Can Income From Capital Be Taxed? An International Perspective

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Although many politicians describe the United States as an "ownership society" because a large segment of the population participates in its capital markets, in fact few people have a significant direct stake in those markets.[1] This fact reflects more than the nation's savings rate; what savings there are are not evenly distributed. Indeed, the distribution of wealth in this country appears to be even more top-heavy than the oft-criticized distribution of income.[2] Thus the question of whether income from capital can be taxed will be of increasing political importance. For if such income cannot be taxed, the pattern of capital accumulation may become increasingly stratified over time and, at least according to doomsayers, put our democratic system at risk.[3] Yet there is great disagreement over whether and how such taxation can be effected in a globalized economy.

Some economists believe that in an open economy, no tax can be collected with respect to capital income. They contend that the economic burden of taxes that appear to fall on capital income are effectively shifted to labor income in the form of lower wages or higher unemployment.[4] If that is the case, the only point in "taxing" capital income would be to satisfy political appearances and such taxation would be a testament to the deficient education of voters. As even proponents of this theory admit, though, while it rests on "plausible" assumptions the theory lacks "empirical support."[5] And not all

[1] ___________, "The Rentier Society," 108 Tax Notes 176 (2005) (top 1% of households owns 38% of total wealth and top 20% of households own 83%; when owner-occupied housing subtracted, top 1 % owns 50%; only 27% of households own security portfolios worth more than $25,000).
[2] Martin J. McMahon, Jr., "The Matthew Effect and Federal Taxation," 45 Boston College Law Review 993, 1017 (2004); Deborah A. Geier, "Incremental versus Fundamental Tax Reform and the Top One Percent," 56 Southern Methodist Law Review 99, 114-116 (2003).
[3] Reuven S. Avi-Yonah, "Risks, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," 37 Tax Notes International 177, 179 (2004).
[4] Roger H. Gordon, "Taxation of capital income vs. labour income: an overview," in Taxing Capital Income in the European Union: Issues and Options for Reform (Sijbren Cnossen, ed. 2000) 15, 24.
[5] Id. At 24.

economists agree that the assumptions are plausible in the context of the United States.[6] This is not a debate which I have any intention of entering lacking as I do the formal economic tools necessary to fully engage with it.

Instead, this paper grapples with the more prosaic question of whether it is possible to (ostensibly) collect an income tax that looks much like our current income tax in a globalized world. It goes about this task by identifying some of the current obstacles to taxation posed by globalization and then suggests some legislative and regulatory changes which might ameliorate these obstacles. The fact that some or all of these suggestions may be politically unpalatable goes to prove a larger point. The effectiveness (or not) of the income tax depends on public and political support for the tax. In the absence of such support, it will quickly devolve to the most restrictive form of a wage tax, as wages are the only income subject to mandatory reporting and withholding obligations. Moreover, some of the required changes can only be effected in concert with other nations, not all of whom will see themselves as having the same interests in stemming tax avoidance as the U.S. The most substantial barriers to effective income taxation, then, may be political rather than technical in nature.

Conclusions

1. Globalization makes it easier for U.S. persons to adopt the identity of foreign persons for tax purposes. This is important because foreigners are largely exempt from U.S. income taxation on their capital income. To combat such tax evasion (and by and large, we are talking about illegal evasion rather than perhaps legal tax avoidance techniques here), the U.S. either will have to increase its taxation of

[6] See (arguing that the United States is not a "small country" in economic terms, and hence, that taxes that fall on capital income burden capital income rather than labor income).

foreigners' capital income, invest more in expensive enforcement techniques such as net worth audits or close scrutiny of the records of third party payors,[7] or work with other countries to establish a credible transnational information return system.

2. Globalization makes it easier for all taxpayers to attribute their income to foreign rather than U.S. sources, thus reducing if not eliminating the jurisdictional basis for the imposition of a U.S. income tax on such income. Dealing with these avoidance techniques requires rethinking and revising both the structure and content of the current source rules. It will probably require moving to a variant of formulary taxation, where the worldwide income of a taxpayer is allocated among nations in accordance with a mathematical formula based on relevant criteria. U.S. states have long used formulary methods to allocate income generated by multistate taxpayers. Their experiences—both good and bad—can serve as a guide when designing a formulary system to apply to the international context.

I. Background: The U.S. Rules for the Taxation of International Transactions and Taxpayers

It is impossible to understand how globalization has undermined the U.S.'s ability to tax capital income without understanding at least the basic outlines of the U.S. regime

[7] For example, some U.S. taxpayers obtained credit cards from foreign banks, and paid the resulting charges out of undeclared foreign income held in undeclared foreign accounts. In 2001, Treasury began issuing John Doe summonses to there foreign credit card issuers. Amy Hamilton, "Justice Advances Offshore Crackdown by Going After Individuals," 2003 Tax Notes Today 50-3 (2003). This initiative identified far more taxpayers than the Service had the capability of auditing. The Service tried to reduce the number by establishing a "voluntary compliance initiative" under which violators could escape civil fraud and information return penalties in return for payment of back taxes, interest, some other penalties, and the provision of information regarding promoters and marketers of such schemes. "IRS Announces Amnesty Program for Offshore Credit Card Abusers," IR-2003-5, reprinted in 2003 Tax Notes Today 10-11 (2003). Although some taxpayers stepped forward under this initiative, generating a substantial revenue flow, they represented only a small fraction of the identified individuals. The remainder presumably are continuing to play the audit lottery, banking on the IRS's limited enforcement budget.

for taxing foreign taxpayers and foreign income. The section of the Internal Revenue Code dealing with international issues is intricately detailed and amazingly (some would say mind-numbingly) complex. Some of the problems stem from these intricacies, but the majority result from the basic design decisions discussed below, design decisions that are in fact common to virtually all developed nations.

