International Tax as International Law

An Analysis of the International Tax Regime

REUVEN S. AVI-YONAH

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INTERNATIONAL TAX AS INTERNATIONAL LAW

This book examines the coherent international tax regime that is embodied both in the tax treaty network and in domestic laws, and the way it forms a significant part of international law, both treaty-based and customary. The practical implication is that countries are not free to adopt any international tax rules they please, but rather operate in the context of the regime, which changes in the same ways international law changes over time. Thus, unilateral action is possible, but is also restricted, and countries are generally reluctant to take unilateral actions that violate the basic norms that underlie the regime. The book explains the structure of the international tax regime and analyzes in detail how U.S. tax law embodies the underlying norms of the regime.

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For Michael and Shera, my globalizing children

Contents

1 Introduction: Is there an international tax regime? Is it part of international law? *page* 1

2 Jurisdiction to tax 22

3 Sourcing income and deductions 38

4 Taxation of nonresidents: Investment income 64

5 Taxation of nonresidents: Business income 79

6 Transfer pricing 102

7 Taxation of residents: Investment income 124

8 Taxation of residents: Business income 150

9 The United States and the tax treaty network 169

10 Tax competition, tax arbitrage, and the future of the international tax regime 182

Bibliography 189

Index 205

1

Introduction: Is there an international tax regime? Is it part of international law?

This book has a thesis: that a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based and customary). The practical implication is that countries are not free to adopt any international tax rules they please, but rather operate in the context of the regime, which changes in the same ways international law changes over time. Thus, unilateral action is possible, but is also restricted, and countries are generally reluctant to take unilateral actions that violate the basic norms that underlie the regime. Those norms are the single tax principle (i.e., that income should be taxed once – not more and not less) and the benefits principle (i.e., that active business income should be taxed primarily at source, and passive investment income primarily at residence).

This thesis is quite controversial. Several prominent international tax academics and practitioners in the United States (e.g., Michael Graetz, David Rosenbloom, Julie Roin, Mitchell Kane) and elsewhere (e.g., Tsilly Dagan) have advocated the view that there is no international tax regime and that countries are free to adopt any tax rules they believe further their own interests.[1] Other prominent tax academics (e.g., Hugh Ault, Yariv Brauner, Paul McDaniel, Diane Ring, Richard Vann) and practitioners (e.g., Luca dell'Anese, Shay Menuchin, Philip West) have supported the view just advocated.[2] However, there is no coherent exposition of this view in the academic or practical literature. This book is intended to fill this gap, following up on previous articles in which I developed the foregoing thesis.[3]

This chapter introduces the overall thesis of the book by addressing three issues. First, the chapter argues that an international tax regime exists, embodied both in the tax treaty network and in the domestic tax laws of the

[1] Graetz (2001); Rosenbloom (2000, 2006); Roin (2001); Dagan (2000); Kane (2004).
[2] dell'Anese (2006); Ring (2002); Menuchin (2004); Ault (2001); McDaniel (2001); Vann (2000); West (1996).
[3] For example, Avi-Yonah (1996, 1997, 2000a).

major trading nations. Illustrations are provided from recent developments that show countries such as the United States and Germany complying with basic norms of the regime, for example, nondiscrimination. Second, the chapter argues that the international tax regime is an important part of international law, as it evolved in the twentieth century. In particular, the chapter argues that parts of international tax law can be seen as customary international law and therefore as binding even in the absence of treaties. An example would be the arm's-length standard under transfer pricing. Finally, the chapter explains the basic structure of the international tax regime and its underlying norms, the single tax principle (income should be taxed once, no more and no less) and the benefits principle (active business income should be taxed primarily at source, passive investment income primarily at residence). The chapter further sets out the normative rationale for these norms and explains how U.S. tax rules fit in with them.

I. IS THERE AN INTERNATIONAL TAX REGIME?

The most important statement denying the existence of the international tax regime was the 1998 Tillinghast Lecture delivered by H. David Rosenbloom at the NYU law school.[4] Rosenbloom began his lecture by quoting from the legislative history of the U.S. dual consolidated loss rules a statement referring to an "international tax system." He then proceeded to deny the existence of this system or regime ("that system appears to be imaginary"), because in the real world, only the different tax laws of various countries exist, and those laws vary greatly from each other.

Of course, this description is true as far as it goes, but is this the whole truth? As Rosenbloom noted, in fact, there has been a remarkable degree of convergence even in the purely domestic tax laws of developed countries. Not only can tax lawyers talk to each other across national boundaries and understand what each is saying (the terminology is the same), but the need to face similar problems in taxing income has led jurisdictions with different starting points to reach quite similar results. For example, countries that started off with global tax systems (i.e., tax "all income from whatever source derived" in the same way) now have incorporated schedular elements (for example, the capital loss and passive activity loss rules in the United States), whereas countries with a schedular background (i.e., tax different

[4] Rosenbloom (2000).

types of income differently) have largely adopted schedules for "other income" that lead to a global tax base (for example, the United Kingdom).

Not surprisingly, this convergence is most advanced in international tax matters, because in this case the tax laws of various jurisdictions actually interact with each other, and one can document cases of direct influence. For example, every developed country now tends to tax currently passive income earned by its residents overseas (through controlled foreign corporations and foreign investment funds [FIF] rules, which were inspired by the U.S. example), and to exempt or defer active business income. Thus, the distinction between countries that assert worldwide taxing jurisdiction and those that only tax territorially has lost much of its force. We will develop other examples of such convergence in the course of the book.

The claim that an international tax regime exists, however, rests mainly on the bilateral tax treaty network, which, as Rosenbloom stated, is "a triumph of international law." The treaties are of course remarkably similar (even to the order of the articles), being based on the same Organisation for Economic Co-operation and Development (OECD) and UN models. In most countries, the treaties have a higher status than domestic law, and thus constrain domestic tax jurisdiction; and even in the United States, the treaties typically override contrary domestic law. This means that in international tax matters, countries typically are bound by treaty to behave in certain ways (for example, not tax a foreign seller who has no permanent establishment) and cannot enact legislation to the contrary.

I would argue that the network of two thousand or more bilateral tax treaties that are largely similar in policy, and even in language, constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties. These principles are the single tax principle and the benefits principle, which will be articulated further in later sections. In brief, the single tax principle states that income from cross-border transactions should be subject to tax once (that is, not more but also not less than once), at the rate determined by the benefits principle. The benefits principle allocates the right to tax active business income primarily to the source jurisdiction and the right to tax passive investment income primarily to the residence jurisdiction.

To those who doubt the existence of the international tax regime, let me pose the following question: Suppose you were advising a developing country or transition economy that wanted to adopt an income tax for the first time. How free do you think you would be to write the international tax rules for such a country in any way you wanted, assuming that it wished to attract foreign investment? I would argue that the freedom

of most countries to adopt international tax rules is severely constrained, even before entering into any tax treaties, by the need to adapt to generally accepted principles of international taxation. Even if divergent rules have been adopted, the process of integration into the world economy forces change. For example, Mexico had to abandon its long tradition of applying formulas in transfer pricing and adopt rules modeled after the OECD guidelines in order to be able to join the OECD. South Korea similarly had to change its broad interpretation of what constitutes a permanent establishment under pressure from the OECD. And Bolivia had to abandon its attempt to adopt a cash flow corporate tax because it was ruled not creditable in the United States. Even the United States is not immune to this type of pressure to conform, as can be seen if one compares the 1993 proposed transfer pricing regulations under IRC section 482, which led to an international uproar, with the final regulations, which reflect the OECD guidelines.

Another illustration can be derived from recent developments in both the United States and Germany regarding the application of the principle of nondiscrimination, which is embodied in all the tax treaties, to thin capitalization rules that are designed to prevent foreign taxpayers from eliminating the corporate tax base through capitalizing domestic subsidiary corporations principally with debt. When the United States first adopted its thin capitalization rule in 1989, it carefully applied it both to foreigners and to domestic tax exempts, so as not to appear to be denying interest deductions only to foreigners. The United States did this even though thin capitalization rules are an accepted part of international tax law and even though its constitutional law permits unilateral overrides of tax treaties. The Germans adopted the same rule, but when it was nevertheless struck down as discriminatory by the European Court of Justice in 2002, they responded by applying thin capitalization to all domestic as well as foreign taxpayers. Neither the United States nor the German actions are understandable in the absence of an international tax regime embodying the principle of nondiscrimination.

II. IS THE INTERNATIONAL TAX REGIME PART OF INTERNATIONAL LAW?

Few would dispute that the network of bilateral tax treaties forms an important part of international law. Thus, the key issue is whether these treaties and the domestic tax laws of various jurisdictions can be said

to form an international tax regime that is part of *customary* international law.

Customary international law is law that "results from a general and consistent practice of states followed by them from a sense of legal obligation."[5] "International agreements create law for states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted."[6]

There clearly are international tax practices that are widely followed, such as avoiding double taxation by granting an exemption for foreign source income or a credit for foreign taxes. Moreover, there are more than two thousand bilateral tax treaties in existence, and they all follow one of two widely accepted models (the OECD and UN model treaties), which themselves are quite similar to each other and are "intended for adherence by states generally." Is this enough to create a customary international tax law?

In the following, I will briefly survey some examples that in my opinion strengthen the view that the international tax regime rises to the level of customary international law. As usual, the hard question is whether countries not only follow a rule, but do so out of a sense of legal obligation (*opinio juris*).

A. Jurisdiction to tax

Can a country simply decide to tax nonresidents who have no connection to it on foreign-source income? The answer is clearly no, both from a practical perspective and, I would argue, from a customary international law perspective. The fact that this rule is followed from a sense of legal obligation is illustrated by the behavior of the United States in adopting the foreign personal holding corporation (FPHC) and controlled foreign corporation (CFC) rules, which will be described in more detail in Chapter 2. In the case of corporations controlled by U.S. residents, the United States does not tax those corporations directly, but rather taxes the U.S. resident shareholders on imaginary (deemed) dividends distributed to the shareholders. This deemed dividend rule was adopted precisely because the United States felt bound by a customary international law rule not to tax nonresidents directly on foreign-source income, even though they are

[5] Rest. 3rd (For. Rel.) sec. 102(2).
[6] Rest. 3rd (For. Rel.) sec. 102(3).

controlled by residents. The United States no longer feels bound by this rule, but that is because enough other countries have adopted CFC legislation that expands the definition of nationality that customary international law has changed. The spread of CFC legislation from 1962 onward is a good example of how rapidly customary international law can in fact change.

B. Nondiscrimination

The nondiscrimination norm (i.e., that nonresidents from a treaty country should not be treated worse than residents) is embodied in all tax treaties. But is it part of customary international law? The behavior of the United States in the earnings stripping episode just described suggests that the United States felt at the time that the nondiscrimination norm was binding even outside the treaty context. Otherwise, even if it did not wish to override treaties, it could have applied a different rule to nontreaty country residents (as it did in the branch profits tax context three years earlier). Thus, I would argue that the nondiscrimination norm may in fact be part of customary international law even in the absence of a treaty.

C. The arm's-length standard

The standard applied in all tax treaties to the transfer pricing problem of determining the proper allocation of profits between related entities is the "arm's-length standard," which means that transactions between related parties may be adjusted by the tax authorities to the terms that would have been negotiated had the parties been unrelated to each other. This standard has been the governing rule since the 1930s.

In the 1980s, the United States realized that in many circumstances it is very difficult to find comparable transactions between unrelated parties on which to base the arm's-length determination. It therefore began the process of revising the regulations that govern transfer pricing. This culminated in 1995 with the adoption of two new methods, the comparable profit method and profit split method, that rely much less on finding comparables (and in the case of profit split sometimes require no comparables at all).

What is remarkable about the process by which these regulations were adopted is the U.S. insistence throughout that what it was doing was consistent with the arm's-length standard. It even initially called profit split the "basic arm's-length return method." But as I have pointed out elsewhere, once you abandon the search for comparables, it is meaningless to call a

method "arm's length," because without comparables nobody can know what unrelated parties would have done.[7]

Nevertheless, despite initial objections, the OECD ultimately came to accept the gist of the new methods in its revised transfer pricing guidelines, which were issued a short time after the new U.S. regulations and represent the widely followed consensus view of transfer pricing. The new methods are thus accepted under the rubric of "arm's length."

As Brian Lepard has suggested, the U.S. insistence that it was following the arm's-length standard indicates that it felt that the standard is part of customary international law.[8] Such a finding has important implications because the U.S. states explicitly follow a non–arm's-length method, formulary apportionment, which has been twice upheld by the U.S. Supreme Court. If the arm's-length method is customary international law, these cases may have been wrongly decided, as customary international law is part of federal law and arguably preempts contrary state law.

D. Foreign tax credits versus deductions

Many economists argue that countries should only give a deduction for foreign taxes rather than a credit. However, countries generally grant either an exemption for foreign source income or a credit for foreign taxes paid. Remarkably, in most cases (following the lead of the United States) this is done even in the absence of a treaty. It is likely that at this point countries consider themselves in practice bound by the credit or exemption norm, and a country would feel highly reluctant to switch to a deduction method instead. Thus, arguably preventing double taxation through a credit or exemption has become part of customary international law.

E. Conclusion

If customary international tax law exists, this has important implications for the United States and other countries. As Justice Gray wrote more than one hundred years ago in the *Paquete Habana* case,

> [I]nternational law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction as often as questions of right depending upon it are duly presented for their determination. For

[7] Avi-Yonah (1995).
[8] Lepard (2000).

> this purpose, where there is no treaty and no controlling executive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations.

To the extent legislation exists, in the United States it can override customary international law as well as treaties. But in the absence of treaties or legislation, resort can be had to customary international law; and I would argue that it can also be used to ascertain the underlying purposes of treaties.

To the extent that customary international tax law exists, this suggests that it is a mistake to deny the existence of an international tax system or regime. Admittedly, even if an international tax regime exists, it does not follow what we should do about it – this has to be investigated in each particular case. But we should not pretend that there are no binding, widely accepted international tax norms that we should flout only when significant national interests are at stake. This view has important implications whenever differences between countries' domestic laws lead to the possibility of tax arbitrage, which will be discussed further in Chapter 10.

III. THE STRUCTURE OF THE INTERNATIONAL TAX REGIME

If an international tax regime exists, what does it look like? The following sections will first define the two basic principles that in my view underlie the international tax regime and why they are normatively justified. I will then illustrate how the U.S. international tax rules are generally consistent with these two principles.

A. Defining the tax base: The single tax principle

International income taxation involves two basic questions: (1) What is the appropriate level of taxation that should be levied on income from cross-border transactions? (2) How are the resulting revenues to be divided among taxing jurisdictions?

The answer to the first question is the single tax principle: income from cross-border transactions should be subject to tax once (i.e., neither more nor less than once). The single tax principle thus incorporates the traditional goal of avoiding double taxation, which was the main motive for setting up the international tax regime in the 1920s and 1930s. Taxing

cross-border income once also means, however, that it should not be undertaxed or (at the extreme) be subject to no tax at all.

The appropriate rate of tax for purposes of the single tax principle is determined by the second principle of international taxation, the benefits principle. The benefits principle, discussed later, assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions. Therefore, the rate of tax for purposes of the single tax principle is generally the source rate for active business income and the residence rate for passive (investment) income. When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible and may be necessary to prevent undertaxation. Such residual taxation means that all income from cross-border transactions, under the single tax principle, should be taxed at least at the source rate (which tends to be lower than the residence rate), but at no more than the residence rate.

What is the normative basis for the single tax principle? As an initial matter, I assume that most countries would like to maintain both a personal income tax and a corporate income tax. The reasons for having both a personal income tax and a corporate income tax have been discussed extensively elsewhere and are not repeated here.[9] For purposes of justifying the single tax principle, it is sufficient that most countries in fact maintain their existing personal and corporate income taxes.

Given a preference for imposing both a personal and a corporate income tax on domestically derived income of individuals and corporations, it becomes relatively easy to establish why the single tax principle is justified as a goal of the international tax regime, on both theoretical and practical grounds. From a theoretical perspective, if income derived from cross-border transactions is taxed more heavily than domestic income, the added tax burden creates an inefficient incentive to invest domestically. This proposition is widely accepted and underlies the effort, which by now is about a century old, to prevent or alleviate international multiple taxation.

The corollary also holds true: if income from cross-border transactions is taxed less heavily than domestic income, this creates an inefficient incentive to invest internationally rather than at home. The deadweight loss from undertaxation is the same as that from overtaxation.

In addition, there is also a strong equity argument against undertaxation of cross-border income, which applies to income earned by individuals.

[9] See, for example, Avi-Yonah (2002, 2004b).

From an equity perspective, undertaxation of cross-border income violates both horizontal and vertical equity when compared to higher tax rates imposed on domestic-source income, and in particular on domestic labor income. In this case, the argument that equity violations tend to turn into efficiency issues does not hold, because labor is less mobile than capital and wage earners typically do not have the ability to transform their domestic wages into foreign-source income.

