some other manner) is, of course, uncertain.

⁸³ As I have stated elsewhere, legal reforms are unlikely to be of much help in the international tax arena in the absence of better control over the "microprinciples, embodied in the accounting rules." See Roin, *supra* note 56, at 949. We do not seem to have made much progress in this area over the last five years. The Internal Revenue Service loses, either wholly or partially, a high percentage of the section 482 transfer pricing cases that it pursues. See Francis M. Allegra, Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review, 13 Va. Tax Rev. 423, 433 & n.25 (1994). A variety of explanations have been proffered for this phenomenon, from the inherent difficulty of the issues involved to the incompetence and/or underfunding of the IRS. See *id.* at 433 n.26. The author of the cited article attributes the losses to the courts' application of an unreasonably demanding standard of review, contrary to Congress' expressed mandates. *Id.* at 513.

Perhaps in response to the failure of more targeted efforts to control taxpayer misbehavior, Congress has promulgated several ad hoc, indiscriminate limitations on U.S. taxpayers' ability to use foreign tax credits. Affected taxpayers are encouraged to reduce their foreign tax liability. These measures range from the alternative minimum tax foreign tax credit limitation, see *supra* notes 13 & 58, and the limit on foreign tax credit carryovers, see I.R.C. § 904(c), to the use of a water's edge (rather than world-wide) fungibility interest allocation rule, see I.R.C. § 864(e) (West 1995); Treas. Reg. § 1.861-10(e) (as amended in 1992), and the absence of a domestic loss recapture rule. See generally Paul M. Bodner & Thomas A. Bryan, New Allocation and Apportionment Regs. Contain Contradictory Approaches, 75 J. Tax'n 112 (1991) (describing the different theories of allocation employed in various regulations detailing the allocation of particular expenses between foreign and domestic source income). None of these rules, of course, are limited in their use to treaty situations, let alone treaties with an imputation country treaty partner. To the extent they result in the denial of tax credits for reasonable foreign tax levies, they can (and often are) legitimately criticized as unfair. Moreover, their narrow specificity limits the number of situations affected, and thus the number of taxpayers with an incentive to reduce foreign taxes.

These difficulties with the presumed revenue trades in treaties are not new; they existed even when U.S. corporate tax rates approached 50%. They also have nothing to do with integration or other tax system differences. The decrease in the U.S. corporate tax rate, though, makes it even less likely that treaty tax concessions will bring additional revenue to U.S. coffers from the international operations of U.S. taxpayers.⁸⁴

As the U.S. tax rate has decreased relative to foreign tax rates, more U.S. taxpayers with foreign operations are incurring heavier foreign tax burdens than are creditable against their U.S. tax obligations. In technical terms, there are now more taxpayers in an "excess credit position."⁸⁵ Even when treaty concessions are fully exploited by such taxpayers, in most cases they merely bring the foreign tax burden on combined foreign income (including non-treaty income) down to U.S. levels rather than below them, meaning that all the benefits of the treaty reductions accrue to the taxpayers and none to the U.S. treasury.⁸⁶ Though at first blush this might seem unobjectionable (since treaties are supposed to reduce "excessive foreign taxation"), further reflection reveals a less sympathetic story. Not all "excessive foreign taxation" is deserving of federal sympathy or relief. Congress has been adamant that countries with generally high tax rates (and the investors with income derived from them) bear the costs of those tax rates. That is, after all, the rationale for the tax credit limitation. Accordingly, taxpay-

⁸⁴ The fact that a revenue decrease is likely has been recognized by Treasury officials, though it has not sparked any noticeable policy changes. See International Tax Counsel Morrison Calls for 'Fundamental Debate' on Treaty Issues, *Daily Tax Rep. (BNA)*, Nov. 8, 1991, at G-10, G-11. There is no way to determine the exact amount of income tax lost or gained as a result of treaty exchanges; Treasury makes no attempt to keep such statistics. It is hard to imagine Treasury keeping track of its residence country gains. To do so would require it to recompute the tax liability of taxpayers taking advantage of treaty provisions assuming higher source taxes, and then compare the resulting number to the taxpayer's actual tax liability. The source country losses are easier to compute, see *infra* note 100, but the resulting figures are not particularly useful. What one really needs for an empirical test of revenue exchanges is a comparison of the taxes foregone and the taxes collected by the United States as a result of treaty reductions of source taxation from reasonable to less-than-reasonable (that is, less than the amount that would have been collected from a resident with respect to such income) levels. The undoubted cost of treaties' mutual forgiveness of "excessive" taxes should be excluded from this calculation.

⁸⁵ See Ault & Bradford, *supra* note 30, at 40 ("[T]he majority of firms are in an excess credit position . . ."); *supra* note 68 (containing Statistics of Income figures).

⁸⁶ See *supra* note 62.

ers rather than the federal treasury should be bearing the burden of "high" taxes (i.e. taxes in excess of U.S. tax rates) whenever that excess results from generally high tax rates, as opposed to discriminatorily high tax rates imposed solely on foreign investors.⁸⁷ The federal treasury, rather than those taxpayers, all too often ends up footing the bill for high levels of foreign tax if the United States agrees by treaty to give up reasonable (i.e. non-excessive) tax claims against foreign investors in return for reduced taxation of the foreign investments of U.S. investors. The United States should be as unwilling to use an indirect tax forgiveness arrangement as to provide direct credits to compensate investors facing high foreign taxes. In short, it appears likely that rather than providing relief from excessive taxation, U.S. tax treaty concessions are subsidizing investment abroad, to the benefit of U.S. investors and the treasuries of high tax countries, and in complete contradiction of the principles behind the foreign tax credit limitation.

Moreover, as explored in the next Section, differences between the tax systems of the United States and its treaty partners provide a further reason to believe that treaties are money-losing proposition for the United States.