There are two generally accepted bases of income tax jurisdiction: source and residence. All countries assert a right to tax the income generated within their borders regardless of the identity of the taxpayer earning such income. The United States follows the general pattern by levying (as a statutory matter) its income taxes on two categories of income earned by foreign corporations and "nonresident aliens." Foreigners who are not engaged in a trade or business in the United States are subject to a tax equal to 30 percent of the gross amount of certain types of passive income from U.S. sources; foreigners who are engaged in a U.S. trade or business must pay tax on the income generated by that business from U.S. sources under the normal income tax rules, just as if the taxpayer was a U.S. resident.

Countries also claim the right to levy an income tax on the worldwide income of their residents and, in the case of the United States and a few other countries, their nationals (non-resident citizens). The source and residence tax claims overlap, leaving many income items subject to tax by two (or more) national tax systems. Given the high rates of tax imposed by many jurisdictions, such duplicative or "double taxation" threatens the financial viability of international transactions. Since the 1920's, the international consensus has been that the country of source has "primary" taxing jurisdiction while the country of residence has "secondary" or residual taxing jurisdiction.

This means that, in the absence of explicit agreement to the contrary, countries have the right to impose their full tax levy on all income derived within their borders, but must take taxes levied by a source country into account when calculating the tax due on the foreign-sourced income of their residents. Residence countries can take source country taxation into account in a variety of ways: they can allow those taxes as a deduction when calculating the taxpayer's taxable income, they can treat source taxes as a credit against the their own taxes imposed on the foreign income or they can simply exclude the foreign sourced income from their tax base altogether. The United States, like most countries, employs a combination of those techniques, though it relies more heavily on the foreign tax credit and less on outright exemption of foreign source income than many other developed countries.

Although an enormous amount of the practitioner and academic literature about the international tax rules focus on the operation of these foreign tax credit, in fact its defects are a second order problem. To a large extent, the defects in the operation of the foreign tax credit regime create problems only because of an underlying problem in the implementation of source jurisdiction, a problem that the U.S. shares with many other nations. Despite the fact that countries are supposed to exercise primary taxing jurisdiction over income derived within their borders, in many cases they fail to exercise that jurisdiction without any guarantee that another country will take up the slack. In short, failures to tax at source lead to nontaxation of certain categories of international income, with predictable effects on the growth of such income and accompanying revenue losses to national treasuries. Nontaxation of transnational income rather than double taxation of such income is the more serious problem today. Such nontaxation, as

explained below, affects both transnational investment income and transnational business income.

II. Causes of Double Non-Taxation

Although economists often argue whether source taxation or residence taxation is "better" from an economic standpoint, as a practical matter, neither source nor residence taxation is effected in many circumstances. The most striking feature is the absence of attempts to tax by the country of source, the country with primary taxing jurisdiction.

A. Passive Investment Income

1. Explicitly Excluded Income

Although countries have the right to levy an income tax on all income generated within their borders, they lack personal jurisdiction over many of the foreign individuals and entities that earn such income. In particular, a country of source is unlikely to be able to collect unpaid taxes or run an effective audit on foreign investors who are "passive" investors, investors who do not engage in active business activities in the source country but merely receive payments such as interest or dividends from source country entities. Many such taxpayers will never be physically present within the source country, conducting all of their income producing activities through agents or even the mail. As a result, source countries do not impose their normal income tax regimes on such taxpayers. Instead, they impose flat rate withholding taxes on the gross amount of certain types of investment income paid to such foreigners, while totally excluding large categories of other income from taxation at source on grounds that such income is unsuited to being taxed under such a mechanism. The U.S., for example, by statute levies a 30% withholding tax on the gross amount of U.S. source "fixed, determinable, annual

and periodic income" earned by nonresident aliens and foreign corporations outside the context of a U.S. trade or business.[8] The term "fixed, determinable, annual and periodic income" includes interest income and dividend income, but excludes most types of capital gains and even many gains that would be considered as ordinary income. Gains have largely been excluded because a withholding tax on gross sales proceeds threatens to confiscate the entirety, if not more, of the sellers' profits on such sales, while an alternate rule imposing a withholding tax equal to a percentage of gains is perceived as unadministerable given buyers ignorance of sellers' tax bases.[9] Over time, the category of exempt income has grown. For example, most forms of interest income are now exempt, as a matter of statutory law, from U.S. income tax when earned by unrelated passive investors.[10]

These exemptions from source taxation are not conditional on the foreign taxpayer paying taxes on such income in their country of residence. They are not even conditional on the taxpayer reporting such income items to their country of residence. And it is widely believed that few taxpayers report and pay tax on such income in their home countries.

Whatever the merits of turning the U.S. into a tax haven for residents of foreign countries, [11] U.S. residents also take advantage of these rules to avoid paying U.S. taxes

[8] I.R.C. §§871(a), 881(a).
[9] Whether this perception is correct is another matter. Congress has mandated withholding from the gross proceeds derived from the sale of U.S. real estate. This withholding obligation is imposed at a rate lower than the standard 30 percent tax, and the amounts withheld are refundable to the extent they exceed the receipts from sale, Whether such a tax regime can be transferred to contexts involving many more transactions, perhaps less formal transfer mechanisms and (at least in the stock market context) greater susceptibility to replacement by derivative contracts is unclear.
[10] I.R.C. §§871(h)-(i), 881(c).
[11] Congress knew full well when it added the exclusion for portfolio interest to the Code that doing so would help foreigners avoid residence country taxes; indeed, one of its justifications for enacting the rule

due on both their foreign income and, increasingly, their U.S. income and specifically the income derived from passive investment in widely traded securities. It is relatively easy for a U.S. resident to masquerade as a foreigner by holding assets indirectly through an artificial entity such as a corporation created in a foreign jurisdiction. As long as the U.S. payor can attest that its payment was made to a foreign taxpayer's foreign bank account, the payor is exempted from any withholding requirement regardless of the identity of the ultimate owner. Although in most cases, the U.S. owner of the receiving corporation should be reporting and paying tax on this income in the U.S. on a current basis,[12] the chances of her relationship to the foreign corporation being discovered, and thus her liability for the tax, are remote. Indeed, to increase the difficulty of detection, some taxpayers use tiered entity structures. That is, they interpose several artificial entities between themselves and the U.S. payor.[13] It helps if the intermediary entities are established in tax haven countries—countries which, by definition levy low or no income taxes and which have bank secrecy laws—but it is by no means essential. The interest income derived by a U.S. individual investing in U.S. bonds through a French corporation is not much more likely to be discovered by the French or U.S. tax authorities than such interest income derived by a French individual.