On a practical level, the single tax principle can be justified because double taxation leads to tax rates that can be extremely high and tend to stifle international investment. Zero taxation, on the other hand, offers an opportunity to avoid domestic taxation by investing abroad, and therefore threatens to erode the national tax base. T. S. Adams, the architect of the foreign tax credit and a major influence in shaping the international tax regime, recognized both of these propositions in the 1920s. In justifying the foreign tax credit, Adams wrote, "The state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax." Contrary to an exemption system, Adams' credit operated to eliminate double taxation by both source and residence jurisdictions, but preserved residual residence-based jurisdiction to enforce the single tax principle.[10]

The practical justification for the single tax principle can be seen most easily if one imagines a world with only two countries, A and B, and only two companies, X (a resident of A) and Y (a resident of B). If both A and B tax the foreign source income of their residents and domestic source income of foreigners, and neither gives relief from double taxation, then both X and Y would minimize their taxes by only deriving domestic source income (because any foreign tax would by definition be an added burden). The result would be adequate revenues collected by both A and B, but no cross-border trade or investment.

On the other hand, suppose both A and B exempted from tax both foreign-source income and domestic-source income of foreigners (a not inconceivable proposition in many developing countries, which tax residents territorially and grant tax holidays to foreign investors). In that case, the way for both X and Y to minimize their taxes would be to derive their entire income from cross-border transactions. The result would be adequate cross-border trade, but no revenues for A or B. In a world in which international trade and investment are important, but taxes (unlike tariffs) cannot be reduced to zero, the single tax principle is the best option.

[10] Graetz & O'Hear (1997).

B. Dividing the tax base: The benefits principle

Having defined one goal of the international tax regime as taxing cross-border income once, the next question is how to divide that base among the various jurisdictions laying claim to it. The benefits principle states that the residence jurisdiction has the primary right to tax passive (investment) income, whereas the source jurisdiction has the primary right to tax active (business) income. As explained earlier, this division also determines the appropriate rate of tax for purposes of the single tax principle.

This distinction, which stems from the work of the League of Nations in the 1920s, also can be justified on both theoretical and pragmatic grounds. On a theoretical level, the benefits principle makes sense because it is primarily individuals who earn investment income, whereas it is primarily corporations that earn business income. In the case of individuals, residence-based taxation makes sense. First, residence is relatively easy to define in the case of individuals. Second, because most individuals are part of only one society, distributive concerns can be addressed most effectively in the country of residence. Third, residence overlaps with political allegiance, and in democratic countries, residence taxation is a proxy for taxation with representation.

In the case of multinational corporations, source-based taxation seems generally preferable. First, the grounds for taxing individuals on a residence basis do not apply to corporations. The residence of corporations is difficult to establish and relatively meaningless. Residence based on place of incorporation is formalistic and subject to the control of the taxpayer; residence based on management and control also can be manipulated. Moreover, multinationals are not part of a single society and their income does not belong to any particular society for distributive purposes. Finally, multinationals can exert significant political influence in jurisdictions other than the residence jurisdiction of their parent company, and therefore the concern about taxing foreigners who lack the ability to vote is less applicable to them.

Second, source-based taxation is consistent with a benefits perspective on justifying tax jurisdiction. Source jurisdictions provide significant benefits to corporations that carry on business activities within them. Such benefits include the provision of infrastructure or education, as well as more specific government policies such as keeping the exchange rate stable or interest rates low. These benefits justify source-based corporate taxation in the sense that the host country's government bears some of the costs of providing the benefits that are necessary for earning the income. As T. S. Adams wrote in

1917, "A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment." These costs justify imposing a tax as compensation to the government bearing them.

On a more pragmatic level, as Adams also observed, because the source jurisdiction has by definition the "first bite at the apple," that is, it has the first opportunity to collect the tax on payments derived from within its borders, it would be extremely difficult to prevent source jurisdictions from imposing the tax. "Every state insists upon taxing the non-resident alien who derives income from source [sic] within that country, and rightly so, at least inevitably so." Thus, as Michael Graetz and Michael O'Hear observe, even if economists tend to prefer pure residence-based taxation, this recommendation is unlikely to be followed in practice.[11] This is particularly the case for business income derived from large markets, in which case there is little fear that the foreign investor will abandon the market because of source-based taxation. For portfolio investment, however, even large source countries such as the United States have tended to abandon it for fear of driving away mobile capital. Thus, business income is a better candidate for source-based taxation than investment income.

The division between active (mostly corporate) and passive (mostly individual) income also makes sense because it is congruent with the single tax principle, because most of the rate divergence among taxing jurisdictions arises in the individual income tax, whereas corporate tax rates have tended to converge. The top marginal personal income tax rate among OECD member countries varied in 2006 from 7.5 percent (Switzerland) to 53.8 percent (Germany). This variability is acceptable for purposes of the single tax principle, because under the benefits principle most income earned by individuals in cross-border transactions is investment income that generally is subject only to residence country tax. Therefore, the residence country rate typically determines the single tax rate for investment income.

Corporate tax rates, on the other hand, do not vary so widely (and also tend to be flat, rather than progressive). Among OECD member countries, in 2006 the corporate tax rate ranged from 8.5 percent (Switzerland) to 35 percent (United States), but twenty-two of thirty member countries had rates in the 25 percent to 35 percent range. Thus, for purposes of the single tax principle, the rate applied is generally the residence rate for individual (mostly investment) income and a rate in the 25 percent to 35 percent range for corporate (mostly business) income. It is congruent with both

[11] Graetz & O'Hear (1997).

Table 1. *The structure of the international tax regime*

World			
Residents		Nonresidents	
Active	Passive	Active	Passive
Low tax	High tax	High tax	Low tax

This table will be the basis of our analysis of the details of the international tax regime in the following chapters.

the single tax and benefits principles, however, to have residual taxation by residence or source jurisdictions in cases where the jurisdiction that has the primary right to tax under the benefits principle refrains from doing so. Thus, under the single tax and benefits principles, all income from cross-border taxation under current rate structures should be taxed at a rate between approximately 25 percent (the lower end of the source rates) and approximately 55 percent (the higher end of the residence rates).

Neither the single tax principle nor the benefits principle provides a clear answer to the question of how to divide the corporate income tax base among the various jurisdictions providing benefits. Market prices can provide an answer when transactions are at arm's length, but not when they are between related parties (and there are no comparable arm's-length transactions). In addition, the single tax principle requires that taxation be imposed even on income derived from a jurisdiction that chooses not to levy a tax in return for the benefits it provides. These issues will be addressed further in a later section.

It is useful to summarize the resulting structure of international taxation in Table 1, which divides the world into two categories of taxpayers, resident and nonresident. For each category, there is a further division between active (business) and passive (investment) income. Active income is taxed primarily at source, whereas passive income is taxed primarily at residence.

C. How U.S. tax rules fit the international tax regime

As an illustration, this section will discuss how the U.S. tax rules (both domestic law and treaty-based rules) fit the international tax regime just described.

The fundamental distinction underlying the U.S. international tax regime is between domestic taxpayers (U.S. citizens, residents, domestic

corporations, partnerships, and trusts), who are taxed on their worldwide income, and foreign taxpayers (all others), who are taxed only on their U.S.-source income. Domestic taxpayers are taxed by the United States because of their personal connection to the United States, that is, on the basis of residence; the United States does, however, include nonresident U.S. citizens in this category. Foreign taxpayers are taxed by the United States on the basis of their territorial connection to the United States, that is, on the basis of source. One problem that is raised by this distinction is that the choice between being taxed on a residence or source basis is initially left to the taxpayer, because corporations are classified as domestic or foreign based on their formal place of incorporation. Therefore, it is possible for a domestic taxpayer to shift income from residence- to source-based taxation by routing it to a corporation incorporated abroad; if the income is foreign source (and not effectively connected with the conduct of a trade or business in the United States), the result is the avoidance of current U.S. taxation. Much of the complexity of the current U.S. international tax regime stems from attempts to address this problem through antideferral regimes.

1. *Foreign taxpayers*

The active or passive distinction is reflected in the two ways in which the United States taxes foreign taxpayers on income derived from sources within the United States. Income that is effectively connected with a U.S. trade or business, which includes primarily active business income, is taxed on a net basis in the same way as it would have been taxed if earned by a domestic business. On the other hand, "fixed or determinable, annual or periodic" income (FDAP), which includes passive income, is nominally taxed on a gross basis at a relatively high rate (30 percent), but a combination of source rules, statutory exemptions, and tax treaties results in such income being generally taxed only when earned by foreign businesses as part of their active business operations; such income generally is not taxed when earned by portfolio investors.

a. Active business and effectively connected income

The taxation of active business operations in the United States is relatively straightforward. Income that is effectively connected with a U.S. trade or business is taxed at the regular rates and on the same net basis as income earned by domestic taxpayers. The crucial terms, *trade or business* and

effectively connected, are not defined in the Code (with certain exceptions), but a series of rulings and court cases has sought to distinguish active business operations, which are subject to this regime, from mere investment activity, which is not subject to it. In particular, since 1966, the United States generally has not treated passive earnings of foreign businesses in the United States as subject to tax on a net basis unless the assets or operations of the business participated in generating the income. In addition, a specific Code provision excludes investments made through a U.S. broker from being treated as a trade or business for this purpose.

In general, the definition of effectively connected income corresponds to the economic definition of active business income. However, effectively connected income is in some respects broader, and in others narrower, than active business income from U.S. sources. First, the source rules operate to exclude from the U.S. taxing jurisdiction income that would not be subject to U.S. tax under the permanent establishment threshold of tax treaties. In particular, income from sales is generally sourced according to the residence of the seller, and income from sales of purchased inventory is sourced according to passage of title (a formal attribute totally within the taxpayer's control) unless such income is attributable to a U.S. office or other fixed place of business. Similarly, income from international communications and from activities in space – two of the newer additions to the source rules – is sourced according to the residence of the seller and, thus, is not subject to U.S. tax if the seller is foreign unless it is attributable to a U.S. office or fixed place of business. These rules reflect the international consensus that source-based taxation of active business income should be limited to business operations that exceed a certain minimal standard of activity in the host country.

In certain cases, the United States treats passive income as effectively connected income. For example, capital gain from the sale of real property located in the United States is treated as effectively connected income even if the foreign investor plays an entirely passive role. In other cases, income that is not clearly active or passive is treated as active. This is true, for example, if U.S.-source income is not effectively connected but is also not FDAP (such as capital gains of an active U.S. business from its portfolio investments).

b. Passive income

It is more difficult to see how the United States follows the international tax regime regarding the taxation of passive income because the statute

provides for a heavy 30 percent withholding tax on gross passive income from U.S. sources. In this case, however, it is necessary to look beyond the basic statutory rate and to determine how often the current regime actually imposes it. In effect, through a combination of source rules, treaties, and statutory exemptions, few items of income from the portfolio investments of foreign taxpayers end up being subject to the 30 percent tax. In 2003, foreigners earned approximately $26 billion in passive income (including passive income of controlling shareholders), but the United States collected only about $4 billion from all its withholding taxes together, an effective rate of only 12.5 percent. Approximately an additional $42 billion of passive income was exempt from tax under the provisions described next.

(i) Capital gains. First, it should be noted that capital gains, which are a form of passive income, have never been subject to withholding, except in the case of real property. Thus, a nonresident's gain from the sale of stock in a U.S. corporation is untaxed by the United States, even though it represents the present value of the future stream of income from the stock.

(ii) Interest. The most prevalent exemption from the nominal 30 percent withholding tax is interest, which, under an exemption enacted in 1984, is not subject to tax if earned by foreign portfolio investors. The exceptions to this exemption are instructive. One exception addresses foreign banks making loans into the United States in the ordinary course of their business, in which case the interest represents active business income. Another exception to the portfolio interest exemption concerns interest paid to foreign shareholders who own more than 10 percent of the stock of the payer. This rule reflects the distinction outlined earlier between active and portfolio income on the basis of control, and it also provides some deterrent against controlling shareholders' attempts to disguise dividends as interest. Similarly, another rule restricts the application of the exemption to contingent interest, which is similar to dividends and thus subject to abuse in the hands of controlling shareholders.

In addition, yet another rule restricts the deductibility of interest paid to foreign related parties (generally, under a 50 percent common ownership threshold) if the payer's debt-to-equity ratio is too high. This "earnings stripping" rule is also designed to backstop the interest or dividends distinction and to prevent too high a percentage of U.S. business profits from being paid out as deductible interest to controlling shareholders. The combination of the 10 percent stock ownership limit on the portfolio interest exception and the limits on deductibility keeps a foreign enterprise engaged

in an active business operation in the United States through a subsidiary from escaping U.S. tax by paying interest that is not subject to withholding and that reduces the profits of the subsidiary, although that result can still be achieved by financing the subsidiary from an unrelated foreign entity (as long as it is not a "bank"). The emphasis on related parties in both the earnings stripping rule and the 10 percent stock ownership exception reflects the sense that a related foreign party is really engaged in active business in the United States through its control of its subsidiary, and that the interest income it receives represents more than purely passive income. Thus, these rules run contrary to the formal distinction between the foreign parent and the subsidiary – the internationally accepted definition of a permanent establishment excludes a parent from being treated as engaged in an active business in a country merely because it controls a subsidiary – but the rules are congruent with a view that restricts passive income to portfolio income.

(iii) Dividends. The situation in the case of dividends is more complicated. Unlike interest, which is not subject to withholding under the U.S. Model Treaty, dividends are usually subject to taxation at their source (at 5 percent or 15 percent, depending on whether or not they are paid to shareholders owning 10 percent of the payer or not) even if a treaty is in place (although some recent U.S. treaties reduce the dividend withholding rate to zero in the case of over 80 percent controlled subsidiaries). Second, dividends are subject to potential triple taxation: they are not deductible to the payer, they are subject to withholding, and they are potentially subject to tax in the hands of the recipient (subject to foreign tax credit or exemption). Thus, dividends are a tax-inefficient way of repatriating the earnings of U.S. corporations.

Nevertheless, even in the case of dividends, certain rules operate to reduce the likelihood that portfolio dividends will be subject to effective source-based taxation. First, the source rule for dividends, like the rule for interest, is formalistic: dividends are sourced according to the residence of the payer. In the absence of other rules, this would mean that a foreign corporation whose entire income is effectively connected with its U.S. trade or business could pay dividends to foreign shareholders without withholding tax being imposed. In fact, however, the source rule has been modified to make such dividends U.S.-source income in certain cases; but in practice, the Treasury Department has found it impossible to enforce withholding on dividends paid by a foreign corporation to foreign shareholders and is forbidden from doing so by many U.S. treaties. To counteract this result, Congress in 1986 enacted the branch profits tax, which seeks to impose an

equivalent tax on the earnings of the foreign corporation that are withdrawn from its U.S. trade or business. Although the branch profits tax operates as a replacement for withholding on dividends (and interest) paid by the foreign corporation from its U.S. business, note that unlike a withholding tax on dividends, the branch profits tax is an additional tax on the corporation engaged in an active U.S. business, which may or may not be passed on to the passive investors in that corporation. In addition, the United States has agreed with many of its treaty partners to refrain from imposing the branch profits tax on corporations resident in the other country, and in fact, the United States collects very little revenue from the tax.

Second, in many cases, dividends can be disguised as interest, with respect to which small investors can take advantage of the portfolio interest exemption. Although the 1993 Tax Act reduced the size of this loophole, it still exists, for example, in the case of interest based on the value of publicly traded stock.

Third, the tax on dividends can be avoided for portfolio investors by the use of derivatives, such as equity swap. Under an equity swap, a foreign investor receives a return that is identical to the dividends on the underlying stock, but such substitute payments are not usually treated as U.S. source and therefore not subject to withholding tax.

The combination of opportunities for avoidance just described means that dividend withholding is infrequent for portfolio investors.

(iv) Rents and royalties. The withholding tax on royalties and rents is slightly harder to avoid than the tax on dividends or interest because the source rule is less formalistic and more reflective of economic reality. Royalties and rents are sourced according to the place where the asset that gives rise to them is used. However, the United States, like most industrialized countries, negotiates for a 0 percent withholding rate on rents and royalties in its tax treaties. Moreover, even in the absence of a treaty, companies can frequently recharacterize royalties as sale proceeds or as income from services, and in both cases, favorable source rules exist that allow taxpayers to avoid U.S. withholding taxes altogether.

To sum up, the taxation of foreign taxpayers generally follows the active or passive distinction. Active income – income effectively connected with a U.S. trade or business – is subject to U.S. tax at its source. Passive FDAP income is nominally subject to withholding taxes, but because of the operation of statutory rules (e.g., the portfolio interest exemption), source rules (e.g., the formal rules for sourcing dividends, interest, and wages), and treaties (e.g., the 0 percent rate on interest and royalties), the

United States frequently does not tax such income in the hands of portfolio investors.

2. *Domestic taxpayers*

Domestic U.S. taxpayers are taxed on their worldwide income, but a foreign tax credit is given for foreign income taxes on foreign-source income up to the U.S. tax rate. This suggests that U.S. policy is to give the source country primary tax jurisdiction over all types of income. Although this is true to some extent, a combination of statutory rules results in passive foreign income being treated far less favorably than active foreign income, so that in practice, the United States is more likely to respect the primary right of the foreign jurisdiction to tax active income than passive income.

a. Deferral

The first distinction between active and passive income involves deferral. The possibility of deferring current U.S. tax on foreign-source income results from the fact that only domestic taxpayers are taxed on their worldwide income and that taxpayers can easily choose between classification as foreign or domestic according to the formal jurisdiction of their incorporation. If only these rules applied, a taxpayer could defer current U.S. tax on foreign-source income simply by routing it to a subsidiary incorporated abroad. If the subsidiary were incorporated in a tax haven, the result would be no current taxation of the foreign-source income of the subsidiary, which is equivalent to a tax exemption for the interest on these earnings for the period of deferral. This would amount to virtually complete exemption in present-value terms if the deferral lasts long enough.