C. A Small Finger on the Scale: Exemption Methods

Though treaty trades may never generate much residence country revenue for the United States by virtue of its use of a tax credit mechanism, such trades may still be relatively equal if foreign investors in this country are equally disinclined to take advantage of the treaty concessions they are entitled to utilize. The revenue trade may be equivalent in its insignificance for both treaty partners. This may have been the case when our treaty partners also maintained tax-credit systems for coordinating the taxation of international income and imposed corporate tax burdens similar to

⁸⁷ Indeed, it is plausible to argue that taxpayers should bear the burden of excessive foreign taxation as well when Treasury negotiators have been unable to convince their foreign counterparts to waive such taxes as part of a bilateral treaty arrangement. There is no more justification for the U.S. Treasury to forfeit a portion of its reasonable tax source tax claims for the benefit of taxpayers who choose to invest in countries that discriminatorily tax foreign investors (or the countries that choose to do such discriminating) than to do so for the benefit of taxpayers who choose to invest in non-discriminatory high-tax countries.

ours. However, this is less likely to be the case for investors resident in exemption countries. Instead of facing the same lack of incentives as U.S. investors to take advantage of the tax reductions made available by treaty, foreign taxpayers from exemption countries tend to be quite eager to take advantage of U.S. source-tax reductions.

Under an exemption system, unlike a tax-credit system, foreign income is excluded from the residence country income tax base. The only tax a taxpayer resident in an exemption country pays on foreign income is the source country's tax; that tax reduces the investor's economic return on a dollar-for-dollar basis. Taxpayers resident in exemption countries benefit from earning income in low tax jurisdictions. They also have an incentive to turn high-tax jurisdictions into low-tax ones whenever possible; for example, by utilizing treaty tax concessions to the maximum extent possible. As they, rather than their residence-country treasury, benefit from source-country tax concessions, they have an economic stake in arranging their affairs to be able to take advantage of them.

Fortunately for the United States, most of the countries that use an exemption method for coordinating the taxation of business profits and dividend income⁸⁸ have not extended it to other types of income subject to source tax relief.⁸⁹ As a result, there has been little room for foreign taxpayers to exploit this treaty advantage. This has limited the associated loss to the U.S. Treasury.

⁸⁸ Many of our major trade and investment partners purport to use the exemption method. For example, Canada, France and Germany all use an exemption system. See Convention on the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Aug. 29, 1989, U.S.-F.R.G., art. 23(2), S. Treaty Doc. No. 101-10, 101st Cong., 2d Sess. (1990) at 62-63 [hereinafter U.S.-Germany Convention on Double Taxation]; U.S.-Canada Convention on Double Taxation, *supra* note 73, art. 24(2)(b); Convention on Double Taxation: Taxes on Income and Property, July 28, 1967, U.S.-Fr., art. 23(2)(a), 19 U.S.T. 5280; Kingson, *supra* note 3, at 1244.

⁸⁹ Germany, for example, grants a "participation exemption" that exempts from German income tax all dividends paid from foreign subsidiaries as well as income from overseas branch operations. It does not, however, exempt foreign-sourced royalties, interest or service fees from the German income tax base, even when paid by a subsidiary. See OECD, *Taxing Profits*, *supra* note 22, at 63 (table comparing countries' treatment of foreign source dividend and interest income); *id.* at 185 ("[A]ll OECD countries use some form of the credit method to tax foreign source interest income . . ."); Frisch, *supra* note 77, at 586; see also *supra* note 73 (describing treaty sourcing rules).

The relative harmlessness of source-tax waivers with exemption countries is explicable from the viewpoint of those countries; exemption countries have little to gain and much to lose from entering into a treaty that allows their residents to escape source taxation without incurring an offsetting residence tax obligation. Not only would such treaties require them to forgo source revenues with no income offset through an increase in residence taxes, but they would set up an uncomfortable incentive for foreign investment in low-tax countries. Few if any countries have been willing to accept such results.

The lowering of U.S. tax rates may have sparked some additional interest by foreign investors in exploiting such treaty deals with respect to dividend income. However, it is somewhat difficult to contend that the United States suffers greatly from such "exploitation" as it collects a full corporate level tax on income qualifying for the treaty advantage (though it does lose some portion of the second-level tax); moreover, it is more likely that any such effect has been outweighed by the countervailing influence of residence country integration systems. Integrated tax systems, and particularly those that take the form of imputation systems, are far more dangerous to the federal fisc than exemption systems have been or will be.

D. The Thumb on the Scale: Integration and Imputation

Under a "classical" income tax system, corporate profits are taxed twice, once as income to the corporation and again in the hands of shareholders upon their receipt of dividend distributions. An integrated tax system, on the other hand, reduces the tax levy on corporate income by "integrating" or combining the taxation of corporations and their shareholders. Integration can be achieved through a number of mechanisms,⁹⁰ including allowing a deduction at the corporate level for dividends paid, an exclusion at the shareholder level for dividends received, or a credit for shareholders for a portion of the income tax paid by the corporation. Depending on the level of integration provided by the system, taxation of the cor-

⁹⁰ See, e.g., OECD, *Taxing Profits*, supra note 22, at 47-49 (describing various integration methods).

poration and its shareholders can be reduced to the level of a single layer of tax.⁹¹

Most of the United States' major trade and investment (and treaty) partners utilize an integrated tax system rather than the classical, two-tier system for the taxation of corporate income. And most of those implement their integration system through an imputation system.⁹² Under an imputation system, the income taxes paid by a corporation with respect to income paid to shareholders in the form of a dividend are "imputed" to the shareholders, in whose hands they are treated both as additional dividends and as prepayments of the taxes due on the grossed-up dividend amount.⁹³

Both foreign taxpayers and the foreign income of domestic taxpayers are disfavored under most integration systems.⁹⁴ Virtually all integration countries levy an income tax on dividend income

⁹¹ See Alvin C. Warren, Jr., American Law Institute, Reporter's Study of Corporate Tax Integration 1 (1993).