2. Treaty Protected Income

In addition to the U.S. source investment income implicitly or explicitly exempted from tax by statute, additional categories of investment income are exempted from U.S.

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was payback for what it saw as Europe's attempt to attract U.S. investors through the creation of a tax-free Eurobond market.

[12] The Internal Revenue Code requires U.S. shareholders of foreign corporations to currently declare and pay tax on their implicit share of the corporations' passive investment income under one of two specialized tax regimes: the "subpart F" regime found at I.R.C. §§ or the "PFIC" regime found at I.R.C. §§ .

[13] See Lee A. Sheppard, "Offshore Investments: Don't Ask, Don't Tell," 108 Tax Notes 171,176 (2005).

tax under the terms of bilateral tax treaty arrangements entered into with countries no one would consider to be tax havens.[14] Tax treaties go beyond statutory law to provide additional source tax reductions. Although dividends generally remain subject to a reduced rate of withholding tax, the typical tax treaty eliminates the withholding tax on royalties and additional categories of interest income.[15] Such reductions are meant to reduce or eliminate the inadvertent overtaxation created by withholding taxes levied on gross income, and to substitute in their place the normal, taxation on net income, rules of the residence country. Treaty exemptions are reciprocal in nature; that is, when the U.S. gives up its source tax claim with respect to treaty partner residents investing in the U.S., the treaty partner gives up its source tax claims against U.S. residents earning similar income within its borders. As U.S. residents can claim a credit against their U.S. tax obligation for foreign taxes paid with respect to foreign income, a treaty partner's waiver of its source tax claim should increase U.S. residence-based tax revenues by reducing the amount of foreign tax credits claimed as an offset against this liability. When the treaty rule works correctly, both taxpayers and national treasuries should come out in approximately the same place financially as they would have in a no-treaty world, although each country would collect its tax revenues from its residents rather than from its investors.

But these treaty exemptions suffer from the same defect as the statutory exemptions: the source tax concessions are granted by source countries without any proof that the taxpayer has reported or paid tax to the residence country on the associated

[14] The U.S. cancelled most of the tax treaties it had entered into with tax haven countries in the 1980's.
[15] The statutory exemption covers interest received from unrelated U.S. debtors; the blanket treaty based exemptions also cover interest received from related debtors such as wholly-owned subsidiaries..

income.[16] Although tax treaties contain exchange of information provisions which require the treaty partners to provide each other with information regarding the other's residents upon request, the taxing authorities often lack enough information to know about whom or what they should be asking. Certainly neither the governments nor the payors provide anything close to the machine-readable information returns required to be sent by domestic payors of investment income to payees and the IRS, returns which make machine auditing and therefore substantial tax compliance likely. Again, though in the first instance this makes avoidance of home country taxes by foreigners more likely, it also provides more locales for U.S. residents to masquerade as residents of. The extent to which they take advantage of these locales to evade taxes on their U.S. investment income (as opposed to foreign investment income), given the accessibility of tax havens, is unclear.

The route to non-taxation or undertaxation of business income is different. It is discussed in the next section.

B. The Undertaxation of Business Income

All countries tax the income generated from active business activities undertaken within their borders by nonresidents,[17] and generally due so under the same rules as they apply to residents. The reasoning behind such equivalence in treatment is both practical and political; few countries could long sustain a taxing regime that systematically favored foreign businesses over their domestic competitors. Business income generated from

[16] There are other problems particular to the U.S. context that go beyond misreporting. For example, even when treaties eliminate the possibility of source country taxation, income retains its character as "foreign sourced income" for U.S. tax purposes. Under the rules pertaining to the operation of the tax credit mechanism used by the U.S., this often has the effect of allowing the taxpayer to claim additional tax credits for source taxes paid with respect to other items of foreign income instead of increasing the U.S. residence tax due on the treaty protected income. For this reason alone, most tax treaties turn out to be revenue losing propositions.

[17] Bilateral tax treaties provide some source taxation relief for marginally active taxpayers.

foreign sources, though, is treated differently because of both jurisdictional and overtaxation concerns. No country has the jurisdiction to tax foreign income of foreign taxpayers.[18] In addition, many countries exempt the foreign business income of their resident taxpayers from their domestic tax base. The United States takes a slightly different tack. Although it claims to eventually impose a tax on such income equal to the difference between the foreign source taxes paid and what the U.S. tax on such income would be, it allows taxpayers to defer paying this step-up or residual tax and sometimes forgives portions of it.[19] But the net result of the two approaches are surprisingly close. In both, taxpayers benefit by allocating income to low tax jurisdictions.