Such favorable treatment of foreign-source income would encourage U.S. taxpayers to route their income to foreign "incorporated pocketbooks." To counter this tendency, the United States has historically adopted a complex set of overlapping antideferral regimes, all of which result either in current taxation of the foreign-source income to controlling U.S. shareholders or in an interest charge on the income when it is repatriated to the United States. The earliest of these regimes, dating from 1937, applied only to foreign corporations controlled by five or fewer U.S. individuals. In 1962, the antideferral mechanism was applied to foreign corporations controlled by U.S. corporate as well as individual shareholders, and in 1986, it was extended to all U.S. shareholders of foreign corporations, even if they only hold a minuscule percentage of the shares.

It should be noted, however, that the common feature of all of these regimes (three of which were abolished in 2004, leaving three others), is that they apply only to passive foreign income. In 1962, the original Kennedy administration proposal for eliminating deferral on all the foreign earnings of controlled foreign corporations was defeated, as were similar proposals in the 1970s, and no movement in this direction seems to be likely.

The result of this combination of regimes is that active foreign income enjoys a privileged position over passive foreign income. Although passive foreign income may be taxed currently even to noncontrolling U.S. shareholders, most active foreign income is not, even if the active income is not currently taxed overseas. Thus, the United States unilaterally grants the source jurisdiction the primary right to tax active income and does not assert residual jurisdiction even if the foreign country does not exercise that right, as long as the income stays abroad; but it asserts its residence jurisdiction to tax currently passive foreign income, albeit with a foreign tax credit (up to the U.S. tax rate) to avoid double taxation of that income.

b. Foreign tax credit

A second significant distinction in favor of source-based taxation of active foreign income involves the operation of the foreign tax credit. As revised in 1986, the limitation on the credit (by which the credit is limited to the U.S. tax rate on foreign-source income) is further limited by applying it separately by categories of income ("baskets"). Until 2004, there were nine such baskets, but from 2004 on there are only two – passive and active.

The exception to this "basket" system has always been active foreign-source income, which is all lumped into one residual category. This means that high foreign taxes on active income can usually be credited in full if the U.S. corporation can find a low-taxed source of active foreign income. For example, suppose that U.S. corporation X has $100 in U.S.-source income and $100 in foreign-source income from Germany, which is subject to a German tax rate of 50 percent. In that case, X will end up with a high effective tax rate and $15 of excess foreign tax credits: X's foreign tax credit will be limited to $35 (35 percent [the U.S. tax rate] × $100 [X's foreign-source income]); X's U.S. tax liability will be $35 (35 percent × $200 [worldwide income] = $70 [tentative U.S. tax] − $35 [foreign tax credit allowed by the limitation]); X's total worldwide tax liability will be $85 ($50 [German tax liability] + $35 [U.S. tax liability]), an effective tax rate of 42.5 percent; and X will have $15 of excess foreign tax credits ($50 [foreign tax liability] − $35 [United States foreign tax credit]). If in this situation X can find a foreign

country that does not tax active income (e.g., Malaysia, which grants tax holidays to foreign investors) and from which it can earn an additional $100 of foreign-source income, its effective tax rate will be dramatically lower: X can credit the entire amount of foreign taxes paid (35 percent [the U.S. tax rate] × $200 [X's foreign-source income] = $70 [U.S. foreign tax credit limit], which is greater than X's total foreign tax liability of $50); X's U.S. tax liability will be $55 (35 percent × $300 [worldwide income] = $105 [tentative U.S. tax] − $50 [U.S. foreign tax credit]); X's total worldwide tax liability will be $105 ($50 [German tax liability] + $55 [U.S. tax liability]), an effective tax rate of 35 percent, or 7.5 percent less than before.

This ability to average active foreign income from several sources for foreign tax credit limitation purposes gives a significant incentive to U.S. taxpayers who operate abroad to invest in foreign jurisdictions that levy low effective tax rates on the taxpayers' active business income, because this will enable them to credit the often higher foreign taxes imposed on business operations in other countries.

To sum up, active foreign business income of domestic taxpayers is not taxed by the United States currently if earned through a foreign subsidiary until it is distributed to the U.S. taxpayer (as a dividend, as interest, or even as a loan), even if there is no source-based taxation. Moreover, even when it is distributed, such active income retains a privileged position because the averaging rules generally allow a credit against all foreign taxes on such income, so that the United States will rarely levy even residual taxes on this income. Passive foreign income, on the other hand, is taxed currently (or is subjected to an interest charge), and taxpayers are discouraged from investing such income in countries imposing high taxes at the income's source by effectively denying a foreign tax credit for such taxes by segregating them into a separate basket. As a result, the United States most often will get to tax such passive income currently and in full. Whereas the United States retains the residual right to tax active income as the residence country and recognizes the primary right of other countries to tax passive income at its source, these rules promote – as the international tax regime would indicate – source taxation of active income and residence taxation of passive income, even in the absence of a tax treaty with the United States.

2

Jurisdiction to tax

I. INTRODUCTION

The traditional grounds of jurisdiction to prescribe in international law are *nationality* ("the activities, interest, status or relations of [a state's] nationals outside as well as within its territory") and *territoriality* ("conduct that, wholly or in substantial part, takes place within [a state's] territory").[1] Territoriality is expanded to cover conduct outside a state's territory that has, or is intended to have, a "substantial effect" within its territory. As we shall see, international tax law modifies both concepts to a significant extent, resulting primarily in expanding the scope of nationality jurisdiction.

II. INDIVIDUALS: REDEFINITION OF NATIONALITY JURISDICTION AS RESIDENCE

Nationality is usually considered to be equivalent to citizenship. However, with the exception of the United States, almost no other country in the world claims the right to tax its citizens on foreign-source income when they live permanently in another country. The United States reserves the right to tax its citizens on worldwide income no matter where they live (IRC secs. 1, 2(d), 7701(a)(30)), a practice upheld by the Supreme Court in *Cook v. Tait* based on the benefits the United States provides its citizens even if they live overseas. However, the opinion is weak, its underlying rationale is doubtful given the limited benefits available to American citizens overseas, and almost no other country follows the rule. Thus, although international law seems to sanction the U.S. practice (and the United States has written it into all its tax treaties), it faces academic criticism and seems a dubious rule to follow.

[1] Rest. 3rd Foreign Relations Law U.S. sec. 402.

Instead, every country in the world (including the United States) has adopted a definition of nationality for tax purposes that is much broader than citizenship. That definition is residence, which usually implies mere physical presence in the country for a minimum length of time. In the United States, physical presence for 183 days in a given year is generally sufficient to subject an individual to taxing jurisdiction on her worldwide income for that year; this number is even smaller if time was spent in the United States in the preceding two years. Other countries follow a similar rule, which is also sometimes supplemented with a "fiscal domicile" test that looks to less definitive factors including location of principal abode, family ties, and the like. These physical presence and fiscal domicile tests are also incorporated into tax treaties.

This new definition of nationality is a remarkable expansion of the concept of nationality. Perhaps no other substantive area of international law exists in which nationality jurisdiction for individuals is determined by so dubious a ground as mere physical presence. In fact, because of this expansive view, it is quite possible for an individual to be subject to residence-based taxation by a country in one year and not in the next or for an individual to have dual tax residency. Elaborate rules are necessary to address situations in which individuals move in and out of resident status from year to year (e.g., rules on deemed sales of their property when they leave) and to avoid dual-residence double taxation.

Why has nationality-based jurisdiction been expanded so dramatically in tax law? The reason becomes evident if one considers the implications of the relative ease of acquiring a tax haven nationality. If tax law followed the general international law rule and imposed worldwide taxation only on citizens, then it is conceivable that some U.S. citizens might abandon their U.S. citizenship in exchange for that of a tax haven jurisdiction, thereby avoiding taxation on their foreign-source income while living permanently in the United States. In general, living in a country for at least half a year is considered a sufficient ground for worldwide taxation because of the presumed benefits derived from that country.

The residence rule is so widely followed and is incorporated into so many treaties that it can be considered part of customary international law, even though it seems contrary to widely shared understandings of nationality. It is thus appropriate for the United States to follow this rule. It is doubtful, however, whether the United States should continue to insist on taxing its citizens living overseas, especially because a combination of exemptions and credits (in addition to enforcement difficulties) means that this practice generates little tax revenue.

III. CORPORATIONS: EXPANSION OF NATIONALITY JURISDICTION TO CFCS

The nationality of corporations is an equally difficult issue and is relevant to other areas of the law as well. In general, corporations are considered nationals based on the country in which they are incorporated (the U.S. approach), the country from which they are managed and controlled (the U.K. approach), or both. Each approach has its advantages and disadvantages; the U.S. approach is the easiest to administer but also the most manipulable, as shown recently by so-called inversion transactions in which corporations shifted their nominal country of incorporation to Bermuda while retaining all of their headquarters and management in the United States. The U.K. approach is less easily manipulated but requires more administrative resources to police.

The interesting aspect of nationality jurisdiction for corporations in tax law is the gradual adoption of a rule that permits countries to tax "controlled foreign corporations" (CFCs), that is, corporations controlled by nationals, as if they were nationals themselves. This rule originated with the United States. Because the definition of corporate nationality in the United States is formal (country of incorporation), it is easy for U.S. nationals (residents) who have foreign-source income to avoid taxation on such income by shifting it to a corporation incorporated in another country, preferably a tax haven, where it can accumulate tax free. For example, Jacob Schick, the inventor of the Schick disposable razor, transferred his razor patent to a Bermuda corporation that accumulated the royalties; Schick later proceeded to give up his U.S. citizenship and retire to Bermuda, where he lived on the accumulated tax-free profits.

To address this problem, the United States adopted a rule in 1937 that taxed shareholders in "foreign personal holding corporations" (FPHCs). An FPHC was defined as a foreign corporation controlled (over 50 percent by vote) by five or fewer U.S. resident individuals, and whose income was over 60 percent passive (since passive income was considered easier to shift than active income). Interestingly, at the time, the United States considered it a breach of international law to tax a FPHC (a foreign national) directly on foreign-source income; instead, it adopted a rule that taxed the U.S. shareholders on a deemed dividend of the accumulated passive income of the FPHC. This rule can be compared to the personal holding company (PHC) regime adopted at the same time, which applied to domestic corporations and taxed them directly on their accumulated income at the shareholder rate (PHCs were used by shareholders to shelter U.S.-source income from

the higher individual rate by earning the income through a corporation subject to tax at a lower rate).

The deemed dividend rule was upheld by Judge Frank of the Second Circuit without considering its international-law implications. And yet, it clearly represented a major expansion of U.S. residence taxing jurisdiction, because taxing a deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign-source income. It could certainly be argued that this rule was a breach of international law when it was upheld in 1943, just as Judge Hand's *Alcoa* antitrust decision (1945), which invented the effects doctrine, was likewise arguably a breach of international law.

The impact of the deemed dividend rule was greatly expanded when the Kennedy administration decided in 1961 to propose applying the same rule to all income of corporations that are over 50 percent controlled by large (10 percent by vote each) U.S. shareholders, that is, to subsidiaries of U.S. multinationals (CFCs). Ultimately, this resulted in the enactment in 1962 of "Subpart F," which applied the deemed dividend rule to certain types of income (mostly passive income) of all CFCs.

Again, there was no international law challenge to the deemed dividend rule. Instead, other countries began to copy the CFC regime: Germany (1972), Canada (1975), Japan (1978), France (1980), and the U.K. (1984). Currently, there are twenty-six countries with CFC rules (mostly developed ones), and this number is likely to increase. Thus, the CFC concept has arguably become part of customary international law, in the same way that the expansion of territorial jurisdiction over international waters rapidly changed international law from the 1970s onward.

Even more striking is the fact that many of the countries adopting the CFC rule abandoned the deemed dividend idea, which can lead to significant difficulties in practice, in favor of direct taxation of the CFC's shareholders on its earnings on a pass-through basis.[2] Thus, the jurisdictional rule has been changing and no longer seems to require a deemed dividend; it may even permit direct taxation of a CFC on its foreign-source income because it is controlled by residents. Indeed, the IRS itself has adopted this view, because it now believes that both the PHC regime and the older accumulated earnings tax regime can apply directly to foreign corporations even though their effect is to tax the corporation on foreign-source income. This is particularly striking for PHCs, because lawmakers in 1937 were so sure that the United States had no jurisdiction to tax foreign corporations on foreign-source income that Congress did not bother to specify that a

[2] Avi-Yonah (2004b).

PHC could not be a foreign corporation (Congress concurrently adopted the parallel FPHC regime explicitly for foreign corporations). Today, this oversight enables the IRS to argue that under the new understanding of jurisdictional limits, the PHC rules as well as the FPHC rules apply to foreign corporations. (The PHC rules were amended in 2004 to exclude foreign corporations because they are subject to the stricter Passive Foreign Investment Company (PFIC) rules, but they still apply to earlier years, and the accumulated earnings tax continues to apply to foreign corporations.)

Claiming that nationality jurisdiction applies to foreign corporations solely because they are controlled by nationals is a striking departure from ordinary international law. Compare, for example, the oft-recurring disputes about the extraterritorial application of international sanctions. In both the *Fruehauf* (1965) and *Sensor* (1982) cases, the foreign courts explicitly rejected U.S. claims to require foreign subsidiaries of U.S. multinationals to obey U.S. sanctions aimed at China and the USSR. In *Sensor*, the Dutch court went through all the possible grounds for jurisdiction and explicitly found that none applied, even though the subsidiary was controlled from the United States.

What, then, enables the United States and other countries to expand nationality jurisdiction to subsidiaries in the tax area? The explanation is the "first bite at the apple rule," adopted by the League of Nations in 1923. Under that rule, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. Thus, permitting the expansion of residence jurisdiction to CFCs does not harm the right of source jurisdictions to tax them first; residence (nationality) jurisdiction only applies as a residual matter when the source jurisdiction abstains from taxing. Source jurisdictions sometimes argue that the residence jurisdiction interferes with their right to effectively grant tax holidays to foreign investors, but even that is mitigated by the restricted application of CFC rules to passive income.

This story illustrates the growth of customary international law in the tax area. Between the 1930s and 1960s, there was a clear rule of customary international law that prohibited taxing foreign corporations on foreign-source income. That rule was universally observed and was considered binding, as illustrated by the U.S. effort to avoid an outright breach through the deemed dividend mechanism. However, after other countries changed the rule by taxing shareholders directly on CFC income, the United States no longer considered it to be binding, as indicated by the application of the PHC regime to foreign corporations. If the United States were to continue

in this path, the next step would be to abolish the obsolete deemed dividend rule and replace it with a direct tax on the CFCs.

IV. THE PROBLEM OF TERRITORIAL JURISDICTION (SOURCE)

The right of countries to tax income arising in their territory is well established in international law. In fact, some countries (e.g., France) begin with the assumption that the only income they have the right to tax is domestic-source income, although France and other territorial jurisdictions have long since begun to tax some income of nationals from foreign sources. Even countries that assume worldwide taxation of nationals, such as the United States and the United Kingdom, do not in practice tax foreign-source income as heavily.

The special problem of territoriality in the tax area is that the source of income is difficult to define. In fact, many public finance economists would claim that the concept lacks meaning in the majority of cases. Consider a law firm in country A that provides advice on the legal implications of a merger of two multinationals whose parents are in countries A and B and whose operations are in twenty countries around the globe. What is the economic source of the law firm's income?

Ideally, one could imagine a world in which all countries tax only on a nationality (residence) basis, and the only problem would be assigning residence to individuals (relatively simple) and to corporations (more difficult). In practice, however, the problem of defining source would persist as long as countries desire to tax nonresidents on domestic-source income, as they are permitted to do under international law.

This problem has been partially resolved by arbitrary rules embodied in tax treaties (which arguably form part of customary international law) that define the source of various categories of income. For example, income from services is sourced where the services are provided (and not where they are consumed); dividend and interest income is sourced by the residence of the payer; capital gains are sourced by the residence of the seller; and so on. The difficulty arises in determining the category of income, which may be very hard (consider, for example, how to distinguish among sales, services, and royalty income when downloading software off the Internet, buying it in a store, or receiving it in a preinstalled package on a PC).

In the case of multinationals, the sourcing issue becomes even harder because taxation requires allocating the income of a controlled group of

corporations among taxing jurisdictions. If tax authorities merely followed the form (regarding which subsidiary nominally earned the income from intergroup transactions), multinationals would rationally choose to book all income in tax haven subsidiaries. An entire branch of tax law called transfer pricing is devoted to resolving this problem. We will return to this point in Chapter 6, because it provides a good illustration of customary international tax law.

The key idea is simply that territoriality, which is a relatively easy concept to define in international law in general, becomes very hard when tax law is concerned. It may be unfortunate that international law facilitates the taxation of foreigners on a territoriality basis, although source-based taxation may be inevitable for corporations because the residence of corporations is inherently more manipulable and less meaningful than that of individuals.