⁹² See sources cited in *supra* note 3. Although most countries integrate through an imputation system, some operate a shareholder relief scheme. Such a scheme does not disfavor foreign earnings to as great a degree because the amount of shareholder relief is not correlated with the actual payment of corporate taxes by the distributing corporation. See OECD, *Taxing Profits*, *supra* note 22, at 48 (Japan, Canada); U.S. Dept. of Treasury, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* 166 (1992) [hereinafter *Treasury Report on Integration*].

⁹³ The operation of an imputation system varies depending on the extent of integration to be provided by the system. The following is an example of complete integration achieved through an imputation system. X Corp, a corporation wholly-owned by one individual, Z, earns \$100,000 of income from domestic sources in 1994. It pays a corporate-level income tax of \$35,000 on that income, leaving it with \$65,000 to distribute to its shareholders in the form of dividends. In 1995, it distributes a \$30,000 dividend to Z, who is in the 40% marginal rate bracket due to his receipt of substantial amounts of other income. Z must include in his income both the \$30,000 dividend and $30,000/65,000 \times \$35,000$ of corporate tax, or a total of \$46,154 in income, on which \$18,462 in tax is due. However, Z is allowed to credit his \$16,154 share of the corporation's tax payment against this obligation, leaving a net tax liability of \$2,307—or about 5 percent of \$46,154. To ease the computational burden on shareholders which would otherwise result when a corporation paid different amounts of tax on different items of income, many countries with imputation systems levy a special income tax on distributed funds to ensure that the full corporate level income tax has been imposed on all such funds. See OECD, *Taxing Profits*, *supra* note 22, at 170; *Treasury Report on Integration*, *supra* note 92, at 97-98; Warren, *supra* note 91, at 68.

⁹⁴ See OECD, *Taxing Profits*, *supra* note 22, at 170-71; David R. Tillinghast, *Corporate-Shareholder Integration As An Obstacle to the International Flow of Equity Capital: A Proposal*, 56 *Tax Notes* 1215, 1215 (1992).

earned by nonresidents without the allowance of tax credits or other relief of the sort offered to their own residents with respect to such income, except as specifically provided by treaty.⁹⁵ And most imputation countries refuse to allow the imputation to domestic shareholders of foreign taxes paid with respect to a domestic corporation's foreign income.⁹⁶ That is, foreign taxes are not imputed to shareholders as an additional dividend amount nor treated as a prepayment of shareholders' income tax obligations.⁹⁷ The result approximates the effect of allowing a deduction (rather than a credit or exemption) for foreign taxes,⁹⁸ generating a greater tax liability than if all the taxpayer's income had been earned domestically.

Investors from countries whose rules tax foreign income (or the type of foreign income they are deriving) under a combination of the exemption and imputation methods have a double incentive to avoid foreign source taxes. Not only do foreign source taxes reduce the investing corporation's after-tax income, they reduce its shareholders' after-tax income because the benefits of imputation are not available. It is worth noting, however, that under this com-

⁹⁵ See Treasury Report on Integration, *supra* note 92, at 218 n.20; Ault, Division of the International Tax Base, *supra* note 5, at 578-79. Several countries allow U.S. investors limited imputation credits pursuant to treaty provisions. See Treasury Report on Integration, *supra* note 92, at 218 n.20; see also Ault, Division of the International Tax Base, *supra* note 5, at 585-90 (describing various treaty provisions).

⁹⁶ See OECD, *Taxing Profits*, *supra* note 22, at 197; Treasury Report on Integration, *supra* note 92, at 162 (explaining Australian system); *id.* at 170 (French system); *id.* at 175 (German system); *id.* at 179 (New Zealand); *id.* at 183 (United Kingdom); Warren, *supra* note 91, at 72 (explaining operation of German system).

⁹⁷ Suppose in my earlier example, *supra* note 93, \$20,000 of X Corp's income had come from foreign sources, and it had paid \$7,500 of foreign taxes with respect to that income but no domestic tax (as would be the case under either an exemption or credit system, since the foreign tax rate is the same as the domestic tax rate). X Corp would still be treated as having only \$65,000 available for dividend distributions, but would be treated as having paid only \$27,500 in tax. Therefore, the \$30,000 dividend distribution would engender a \$42,692 income inclusion for Z, generating a \$17,077 pre-imputation credit tax liability. The imputation credit would be \$12,692, leaving a residual tax liability of \$4,385. Counting both the foreign and domestic taxes paid by X Corp and Z, the change in income source costs \$2,077 in additional taxes. This additional tax liability is usually paid by the distributing corporation at the time of the dividend distribution, whereupon the shareholder is allowed a uniform imputation credit for the entire dividend amount.

⁹⁸ The treatment of foreign income under an imputation system is somewhat more favorable than a straightforward deduction rule because of time-value-of-money considerations; the shareholder tax is not due until the corporation pays dividends out of the foreign income, rather than when the income is earned by the corporation.

bination of tax rules, foreign investment is not necessarily disfavored relative to domestic investment. If source-country taxes are substantially lower than residence-country taxes, and if the corporation retains its earnings for a substantial time period, then the benefits accruing through the time value of money may outweigh the additional costs of not being able to impute the foreign taxes. These benefits only occur to the extent that foreign-source taxes are lower than domestic corporate rates. Thus, because of the differing incentives created by an imputation system, investors have an incentive to minimize foreign source taxes by any means, including the exploitation of treaty provisions.

When a residence country combines an imputation system and a tax-credit system, foreign investment is almost always penalized. As the penalty increases along with source-tax levies, investors from such countries again have an incentive to reduce source taxes. The higher the initial source-tax revenue, the closer the "single" tax levy under the imputation system approaches the classical, two-level tax levy. Further, there is less of an offsetting deferral advantage, since the tax credit is levied when the income earned from foreign operations is received by the domestic parent, just like the tax on domestic earnings.⁹⁹ Accordingly, a rational taxpayer subject to such a system would try to use treaty mechanisms to reduce source country taxation.