Not surprisingly, given these tax rules, taxpayers try to attribute as much income as possible in jurisdictions with low income tax rates. To a very large extent, they are successful. The latest statistics coming out of the U.S. show that 58 percent of the profits earned by U.S. multinationals were allocated to 18 “tax haven” countries, “a figure that far exceeds the share of economic activity that multinationals conduct in these low-tax

[18] There are some U.S. statutes that appear to tax the foreign income of foreign residents, but closer examination reveals that in most cases, the income involved should be described as an economic matter as U.S. source income. Because such statutes draw unfavorable comment on international law grounds, see e.g., , it would have been wiser for Congress to have effected the desired results through changes in source rules. In addition, under the subpart F and PFIC regimes, the U.S. taxes U.S. shareholders of certain corporations on their imputed share of some foreign corporations’ income.

[19] Technically, U.S. taxpayers are immediately taxable on their worldwide income. However, if a U.S. taxpayer carries out its foreign business operations through a foreign incorporated subsidiary, the subsidiary does not count as a “U.S. taxpayer” and (unless a special tax regime such as subpart F or PFIC applies) its U.S. parent does not become taxable on its share of the subsidiaries foreign earnings and profits unless and until the subsidiary distributes those earnings and profits to the parent in the form of a dividend or the parent sells the stock of the subsidiary. In both cases, the parent is entitled to claim foreign tax credits for foreign taxes paid by the subsidiary as offsets against the U.S. tax that becomes due. In the Tax Act, Congress allowed taxpayers to repatriate the profits of such foreign subsidiaries for one year in return for a flat tax of . No tax credits are allowed to be claimed as an offset against this tax liability.

countries."[20] The reasons they are so successful stem to a large extent from defects in the statutory rules for "sourcing" income enacted by high tax countries.

1. "Tax Havens"

None of the income sourcing schemes would work were it not for the existence of low-tax or no-tax countries, countries which levy income tax at low rates or have no income tax at all. Countries maintain low income tax rates for a variety of reasons, ranging from governmental incapacity (either to levy such taxes or to effectively spend their proceeds), a desire to attract additional foreign or spur domestic investment, or to raise revenues through facilitating foreign tax avoidance.[21] Mixed motives are common. Ireland, for example, has attracted real business operations because of its low corporate tax rate, but many are suspicious that it also encourages taxpayers to improperly siphon considerable amounts of income away from other jurisdictions.[22]

Although taxation of transnational income would be easier in the absence of tax havens, it is difficult to believe that tax havens can be eliminated. Tax havens exist because haven behavior benefits the haven countries' economies. They gain both tax revenues and at least a modicum of economic activity when foreign investors run their money through the haven's financial institutions. If the benefits enjoyed by such countries are outweighed by the tax and economic losses suffered by other counties, in theory the other countries ought to be able to bribe tax havens into adopting different tax regimes. However, such side payments or bribes are unworkable given the coordination

[20] Martin A. Sullivan, Data Show Dramatic Shift of Profits to Tax Havens, 104 Tax Notes 1190, 1190 (2004).
[21] Even if a country collects little in the way of revenue from each foreign investor, as long as the expenses incurred in serving that investor are lower than those revenues, a country can reap considerable amounts of money through volume. To get a sense of the volumes involved, [need info]
[22] See Martin A. Sullivan, The IRS Multibillion-Dollar Subsidy for Ireland, 108 Tax Notes 287, 287 (2005). This siphoning is distinct from the question of whether it is acceptable to use low tax rates to attract real investment. The issue of tax competition is discussed in greater detail in Part infra.

issues both between the non-haven countries (which would have to agree on their respective contribution levels) and haven and potential haven countries (since non-haven countries could not expect to see any benefits unless all havens discontinued their haven regimes and each haven has the opportunity to be the last operating haven generating extraordinary revenues). Further, even countries that are not currently havens would likely claim that they should participate in any cash outlay because they could become havens.

The only way to neutralize havens, then, is to remove the profit from haven activity. It is important to realize that their profitability depends in large part on the failure of high tax countries to come up with reasonable methods for determining the amount of income allocable to them and, by implication, to other countries. Tax havens pose a threat only because it is so easy for taxpayers to allocate income to them and away from the high tax jurisdictions where such income has been earned as an economic matter.

One must understand the flaws in the current methods of determining the source of income for tax purposes to see how corrections can be made. Taxpayers have two primary techniques for misallocating income to tax haven jurisdictions: transfer pricing manipulation and income characterization. Each is discussed below.

1. Transfer Pricing Manipulation

Although customers tend to view multinational corporations as single, indivisible entities, in fact even the most vertically integrated enterprises tend to be operated through strings of separately incorporated, related corporations. For a variety of legal and business (as well as tax) reasons, manufacturing operations are usually undertaken by a

corporation established in the country in which such manufacturing operations take place while sales operations are undertaken by a corporation established in the country in which customers are located, and neither of which may be the country in which the parent corporation, which handles strategic planning, administration, research and development and a slew of other corporate functions, is incorporated or located. Although ultimately each of these corporations is owned by the same group of shareholders, the parent company's shareholders, as a formal matter, each of these corporations is a distinct entity which interacts with the other entities through contractual arrangements. That is, these related corporations buy things from, and sell things to, each other as well as the general public. To the extent the source of income for tax purposes depends on which of the related entities happens to earn the income, the tax characterization hangs on the specifics of these intercompany contracts, and in particular, the prices which they charge each other for the goods and services they transfer to each other, or, for short, their "transfer pricing" decisions.

As good agents for a common owner, of course, the corporations have an incentive to collude with one another to ensure that the maximum amount of income is earned where it will be subjected to the lowest possible tax rate. Start with the simplest example. Suppose a company, X, manufactures mousetraps in low-tax Ireland (tax rate of 12.5 percent). It sells some of its mousetraps to its wholly-owned distributor, Y, in the U.S. for sale to U.S. customers. Now suppose that these mousetraps cost $6 to make, $6 to market, and are eventually sold for $20. The combined enterprise will make $8 for each mousetrap sold in the U.S. But how much of this $8 will be attributed to the Irish manufacturing operations and subject to tax at 12.5 percent, and how much will be

attributed to the U.S. sales operations and subject to a 35 percent income tax? In the first instance, it depends on the price X charges Y for the mousetraps. If X charges Y $12 per mousetrap, X will make $6 of profit and Y only $2. If X charges Y $8 per mousetrap, X's profit will be $2 and Y's will be $6. If left to their own devices, what price do you think X will charge Y?