V. JURISDICTION AND CUSTOMARY INTERNATIONAL LAW

May a country tax nonresidents that have no connection to it on foreign-source income? They may not, both from a practical perspective and from a customary international law perspective. This rule is followed from a sense of legal obligation, which is illustrated by the behavior of the United States in adopting the FPHC and CFC rules described earlier. The deemed dividend rule was adopted precisely because the United States felt bound by a customary international law rule not to tax nonresidents directly on foreign-source income even for corporations controlled by residents. The United States no longer considers itself bound by this rule, but that is because enough other countries have adopted CFC legislation expanding the definition of nationality that customary international law has changed. The spread of CFC legislation is a good example of how rapidly customary international law can in fact change.

VI. U.S. JURISDICTION TO TAX RULES

The United States, like most countries, taxes its residents on the basis of personal jurisdiction and nonresidents on the basis of territorial jurisdiction. In addition, the United States has always had a global tax regime, meaning that residents are taxed on their worldwide income "from whatever source derived" (IRC Sec. 61). The global tax regime is an attempt to

capture all sources of income of the wealthy (the same reason the United States generally rejected schedular approaches) and to avoid violations of vertical equity that can result from exclusive taxation of domestic income.

The current trend for most countries is to emulate the United States and adopt worldwide taxation of individual residents, at least on paper. Thus, there has been significant convergence between global and territorial jurisdictions in the past twenty-five years: both tend to tax individuals on worldwide income, especially passive income, but both tend to tax corporations on a territorial basis (by deferring or exempting active income earned through corporate subsidiaries).

It thus becomes crucial to define residency status under U.S. tax law, because only residents are subject to worldwide taxation. Residency is defined separately for individuals and legal entities, primarily corporations. In the case of individuals, there are two different definitions: one is based on status, and the other on physical presence. An individual must meet at least one of the criteria to be considered a resident. The rules are written in such a way as to facilitate gaining residency status and hinder avoiding residency status, because tax rates are generally higher for residents than for nonresidents.

There are two ways to be a U.S. resident on the basis of status. The first, which is a relatively unique rule, is simply to be a U.S. citizen. The United States has historically considered holding an American passport to be such a privilege that it entitles the government to tax citizens on worldwide earnings even if they reside primarily outside of the United States. A famous American Supreme Court case, *Cook v. Tait*, involved an American citizen who lived permanently in Mexico. The American citizen derived income from real estate located in Mexico, and there was no question that it was foreign-source income. Nevertheless, the Supreme Court held (in a poorly argued opinion that remains controlling law) that Congress has the authority to tax American citizens even if they don't live in the United States.

How is this enforced if the U.S. citizens are nonresidents? First, a citizen must renew her passport every ten years; if she wants to keep her passport, she must show that she filed tax returns. Second, most Americans living abroad pay relatively little in tax, because of a sizeable exemption – now over $80,000 – for earned income overseas, implemented primarily to benefit expatriates (Americans who work for American multinationals overseas). Also lowering the amount of tax owed is a foreign tax credit that allows U.S. citizens living abroad to credit any foreign taxes that they pay on income over the exemption limit. Finally, by filing tax returns, U.S. citizens qualify

for American social security (pension) benefits. U.S. taxes on Americans abroad are therefore structured such that the benefits of filing tax returns generally outweigh the costs.

Another resident by status is the so-called permanent resident or green card holder, that is, somebody who has been granted the right permanently to live and work in the United States. A green card holder is subject to worldwide tax no matter where she lives, just as if she were a citizen, as long as she maintains her green card. Green cards are difficult to obtain, and therefore U.S. permanent residents generally have an incentive to file tax returns in order to maintain their green card status.

The other alternative to determine individual residence is physical presence, which refers to the number of days that a person is physically present in the United States; this type of rule is relatively common internationally. The international benchmark is that physical presence for more than half the year (183 days in a year) constitutes residence in that country, because more time was spent in that country than any other country in that year. This rule necessitates a formal method of counting days spent in each country. The American rule is that any fraction of a day is counted as one day, and that any physical presence counts except for in transit at airports during international flights. In other words, for the purposes of this rule, you are in the United States once you pass immigration.

However, the American rule is somewhat more elaborate because otherwise, it would be relatively easy to spend quite long periods in the United States without being considered a resident. To illustrate this, imagine spending 182 days in year one and another consecutive 182 days in year two; you would still not be a resident for either of these years because you did not spend more than half a year in either year. So the actual American rule is that you need to count not just the days in the current year, but also the days in the previous two years. In the current year, each day equals one day. In the previous year, each day is counted as one-third of a day. In the year before that, each day is counted as one-sixth of a day.

Why does the United States have such a mechanical rule? This rule creates an objective test based on the counting of physical days – if a person is over the limit she is a resident, and if she is under the limit she is a nonresident. Most countries in the world have a more flexible notion of physical domicile that is based on the location of the usual, habitual abode – where the person usually lives, where her family is, where her social connections are, where she has a driver's license. Historically, the United States had a similar flexible rule, and the individual American states still do; the federal government changed the nature of the test in 1984 because of

difficulty of administration. However, in treaties this test for fiscal domicile still exists. The United States will accept residence definitions in treaties that are based on the notion of fiscal domicile, or habitual abode, or both. However, the strict physical presence test is used for determining residency for purposes of American law.

It is important to note that some days are exempted from the strict 183-day count. Most importantly, time spent in the United States by students and university faculty on exchange programs does not count as long as they are in a bona fide educational program. However, after international students graduate from American universities, they are allowed to remain in the United States for another year, during which time they may work. Time spent as a nonstudent does count, and for that year, they are residents. There are other examples of days that don't count, including people who come to the United States as tourists and then have to be hospitalized, in which case days at the hospital do not count. Similarly, when people come to be treated for medical conditions, those days do not count. Aside from these few exceptions, all days count.

If you are an American citizen or a green card holder, then as a practical matter, the only way to avoid residence is to renounce your citizenship or green card. There are a number of instances in which American citizens have given up their citizenship for tax purposes; sometimes it is to avoid income tax, but more frequently it is to avoid the inheritance or estate tax, which can be up to 55 percent for very rich people in the United States. In such situations, an American may give up her citizenship while her spouse maintains citizenship; being married to an American allows her to get a visa to freely enter and exit the United States. This person can live in another country and maintain a home in the United States: the U.S. residency test lacks a notion of physical domicile, so the only consideration would be to limit the number of days spent in the United States to remain a nonresident under the U.S. test. These ex-Americans with spouses in America are generally the most careful about the physical presence test.

A provision exists in the Internal Revenue Code that was designed to prevent tax-motivated expatriation. That provision (code section 877) states that if the IRS can prove that you expatriated for tax reasons, then you are still considered to be a resident for the subsequent ten years and are taxed accordingly. To enforce this provision, the IRS has to show that you gave up your citizenship for tax purposes rather than another legitimate purpose. Until 2004, the burden of proof was on the tax authorities, not on the taxpayer, and in almost no case has the IRS actually been successful in proving in court that expatriation was motivated by tax purposes. However, under

the 2004 changes to the Internal Revenue Code, the burden has shifted to the taxpayer, and it remains to be seen how that will affect individual expatriations.

The American test for corporation residency is rather simple and formalistic, based solely on place of incorporation. U.S. corporations are governed under state law; in order to incorporate an American corporation, you go to the secretary of state of the state of choice (you can choose any state that you want – Delaware is the most popular), pay a fee, and are allowed to incorporate. No relationship need exist between where the actual business of the corporation is being conducted and the state of incorporation. For example, the majority of the American *Fortune* 500 corporations are incorporated in Delaware, but only one actually has its business in Delaware. The remaining corporations have their business all over the world, but choose to remain Delaware corporations because Delaware law is the most convenient.

An overseas corporation may incorporate in any jurisdiction in the world. In the back pages of the *Economist* magazine, for example, there are many ads offering to incorporate for very low fees in the reader's jurisdiction of choice. Because of the formalistic rule in which place of incorporation determines residency, corporations incorporated in one of the American states are considered to be American, whereas corporations incorporated anywhere else in the world are considered to be foreign. If we consider a U.S. resident with foreign-source income subject to tax, he could easily have a controlled foreign corporation earn the income in order to make it not subject to tax, a strategy that works as long as the income is active.

How is a foreign corporation established? Under American law, the foreign corporation simply must be set up in a foreign jurisdiction, or any area outside the United States. This is, of course, the source of significant planning potential, because it is so easy. Very minimal expenditure is involved in setting up such a foreign corporation. It doesn't need to have any personnel or office; all that is necessary is a post office box outside the United States. The income nominally flows to that corporation and accumulates in a foreign bank account. The transaction costs that are involved in setting up a foreign corporation are therefore very low, and yet it works perfectly well.

By contrast, other systems in the world, primarily the ones that derive from the British tradition, have a different definition of corporate residency that is related to the location of management and control of the corporation. Under this rule, it would be difficult to argue in a single shareholder situation that the corporation is not a U.S. resident, because all the shares

would be owned by that U.S. resident. However, the "managed and controlled" test remains somewhat manipulable, because it depends crucially on interpretation. For example, if "managed and controlled" refers to the location of meetings of the Board of Directors, then it would be relatively easy, for example, to set up those meetings on an offshore island. The Board would not need to actually live on that island all year round in order to run the corporation, but if members could live in their home countries and then go to some nice vacation spot for Board of Directors meetings, all is fine; this is, after all, one of the primary purposes of airport hotels. Thus the possibility of planning exists even with the managed and controlled test, albeit with some residual uncertainty as to whether the tax authorities would find out, depending on the jurisdiction and how formalistic they are.

In the United States, however, this residual uncertainty does not exist because of the simplicity and mechanism of the residency rules. If a corporation is an American corporation, it is a resident; if not, it is a nonresident. Setting up a single shareholder–controlled foreign corporation is thus extremely easy, leading to complex mechanisms in the code designed to prevent excessive deferral of income tax from taking place. The American government has deemed it unacceptable for an American to simply set up a foreign corporation, incorporated overseas, and divert all royalties income or interest income to that company, thereby avoiding current American tax for a very long time. Thus elaborate structures have been designed to prevent that from happening, necessary because of the formalistic definition of corporate residency.

A related topic is the concept of dual residency. Both individuals and corporations may commonly have more than one residency status. In the case of individuals, an American citizen present in any other country more than 183 days will probably be a resident for tax purposes in that country and will also be subject to U.S. tax. However, even without this particularized American definition of citizenship, you may be a resident of two countries simply based on physical presence: if, for example, you are present in the United States for 150 days in the current year and 90 days in the previous year, you will be over the residency limit; you are also present more than 183 days in another country in the current year and you will be a resident of that country as well. For individuals, dual residency may be a problem because you could be subject to tax twice on your income if both countries tax on a worldwide basis (in this case, the individual may or may not receive protection from the foreign tax credit or a treaty provision). Treaties usually have a tie-breaking rule in Article 4 that is designed to resolve dual-residency situations for individuals, and that rule specifies the order of consideration

of different factors to determine residency and to prevent dual residency from taking place. Under U.S. treaties, American citizens are always treated as American residents irrespective of other provisions in the treaty. People who are not American citizens but who are U.S. residents by virtue of physical presence may be regarded as non-U.S. residents by virtue of a treaty if Article 4 so provides. If no treaty exists, domestic law controls and the person may nevertheless be a dual resident. In the United States dual residents are generally protected by the foreign tax credit, but similar protections do not exist in every country in the world.

Corporations may also be dual residents. Under the American rule, a corporation that is incorporated in the United States but managed and controlled from England is considered a dual-resident corporation of the United States and England. Dual residency for corporations may actually be a good thing from a taxpayer perspective, and some corporations may deliberately act to obtain dual-residency status. In particular, if a corporation is expected to incur losses for tax purposes for several years, being a dual resident may allow it to take off the same losses against its taxable income from other profitable enterprises in more than one jurisdiction. That is especially true if the laws of the jurisdictions in question, such as the United States or Britain, allow corporations to consolidate or combine the profited losses of a group of corporations. Thus dual residency opens the possibility for exploitation in a number of situations. A provision in the American Internal Revenue Code designed to prevent this from happening will be discussed in Chapter 10.

One more question remains about corporate residence: how do you know for American tax purposes that a foreign corporation will be considered a corporation for U.S. tax purposes? This would be important in the situation noted earlier, in which a U.S. shareholder with a foreign corporation would like to shift foreign-source income from himself individually to the foreign corporation, because foreign-source income that is earned by a foreign corporation is by definition not subject to U.S. tax. For that to happen, the individual must be sure that the foreign corporation, which was incorporated under the laws of some other jurisdiction, will be treated as a corporation for purposes of American tax law. The question of what constitutes a corporation or a partnership and how they are treated is typically a question of local law in every jurisdiction and may vary greatly.

For a very long time this was a complicated and heavily litigated area of law. In one example, someone would set up this foreign entity with foreign-source income and they would claim deferral (i.e., they would not report an income). The IRS would argue that rather than a corporation, the entity

was really a partnership or maybe just a branch – not a separate legal entity at all – and therefore the income would be attributed directly to the individual. Over time, the courts decided many such cases, and an elaborate test evolved to distinguish between foreign corporations and foreign partnerships. These cases were also applied in the domestic American context in situations where the classification was not entirely clear. In the domestic context, corporations are subject to the corporate tax and partnerships are not, whereas in the international context, corporations are eligible for deferral and partnerships are flow-through entities in which income goes to the partners directly.

However, all of that is now obsolete. In the 1990s a new form of business entity arose in the United States, which has now become a common form of doing business in all fifty states, called a "limited liability company" (LLC). Before the advent of the limited liability company, business ventures in the United States either had to be corporations – most often subject to corporate-level tax – or had to have a partnership, which required finding a person who would be liable for the debts of the partnership on an unlimited basis. In a general partnership all partners are liable for the debts of the partnership on an unlimited basis, but even a limited partnership required finding one person to be a general partner and to be liable for the debts of the partnership – potentially a significant business constraint. The states came up with the notion of the limited liability company to address this situation; a limited liability company operates essentially as a corporation for nontax purposes, meaning that all members enjoy limited liability from the debts; however, for tax purposes, it was characterized under the IRS tests as a partnership, not subject to the corporate tax. The limited liability company spread to all the states, and the IRS ultimately agreed to it. However, the IRS argued that limited liability companies made it possible for everyone domestically to achieve partnership status, and it abolished the entire test that they used before and replaced it with a new set of regulations in 1997. These new regulations are called "check the box" in the United States because in filing an entity's first tax return, you can in most cases attach a form with little boxes representing "corporation" and "partnership." You check which one you want, choosing whether you would prefer to be treated as a corporation, meaning to pay tax, or as a partnership, meaning not to pay tax, for U.S. purposes.

Domestically, this new regulation did not have a large impact because many entities were being created as limited liability companies. Internationally, however, it turned out to have been a major but unforeseen mistake. Almost every provision in the international American rules can be avoided

by using this "check the box" rule, and the rules were not written with this in mind. It was possible to achieve corporate or partnership status before with good planning, but under the new rules, this is much easier now.

How does the check the box rule work in the foreign context? In the domestic context it is quite simple. All corporations that are incorporated under state law are treated as corporations, so the check the box rule does not apply to them. Every other entity can be treated as a partnership (a flow-through entity), with the important exception of a publicly traded entity or partnership (with shares traded on the stock market), which is always taxed as a corporation. Today, the effective rule in the United States is that publicly traded corporations are subject to the corporate tax, whereas all other entities that are closely held are not subject to the corporate tax.

To answer this question internationally, the IRS published a list of entities for a broad range of countries. For each of these countries, they singled out the classic publicly traded corporation under that country's law and determined to always treat that entity as a corporation. So the public limited company in the United Kingdom is always a corporation. The Societe Anonyme in France is always a corporation, and so on for a very long list of countries; the list is updated periodically. The entities on this list make up the so-called per se corporations, and the check the box rule does not apply to them. However, other types of entities also exist in each country, such as the S.A.R.L. in France or the G.M.B.H. in Germany, and you can check the box for those entities. Therefore it is important in tax planning to check which entities are on the list. Because you cannot check the box if your entity is on the list, you want to avoid these entities if you want to do planning in this area; if you are not on the list, you can check the box.

Check the box also operates with a default rule, which is what happens if you set up an entity and then don't do anything. If it is one of the entities on the list of per se corporations, the default rule is that it is a corporation – usually a good thing in the international context, because corporation means deferral. Foreign entities generally prefer to be characterized as corporations to avoid paying current tax on foreign-source income.

What happens in this situation if the entity is not a corporation and there is only one shareholder? A partnership requires two shareholders. Sometimes it might be preferable to be considered a partnership, which is fairly easy to accomplish if you set up another corporation in the United States and have two nominal shareholders. Such an arrangement is not difficult but requires planning. However, setting up two nominal shareholders is usually not necessary because if the entity is not a corporation, and there is only one shareholder, it is called a disregarded entity for tax purposes.

It simply does not exist as an entity for tax purposes even though it is a completely respected entity for purposes of local law; instead, it is treated as a branch belonging completely to the U.S. parent corporation. All of its income and losses flow automatically into the income tax return of the U.S. parent. Now if you neglect to check the box, the entity will be considered a corporation in the international context if it is a per se entity, which is usually preferable unless you have losses. If it is not a per se entity (it is not on the list), the default rule is also that it is a corporation – in the international context, the default rule is always corporation. If you want to achieve partnership status, or branch status, then you need to check the box, which is also a simple procedure requiring one check mark on the form and the signature of an officer of the parent.