A substantial amount of the foreign investment coming into the United States comes from taxpayers whose home countries utilize either exemption systems, imputation systems, or a combination of

⁹⁹ There could still be some deferral gains if the foreign operations were carried out through a foreign corporation, gains which could outweigh the additional cost imposed by the payment of foreign taxes. The corporate-level residence tax may be deferred in that case until such time as the foreign corporation distributes its income to the parent company in the form of a dividend. That is how the U.S. system is structured, with some major exceptions. The value of the deferral would depend on the difference between the United States and foreign tax rates, as well as the length of time prior to repatriation. Deferral would not be available if the U.S. income were repatriated immediately, as it would be if it were treated as earned by a domestic parent in the form of royalty or interest income, or as gains from the sale of goods or services purchased from that parent (unless some way existed under the residence country's and tax treaty's tax rules to park such earnings in a third-country intermediary). In sum, some foreign investors from imputation countries may, like U.S. investors, have an incentive to lower taxes without using treaty mechanisms whenever possible; however, unlike U.S. investors, they can always derive some benefits from taking advantage of treaty source tax relief mechanisms.

the two. In line with expectations, enterprises owned by such taxpayers report abnormally low rates of return, rates held down at least in part through the payment of fees, interest and royalties to related parties which largely escape U.S. tax due to treaty concessions.¹⁰⁰ This analysis suggests that when viewed in terms of revenue, treaty concessions to such countries are just that—concessions which cost the U.S. Treasury money, rather than promoting a balanced exchange of tax revenues. The question is what, if anything, should be done to reverse the present imbalance. The answer to this question depends in part on the answer to another question: what *can* be done without creating other, perhaps more serious, problems. The next Section considers some of the alternatives.

¹⁰⁰ It would take someone with more statistical experience than I possess to tease out any meaningful differences between the profitability of corporations owned by investors from imputation countries versus those from other countries. Nor is it clear that such an exercise would be worthwhile, since foreign investors operating under alternate residence tax systems may have their own reasons for reducing U.S. taxes—to try to take advantage of deferral, for example. Isolating the effects of the imputation system would thus be extraordinarily difficult. However, it is clear that foreign-controlled corporations appear to pay relatively little in the way of foreign income taxes. The paucity of federal income taxes paid by foreign and foreign-owned companies with U.S. source income has been a major political issue at least since 1988, when James Wheeler published a study showing that all multinationals operating in the United States—both U.S.-owned and foreign-owned—paid far less in U.S. income taxes than did other U.S. businesses. See James E. Wheeler, *An Academic Look at Transfer Pricing in a Global Economy*, 40 *Tax Notes* 87 (1988); see also James R. Hobbs, *Domestic Corporations Controlled by Foreign Persons*, 1989, in *Stat. of Income Bull.*, Winter 1992-1993, at 7, 15 (“Like net income (less deficit), total income tax after credits as a percentage of key financial items can be compared for FCDC’s and other domestic corporations. The ratios . . . are lower for FCDC’s than those for other domestic corporations.”) For a partial listing of subsequent studies on comparative profitability and tax contributions, see Roin, *supra* note 11, at 269 n.1.

The effective rate of tax on the U.S. sourced income of foreigners is shockingly low, largely because of the statutory portfolio interest exemption. In 1989 the effective rate of tax on payments to residents of treaty countries was 3.66%, and on payments to residents of non-treaty countries it was 6%. Loengard, *supra* note 1, at 283. By 1991, the effective rate of tax on payments to residents of treaty countries and non-treaty countries dropped to 2.4% and 4.1%, respectively. See Bori, *supra* note 33, at 36 Fig. C. Once statutorily-exempt portfolio interest was excluded from the calculation, the withholding rate on the remaining (\$15.5 billion) income rose to 12%. *Id.* at 36. The discrepancy between that and the 30% statutory rate was due to the effect of tax treaties; “[b]ecause of tax treaties, only \$1.9 billion of the \$15.5 billion of income subject to taxation was taxed at the 30% statutory rate.” *Id.* at 39, 41.

III. INTERMEDIATE SOLUTIONS?

The revenue exchanges effectuated by treaties may be made less one-sided either by increasing U.S. residence taxation or by increasing its source tax revenues. The first can be accomplished only by inducing U.S. taxpayers to behave in ways which increase residence taxation. The second requires convincing foreign taxpayers to accept higher levels of source taxation. This section looks at the possible means toward these ends.

To change the incentive of U.S. taxpayers earning foreign income, a way must be found to penalize them for payments of foreign taxes—taxes which are currently creditable under our system. There are essentially two ways of doing this, both of which would involve quite substantial changes in the operation of the tax system. In one case, the changes would be limited to the international sphere; the other change would have domestic impact as well.

The first alternative is one which has been discussed (albeit for different reasons) and rejected on many occasions: the replacement of the tax-credit system for all U.S. taxpayers with one allowing merely a deduction for foreign income taxes, similar to the deduction allowed for state and local taxes. Although taxpayers would still get some tax benefit from paying foreign taxes, this benefit would be less than the marginal cost of such taxes; like all deductions, the deduction for foreign income taxes would be worth merely the amount of the expense multiplied by the taxpayer's tax rate. Thus, it would be in the taxpayer's financial interest to reduce the amount of foreign taxes paid, even to levels below that of the United States; the side effect of reducing foreign source taxes would, of course, be an increase in the amount of residence tax payable.¹⁰¹

That increase would represent an increase in costs for U.S. businesses of doing business abroad. Not only would such an increase be politically unpopular, but also it would implicate an ongoing tax

¹⁰¹ The change to a deduction method of accounting for foreign taxes would in itself raise additional revenue. It would also violate the terms of almost all U.S. tax treaties; many require the United States to grant a credit for taxes paid to the foreign partner by U.S. residents. See, e.g., U.S.-Germany Convention on Double Taxation, *supra* note 88, art. 23(1), at 61; U.S.-Canada Convention on Double Taxation, *supra* note 73, art. 24(1), at 21.

policy and economic debate over the extent to which investment abroad by U.S. businesses adds to or detracts from the economic strength of the United States. To a large extent, this debate revolves around the question of whether such investment is an addition to or substitutes for investment in the United States. Those who believe that such investment substitutes for investment in the United States tend to support measures which would make outgoing investment unattractive, while those who believe that such investment creates net gains for the U.S. economy tend to oppose disincentives. Given the larger issues involved in this debate, the losses from source tax reductions described in this Article are unlikely to tip the scale either way; however, the impact of present treaty policy on U.S. tax revenues should be a factor in considering the mix of investment incentives and disincentives.