Other, more elaborate schemes can be used to extend the circumstances in which such transfer pricing manipulations provide tax benefits. Suppose X's manufacturing activities in the above example took place in a high tax country, the same country in which X was incorporated. X, or X's parent company, could establish an intermediary corporation, Z, in a low-tax country. X could sell the mousetraps to Z, which would then resell the mousetraps to Y. If X sold the mousetraps to Z for $7, and Z resold the mousetraps to Y for $13, X would have $1 profit to declare to the high tax country of manufacture, Y would have $1 of profit to declare in the country of ultimate sale and Z would have $6 to declare to the low tax country.

Of course, neither tax authorities nor the legislatures that control them are entirely stupid. In the U.S. as in virtually every other country, tax authorities have the power to rewrite (for tax purposes at least) contracts between related parties to ensure that the prices paid conform to the "arm's length" standard; that is, to recompute the taxable income of each of the related parties as if the contractual prices were the same as would have been paid by unrelated companies bargaining at arm's length.[23] In the real world, however, it is far from easy to determine what that "arm's length" price is, and indeed, most economists are convinced that, at best, there is a range of arm's length prices. Accordingly, the Internal Revenue Service allows taxpayers to choose a price anywhere

[23] In the U.S., this power is granted by I.R.C. § 482.

along that (sometimes considerable) range. But the larger problem is that few intercompany transfers involve fungible items with market prices sufficiently clearly defined to establish such a range. Elements of difficult to value intellectual property ranging from trademarks to patents to goodwill infect almost every transaction. So too do location factors arising from unique market and supply factors. Finally, transfer pricing decisions inevitably necessitate allocating the efficiency gains generated by vertical integration of the business enterprise. As a result, third party comparables—prices established in similar transactions involving unrelated parties--the basis of the "arm's length" standard, are very difficult to locate. At best, taxpayers and tax authorities find themselves relying on loosely similar transactions for comparison, leading to disputes about the type and extent of corrections necessary to make the price terms reasonably comparable. Transfer pricing disputes tend to degenerate into very expensive contests of dueling experts. The costs of such disputes weigh on tax authorities as well as taxpayers; tax authorities do not have the resources to challenge more than a fraction of a fraction of the questionable transactions that exist. As a result, many taxpayers overreach and rely on the audit lottery to escape detection.

Manipulating transfer prices is one method of reallocating income from a high tax country to a low or no tax country. But it is not the only one. Equally important is the option taxpayers have to structure their transactions to generate particular types of income. The type of income matters because different statutory source and tax rules apply to different types of income. Thus, changing the type of income may change the applicable statutory source rule, which may change the country in which the income is

sourced. Alternatively, the change in the type of income may change the taxing regime under which it will be taxed.

Tax motivated structuring can be as simple as financing operations with debt rather than equity, since interest income is often treated as (passive) income earned by the creditor and subject to less tax at source than dividend income. Moreover, not only may such income be subject to a lower (or nonexistent) rate of tax in the hands of the creditor, but the interest payment will reduce the income of the debtor, thus reducing its income tax liability.

A more complicated scheme may involve "slicing and dicing" income into smaller or larger numbers of component parts to generate the best tax results. For example, most lending transactions include a service element (loan processing), and interest element (the time value of money charge), and a risk (credit risk) charge. In the absence of tax considerations, a bank might charge a single sum, denominated "interest," as its compensation for undertaking these different functions. That structure would result in the entirety of the income being accorded the treatment applicable to the "dominant" income-producing function; it would be characterized as time value of money or interest income. However, if a bank split the transaction and its fees into the three component parts, one fee would be treated as personal services income and sourced where the services were performed, one would be treated as interest income and sourced accordingly, and the last would be treated as insurance income and sourced under the insurance rules.

The slicing and dicing strategy works for nonfinancial business transactions as well. The owner of valuable intellectual property can exploit such property in a number

of different ways. It could simply license the property in exchange for royalties. Alternatively, it could manufacture goods incorporating the intellectual property for resale and then sell the goods, generating income from manufacturing and sales with nary an intellectual property return in sight. In yet another variation, the taxpayer could hire someone else to perform manufacturing services and to sell the resulting products on behalf of the taxpayer. Even after paying these independent contractors, the taxpayer could be left with substantial income because of its initial ownership of the intellectual property and its acceptance of business risks, not to mention the recompense it deserves for its exercise of managerial or entrepreneurial skill in locating and overseeing the work of such subcontractors. But its profits would be characterized as general business income, or income generated from the manufacture and sale of inventory property and sourced accordingly, rather than being treated as royalty and insurance income which would be sourced under a different source rule leading to a different source allocation.

Taxpayers can and do choose among the alternative characterizations at least partly on the basis of their tax effects. To the extent this affects real business behaviors, this is, according to economists, inefficient. It also tends to reduce governmental revenue since taxpayers rarely voluntarily choose to pay more tax than they have to. And as more and more transactions have a global component, these techniques can be used to avoid an ever-increasing share of corporate tax liability.

Globalization, then, threatens the U.S.'s ability to enforce both the taxation of capital income earned by individuals and the taxation of corporate income. This problem is probably getting worse rather than better as more individuals and corporations gain the knowledge necessary to engage in these tax schemes and the confidence that

they will not be caught or seriously punished if they are caught. The question discussed in the next section is whether anything can be done to rectify this situation.