In summary, the United States taxes residents on a worldwide basis, while nonresidents are only taxed on U.S.-source income. Residence is defined for individuals on the basis of either immigration status or physical presence, and for corporations on the basis of place of incorporation. The definition of a corporation for tax purposes is governed by the check the box rule. It is thus relatively easy for U.S. residents to avoid residence-based taxation of foreign-source active income by earning it through a corporation (under check the box) that is incorporated outside the United States. In that case, the income will not be subject to current U.S. tax even though the corporation may be 100 percent controlled (and managed) by a single U.S. resident shareholder.

3

Sourcing income and deductions

I. WHY ARE SOURCE RULES NEEDED?

Source rules are important for foreign nonresidents because they are taxed only on domestic-source income. In the case of nonresidents, the definition of *source* therefore controls taxation in the source country. Source rules might seem to be unimportant for residents, because residents of global jurisdictions are taxed on all income from whatever source derived. However, in practice, source rules are almost as important to residents as they are to nonresidents.

Source rules are a wonderful thing for lawyers and something that causes economists to despair. Contrary to the opinion of the Seligman commission in the 1920s, most tax economists today believe that income does not have a single source that can be pinpointed. Economists argue that defining the true economic source of income is almost impossible, because income has contributions from many countries. The determination of true source is relatively simple in a few isolated circumstances, including income from mineral deposits (sourced where the mineral deposits are located) or rent from a building (sourced where the building is located). However, defining the correct economic source is quite difficult if the business is more complicated or crosses borders.

Economists generally would prefer a world without any kind of source-based taxation at all. If you imagine a world in which each country taxes only its own residents (assuming for a moment you can agree on what is the definition of a resident to avoid dual-residency problems), defining *source* becomes unnecessary. Instead, all you need to do is assign people and companies to countries by residence, and each country would tax its own residents (however defined) on their worldwide income. Economists have been pursuing such a scenario for many years.

However, it is extremely unlikely that a residence-based taxation system will emerge. From time to time, the economists have gained influence in the U.S. Treasury and have discussed the creation of a residence-based taxation

system. For example, the Treasury Department's first global report on the taxation of electronic commerce in 1996 predicted that the advent of an electronic commerce might lead to a world of pure residence-based taxation. However, this scenario remains highly unlikely. One major difficulty with residence-based taxation is that it would lead to an overwhelming shift of revenue from the developing to the developed world. Second, many countries, including the United States, would be reluctant to give up their right to tax foreigners on a source basis, if only because foreigners typically don't vote and therefore are politically convenient to tax. Taxation of any nonresident requires some definition of source, although not necessarily the current definition. In a world with many taxing jurisdictions, the taxation of nonresidents requires the definition of source, because taxing nonresidents on global-source income would vastly exceed a country's ability to collect tax as well as violate accepted international jurisdictional norms.

What about taxation of residents? We've already seen one example in which the source of income matters to residents. When we discussed the basic example (in Chapter 2) of the U.S. shareholder who wants to achieve deferral with a foreign corporation, we said that if the income belongs to the U.S. shareholder, it is taxed, but if the income belongs to the foreign corporation, it is not taxed. This scenario only applies if the income is foreign-source income (however defined); if it is U.S.-source income, foreign corporations are taxed just like shareholders. Therefore if this income is classified as U.S. source, nothing would be achieved by setting up the foreign corporation except to shift from the individual to the corporate tax rate, which might or might not lead to a small financial benefit, but not nearly as much benefit as would be gained by achieving complete deferral. If the income is foreign-source income, it is not subject to any current tax, in contrast with domestic-source income. That is one reason why domestic resident shareholders would care about the source of the income when they try to shift the income to nonresidents.

But there is another more fundamental and broader reason why domestic U.S. taxpayers care about the source of income, which requires an explanation of how the foreign tax credit works. To start with a simple example: Suppose a U.S. resident taxpayer has foreign-source income equal to 100, and it is subject to foreign tax of 30. That income will appear on the U.S. person's income tax return. So he reports U.S. income, and the U.S. income that he reports is the entire foreign income, including the amount he paid in tax. This is called "gross-up." That is, he adds the tax of 30 to the actual amount that he received in hand, which is actually only 70. He reports 100

and then calculates his U.S. tentative tax before the credit, which would be 35 in the top tax bracket. At that point he takes a foreign tax credit of 30 and remains with a net U.S. tax liability of only 5. The foreign tax credit works to alleviate double taxation by reducing the U.S. tax liability dollar-for-dollar for the foreign tax liability, which is a significant concession on the part of the U.S. Treasury because it gives up one whole dollar for every dollar that is paid to the foreign treasury. The United States in 1918 was the first country to establish such a unilateral foreign tax credit, which doesn't require a treaty, and every other country with a global system has followed it since then. Today, this is the major mechanism for the prevention of international double taxation.

Let us compare for a moment what would have happened if the foreign tax was allowed only as a deduction, and we will see that the taxpayer would have owed much more in taxes. In the foreign tax credit case the net of the taxpayer is 65, just as if all 100 in income had been American income and he had paid 35. Consider the previous example but with a deduction instead of a credit: Recall that the taxpayer had a foreign income of 100 with foreign tax of 30. In the case of a deduction, he would report U.S. income of 70 and would have had to pay 35 percent tax on this number, which is 24.5. Notice that the taxpayer ends up with much less (45.5) under the deduction, as compared to 65 under the credit, because the deduction is worth only 35 cents on the dollar, whereas the credit is worth one dollar for each dollar.

Under the principles established by the Seligman commission, and under accepted international tax practice, countries are supposed to give a credit rather than a deduction. Many economists wonder why countries agree to do that, because it seems like a very unselfish thing to do. However, if you consider a situation where capital flows are more or less bilateral between two capital-exporting countries, the tax credit does make sense. Even more than that, when the United States was already a big capital exporter in the 1920s, it felt that creating the foreign tax credit was the best way to encourage global growth.

Notice that in our example we used a foreign tax rate lower than the American tax rate, 30 as opposed to 35. What happens if the foreign tax rate is greater than or equal to the American rate? Consider a foreign tax rate of 35, exactly the same as the U.S. tax rate. In this case, the entire American tax is eliminated and the net U.S. tax liability is 0. In this case, the taxpayer does not pay any tax in the United States, but rather pays the entire tax to the foreign treasury.

Now consider the case where the foreign tax rate is higher than the U.S. tax rate; in this example we will assume a foreign tax rate of 50. As it was

enacted in 1918, the credit was unlimited. The taxpayer could get the credit for the whole 50; because he owed only 35 in U.S. tentative tax, he would have a negative tax liability to the United States and the U.S. Treasury was actually supposed to send him a check for 15.

The American government realized within the first three years that this was not a workable situation, because it presented a tremendous incentive for other countries to increase their tax rates when they had a lot of investment from the United States; this tax increase would be at the expense of the U.S. Treasury rather than the taxpayers. In 1921, the United States enacted the first foreign tax credit limitation, which is based on the following formula:

$$\text{Foreign tax credit limit} = \text{U.S. tax rate} \times \text{Foreign-source income.}$$

This is the way the formula originally worked and the basic way it continues to work. In the example just given, the U.S. tax rate is 35, and the foreign-source income is 100. The foreign tax rate limit is therefore 35, which means that the taxpayer cannot credit more than 35 out of his foreign tax. He does not owe any tax to the U.S. government, but neither does the U.S. government owe him any refund. And in this situation, the taxpayer actually ends up with only 50 (he started out with 100, paid 50 to the foreign government, didn't pay anything to the U.S. government, and didn't get anything in return from the U.S. government). In this situation, because of the higher tax rate in the country of investment, the taxpayer is actually worse off than he would have been if he had invested in the United States and paid only 35. The United States is not willing to subsidize investment in other countries through the unlimited foreign tax credit, and every other country in the world that has the foreign tax credit operates in more or less the same fashion, although the details vary tremendously.

The key element in the limited tax credit formula is the level of foreign-source income. The U.S. tax rate is not under the taxpayer's control, because it is determined by Congress, but the level of foreign-source income is more under taxpayer control. This is the principal reason why the source of income is so important to American taxpayers. For foreigners, the importance of the source of income is clear because they are taxed only on U.S.-source income and not on foreign-source income. But for U.S. residents, too (both U.S. corporations and U.S. individuals), the source of income is important because that determines how much foreign tax credit they can take. The higher the foreign-source income, the more likely they are to be able to credit all their foreign taxes – which is a major planning consideration, especially for American multinationals.

Incidentally, these two considerations are not at all similar to each other in terms of their purpose. The first element, which affects foreigners, is an essential element of the system of every country: nobody taxes nonresidents on foreign-source income. The second element is a question of tax planning and it affects American multinationals, which have more influence in Washington. One might have expected that the source rules would have been different for these two categories. That is, one might have expected one set of source rules for foreigners trying to put income overseas, and another set for Americans. In reality, however, the same source rules apply to everybody, and for both residents and nonresidents it is preferable to source income overseas and not in the United States. That is, for nonresidents it is preferable to source income as foreign-source income so that it is not taxed at all. For residents it is preferable to source income as foreign-source income to increase the foreign tax credit limit and enable them to credit more foreign taxes. The result is that everyone wants to put income abroad rather than inside the United States. However, that doesn't necessarily mean they want to put it out of the United States for other countries' tax purposes. As we will see, just as in the case of corporate characterization, in the case of sourcing it is also possible to have inconsistent sourcing. The American source rules are to some degree particularized, and the situation does arise where income is sourced to another country in the United States, and to the United States for the other country, creating a situation with double nontaxation. It is also possible to have a source conflict that can lead to dual taxation. These kinds of situations are the most complicated and generally are not covered by treaties, which may resolve some dual-residency situations but do not cover dual-source situations. Actual double taxation may therefore result because of conflicts over source.

The foregoing discussion is meant to demonstrate why the source of income is so important. It is important to nonresidents because it determines crucially what income is subject to U.S. taxing jurisdiction. If it is foreign-source, it is not taxable. Conversely, income source is important to residents because it determines the foreign tax credit limitation.

II. THE SOURCE RULES FOR INCOME

Source rules fall into two basic categories. The first category comprises formal rules. These rules do not attempt to trace the economic source of the income, but rather seek to achieve administrative ease and certainty. For example, the source rule for dividends is residence of the payor. Consider

the following example demonstrating the formal rule: Suppose a foreign corporation exists and all of its income is earned in the United States – it has no other business activity. From an economic perspective, it is clear that a dividend paid by this foreign corporation to its shareholders is U.S.-source. But it is foreign-source under the dividend rule, because the payor is a foreign corporation. Notice also that this means that the source of dividend income is under the control of the taxpayer, because as we have seen, whether a corporation is foreign or American is also a formal rule under the control of the taxpayer. The main reason behind this rule is that it is administratively hard to tax a dividend from a foreign corporation to foreign shareholders, but easy to tax a dividend from a U.S. corporation.

The rule for interest is also a formal rule, and it is the same as the rule for dividends – the residence of the payor. This is fortunate because of the difficulty of distinguishing debt from equity in many cases; at least the source rule is the same. Other rules exist that do distinguish dividends from interest (dividends are usually taxed at source and interest is not), which we will discuss later.

The rule for regular capital gains (gains from the sale of personal property that is not real estate or inventory) is residence of the seller. This is problematic, because the economic source of a capital gain in the case of the sale of stock of a corporation is the current accumulated earnings of the corporation plus the present value of its future earnings. Both of those represent earnings that, if distributed, would give rise to dividend income sourced to the residence of the payor. So in the situation of a U.S. corporation and a foreign shareholder, if the corporation distributes a dividend it is considered U.S.-source income, but if the shareholders sell the shares for a gain it is considered foreign-source income. The problem arises because, in reality, the gain represents the same value as the dividend. The reason behind the rule is that it is hard to tax foreign shareholders on their gains even when they sell shares in a U.S. company; gross-based taxation is impossible because you have to allow an offset for basis. But this distinction offers a lot of planning possibilities because it does not make sense economically.

The last formal source rule is sale of inventory. The rule for purchased inventory is passage of title, which is now a purely legal concept that lacks economic meaning; it does not correlate under the Uniform Commercial Code (UCC) with, for example, risk of loss. However, when the rule was adopted, it was believed that passage of title from seller to buyer had economic meaning. The rule for manufactured inventory is substantive: 50 percent to place of production and 50 percent to place of sale. However, because sales can be made overseas through a distribution subsidiary that

does no manufacturing, in practice the purchased inventory rule applies most of the time. American exporters use the purchased inventory rule to ensure that their income from foreign sales is always foreign-source by making title pass overseas. Foreigners can also use this rule to make sure they have no U.S.-source income when importing into the United States. This is a case where an export subsidy insisted on by U.S. exporters can be used by foreigners, too, because as noted earlier, the rules are the same. Most countries have rules similar to the U.S. inventory rules.

The other kind of source rule is the substantive rule, which attempts to trace the economic source of the income. The first one of these is the rule for royalties, which is significant because an increasing amount of value added is in the form of intangible property rather than tangible goods or services. Much of the highest value added in today's economy comes in the form of intangibles, and intangibles typically produce royalty income, making the source rule for royalties increasingly important. No universal consensus exists about what the source rule for royalties should be. Many countries have a source rule for royalties that focuses on the residence country: the place of ownership of the underlying copyright or the place of production (research and development).

The American rule is a place of use rule, meaning that it focuses on where the copyright or patent is utilized. The place of use rule is favorable to the source country, which may be surprising because the United States is a net exporter of intangible property and one might expect the United States to have a source rule that is more favorable to the residence country. However, the explanation for the rule continuing to exist in the current way rests on business interests of American companies. Consider the example of a U.S. pharmaceutical company that does research and development work in the United States. The company develops a new drug, obtains a patent on it, and sells the drug throughout the world. If the source rule were a place of production or initial place of development of the drug, then all of this worldwide income would be U.S.-source income to the U.S. pharmaceutical company, and it would not be able to credit any foreign tax on such income. However, because the rule is place of use, the company can classify all of its royalty income as foreign-source income and obtain foreign tax credits for it. This is particularly striking because the research and development work to produce the drug was done in the United States, suggesting that although the royalties rule is a substantive rule, it is not necessarily the correct rule economically.

In the case of royalties, it is generally accepted that, economically speaking, some of the royalty income should be allocated to the place where the

patent or the copyright was developed in addition to the market where it is sold. Most American economists consider the current system flawed, because American pharmaceuticals or entertainment companies produce patents and copyrights in the United States that then produce largely foreign-source income. In the case of the pharmaceutical company where research and development is conducted in the United States, the entire value should not be allocated abroad simply because the patent is then utilized and protected in other countries. Regardless of economic critiques, however, the American rule respects place of use, and the rule has become increasingly significant as royalty income has increased.

There are other categories in which a substantive rule applies. In services, for example, the place of delivery of service controls. In many cases, it is not so easy to determine the place of delivery of service, either, because many high value-added services can now be delivered over long distances. In the past, when these rules were formulated, most services were delivered at the same place they were consumed, because physical proximity between the service provider and service consumer was necessary. Although that continues to be true for certain services – you cannot have long-distance haircuts – most services today (including teaching and legal and medical services) do not require such physical proximity. A disjunction may therefore exist between the place of delivery of the service and the place of receipt of the service that did not exist at the time the rules were formulated. Nevertheless, the rule continues to state that the place of delivery controls; in other words, the place where the service provider is located prevails.

To make matters more complicated, consider the situation of a multinational service provider. Where is the service provided in a multinational accounting firm, for example, that has offices in many countries working together on a project? In such a multinational entity, whether it be an accounting, legal, or other type of firm, determining the location of service provision is difficult, if not impossible.

The basic difference between formal rules and substantive rules is that the formal rules require one single determination (residence of the payor, residence of the seller, or passage of title), whereas substantive rules attempt to trace the economics of the transaction. Formal rules are generally relatively easy to administer, from both the IRS perspective and the taxpayer's perspective, whereas substantive rules may involve much more difficult determinations. For example, in the case of patents and copyrights, the rule requires determination of the location of use, which may be difficult to determine if it is used in many countries: it may be difficult to break up the income into where the service was actually delivered. Not all

substantive rules are difficult to administer: real estate is relatively easy because the location of real estate governs residency, and location is simple to determine in real estate. Most of the important applications of substantive rules, however, are difficult to administer and are more difficult for the taxpayer to avoid because the formal rules are much more under the taxpayer's control.

An illustrative case of the difference between formal and substantive rules involves a company in The Netherlands that has a U.S. subsidiary and a Bermuda subsidiary. The Netherlands company developed a piece of software with contributions from the Bermuda subsidiary, and the Bermuda company owns the software and licenses it to the Netherlands company, which in turn licenses it to the United States and many other countries around the world. The U.S. company pays a royalty to the Netherlands company and the Netherlands company pays another royalty to Bermuda.