A move to an imputation system also implicates the debate over U.S. investment abroad. However, adopting an imputation system would have less of an immediate impact because the disincentive for foreign investment provided by such a system would be less than that created by the deduction system described above. An imputation system can coexist with either a credit¹⁰² or an exemption system. Assuming Congress desired to continue to use the tax-credit mechanism, the corporate-level tax can be determined using the tax-credit methodology; then when computing the amount of the corporate-level tax imputed to shareholders for purposes of defraying their tax liability, only U.S. income taxes could be counted. The result, as explained above,¹⁰³ would approximate moving to a deduction system with a time delay. Because the "penalty" for paying foreign rather than domestic income taxes would not be imposed until the corporate earner paid dividends out of the foreign earnings, its economic burden would be lower than if collected as the foreign profits are earned. This would reduce the negative impact on foreign investment below that of the first alternative, but it would simultaneously reduce (though not eliminate) taxpayers' incentives to reduce foreign income taxes.

¹⁰² The United Kingdom, for example, maintains both a tax credit and an imputation system.

¹⁰³ See *supra* text accompanying notes 94-98.

Of more concern is that the shift to an imputation system, unlike the shift to a deduction system, would have an impact on fully domestic transactions as well as international ones. The United States would need to provide for the integration of corporate and shareholder taxes across the board. Though there are many proponents of such a change for other reasons,¹⁰⁴ it has many opponents as well.¹⁰⁵ One focus of concern is cost. It is clear that moving to an integrated tax system would be costly in terms of domestic tax revenues.¹⁰⁶ The increase in residence-tax revenues is unlikely to offset this decrease. Other arguments in favor of maintaining a classical system of taxation exist as well.¹⁰⁷ Finally, it is unclear whether such a fundamental change in the tax system is warranted solely to deal with foreign transactions.

As the prospects for changing the incentives of U.S. investors seem fairly unappealing or impractical,¹⁰⁸ it is time to turn to the possibilities for changing the incentives and thus behavior of for-

¹⁰⁴ Two of the most substantial expositions of the case in favor of integration (but which advocate different methods of effectuating that end) are Warren, *supra* note 91, and Treasury Report on Integration, *supra* note 92. A balanced account of both sides of the debate can be found in OECD, *Taxing Profits*, *supra* note 22, at 166-71.

¹⁰⁵ See George R. Zodrow, On the 'Traditional' and 'New' Views of Dividend Taxation, 44 *Nat'l Tax. J.* 497 (1991).

¹⁰⁶ Douglas R. Fletcher, The International Argument for Corporate Tax Integration, 11 *Amer. J. of Tax Pol'y* 155, 158 & n.13 (1994).

¹⁰⁷ The business community has never been a great fan of integration proposals. See George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 *Tax L. Rev.* 431, 488-89 (1992) (recounting the history of legislative defeats of integration proposals). Though one might think that they would support any proposal that lowered business taxes, several features of an integration system are unappealing. One has been the fear that integration would lead to greater shareholder demand for distributions. See Lee A. Sheppard, Tax Officials Discuss Integration, Future Legislation at ABA Meeting, 46 *Tax Notes* 756, 756 (1990) ("[c]orporate managers would rather retain the corporation's earnings, acting as investment managers for the shareholders, than pay them out."); Yin, *supra*, at 489 ("[c]orporate managers generally prefer reducing the tax on capital retained by the corporation." (emphasis omitted)); Fletcher, *supra* note 106, at 186 (same). Further, multinational businesses have objected to their harsh treatment of international income. See Yin, *supra*.

¹⁰⁸ Some readers have suggested a third alternative for changing the incentives of U.S. investors. The basket system could be reformed so that it has real "bite" by improving the rules for the allocation of income and expenses, imposing tough antidiscrimination rules, and taking other, similar steps to limit cross-crediting opportunities. Though certain reforms of the basket system seem plausible, if not desirable, see *supra* text accompanying notes 71-73, I remain suspicious that such changes alone could eliminate the problem of unequal revenue trades. See *supra* text accompanying notes 74-83.

eign investors in the United States. What can be done to prevent them from taking advantage of treaty source tax reductions?

Foreign taxpayers can be discouraged from taking advantage of treaty source-tax reductions by reducing the value of those reductions. Achieving such reductions unfortunately requires not U.S. tax changes, but changes in the treatment of the U.S. taxes by the taxpayers' home countries. The payment of U.S. source taxes ceases to be a burden to foreign investors only to the extent their residence country treasury absorbs them by allowing them as an offset against residence country tax liability. This implies that the United States' strategy must be to encourage the residence countries to give up or alter their use of the exemption and imputation methods. The former seems so outrageous that it has never been attempted. The United States has attempted to alter the operation of imputation systems through treaties,¹⁰⁹ with little success. It has been able to win limited source concessions for its own residents. In several treaties, the United States has been able to persuade the treaty partner to allow U.S. residents with portfolio investments some of the imputation credits generally allowed to domestic investors; one country has agreed to grant a partial imputation credit against the shareholder level tax obligation of direct investors.¹¹⁰ No country, however, has been willing to go beyond having internal rules (usually statutory) which allow "untaxed foreign profits"¹¹¹ to be treated as the last profits to be distributed in the form

¹⁰⁹ Treasury, and Congress, have long been aware that imputation systems operate as a disincentive for foreigners thinking about investing in the United States; any uncertainty as to this fact should have been dispelled by Charles Kingson's 1981 article, *supra* note 3. However, they may not have thought about the implications of imputation systems on the behavior of those foreigners who decided to invest. If they had done so, they might have tried somewhat harder to achieve treaty concessions. It is questionable whether such concessions would have been possible, however, given the lack of bargaining power. See *infra* text accompanying notes 115-118.