III. Can the Omitted Income Be Taxed?

No tax on capital income can survive for long if it is not levied on such income generated in the context of international transactions. What happens instead is that wholly domestic transactions disappear, as taxpayers increasingly choose to invest and earn (or appear to invest and earn) in neighboring countries. Thus, problem becomes how to tax capital income generated by international transactions. There are rarely perfect solutions to any problem, and this is no exception to the general rule. What there are are a variety of imperfect alternatives.

A. Taxing Passive Income

At present, virtually all interest income and much other passive investment income goes untaxed by both source and residence countries. In most cases, source countries have voluntarily withdrawn their tax claims while residence countries have found themselves unable to enforce their tax claims. The favorable treatment of cross-border investment income has led many taxpayers earning domestic income to transform this income into effectively exempt transnational income by interposing a foreign entity as an intermediate recipient. The question is how to ensure that this income gets taxed somewhere.

1. Residence Taxation Possibilities

In a perfect world, the solution would come in the form of full residence country taxation, at least in those situations in which the source country's nontaxation stems from a treaty agreement. It may be the better solution in other cases as well because it would

make taxation on net, rather than gross income more probable, as well as leaving open the possibility of the application of progressive rate schedules, though those gains may be offset by some unfavorable revenue allocations.[24] But is it technologically feasible?

To be completely effective, source countries would have to provide residence countries with information returns capable of being seamlessly integrated into their internal audit processes. Ideally, this means that the returns could be matched by computer to the account of the affected taxpayer, enabling computer matching and billing as is currently done in the U.S. with Form 1099's issued by banks and other financial and brokerage institutions. Because of such computer matching, compliance rates with respect to such income has gone way up. It is only unmatched or unverified income, such as the income derived from the operation of small businesses such as sole proprietorships—and of course foreign income—that remains as a source of the infamous "tax gap" in the U.S.

Even to a novice in tax administration, several challenges to this scheme are apparent. For such a matching scheme to work perfectly, the Form 1099 issuers would have to have the foreign taxpayer's foreign tax identification number (or whatever the foreign equivalent is). That may not be an insuperable barrier; investors may be asked for that number as part of their certification of foreign status, something they must file to be exempted from backup withholding under current law. [check] And as is done with domestic investors, backup withholding may be imposed if the foreign government informs the payor that the account number is invalid. A more serious technical issue is

[24] Particularly outside of the treaty situation, one must worry that some source countries will give up more in the way of potential source tax revenues than they will gain in the way of residence tax revenues. The effective switch in "primary taxing jurisdiction" from country of source to country of residence may create winners and losers, justifying revenue sharing.

that the computer systems of the IRS and the foreign government would have to be compatible, or the payor would be left with the technically challenging (if not impossible) task of creating and maintaining different programming formats for each country's investors. Given the problems the IRS seems to be having with its current computer system and the difficulties it is having coming up with a more modern system, it is hard to envision any circumstances in which other countries would find it worth their while to change their own systems to become more compatible with the U.S. system.[25]

A less perfect but perhaps more attainable goal would be to require payors to construct and send U.S. based information returns containing both the taxpayer's source and residence country tax identification numbers on a routine basis to each taxpayer's country of residence. Though matching in the residence country would have to be effected by hand, and the costs of doing so may prohibit complete matching, there could certainly be more matching than at present. Combined with a increase in penalties for nonreporting of (specifically) foreign income, this may be enough to significantly increase residence country tax compliance.

Whether this would be enough remains uncertain, however. Taxpayers may try to avoid residence country taxation by investing through intermediary companies resident in tax haven jurisdictions. The short term effect may be to increase returns to tax haven treasuries rather than the treasuries of "true" residence countries.[26] Ultimately, the only solution may be for source countries to withhold taxes from payments to taxpayers "resident" in tax haven countries while providing information returns for others.

[25] Although perhaps Treasury could use this as an excuse to investigate the operation of the computer systems used by other countries and identify one which it could use as a model for its own system. But we may not be alone in having a dysfunctional system.
[26] I.e. the country in which the individuals owning the tax haven entity's shares actually reside.

Whether such an information regime is susceptible to being undercut if taxpayers substitute derivative contracts for plain-vanilla securities transactions is also unknown.

We should soon have more information regarding the practicability of such a residence country taxation scheme because on July 1, 2005 the European Union began implementing its long awaited "savings tax directive." After more than a decade of negotiations, the 25 EU member states and 15 other countries or territories have begun implementing mechanisms designed to ensure that cross-border interest income does not escape income taxation. Depending on the country, each participating country agreed either to participate in an automatic information exchange system which reports interest income derived by a foreigner to his or her country of residence or to impose a withholding tax on interest income derived by foreigners, with the proceeds of the tax divided between the source and residence countries.

The EU scheme is hardly fool-proof. Among other things, by its terms it applies only to individual EU residents so business entities and residents of other jurisdictions—or those pretending to be residents of other jurisdictions—fall outside the reporting/withholding net. Moreover, it does not cover every potential source jurisdiction, particularly Asian financial centers. And by its terms it is limited to interest income.

Interestingly, despite British and other European pressure, the U.S. refused to sign on to the directive or to go beyond the information exchange requirements established in its bilateral treaties. Although EU eventually agreed that these treaty mechanisms were

comparable,[27] that is far from true. Not only is much information exchange only on request rather than automatic, the U.S. does not require banks to report interest paid to non-residents. Several reasons were given for failing to participate, including the reluctance to enter into treaties with the EU rather than its constituent members.