Compare the foregoing case with the analogous situation of a Netherlands company, a U.S. company, and a Bermuda company involved in a loan transaction rather than software licensing. This second case is a classic situation of what is called treaty shopping. Bermuda is a tax haven and does not have a treaty with the United States, and therefore if interest was paid directly from the U.S. company to the Bermuda company, it would be subject to 30 percent withholding tax. However, The Netherlands does have a treaty with the United States, and the treaty (as is usual in OECD model cases) provides for zero withholding on interest; there is therefore no withholding on this interest. Now what about the interest that is paid from the Netherlands company to the Bermuda company? The Netherlands company is not obligated to withhold on this interest because the interest is sourced by the residence of the payor; this payor is the Netherlands company (a foreign company), and therefore this interest is foreign-source interest and there is no withholding. A formal rule governs loan transactions, and therefore the interest is not U.S.-source even though it derives economically from the United States.

Conversely, the royalty case is governed by a substantive rule. Under the substantive rule, the source of the U.S.-Netherlands royalty must be determined. The source of the royalty is the license for using the software in the United States, so the royalty is clearly U.S.-source. However, the U.S.-Netherlands tax treaty provides for zero withholding in this case, and therefore there is no tax. In the case of the royalty paid by the Dutch company to the Bermuda company, the IRS argued (in accordance with a published ruling) that this royalty is also for use of the same software in the United States. The royalty ultimately also covers other countries, but some

proportion of it, which can be traced, is for use in the United States. The IRS argued that the royalty therefore must be traced to its ultimate source, and because this was the United States, the royalty paid by the Dutch company to the Bermuda company is also a U.S.-source royalty. The payment was completely outside the United States and was unrelated to the United States; nevertheless, the IRS argued that it was a U.S.-source payment to a foreign person and therefore the Dutch company was obliged to withhold. When the Dutch company did not do so, the IRS claimed it had the right to catch its money in the United States and collect the tax from it, despite the treaty, in place of the unpaid tax from the Bermuda royalty. That argument was rejected by the court but nonetheless is a dangerous precedent. Most tax experts agree that the position of the IRS was well founded because of the language of the source, which specifies that a royalty is a payment for the use of intangible property in the United States. In this case, the Bermuda company's software was protected by copyright and was used in the U.S. market in the sense it was licensed for exclusive use in the United States and then was sold to U.S. users; current scholars generally agree that the IRS was correct in using the substantive rule to attack the transaction.

III. EXAMPLES: SOURCE AND CHARACTER OF INCOME

The following are concrete examples, based on actual cases, about how these rules work in practice and the problems that arise in their application. The first example involves an American Supreme Court case concerning a British writer by the name of P. G. Wodehouse who was relatively famous in the early 1900s for his humorous stories. Wodehouse was a British citizen residing in France, and was therefore a tax resident of France. He agreed with an American publisher to transfer the rights to stories that would be published in the American market: the American publisher would publish them in English in the United States market with exclusive copyright to the American market in exchange for a single lump-sum payment to Wodehouse.

The Supreme Court was asked to decide the source of Mr. Wodehouse's income from that transaction, and accordingly also needed to decide the character of the income. Mr. Wodehouse transferred rights to stories that had not yet been written in exchange for a sum of money. The government argued that the payment represented a royalty for the use of a copyright inside the United States, and because place of use controls in royalty cases,

it was U.S.-source income and Wodehouse had to pay tax on it to the United States. On the other hand, Mr. Wodehouse argued that it was a sale transaction rather than a royalty case: he had sold his American rights to the stories to the American publisher for a fixed sum. According to Wodehouse, because the transaction represented a capital gain and was not inventory or real estate, the residence of the seller should control; he was a resident of France and therefore the income was foreign-source income and should not be taxed to the United States.

The Supreme Court held by majority opinion that the payment was a royalty and therefore Wodehouse should be subject to American tax on the payment. How did they determine that it was a royalty? The court decided that the fact that there was a single payment rather than a stream of payments did not matter. The court also said is that the payment was really for the American rights to the stories and to the right to use the American market and therefore it represented a royalty.

Today, many scholars question whether that was the correct characterization. Justice Frankfurter, one of the justices deciding the case, wrote a strong dissenting opinion stating that Mr. Wodehouse had given up all of his rights over the stories and had no control whatsoever over what the publisher would do with them once they were in the United States. Because Wodehouse had no control over the form, frequency, or any other aspect of publication, Justice Frankfurter believed that the transaction was a sale. Today, the majority of scholars think that Frankfurter's view was a more persuasive opinion, although it was not the majority view.

There was another possible characterization for the transaction that was not raised in the case. Wodehouse could have argued that the transaction was really an agreement for services, because the stories had not yet been written. Perhaps what he was really doing was performing a service for the American publisher; this argument would have been advantageous for Wodehouse because the rule for services is place of delivery, not place of consumption, and the place of delivery for the services was outside the United States. Nevertheless, Wodehouse did not take this approach, and in this case the taxpayer lost.

Another similar case also involves a famous person by the name of Karrer, a Swiss-born chemist who eventually received a Nobel prize in chemistry for discovering vitamins B and E during the years before World War II. While he was in Switzerland, Karrer entered into agreement with Hoffman–La Roche, a large Swiss pharmaceutical company, whereby they would provide him with the raw materials that he needed to extract the vitamins and he would provide his services, and if anything useful was discovered

he would get paid a percentage of the sales. Not surprisingly given their victory in *Wodehouse*, the IRS took the position that this was even more clearly a royalty payment because it involved an actual percentage of American sales, which is traditionally the way royalties are structured. (Patents must be registered in the name of individuals under American rules, and therefore the patent to the vitamins in the United States was personally in Karrer's name, although he then transferred patent rights to the company.) The IRS argued that the payment was a royalty and therefore the place of use rule controlled. Karrer, on the other hand, said his agreement was to provide the Swiss company with services and therefore represented a personal service agreement. He argued that although he was paid based on a percentage of sales, under Swiss law it was still a contract for provision of services. Karrer claimed that because he was in Switzerland and never entered the United States, his services were delivered in Switzerland and therefore should represent untaxable foreign-source income in the United States.

In the *Karrer* case, the court held in favor of the taxpayer that the payment was services income rather than royalty income. These examples therefore represent two contrasting cases: one with a single fixed payment up front, which the court held was a royalty, and another one with an ongoing percentage payment, which the court held was services and not a royalty. These opinions do not seem to be consistent, and it is possible that both cases were wrongly decided; nevertheless, those were the results.

The foregoing cases illustrate the difficulty of drawing the line between categories in border cases. In both of these cases the categorization completely controlled the tax results. The category of the payment determines whether or not it is taxable. In *Wodehouse*, if the payment had been a capital gain, residence of the seller would have controlled and it would have been considered foreign-source income not subject to U.S. tax; however, because it was considered a royalty, place of use controlled and it was considered U.S.-source income subject to U.S. tax. In the *Karrer* case, because it was characterized as services, place of delivery controlled and it was considered foreign-source, not subject to U.S. tax; conversely, if it had been royalties, place of use would have controlled, and it would have been subject to U.S. tax. Source rules are therefore very important because the sourcing determines the results.

The following example illustrates the extreme case of when two countries disagree about the source of income, which represents a very unfavorable situation for the taxpayer. Such a case arose in the 1980s involving the relatively famous composer and conductor Boulez, who at the time was a

resident of Germany but was originally from France. Boulez was invited to come to the United States from Germany to conduct a number of performances of the Philadelphia Symphony Orchestra which were recorded by CBS; CBS paid Boulez a percentage of the sales of the records.

In this case, Boulez and the German government took the view that this payment represented a royalty because it was a percentage of the use of records in the American market. On the other hand, the American tax authorities argued that this was a payment for services, because Boulez was actually in the United States when he did the conducting. In this case, the court needed to decide whether to characterize this as services or royalties. If it was royalties, it would be U.S.-source income because the place of use was the American market; if it was services, it would also be U.S.-source income because the place of delivery was also the United States.

Given that the income would be U.S.-source based on either characterization, what is the difference? In this case the difference results from the terms of the U.S.-German tax treaty, which, like most tax treaties between developed countries, has a zero rate withholding tax on royalties. If the payment was characterized as a royalty, the Americans could not tax it because it is only taxable in Germany according to the provisions of the treaty. On the other hand, if it was characterized as services income, then the Americans could tax it because services income is not covered under the U.S.-German tax treaty and is therefore taxable in the country where the services are delivered. In this case, each country maintained its own position; the American tax authorities won in court and the court upheld their view that the payment in this case was for delivery of services. The court conducted an analysis to determine the extent to which Boulez had control over the sale. They showed that he did have some control and therefore it was more similar to a services case than a strict royalties case (in the sense of purely passive royalties).

It is not clear that the control factor should have been the decisive one because, according to the now widely endorsed dissent in *Wodehouse*, it is clearly a sale when the taxpayer completely gives up control over a copyright or an article, but when there is a question between royalties and services it is not clear that the taxpayer necessarily always has control. The taxpayer generally has more control in the provision of services and less in the provision of royalties, but that is not always the case. In a counterexample, McDonald's is famous for exerting a huge amount of control over its franchises all over the world, and they also receive the royalty for the franchisees' use of the brand name, so control does not always affect cases in any one predictable way.

In the *Boulez* case, however, the American courts ruled for the U.S. government against Boulez; the Germans insisted it was royalties and taxed him in Germany on it and would not give him a foreign tax credit, because they claimed it was German-source income under their interpretation (they also had a source rule for royalties that was residence of the provider). The result in this case was that Mr. Boulez was actually taxed twice. This case therefore represents a real case of international double taxation with full taxation by both countries.

What these cases illustrate is that it is truly difficult to make distinctions among sales, royalties, and services income, which are the three traditional categories of active business income.

The following is another example regarding financial institution such as banks. This problem stems from the way that the value-added tax operates: value-added tax is usually levied on services income but it is not levied on interest because interest is not regarded as consumption. Banks, however, usually bundle an interest charge and services charge together in the same payment. Europeans simply do not tax banks because of this issue, but there are other more sophisticated solutions to this problem. The same problem arises in the income tax context in the United States. One case involves commitment fees charged by the Bank of America, where the court had to decide whether the essence of the commitment fee was for substituting Bank of America's credit for the foreign bank's credit (when it was a letter-of-credit situation) or whether it was a services transaction. The court decided that in letter-of-credit situations, the payment is more like interest and therefore it is foreign-source income because it originated from a foreign payor. However, the payment was considered a services transaction if the bank was required to do extensive document checks and would therefore be U.S.-source income.

What is important is to realize how difficult it is to make the analysis. All of these court cases include pages and pages of arguments attempting to decide how to categorize income. It may seem that whereas these are the most difficult cases, in most cases it should be obvious what the income is, but in today's complex business world that may not be true. Modern business entails more and more transactions where it is truly difficult to know how to categorize the income. The most obvious case is the area of computers and electronic commerce. If you buy a computer program on a disk, it is usually formally characterized as a license to you. Under the *Wodehouse* case, you may argue that it is a royalty payment because you have signed the license; the reason that it is characterized as a royalty is so that you do not have the right to make copies of it and distribute it broadly.

Nevertheless, in other ways it is a sale because you went to the store and bought an item.

Now how about if you download the same program from the Internet and you made a payment online? Does it make it more like a royalty rather than a sale? What about if you keep getting current updates to what you purchased, so that in some ways you are really paying for the services of the provider company in updating the software? The Americans relatively recently put in place a set of regulations that applies specifically to the characterization of income from software transactions. These regulations attempt to make these distinctions, and they do a good job as far as it can be done.

The main rule in these regulations is that the key question is whether you have the right to freely distribute the article. If you have the right to freely distribute the article, then you completely own it, and there is no question that the transaction is a sale. If you do not have the right to freely distribute the article that you got, which is almost always the case, then you need to go into a much more detailed analysis about what rights exactly you do have; generally speaking, however, it still results in sale characterization. In this case it does not matter what the software product is labeled or whether you have signed the license or not for nontax purposes.

These regulations were written to characterize most transactions as software sales precisely because that was the result that was most favorable to the residence country. Americans write a lot of the world's software, and that is the most revenue-producing result for the United States because it means that most software sales are characterized as capital gains or inventory, resulting in less source-based taxation than a royalties-based rule that follows the place of use. However, it remains unclear whether these regulations really achieve their aim of clearly distinguishing in this area among royalties services and sales; fundamentally, that distinction may be impossible to maintain, and a better rule could be to source all business income together.

More generally, there is some overlap in the distinction between formal and informal rules and the distinction that we drew before between active and passive income. The formal rules are generally rules for passive income: dividends, interest, and capital gains. Although inventory is not passive (income from the sale of inventory is active business income), the rule for inventory was originally intended to be a substantive rather than a formal rule. Royalties and services are the classic categories of active income, so if inventory were to be moved from formal to substantive as it was originally intended to be, then the formal rules are all the rules for passive income and the substantive rules are the rules for active income.

Why does this make sense? The fundamental consensus that underlies the whole system is that passive income is primarily taxable by the residence country, and active income by the source country. That means that source rules operate for the benefit of the source country because they define the source and its ability to tax. The source country thus cares more about the rules for active income than about those for passive income because it has more rights to tax active income than it does to tax passive income, which explains why the rules for passive income are formal ones. The formal rules (for dividends, interest, and capital gains) are basically rules that are designed for administrative convenience.

Fundamentally, it is not difficult to avoid source-based taxation under formal rules for dividends, interest, or capital gains. It is more difficult to avoid source-based taxation of royalties or services, and it used to be more difficult to avoid source-based taxation on inventory, because the source country has more legitimate interest in taxing them. So this distinction does have some real meaning. However, this also suggests that there should be less emphasis on maintaining the differences between the various categories of active income and the various categories of passive income; dividends and interest are very difficult to distinguish, as are dividends and capital gains.

Setting aside the particularized problems of inventory and real estate, two sets of rules remain: one for passive income and one for active income. It is certainly possible to have a more formal rule for passive income than for active income, but the attempt to maintain the current set of rules for active income that distinguish services, royalties, and sales involves a huge amount of effort on the part of tax administrations and the courts and ultimately is unlikely to be successful.

However, the current set of distinctions is so well established and so much incorporated into the structure of tax treaties that it will be enormously difficult to change. Full-scale reform would basically entail rewriting the whole tax treaty structure that is based on these distinctions. This illustrates that the categorization may also be part of customary international law, because it is hard to change. However, the actual source rules are not generally written into the treaties, so some reform along the lines suggested earlier may be possible even though the treaties require distinguishing among the categories for withholding tax purposes.

Another difficulty that arises with the current system is when a category of income arises that is not listed and does not have a source rule. In this case, the courts have to come up with creative analogies to see what category of income this new category most resembles. A classic example of this is the problem of cancellation of indebtedness income. Under U.S. income tax

principles (most countries follow the same rule), when a person borrows money he does not have income. The reason that this cash receipt is not considered income and is therefore not an occasion for taxation is because the borrower has an offsetting obligation to repay, and as an accounting matter, the obligation to repay cancels out the asset that the borrower receives.

Consider the situation in which the borrower encounters financial difficulties and declares bankruptcy or renegotiates the debt with the lender so that the lender forgives some of the debt. Let us say the borrower originally received $1,000 and the bank agrees to reduce the principal on the amount of the loan from $1,000 to $500. In this case, under very well-established principles the borrower has $500 of what is called "cancellation of indebtedness income," which is taxable. However, the code does not have a source rule for a cancellation of indebtedness income.

Another example is income from a covenant not to compete. This example arose in a case called *Korfund*, which involved an agreement between a German company and a U.S. company. The agreement was that the U.S. company would market its product in the United States under license of the German company and would pay a certain amount in royalty and an additional amount in exchange for the promise of the German company not to enter into the American market itself. This type of agreement is called a covenant not to compete; because the U.S. company had the license, it is the only one allowed to use the particular technology in the American market, and the German company agreed not to enter the American market itself.

The *Korfund* case arose because the business relationship was broken after the rise of the Nazis in Germany, but the U.S. company eventually made a payment to the German company in lieu of this payment under the covenant not to compete. The question was how a payment for an agreement not to compete in the United States should be characterized. The Germans argued that they were performing a service by not competing; they were restraining themselves from doing something, and this happened in Germany, so the payment should be considered services income taxed in the place of delivery (which would be Germany). American tax authorities and the court, however, held that the decision should be based on what the covenant income was really replacing, which was the business income that the German company would have earned from the United States had it competed, which would have been U.S.-source income.

In this case, despite the amount of detail in the Internal Revenue Code, there is no answer and therefore it is necessary to find an answer by analogy.

Sometimes the IRC is updated for new kinds of technologies. For example, a specific provision for income for satellites was added in 1986 and states that the income from "space-based activities" is taxed on a residence basis unless it is linked to a fixed establishment in the United States. Although there might be an argument whether a satellite node that is a transmission device is a permanent establishment, generally speaking in the case of satellites there is an answer in the code. In addition, it is sometimes possible to find source rules in the regulations, as in the case of software income; income from derivative financial instruments is also governed by the regulations and is generally sourced to the residence of the recipient.

It is clear, however, that there are now many new kinds of income where the source rule is not established in the code. The more general point is that this method of providing source rules specifically for each category of income has the problem that there are new categories of income arising all the time as the market evolves; unless the law is continuously updated, the courts have to create this kind of innovative solution. Furthermore, even if the result in a particular case seems to make sense, in other cases it might not, and in general it is not good to provide loopholes that call for litigation.