¹¹⁰ The tax treaty with the United Kingdom provides that the U.K. will grant a partial imputation credit to U.S. direct investors. Ault, *Division of the International Tax Base*, *supra* note 5, at 585-86. Obtaining this benefit for its residents may have been no great feat, and indeed may be viewed as a pyrrhic victory for the Service, according to Charles Kingson, who argues that the direct reductions in U.K. tax revenues may well be offset by the effects of increased U.S. investment. See Kingson, *supra* note 3, at 1238.

¹¹¹ "Untaxed foreign profits" are profits which have not been subjected to domestic (residence country) tax. Considerable foreign taxes may have been paid on this income in the country of source. However, as only domestic tax payments are imputed to the

of dividends.¹¹² That is, domestically-earned profits are treated as funding dividends until all such profits have been distributed. Only at that point are foreign profits, which require the payment of an additional tax at the corporate or shareholder level¹¹³ at the time of a dividend distribution, treated as funding a dividend distribution.¹¹⁴ These internal ordering rules delay and thus diminish the impact of the discriminatory treatment of foreign source income; they do not eliminate them.

The lack of success in negotiating better treaty arrangements demonstrates the impact of the "entitlement" or "endowment effect."¹¹⁵ Having overcome domestic opposition to a set of rules disfavoring foreign investment by domestic taxpayers,¹¹⁶ imputation countries enter treaty negotiations with a considerable advantage. Prospective treaty partners must entice them to give up their isolationist rules. If those partners themselves have similar rules, a mutually advantageous trade may be arranged.¹¹⁷ However, if the

shareholder and treated as a prepayment of the taxpayer's own tax liability, foreign tax payments can be disregarded; once this is done, the income becomes "untaxed."

¹¹² No treaty, and no statutory scheme, requires a country to provide an imputation credit for foreign corporate level taxes. See Ault, *Division of the International Tax Base*, *supra* note 5, at 587. However, in most countries, fully-taxed domestic income is deemed distributed first. See Report of the Senate For. Relations Comm. on the Income Tax Treaty between Germany and the United States, S. Exec. Rep. No. 27, 101st Cong., 2d Sess. 17 (1990); OECD, *Taxing Profits*, *supra* note 22, at 48-49; Ault, *Division of the International Tax Base*, *supra* note 5, at 590.

¹¹³ To simplify the tax calculations of shareholders, most imputation countries require the distributing corporation to pay the difference between the amount of tax that would have been paid on the profits being distributed had they been earned domestically and the actual amount of domestic tax paid.

¹¹⁴ This provision reduces the economic significance of the "compensatory" German corporate-level tax, which is imposed immediately prior to the distribution of dividends paid out of "untaxed" profits, by delaying its imposition.

¹¹⁵ Though there is an extensive and controverted literature regarding the efficiency implications of initial endowments or entitlements, there is universal agreement that one is better off entering into negotiations with an entitlement, rather than without it. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1095 (1972).

¹¹⁶ As noted above, *supra* note 107, the U.S. Congress has encountered substantial political opposition whenever it has considered integration proposals which disfavor foreign investment. It is unclear why such opposition either did not develop or was unable to forestall the adoption of imputation methods of integration in other developed countries. But see *infra* note 117.

¹¹⁷ In fact, such trades have not been negotiated even between imputation countries, illustrating, perhaps, that the leaders of these countries do not share the belief that the

partner, like the United States, maintains a system which does not discriminate against foreign investment even in the absence of a treaty, it would have to give up something else to get the imputation country to agree to give up its advantageous rules. Though imputation countries could conceivably be "bought off" by unrelated concessions, the cost of making those concessions may dissipate enough of the benefits of eliminating the imputation discrimination to give the treaty partner pause.¹¹⁸ The chances of making treaty exchanges more even, in short, seem quite long.

IV. TREATY POLICY REVISITED

One obvious solution to the problem of unequal treaty exchanges is not to make them in the first instance—that is, to change our treaty policy to insist on reasonable¹¹⁹ levels of source taxation rather than their complete elimination.¹²⁰ If tax treaties

elimination of barriers to international capital movements will benefit the world economy—or that they believe that their countries would be hurt while the rest of the world benefits. See Ault & Bradford, *supra* note 30, at 36 (noting uncertainty over prospects for individual country's fortunes under efficient tax rules). If these doubts are widely shared by their constituents, the absence of substantial opposition to the adoption of imputation measures becomes explicable. Holding a belief that the imputation system does in fact serve their nations' best interests (or at least does not unduly compromise them) would also make their negotiating position stronger, since the outcome of a negotiating failure, the maintenance of the status quo, would be far from untenable.

¹¹⁸ The treaty partner benefits from such a trade only if and to the extent that the benefits derived from eliminating the isolationist tendencies of the imputation system outweigh the cost of making the concessions necessary to get that elimination. If the cost of concessions outweighs the benefits, of course, the discrimination should remain (and would be bargained into if the endowment ran in the other direction). This would occur only if eliminating barriers to capital mobility would fail to lead to greater economic efficiency—or if one of the parties to the treaty negotiations (presumably the imputation country) believed this would be the case; this belief would lead that country to set a higher price for changing its rules than the other country would find acceptable to pay to get rid of it.

¹¹⁹ The determination of a "reasonable" level of taxation will not be uncontroversial, particularly for portfolio income which, for administrative reasons, must be taxed on a gross income basis. Any decision will rest upon an assumption of a "normal" amount of associated expenses, which even if accurate in the aggregate will not be so for particular taxpayers. The question will then become whether and how far to deviate from the average to avoid hurting or benefiting the outliers.

¹²⁰ This may well put the United States at odds with the OECD model treaty, see *supra* note 34, as well as the current practice for treaties among developed nations. In many cases, however, that current practice is being defined by agreements reached between two imputation countries. Terms and practices which may be desirable (or lead to a relatively

eliminated only excessive source taxation, and allowed source countries to impose levels of source tax consistent with general domestic tax levels,¹²¹ there would be no treaty-induced revenue trade to be equal or unequal.