However, other statements were more troubling. In particular, some Congressmen expressed concern that by helping other countries collect taxes, the U.S. would become a less desirable investment locale, harming the local economy. Others objected to the inherent loss of privacy. The privacy issue seems overblown, particularly as applied to the EU. Given that we are willing to require U.S. citizens investing domestically to share this information with U.S. tax authorities, it is unclear why foreigners should be entitled to a higher standard of privacy protection.[28] And concern about the economic consequences of reporting are hypocritical at best. Not only does the U.S. purport to believe that its citizens should pay tax on worldwide income at U.S. rates, thereby undercutting other countries' attempts to attract U.S. investors by offering tax concessions or low tax rates, those making these statements appear not to appreciate the fact that while widespread underreporting may lead to more <u>foreign</u> investment in the U.S. it is likely to lead to less <u>domestic</u> investment in the U.S., as U.S. residents seek to avoid taxation by making similar investments abroad. Whether such a trade is a net benefit to the U.S. economy is uncertain at best.

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[27] The EU had to make such a finding for the savings directive to go into effect as its implementation was conditional on reaching agreements with specified other financial centers. EU members worried that without more widespread agreement, money would simply be moved to non-participating countries.

[28] Although there would be reason for concern if the foreigners resided in countries governed by tyrannical or dictatorial regimes, that does not describe the situation of any residents of EU countries. Inasmuch as the information sharing obligation would have been imposed by treaty, the U.S. should not have had to worry about its indiscriminate extension to other regimes.

What is certain is that in the absence of effective and automatic multilateral reporting to residence countries, countries will find it difficult and expensive to tax the foreign investment income of their residents. Knowing that the tax authorities will not have enough financial resources to track down more than a small percentage of taxpayers, many residents will decide to play the audit lottery. And, of course, the more taxpayers make such decisions, the better the odds in that lottery become. [Insert more detail about the foreign credit card enforcement action]

Residence country taxation is not the only alternative. Another possibility would be to revert to source taxation. Some increases in source taxation, as explained above, are probably necessary even if a widespread multilateral reporting system exists because not every country would agree to participate in such a system. As explained below, in some respects, source taxation works better than residence country taxation. However, it also has problems that residence taxation does not.

2. Source Taxation

Even if effective multilateral reporting existed, it would have gaps. Tax havens, and entities formed in tax havens, would pose particular problems since reporting of income to those jurisdictions would be fruitless. Further, moving from source to residence based taxation of passive income could shift net revenues from one country's treasury to another as not all jurisdictions have as much outgoing as incoming foreign investment. Given that much "passive" investment income reflects untaxed (at the business level) distributions of business income, it is far from certain that that shift is defensible. Effective taxation of passive income at source would solve those problems.

Other problems, however, would be created. These other problems probably outweigh the benefits of source taxation in most situations.

It is relatively simple for source countries to impose flat rate withholding taxes on many types of passive income due to their control over the payors of that income. Failure to withhold could be punished either by imposing joint and several liability on the payor (current rule) or in some other circumstances, the loss of a deduction for the payment being made. But source taxation would be difficult in some situations. If attempts were made to impose taxes on transfers of local securities, for example, taxpayers may try to escape such taxes by trading securities indirectly, holding such shares in companies established in tax haven jurisdictions and trading only the shares of the holding company parent. A special regime might be applied to shares held by tax haven entities. Every dividend or other cash distribution could be treated (and taxes withheld) as if it were both a dividend distribution and the concurrent sale of the stock. Appreciation in the value of the stock since the prior distribution could be treated as capital gain, and the relevant taxes deducted from the amount of the dividend distributed to the owner.

The more serious problem, of course, is that the withholding tax is of necessity a tax on gross income. Particularly if made to an entity that is part of a complex ownership structure, "cascading" taxation becomes an issue. To take the simplest example of this problem, assume a Corporation X established and operating in Country E which levies a 30 percent withholding tax on income earned within its borders by foreign passive investors. Corporation Z is established and operating in Country D, which has a 25% withholding tax on the income of foreigners, and Corporation Y is established and operated in Country F. Now suppose Corporation X pays a royalty of 10b to Corporation

Z, on account of which Corporation Z pays a royalty of 6b to Corporation Y. What should happen, tax-wise"? Surely X should withhold and pay 3b to E, leaving Z with 7b. But should Z withhold another 2b from its payment to Y, and remit this money either to E or D? If so, what started as a 10b royalty would be subject to 5b of taxes, for an effective tax rate of 50 percent. And the rate would go up if Y paid royalties to yet another party. That result seems wrong; the total tax rate seems excessive. Perhaps Y should be entitled to claim a tax credit against its liability for tax arising out of the second stage of the transaction, as corporations currently can for income taxes paid by their subsidiaries when those subsidiaries pay taxable dividend distributions. But how would this tax credit arrangement work if, for example, the payment to Y took the form of an interest rather than royalty distribution?

One may not have much sympathy when X, Y, and Z are related corporations; after all, they can avoid most if not all of their problems by avoiding the complicated ownership or transactional structure. Indeed, many complex structures exist largely to game the income tax system. However, not all X,Y, and Z combinations are related. Not all business enterprises are vertically integrated.

There is no easy (or perhaps even difficult) solution to this problem, which is one reason so many tax treaties eliminate source taxation on such income. Those who have worked with indirect foreign tax credits, the one form of pass-through credits currently utilized by the U.S. tax system, can attest to its complexities and inevitable failures. This suggests that source taxation on gross amounts of passive income should be restricted to potentially abusive situations. Of course, in the absence of effective residence taxation, that covers almost all transactions involving foreign payees!

Ensuring proper taxation of passive income is also important for ensuring proper taxation of business income, since one of the ways of avoiding taxation of business income is to transform that income into deductible distributions of untaxed passive income. If such passive income were subject to a substantial tax in a source or residence country, such maneuvers would be less valuable and, accordingly, less troublesome.[29] But it will take more than rationalizing the tax treatment of passive investment income to solve the problem of undertaxation of business income.