IV. THE ALLOCATION OF DEDUCTIONS

As discussed previously, both residents and nonresidents prefer to have their income classified as foreign-source: nonresidents prefer foreign-source income because it is not taxable, and residents prefer foreign-source income because it increases the foreign tax credit limitation. It follows that the preference for deductions is exactly the opposite: everyone wants their deductions in the United States. Nonresidents prefer deductions in the United States because otherwise they are worthless as a U.S. tax matter. Foreign-source deductions do not help in reducing U.S. tax liability because they reduce foreign-source income, which is not taxed anyway. Americans also prefer U.S.-source deductions because foreign-source deductions reduce foreign-source income and cut into the foreign tax credit limitation. Thus both residents and nonresidents prefer to put deductions in the United States.

Let us now consider the allocation of deductions. Surprisingly, the situation is less complicated than in the income area, precisely because there is not that much detail in the statute. There are specific rules for the allocation of deductions in only two areas, and in fact both of these areas are problematic. All other deductions are left to a general rule that provides more

flexibility, although the problem is that this deduction allocation rule is tied to the rule for sourcing income and thus suffers from the same limitations. The rule states that deductions should be allocated in a two-step process.

The idea is to match the deductions with the income that they produce, which is an accounting concept. The first step is to match the deduction to income it produces, and the second step is to apportion (divide) deductions into U.S. and foreign source, according to the income ratio.

For example, consider a 100 deduction for cost of goods sold, which is what was originally paid for the goods. First, we must match this deduction to the income it produces, which is the income from the sales of the goods. The second step is apportionment, where we must identify the percentage of the income that originated from the sale of the goods. Let us suppose that these particular goods are all sold outside the United States, so then the deduction must be apportioned to foreign-source income. However, if 50 percent of the goods were sold in foreign markets and 50 percent in the United States, the deduction is apportioned the same way: 50 percent to the United States and 50 percent overseas. That is apparently a sensible system and is relatively flexible.

The problem is that there are some deductions that are not obviously related to a single category of income, including general overhead deductions for headquarters or even the salaries of the CEO and top management. They are related to the entire business of the firm and impossible to divide up. In this case, the regulations say that you are allowed to use any reasonable method. If you cannot match the deduction to a particularized category of income, you could choose to look at how much time the top management spent on overseas activities as opposed to how much time they spent on American activities and allocate the salary in that way, or use any other reasonable method that you choose. The IRS may try to challenge you, but usually they do not challenge the method; instead, they try to argue that some deductions are related to particularized income categories rather than general ones. They do not like the general categories because they feel it gives taxpayers too much flexibility.

Another example of a particular case in which this method was employed to the taxpayer's disadvantage involves Black & Decker, a large American manufacturer of mechanical equipment. In the 1970s, Black & Decker was faced with increasing competition from Japanese companies in the American market and decided to set up a subsidiary in Japan, in order to try to force the Japanese to compete on their own home territory and devote less effort to the American market (standard strategy for most multinationals).

However, the Japanese subsidiary failed to sell any product in Japan and the company lost a lot of money. In the end, the American company decided to give up and liquidate the Japanese subsidiary, and took a deduction for $2 billion on their tax return, which was equal to the amount of money they put into it and was lost. This was a worthless stock deduction, as the stock of the company had become worthless, but the question was how to allocate the deduction.

Black & Decker hoped to allocate the deduction to the United States so as to prevent it from reducing the foreign tax credit limitation. They argued that this deduction related to a strategy for protecting the U.S. market and brought evidence that this was really the reason for setting up the Japanese subsidiary. The IRS disagreed, and the court agreed with the IRS. The IRS and the court said that Black & Decker needed to use the two-step process. The first step is to decide the kind of income that this investment would have produced had it been successful, just as in the case of the *Korfund* covenant not to compete. In the *Black & Decker* case, the answer was that you normally invest in stock in order to produce dividend income, so if the company had been successful, it would have ultimately received dividend income. The source rule for dividend income is residence of the payor – in this case a Japanese company – which would have been foreign-source; this loss should therefore be considered a foreign-source loss. That was an unfavorable result for the taxpayer, and that result is now embodied in the regulations.

However, Black & Decker could have perhaps made a more persuasive argument. Part of the problem that they encountered is the difficulty in making arguments based on motivation. This type of argument always leads to the suspicion that the argument is being made in hindsight. In this case, the argument looked especially suspicious because Black & Decker had to provide documentation of expected profitability to the Japanese Ministry of Industry and Trade in order to get permission to get into Japan, and had claimed to the Japanese that they were going to be profitable. After the fact, it was therefore hard to argue that they intended only to protect the American market and did not really intend to make a profit in Japan.

Black & Decker could have argued, however, that there was no reason to expect that the subsidiary would really have paid dividends to its parents if it had been profitable. Most American multinationals that are profitable in their overseas operations do not repatriate the profits because of deferral, and in fact the overall repatriation rate for foreign subsidiaries of U.S. multinationals is only about 16 percent. If the Japanese subsidiary

had ultimately been profitable, the U.S. company might have sold the subsidiary and produced capital gain income, which would have been sourced according to the residence of the seller. Because in this case the seller would have been American, this would have been U.S.-source income and the deduction would have also been a U.S.-source deduction. This case illustrates that unfortunately this line of analysis can be quite inconclusive. Generally speaking, allocating deductions in this way is flexible but not necessarily satisfactory because it depends ultimately on matching deductions with income. As in the case of income, where more than one possible categorization exists, there may be more than one possibility of categorizing the deduction according to the category of income that it produces. However, the general rule is relatively easy to work with.

Two important categories of deductions have specific rules associated with them. These categories are research and development and interest, and these rules are in the code rather than just in the regulations, although the interest deduction is also governed by multiple regulations. The rules present in the code represent a conscious decision by Congress to depart from the general rule and to adopt some particularized policies. In general, the rules for the R&D deduction are very taxpayer favorable, whereas the rules for the interest deduction were, until they were amended in 2004, very taxpayer unfavorable.

To begin with research and development: Consider our previous example of an American pharmaceutical company that spends a large sum of money in the United States. American multinationals spend billions of dollars in R&D, and this makes up the largest part of their budget, especially for high-tech companies. Ultimately the pharmaceutical company develops a patented drug that frequently must wait years for Food and Drug Administration approval in the United States. Often, however, approval is granted more quickly overseas, so it is quite realistic that an American pharmaceutical company might spend a lot of money in R&D in the United States and then derive 100 percent of the profit from sales abroad for several years before receiving FDA approval.

The question is, what is the source of income? The income is royalty income and is all foreign-source. We start with the proposition that the income is foreign-source: although the R&D expenses are all in the United States, the sales are all foreign and the income, which is typically royalty income from subsidiaries and licenses, would all be foreign-source income. Using the usual rule to analyze this deduction, this deduction would be characterized as foreign-source income because all sales are foreign. After

matching the deduction to its corresponding category of income, it follows that R&D expense should all be foreign-source as well. That is the answer under the general rule.

This answer, however, is not favorable to the U.S. pharmaceutical company. The company would prefer to deduct the R&D in the United States as a U.S.-source deduction, because if it is foreign-source it significantly reduces the foreign tax credit limitation.

Because of this conflict, the American companies lobbied the Clinton administration in its early years, and the Clinton administration was sympathetic because it was very much in favor of encouraging American R&D. Vice President Gore in particular was very much in favor of using the tax code to encourage American companies to conduct research and development in the United States, because he believed that positive externalities (spillover effects) exist from having R&D conducted in the United States. The externality argument is that R&D produces knowledge, which is not something that companies can keep within them. Employees may leave and spread the knowledge to other companies, producing positive effects for the economy.

When the Clinton administration came into office in 1993, it proposed a rule saying that all R&D that is performed in the United States (a classification based on location) should be deductible as U.S.-source income. That rule would have been extremely beneficial for U.S. corporations, who would have had all R&D expense as U.S. source, and all income as foreign source. That rule would have been too costly in revenue for the U.S. government, so the rule that was adopted in 1993 and continues to govern is that 50 percent of R&D is sourced based on location. In other words, it does not matter where the income that it produces is earned; instead it is just a question of where the R&D is performed. This rule was intended to be a deliberate incentive for U.S. companies to perform R&D in the United States and then sell overseas.

It is highly questionable whether some of these rules would withstand a World Trade Organization scrutiny if challenged. One example would be the title passage rule, which is a huge export subsidy for American exporters, because it creates the ability to classify export income as foreign-source just by putting the title passage there. The R&D rule is another example of a very significant export subsidy; if, for example, the European Union decided to challenge the R&D rule in the same way that they challenged the foreign sales corporation, the WTO would likely disapprove of the rule, which is a deliberate device to encourage R&D in the United States. The other

50 percent is sourced based on either sales or income; companies can compare their U.S. sales of the product to the foreign sales or their U.S. income from the product to their foreign income and divide it up either way.

This rule does also create a limitation: income is much more under control than sales, because sales are really to outside parties and it is impossible for a company to control how many people would want to buy its product. Income, however, is a much more flexible proposition, because it is much more possible to adjust income numbers. There is a limitation that the amount apportioned on the basis of income cannot fall below 30 percent of what the allocation based on sales would have been, which demonstrates how much flexibility is present in income numbers. The basic rule is half of R&D expense is sourced based on location, which is beneficial to American taxpayers because they get to source R&D in the United States if they locate the R&D there. The other 50 percent is sourced based on this proportion, so in this case where all the sales are abroad and all the income is abroad, 50 percent of R&D would be American and 50 percent would be foreign. In the more common situation where sales and income are both American and foreign, then half of the R&D expense would be U.S.-source and the other half would be apportioned between U.S. and foreign, based on the formula.

The last item is the allocation of interest deductions. American multinationals were successful in having this law changed in 2004, so we will first discuss what the law was until 2004 and then how it was changed. Interest deductions is one area in which the United States differs from the rest of the world. Most of the world simply allows interest to be deducted where the loan is booked; even in the case of banks that have many branches, every branch has its own loans on its books and the interest deduction is taken at whichever branch booked the loan. The American method is more complicated and arguably more economically accurate, because money is fungible: a dollar is a dollar no matter where it is in the world. If you borrow a dollar in country A, you have the dollar available and it potentially can serve your needs in country B, too; conversely, it could save a dollar to the country B entity that otherwise would have transferred it to country A. Because money is fungible, the American interest allocation rule is based on some kind of worldwide fungibility, as opposed to a system like the ones in other countries that are based on tracing.

So far we have tried to allocate the deduction to the income that it produced. In theory, the same could be done with interest expense, because you could try to see what item of income was gained by the use of the proceeds of this particular loan. There are other areas in the Internal Revenue Code

where this type of tracing has been attempted; for example, one provision states that if you borrow in order to either buy or keep government securities, the interest on which is tax-exempt in the United States, then you are not allowed to deduct the interest. This is an example of tracing, because you must try to match the interest on the borrowing with the tax-exempt income that it produces. Consider also terminology, which states that you may borrow in order to buy or also to keep, which affirms that borrowing may enable you not to sell something you bought in the past. This type of tracing is not easy to administer, however, and that is not the way it is done in the international area.

Before 1986, a U.S. parent company with U.S. and foreign subsidiaries almost always had what was called a finance subsidiary, which did all the borrowing for the entire group. All of the borrowing for the group was channeled though the finance subsidiary and all the interest expense flowed from the finance subsidiary, which had no purpose other than to lend money to other companies in the group and would receive interest income. Until 1996, the rule for the allocation of interest expense was based on the location of the assets of the company paying interest. If the assets are in the United States, the interest expense is domestic; if the assets are overseas, the interest expense is foreign. Companies prefer to have their interest expense in the United States.

The finance subsidiary did not have any assets except the notes from the various other U.S. companies in the group to which it lent money. It was a shadow company whose only purpose was to borrow and lend money; because all of these assets were domestic assets, all of its interest was treated as allocable to U.S.-source income.

A major tax reform act was passed in 1986 with the intent of reducing tax on individuals but increasing tax on corporations. Part of this reform was to change this rule and adopt the current rule, which states that the entire U.S. group should be treated as a single company for purposes of the asset calculation. When you consider the whole American consolidated group and the location of its assets, its assets are no longer all located in the United States. Consider the example of a company with $1,000 in domestic assets but that also has a foreign subsidiary with assets of another $1,000. According to the definition, the assets of the foreign subsidiary itself do not count because the foreign subsidiary cannot be consolidated and therefore is not included in the group. However, the stock of the foreign subsidiary is an asset of the group and it is a foreign asset worth $1,000. Suppose there is $100 in interest expense; in this example, this interest must be allocated 50/50, $50 to the United States because of the

$1,000 in U.S. assets, and $50 to foreign because of the $1,000 in foreign assets.

What happens in the preceding example if the foreign subsidiary is the one that does the borrowing? How should this interest expense be allocated? The answer given by the IRS is that this interest expense is incurred by the foreign subsidiary and that foreign subsidiary's assets must be considered. In our example, the foreign subsidiary has only foreign assets, so all of this interest expense is allocated to foreign-source income. This is a very bad result for the corporation, because the entire $100 is now a foreign-source deduction. It is true that there is probably also a loan in the United States at the same time, and the foreign loan would also change the allocation of that loan favorably because this loan reduces the value of stock with the foreign subsidiary from $1,000 to only $500 because it is burdened by this loan. This $100 would therefore be allocated 67/33, $67 to the United States and $33 overseas, which is a better result than 50/50. However, this benefit is not enough to compensate for the fact that this $100 of interest expense is completely foreign-source.

However, very good business reasons exist for a foreign subsidiary to borrow overseas. The foreign subsidiary may have good credit relationships with local banks and may prefer to borrow in the local currency to avoid risk from exchange-rate fluctuations. Other legitimate, nontax business reasons exist for a foreign subsidiary to borrow locally as well. But this rule is a very strong incentive against local borrowing by foreign subsidiaries, because assuming that foreign subsidiaries own all foreign assets, all that expense is treated as being completely foreign-source. By contrast, all borrowing in the United States is apportioned based on the asset ratio of the group, which in turn depends on the value of the domestic asset versus the value of the stock of the foreign subsidiaries.

This seems like a very unfair result: if money is fungible, the whole group should be treated as a whole, because borrowing by one member is borrowing by all. This is, in fact, the rationale behind the 1986 change. Companies began to question why, if you should not respect the formalities of the separate existence of the finance subsidiary, the foreign subsidiary could not also be included in the group as a whole. Thus, after many years of lobbying, the law was changed in 2004 to allow foreign subsidiaries to be included in the group.

Current law therefore states that the assets of the company must be considered rather than the stock, so the $100 of foreign interest expense in our example would be 50/50 and the $100 of domestic interest expense would be 50/50, and regardless of whether the money was borrowed domestically

or abroad, the allocation is done in the same way based on the overall assets of the group.

V. CONCLUSION: THE SOURCE RULES AND CUSTOMARY INTERNATIONAL LAW

It can be argued that most of the source rules are part of customary international law. As Yariv Brauner has shown,[1] most of the source rules for income are quite similar among countries, with a few exceptions (most notably the royalty rule). Most countries follow a flexible rule for allocating deductions, except for the specific U.S. rules on R&D and interest expense, which have been sharply criticized by Shaviro for departing from the global practice.

Although the source rules themselves are not usually embodied in the tax treaty network, the permission to tax at source is included, as is the need to characterize income as dividends. Thus, source rules for income can be quite difficult to change, despite the obvious need to do so in certain cases. That is precisely why they are part of customary international law: they are rules that countries feel they have to follow because most other countries do so. Even for a new country without any tax treaties, it would be hard to adopt completely new source rules. Unfortunately, from an economic perspective, source rules are here to stay.

[1] Brauner (2003).

4

Taxation of nonresidents: Investment income

I. THE GENERAL RULE

Some history may be necessary for the understanding of rules for taxing nonresidents on investment income. When the income tax was implemented in the United States, nonresidents were treated the same way as residents but were taxed only on their U.S.-source income; the tax rate and ability to take deductions were the same. Over time, the Internal Revenue Service discovered that it was not really possible to audit foreigners' tax returns or to establish what kind of deductions they should or should not take.

By the mid-1930s, the present system was developed, under which nonresident income is divided into two categories – passive income and active income. Passive income is subject to a flat 30 percent tax on gross income, without any deductions, whereas active income is subject to graduated rates, which vary depending on whether the taxpayer is an individual or a corporation. Deductions are allowed on active income because the IRS can audit businesses earning active income in the United States to verify the validity of deductions.

The 30 percent gross tax rate on passive income has remained more or less unchanged since the 1940s. By contrast, the net rates (which are the same rates that apply to Americans) have been changing every time there is a new tax law and in almost every election. For example, tax rates were raised in 1993 after Clinton's election and then lowered in 2001 after Bush's election. As the net rates have gone up and down over time, there were changes in whether it is beneficial to pay the 30 percent rate (passive income) or the net rate (active income). Another factor in determining whether it is advantageous to pay the gross rate or the net rate is the potential number of deductions for the net rate. People with very few deductions can just compare the rates, but a higher net rate may translate into a lower effective tax than the 30 percent rate for people with many deductions.