Though this change in tax policy would be an improvement, it is important to realize that it is not a panacea for all the problems associated with the taxation of international transactions. Foreign investors, like U.S. investors abroad, will undoubtedly try to frustrate the aims of such a change by altering their business tactics. Instead of sending money home to parent companies through interest and royalty payments, they may try to achieve the same income reduction through increasing transfer prices for other goods and services provided to their subsidiaries.¹²² As with domestic taxpayers, the Service's counterattacks under section 482 are likely to be partially successful at best.

Further, increasing the source tax imposed on foreign investors in the United States will drive some foreign investment away from the United States. Additional source taxes impose a real economic burden on investors from exemption and imputation countries,¹²³ a burden which on the margin may make other possible investment locales more attractive. As a result, there may be somewhat fewer foreign investors (and investments) to subject to this higher tax.

On the other hand, there may be somewhat more domestically-owned U.S. business to contribute to the federal fisc. Treaty changes would increase the source tax payable by U.S.-owned busi-

even revenue exchange) under those circumstances, as explained *supra* text accompanying notes 102-104, may have totally different consequences when one of the treaty partners maintains a classical tax system. It would therefore seem both logical and proper for the treaty practice of the United States to differ from that established by some other members of the OECD.

¹²¹ Note that this statement seems to proscribe discriminatory taxation of foreigners and foreign investment. This proscription is intentional, although it is clearly not universally accepted. Few countries have been able to resist imposing additional taxes on foreigners when assured that their residence country treasuries will absorb the impact through tax credits—and sometimes even when they will not.

¹²² Depending on how and where those goods and services are provided, the taxpayers may be able to characterize the income generated from the sales as sourced outside the United States, thus forestalling any attempt to tax such income on the basis of source or residence.

¹²³ See *supra* at 1782 (exemption countries) and text accompanying notes 97-99 (imputation countries).

nesses with foreign operations. Though some of this increase would undoubtedly be offset by reduced residence taxation (thus decreasing the revenue gains associated with the proposed treaty changes), not all of the additional source taxation would be absorbed by the federal treasury. Some taxpayers would lose blending opportunities currently made available by source country treatment of royalty income, for example. Politics aside, such a tax increase appears to be desirable. At present, the combined treaty-tax credit regime makes investment in high-tax countries more attractive than it should be, if one truly believes in the foreign tax credit limitation.¹²⁴ The system brings investors' total tax liability closer to U.S. levels than is justifiable under the circumstances.¹²⁵ Making foreign investment less attractive relative to domestic investment should lead to future increases in U.S. business and thus U.S. tax revenues.¹²⁶

As one looks at who would be affected and how they would be affected by changing our treaty policy, it becomes clear that our current treaty policy involves the simultaneous subsidization of both ingoing and outgoing investment. The arguments for doing

¹²⁴ There are, however, enough flaws in the operation of the foreign tax credit scheme that an argument can be made that the over-friendly treatment of treaty income is a case of "two wrongs make a right." For a discussion of flaws in the tax credit mechanism that disadvantage taxpayers, see Roin, *supra* note 11, at n.75 & n.102. Of course, there is no direct correlation between the taxpayers suffering from the anti-taxpayer biases of the tax credit system and those profiting from its pro-taxpayer aspects, which weakens the "offsetting errors" argument.

¹²⁵ See *supra* text accompanying notes 85-87. Although high-tax countries generally benefit from overly-favorable treatment of their taxes under the U.S. tax credit system, even they have been known to complain when, as the result of a treaty, U.S.-based companies pay less tax on operations in the treaty country than their own domestic competitors. See, e.g., Ault, Division of the International Tax Base, *supra* note 5, at 583-84 (detailing German concern in treaty negotiations over "the fact that profits earned and distributed by a German corporation to its foreign parent could be reinvested at a lower overall tax burden than would be borne by a wholly German group that had retained profits").

¹²⁶ Opponents of the policy change will undoubtedly argue that increasing taxes will cause the U.S.-owned businesses to go out of business rather than to move back to the United States, eliminating any possibility of U.S. revenue gains. However, if that is the case, there is no reason to expect that response will be limited to U.S.-owned foreign businesses. The same phenomenon should occur with respect to foreign-owned U.S. businesses, opening up opportunities for wholly domestic businesses to take their place. Though increasing taxes may have a slight activity level effect, as discussed *infra* text accompanying note 129, there is something peculiar about simultaneously subsidizing both incoming and outgoing foreign investment at the expense of domestic investment.

either are fairly weak; the arguments for doing both simultaneously appear to be nonexistent.

The argument for subsidizing incoming investment is familiar, though far from convincing. Reducing taxes to entice outside investors to locate in a particular location is hardly a new phenomenon. Developing countries often grant "tax holidays" of one sort or another to entice foreign investment.¹²⁷ Nor are developed countries immune from such tactics.¹²⁸ In the United States, states have often entered into bidding wars for potential investors, offering tax discounts as well as positive services such as the construction of new roads and modifications of zoning restrictions. Participants justify their bids by pointing to the positive externalities of providing residents with additional jobs. Scholarly comment on such transactions is less positive. Economists argue that the externalities would exist for many if not most of the jurisdictions in which a business might locate; little if any value is created by luring a business from one jurisdiction to another. Instead, entrenchment of such auction practices has created a destructive "race to the bottom" in local tax rates. Although some additional investment may be created by the resulting diminution of business tax burdens, in most cases the result is merely to lower taxes on businesses that would have located within the jurisdiction without tax breaks.¹²⁹ This is no less true at the international than at the intrastate or interstate levels, though it has reached its logical conclusion—that is, no source taxation—only when it comes to interest income.

¹²⁷ See Yitzhak Hadari, *The Role of Tax Incentives in Attracting Foreign Investments in Selected Developing Countries and the Desirable Policy*, 24 *Int'l Law.* 121, 151 (1990) ("Almost all developing countries are using tax incentives in order to attract foreign capital investments . . .").