B. Taxing Business Income

The seemingly eternal tax policy question "capital import neutrality" versus "capital export neutrality"[30] has attained the importance it has largely because so much foreign sourced income goes untaxed at source. If foreign sourced income was subject to a full source tax in the country in which it was economically earned, in many if not most cases, the rate differential and thus the economic stakes in this dispute would be reduced, perhaps into insignificance. But the question is whether such source taxation is possible—and beyond that, if it is politically plausible. If it is technically possible but politically implausible, of course, that raises questions about political support for the concept of an income tax. One way of getting to a consumption tax is to pretend to have an income tax but not enforce it as it applies to capital income, which is more or less the situation we are now in. Whether the resulting tax regime is the best form of consumption tax is another question entirely.

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[29] They would continue to be valuable to the extent they generated "homemade integration", i.e. reduced the two-level tax on corporate earnings to a one-level tax. But that is a separate problem that is as pervasive in the wholly domestic sphere as it is in the foreign context.

[30] This roughly translates into "which is more desirable, to tax foreign sourced income at the rate prevailing in the country of source or the rate prevailing in the taxpayer's country of residence?"

The problem, as detailed earlier in the paper, is that the source rules have been constructed in such a way as to allow taxpayers considerable freedom to allocate their income to low tax jurisdictions, whether or not such income was earned there from an economic standpoint. Such freedom exists both because of adherence to a pricing standard that does not work in real world circumstances and because sourcing decisions often depend on formal criteria that have little or no underlying economic significance, leaving taxpayers free to rearrange their facts to minimize their tax obligations. The question is whether anything can be done about this.

The answer is surely yes. The source rules do not have to be constructed so that their outcome depends on how a transaction is structured as opposed to its economic realities. Neither do they have to depend on the uncertain science of determining arm's length transfer prices. Indeed, there is a model for an alternative approach: formulary taxation as used by the states of the U.S. to allocate income of multistate enterprises. Most states determine their share of a unified tax base (the entirety of a taxpayer's U.S. income) by a formula based on some weighted average of the taxpayer's property, payroll and sales located within the state to the taxpayer's total property, payroll and sales. The U.S. has been inching towards the formulary approach when it comes to allocating deductions; there would be no technical impediments to expanding that approach to the allocation of income.

This is not to say that it would be as simple as copying the formulary method used to allocate interstate income. As many have pointed out, the interstate experience with formulary taxation has not been a completely happy one. Taxpayers have learned to game the formula to over-allocate income to low tax or no tax states just as international

taxpayers use the source rules to over-allocate income to tax haven countries. However, drafters of a federal formula could draw lessons from the state experience to do a better job of constructing a federal formulary system. For example, it may be wise to eliminate moveable property such as securities and most forms of intellectual property from the allocation formula, and rely instead on "hard assets" such as buildings and other more easily sited factors such as payroll and sales. No formula, of course will be perfect. It certainly will not replicate the results that would be reached under a perfectly administered arm's length standard test. But in the real world, there is no such thing as a perfectly administered arm's length standard, and it is hard to believe that the U.S. would come up with a formula that would work less well than the current source rules.

There is little question, then, that the U.S. could do more to preserve its income tax base against tax machinations. The question is whether it should. The objection to doing so would be the same as that expressed by some as grounds for refusing to sign on to the EU savings tax directive: competition. Just as they worry about chasing away foreign passive investors by ensuring that they pay tax on their income, some people worry that if the U.S. imposes a substantial source tax on businesses operating in the U.S., one that is greater than that is levied on those businesses operating in other similar jurisdictions, the businesses may move their operations out of the U.S. and into those other jurisdictions. That is of course the worst of all worlds result for the U.S., since its tax revenues would decrease as its economic base disappears; it would be left with neither. In the spirit of "half a loaf is better than none," it can be argued that the better policy is to engage in surreptitious tax competition by allowing businesses to avoid taxation on their U.S. income through clever use of tax base machinations.

Which policy is better may well depend on whether we can get other, similar countries to adopt similar or identical changes in their tax systems (i.e. form a cartel). Indeed, even from a technical standpoint, their cooperation may be required. Most of our bilateral income tax treaties require us to determine the U.S. business income of treaty partner residents under the arm's length standard. But there are additional pitfalls. For example, even before the economic literature began suggesting that "to the extent tax rates vary across jurisdictions, formula-apportioned corporate income taxes are similar in their incidence to a set of implicit excise taxes on the apportionment factors,"[31] states of the U.S. had begun moving from an allocation formula that equally weighted property, payroll, and taxes towards a single factor sales allocation formula. This trend has only accelerated as the economic literature convinced state legislatures that sales were the least moveable of these factors, so that changing their formula to one heavily weighting sales location would reduce the costs of production and stimulate economic development in their jurisdiction. Should competition force the use of such a single factor formula, the economic incidence of the tax would closely resemble that of a value added tax. One then must wonder whether the easier road to that result would be the replacement of the corporate income tax with an explicit value added tax.

To put the issue in its starkest terms, the U.S. lacks the market power to impose significantly higher income taxes on businesses operating within its borders than those imposed by other similar countries. This does not mean that we have to compete, tax-wise, with Saudi Arabian or Tanzania or a host of other countries. But at the very least, we have to compete with Canada, Europe, and China. And to the extent they only

[31] Kelly D. Edmiston, "Strategic Apportionment of the State Corporate Income Tax," 55 National Tax Journal 239, 239-40 (2002).

pretend to tax business income, the U.S. will only be able to pretend to tax business income. However, if they are willing to be serious about taxing capital income, the U.S. can also be serious about taxing capital income.

Thus far, though, the reluctance to tax capital income appears to be coming from the U.S. rather than from those other countries. Refusing to sign on to the EU savings directive was not, from a technical perspective, a move in the right direction. But it may have been an honest indication of this administration's (lack of) desire to tax capital income.