¹²⁸ *Id.* at 122 ("Indeed, many developed countries use tax incentives to encourage certain economic activities. Tax concessions for many purposes are still used by most developed countries . . .").

¹²⁹ See, e.g., Staff of Joint Comm. on Tax'n, 101st Cong., 2d Sess., *Report on Background and Issues Relating to the Taxation of Foreign Investment in the United States* 62 (Joint Comm. Print 1990) ("[W]hile the tax inducement strategy may be beneficial to some country when it is the sole practitioner, widespread adoption of such a policy would leave all nations worse off."); OECD, *Taxing Profits*, *supra* note 22, at 173 ("Studies in Canada and elsewhere suggest that in many cases the value of new investment is less than the revenue loss [from the tax incentives]."); Hadari, *supra* note 127, at 152 ("States should limit the competition among each other on the greatest tax concessions. Such national concessions offset one another and result, in effect, in a giveaway by host countries, usually the less developed countries.").

Even if (and it is a big “if”) this race to the bottom makes sense from the perspective of particular locales competing for a particular investor or investment, the generalization of tax relief through a treaty provision raises additional questions. What if, for example, after the treaty relief is taken into account, the foreign-owned enterprise bears a combined source-residence tax burden that is lower than its domestic competitors? What if the enterprise offers little to the surrounding community in terms of jobs or other benefits—or at least little in relation to the revenue costs of the treaty benefit? The fine-tuning of incentives available to states and localities, which can offer enterprise-specific arrangements, is denied the federal government when it works through the tax treaty mechanism. It must make generalizations about the benefits of investments by the country of the investors’ residence, which may not be terribly adequate.

The arguments for subsidizing outgoing investment are even weaker.¹³⁰ Once again, it seems likely that most of the subsidy is misdirected. It can only be beneficial if it goes to businesses that

¹³⁰ It is worth noting that the countries with imputation-based integration systems have decided actively to discourage such outward investment by imposing discriminatorily high taxes on income generated by such investment. Presumably they believe that is the preferable course from an economic standpoint. There is no doubt that allowing taxpayers to appropriate the benefit of treaty source-tax reductions is a monetary subsidy to such taxpayers rather than a “costless” artifact of a treaty “deal” deemed desirable for other reasons (i.e. a belief that forgoing source taxation of incoming foreign investment is cost-justified as an investment inducement). Congress could appropriate at least some of the benefit of a treaty partner’s source tax reduction for the federal treasury. See *supra* text accompanying notes 71-73. Its failure to do so is the financial equivalent of paying the forgone taxes to the affected taxpayers. To the extent these constructive payments encourage businesses to engage in business in other countries rather than the United States, they impose a real cost on the U.S. economy in addition to the loss of the forgone tax revenues. When these constructive payments have no behavioral impact at all, they represent an unwarranted benefit flowing from the federal government to taxpayers with foreign business operations. Congress could provide foreigners with any desired tax relief without benefiting domestic taxpayers nearly to the extent it now does. For example, unilateral relief can be provided by statute. Congress did exactly that for portfolio interest. It eliminated the withholding tax on carefully defined categories of interest paid by U.S. interests to unrelated foreign investors by statute. See I.R.C. §§ 871(h), 881(c) (West 1995). Of course, statutes do not discriminate between foreign taxpayers based on their country of residence—nor on the method of corporate taxation utilized by that residence country. A statute would likely apply to investors from other countries as well, countries with tax systems that would deprive the investors of the benefit of U.S. source-tax concessions. Treaties are a better tool if the desire is to limit source-tax concessions to taxpayers resident in imputation countries; appropriate basket rules could then be used to

would be unable or unwilling to compete abroad in the absence of such a subsidy, and then only to the extent that those marginal businesses are operations whose presence abroad would on the whole benefit the U.S. economy.¹³¹ These investments must involve business operations which would be unable to compete in world markets if restricted to U.S. operations, and they must use more U.S. inputs in their foreign operations than would foreign businesses filling the same market niche. The tax treaty mechanism is again too nonspecific to limit its subsidies to appropriate situations.

Finally, it needs pointing out that if taxes are paid by neither incoming nor outgoing investment, the revenue shortfalls must be made up by increasing taxes on domestic taxpayers, both corporate and individual. This effect could snowball. Over time, as the discrepancy between the taxes borne by domestic and international transactions grows, efforts to reduce barriers to profitable opportunities to trade internationally could lead to skewed incentives in favor of international trade.

In sum, the source-tax reductions agreed to by treaty—at least, those that reduce the tax liability below generally applicable domestic tax rates—should be recognized for what they are: tax expenditures rather than a convenient form of rearranging tax liabilities. They should be evaluated with the same care, and under the same criteria, as any federal spending program. Do their benefits justify their costs? When viewed from this perspective, it is hard to justify a positive response.

CONCLUSION

The reductions in source taxation provided by treaty are reciprocal in form. But it should be clear that they are not reciprocal in

ensure that the bulk of the benefit of reciprocal source-tax reductions flows to the U.S. treasury rather than taxpayers. See *supra* text accompanying notes 71-73.

¹³¹ It is hard to come up with a plausible rationale for the United States government to subsidize foreign business operations hiring foreign workers and using foreign-produced components, particularly if the products being produced may compete in the marketplace against products produced by U.S. manufacturers using U.S. labor and components. One argument might be that such subsidies reduce illegal immigration into the United States by providing employment opportunities in poor countries, but such countries rarely maintain integrated tax systems.

substance. Imbalances in investment flows have long been identified as a cause of imbalances in treaty revenue flows—and as an excuse for limiting source-tax reductions. This Article shows that differences in the tax rates and tax systems of treaty partners are equally capable of causing imbalances in treaty-revenue exchanges. The solution to investment imbalances has been the adoption of treaties allowing a greater measure of source taxation. It seems likely that this is the proper response as well to situations where the treaty partners maintain different tax systems.