For example, the gross rate in 1980 was 30 percent, and the net rate for individuals was 70 percent. Consider an individual at that time with income of 100 and deductions of 50 (therefore with a net income of 50). This individual has many deductions, so it is possible that it would be better to be in the net-rate situation; however, we will see that is not the case in this example. On the gross side, this individual would pay 30 percent of 100, and you do not get any deductions, so she would have an income of 100 and tax of 30; no deductions are allowed, so her after-tax income would be 70. On the active side, she would have an income of 100 and deductions of 50; her net income of 50 would be subject to a tax rate of 70 percent, and therefore her tax owed would be 35. In this example, the tax on the active side is higher than the tax on the passive side even with the deductions present, so the individual would prefer gross-based taxation at the gross rate.

How can one choose to pay tax at the gross or net rate? In many situations it is possible to design your affairs so as to be in one or the other. As we will see, the key question is whether passive income is somehow "effectively connected" with business in the United States, and making passive income connected with that business is not difficult.

In the preceding example, using the tax rates of 1980, it would have been better to be in the gross rate. This situation was typical historically; in all the periods before 1980 the net rates were higher than 70 percent, so even with high deductions it was generally preferable to be in the gross situation. Thus passive income was preferred to active income, and taxpayers would try to avoid having a trade or business in the United States; if they did have one, they tried very hard to avoid having their income drawn into the active business.

However, if we consider the same scenario in the year 2006, in which the gross rate is still 30 percent but the net rate is now 35 percent, the situation changes. The gross result does not change, but in this situation if the net rate is now only 35 percent, the tax is only 17.5 on 50 (the net income after deductions), and the individual is better off in the net-rate situation. In a similar way, it is possible to calculate exactly the break-even point for any given net tax rate. The choice between being taxed on the gross basis (for passive income) or being taxed on the net basis (for active income) depends on the number of deductions and also on the rate relationship, which changes over time.

The question arises as to why the 30 percent rate remained unchanged. Originally this 30 percent rate was conceived of as a reasonable substitute for the net rate, because 30 percent of gross income was approximately

equal to 70 percent or 90 percent of net income. Over time, as the net rates have fluctuated, this tradeoff has become completely different. The United States chose to keep the 30 percent withholding tax rate, however, because it is an incentive for other countries to enter into tax treaties with the United States. The tax rate is a good bargaining tool because the Americans are willing to reduce the rate, in some cases even to 0 percent, when other countries enter into tax treaties. There are now so many exceptions to the rules that, in fact, the United States collects very little money from this 30 percent withholding tax.

It is important to understand the way that passive and active income is defined. In this case it is helpful to look at the language of the Code; section 871 imposes tax on nonresident alien individuals, and section 881 imposes a similar tax on nonresident alien corporations. Section 871, dealing with individuals, is divided into 871(a), which imposes the 30 percent gross tax, and 871(b), which imposes the net tax. In each case the gross tax is imposed on "fixed or determinable, annual or periodic income."

What does the Code mean when it says "fixed or determinable, annual or periodic income" (FDAP)? This language has been in the Code practically unchanged since the mid-1930s when the withholding tax was made into a final withholding tax. However, the words have changed meaning over time, because the courts and the IRS have interpreted them to mean something different than what they usually mean.

Let us start with the second set of words, "annual or periodic." What does that mean? The usual dictionary meaning of *annual* is something that happens every year, and *periodic* means something that happens every period other than a year. Annual income should mean that you have one interest payment every year, whereas periodic income should mean that you have interest payments on a regularly recurring basis. However, recall the previously discussed *Wodehouse* case, in which a nonresident alien residing in France transferred his rights in stories to be written to an American publisher for a single lump-sum payment up front. The first issue in that case was the character of that payment; Wodehouse said it was a sale and therefore a capital gain, and the IRS said and the Supreme Court agreed that it was a royalty. But after that, Wodehouse argued that even if it was a royalty, he still should not have to pay tax on it, because the language of the law stated that tax was payable only on FDAP. Royalties are not mentioned in the list and are neither fixed nor determinable annual or periodic income. The *Wodehouse* payment was made only once and was therefore not annual or periodic. The Supreme Court held, however, that every stream of payment can be converted into a single lump-sum payment

by using present value, so there is really no difference between a lump-sum payment and a periodic payment: the Code does not actually mean annual or periodic. The Supreme Court thus held that a single lump-sum payment could be taxed even though the Code language says "annual or periodic."

What does "fixed or determinable" mean? *Fixed* presumably means a fixed amount, for example, $100. What does *determinable* mean? Determinable probably means "determinable in advance according to some formula," for example a royalty of 5 percent of sales. In this case, you do not know what the exact amount would be because you do not know how much sales would be, but you do know how to calculate the payment if you are given the amount of sales.

Let us consider the example of a case involving a Mexican resident named Barba. On vacation in the United States, Barba went to Las Vegas, Nevada, and gambled at a casino there. Barba actually lost a lot of money, but once he hit the winning jackpot for $60,000. He lost money on net, but on one play he made $60,000, and the casino withheld 30 percent of that and sent it to the IRS. Barba argued that the IRS should not have withheld. He could not argue that the payment was not annual or periodic, because that was foreclosed by *Wodehouse*.

Instead, Barba argued that the payment was not fixed or determinable. He claimed that it was not fixed because he did not know that he would win any money ahead of time, and in fact the probabilities were that he would lose. It was not determinable either, because there was no formula at all that would determine that he would win anything, but rather it was completely a matter of chance that he happened to win this particular jackpot. The court, however, ruled that Barba did need to pay tax on the $60,000, because what the Code meant by *determinable* was "determinable in hindsight." This reading is questionable because income is always determinable with hindsight, so the word loses any meaning. If the Code actually means "determinable after the event," we might as well eliminate "fixed or determinable" from the language.

After looking at all of these interpretations, we can conclude that the Code means by FDAP exactly what it says in the caption: income other than capital gains. Why are capital gains not covered by the withholding tax? First, they are not usually from sources within the United States. In addition, the traditional interpretation of the court has always been that the withholding tax never applies to a capital gain because it is not fixed or determined or annual or periodic. According to the interpretation, Congress explicitly meant to exclude capital gains with this wording. Everything else is basically open to withholding.

In theory, then, this withholding tax is extremely broad because it can encompass practically any payment made from the United States to a nonresident alien. The location of the payment does not really matter; rather, it is the source of the income that matters. The general rule is that once a payment is made to a nonresident alien that is not a capital gain and that is not a sales transaction, it is subject to the 30 percent withholding tax. There are many exceptions to this rule, but in principle that is the rule.

How does tax withholding actually work? The general rule is that there is a withholding tax on the gross payment of passive income, which is technically FDAP, but more broadly the various normal categories of passive income to nonresidents. However, we will discuss in the next section that the many exceptions to this rule generally overshadow the rule itself. The United States is the world's biggest importer of capital – it imports about $1.2 trillion a year of foreign direct investment and over $2.5 trillion a year of portfolio investment from overseas, which are both much greater than outgoing investments.

If we consider just the portfolio investment side, this investment represents acquisitions of equity and debt of American companies and debt of the American government. If all of this tremendous flow were covered by a 30 percent withholding tax, it would presumably produce staggering amounts of revenue for the American government. However, the American government in reality collects less than $4 billion a year from this 30 percent withholding tax, which is a very small amount compared to $2.5 trillion of investment. The reason is that the American government has chosen not to collect the tax for most types of investment.

II. EXCEPTIONS

A. Capital gains

Let us consider some of the exceptions. The first major exception is the capital gains rule, which we examined in depth in Chapter 2. The source rule for capital gains is residence of the seller, which means that sellers of shares in American companies do not pay any tax because the income is not U.S.-source. Proceeds from these sales are also not FDAP, because that is the one item that is excluded by the rule.

To illustrate the importance of this exception, consider a foreign parent company with a U.S. subsidiary that has a pile of accumulated cash. As an economic matter, it really makes no difference in distributing the cash

whether the subsidiary distributes a dividend, which would be subject to withholding tax, or whether it sells the shares and receives the value of the same cash from the buyer. Either way, the money received from the buyer in part represents payment for the money that is inside the company because the buyer knows that it will be able to obtain the accumulated earnings. Even so, the dividend is subject to a withholding tax (usually not even reducible to zero by treaty), but the capital gain transaction is not subject to any withholding tax and is therefore completely tax-free by virtue of the source rule.

Thus one obvious way of avoiding the withholding tax on dividends is to sell shares. The foreign parent may not want to sell their shares for some time, but it can always let the cash accumulate inside the United States and sell the shares when it is ready to realize the investment. It then collects the money tax-free and benefits from the entire appreciated value of the U.S. subsidiary from its business operations and its earnings that it has accumulated, including completely passive earnings that just sit in a bank account and are not subject to any shareholder-level tax.

This is a major loophole in the system that is probably not absolutely necessary. There is the administrative problem of knowing how much the capital gain is, and another administrative problem of collection. In the case of small buyers on a stock exchange, these administrative problems increase, because it is a difficult enforcement matter to even know the identity of the seller. But in the case of a larger buyer such as a multinational parent corporation, it should be possible to impose the tax as a condition to registering the shares in the name of the buyer, as is done by several countries for large share ownership situations.

The one exception where there is a definite attempt to ensure that taxation takes place is in the appreciation of real estate in the United States, which will be discussed in Chapter 5. The treatment of real estate proves that it is in fact possible to collect tax on capital gains.

B. Interest

The capital gain exception, however, is not the most important one. The most important exception in terms of its influence on the rest of the world is the rule for interest. In the early 1980s, Ronald Reagan was elected president and pursued two simultaneous policies. One was to cut taxes dramatically in 1981, and especially to cut the effective tax rates for corporations. Reagan also pursued an aggressive policy of defense buildup. The combination of these two policies created a tremendous budget deficit, and because

the American domestic savings rate was notoriously low, the only way to finance the budget deficit was to borrow from overseas.

The early 1980s therefore saw a tremendous influx of foreign investment. This was when America originally became a debtor country, when ingoing capital began to exceed outgoing portfolio capital. This borrowing was financed largely from Japanese sources, who were then very rich and had large savings to invest, and also from Arab countries, who were wealthy from oil proceeds. In 1984, it was decided that it was necessary to make sure that foreign investors would be able to lend money to the U.S. companies and to the U.S. government without having to pay any withholding tax on their interest payment, because it was felt that under this tremendous demand for foreign capital, any tax would be passed on to the American borrowers rather than really borne by the foreign investors, which would not benefit the United States.

In 1984, Congress therefore enacted the portfolio interest exemption, which is still in place today. This exemption specifies that all payments of U.S.-source interest to foreigners are exempt from the withholding tax as long as they are "portfolio interest." This exemption covers interest on deposits in banks (which is actually an even older exception), interest on bonds issued by the government, and interest on all bonds issued by private corporations; basically all interest is exempt from tax as long as it is so-called portfolio interest. Portfolio interest is interest that is paid to nonshareholders. The test is whether the shareholder owns 10 percent of the stock – that is, interest paid to foreign parents or to large foreign shareholders does not qualify for the portfolio interest exemption. The classic example of a situation that does not qualify is that of a foreign parent lending money to its U.S. subsidiary; the parent lends the money to the subsidiary and receives interest in return, which does not qualify for the exemption because there is 100 percent ownership.

The reason behind the limited exemption is to discourage thin capitalization, which refers to taking all earnings out of the United States by capitalizing with debt rather than equity and deducting interest payments to related parties, free or withholding.

The one other exception to this exemption rule is for bank loans made by foreign banks. This exception was basically a protectionist device for American banks who wanted to maintain a preferred position in lending to American companies. They added a provision to the Code that says that foreign banks lending in the normal course of their business to American companies will not benefit from the portfolio interest exemption. There are many problems with this provision, including defining what a bank is

or what "in the normal course of business" means, and additionally it is considered discriminatory against foreign lenders.

The portfolio interest exception has had a dramatic effect. It is estimated that the first few years after 1984, more than $300 billion moved from Latin America to bank accounts in Miami. This money transfer was illegal from the Latin American countries' perspective because of local capital restrictions, but was attracted by the availability of interest free from withholding in bank accounts. In addition, deposits in American banks are guaranteed by the U.S. government and insured by the Federal Deposit Insurance Corporation, so it is a low-risk location. This quantity of money is large even by American standards, but by Latin American standards it is tremendously large: it was much more than all the World Bank and even private investment in Latin America at the time. The money went into Latin America and went back out to the U.S. bank accounts without benefiting Latin America. The attractiveness of American banks in the 1980s was one factor in why the 1980s were the "lost decade" for Latin America in terms of development, because money given to them was transferred back into the United States.

The fact that the United States does not withhold tax on interest has meant that Japan is almost the only developed country that now withholds on interest payments. The interest exemption has become a problem in a number of contexts, most notably Germany, because German residents have been able to manipulate the exemption to gain the benefit even for interest on local investments. The Germans would put their money into Luxemburg and then reinvest money into Germany; the interest would leave Germany tax-free and then hide in Luxemburg under bank secrecy. To solve this, the European Union recently adopted a directive that would impose information exchange or a 20 percent withholding tax on all interest payments to residents of the European Union, although this does not apply to payments to non-EU residents.

Another example of complications from the interest exemption involves a Mexican investor who puts money abroad. She would like to put it in the United States because of the availability of profitable investment opportunities, but the United States and Mexico have a tax treaty with an information exchange provision, so it is conceivable that the United States would provide the Mexican tax authorities with information that would enable them to tax the interest. If, however, the Mexican investor first puts her money in a secret bank account in the Cayman Islands, the interest becomes taxable income that is not declared to anyone. Neither the IRS nor the U.S. bank knows who owns the bank account to which it is sending the interest tax-free because of bank secrecy provisions.

Scholars estimate that investors receive $7 trillion a year in interest income that is not subject to withholding. The exact number is unknown because the practice is illegal, but the number is very large. The majority of countries agree that all would be better off with universal imposition of tax on interest, but no single country is willing to be the first to lift the exemption and therefore the system is very difficult to change.

In any case, it is important to be aware of this exemption. In addition, remember the discussion in Chapter 2 that it is fortunate that interest and dividends have the same source rule because it is unnecessary to distinguish between dividends and interest. However, we see now that even though interest and dividends have the same source rule, the actual substantive tax treatment is very different. Interest is subject to exemption, but there is no portfolio dividend exemption. The most obvious way of avoiding the tax on dividends is to change them into interest, and people have devised elaborate schemes to create financial instruments that pay interest (in order to qualify for portfolio interest exemption) but would also give returns that would more likely be return on stock, in particular the upside potential for appreciation.

Many types of convertible debt instruments have therefore been created that can be made into stock if the company is successful. Certain provisions in the IRC attempt to prevent that from happening, but the line is notoriously difficult to draw. Thus an additional problem with the portfolio interest exemption is that once again necessitates drawing the line between interest and dividends. The interest rule is the most important because most capital flows out that way.

C. Royalties

Royalties do not have any specific exemption but are addressed by an important treaty provision. Interest is also covered by the treaty provision, but treaty protection is generally unnecessary because of the portfolio interest exemption, which applies with or without a treaty. Royalties, however, are only covered in countries that have a treaty with the United States, because the United States is willing to enter into treaties under the U.S. model treaty that reduce the withholding rate of both interest and royalties to zero. This is also the position of the OECD on royalties, although not on interest.

Thus, the key for royalties in terms of withholding tax is to find the correct treaty partner. In certain cases it is possible to so-called treaty shop, which refers to finding a country that has a suitable treaty even if the country of residence does not.

Consider the case discussed briefly in Chapter 3 involving the Dutch company SDI. The *SDI* case involved three related entities: SDI Bermuda, which had software in it; SDI Netherlands; and SDI United States. SDI Bermuda licensed software to SDI Netherlands, which then licensed it to the United States and also to other countries. Royalties were paid at a 6 percent rate from the United States to The Netherlands and at a 5.5 percent rate from The Netherlands to Bermuda. The U.S. to Netherlands royalty is not subject to tax by virtue of the terms of the U.S.-Netherlands tax treaty, which like most OECD model treaties provides for 0 percent withholding tax on royalties. The royalty to SDI Bermuda was more complicated because the IRS argued (with the support of a prior revenue ruling) that royalties are sourced at the location of use; they argued that even in the Netherlands-Bermuda royalty, the place of use was in the United States because the software was being used in the United States.

Although the IRS reading may be a legitimate reading of the language of the Code, the court disagreed, supported by two somewhat questionable reasons. First, the court found that the Netherlands-Bermuda royalty included many other royalties from other countries, because the Netherlands company collected royalties from many countries in addition to the United States. The IRS argued that it was possible to calculate how much of this royalty derived from the U.S. payment because it was possible to see the spread (0.5 percent), but the court did not accept this argument.

The court's second reason was perhaps the most important. The court said that we have to imagine that there was no treaty between the United States and The Netherlands. In that case, if we were to accept the IRS interpretation that both of these royalties are U.S.-source, then there would be a 30 percent withholding tax on the U.S.-Netherlands royalty, because it is clearly U.S.-source, and another 30 percent withholding tax on the Netherlands-Bermuda royalty; this is what is called a cascading tax problem, because we would have a tax on a tax, even though they represent taxes on the same underlying income.

The major weakness in the court's opinion is that if no treaty existed, no one would choose to structure the transaction this way. The reason for going into The Netherlands and then back to the United States was to benefit from the treaty; if no treaty existed, they would go directly from Bermuda to the United States. The only function of the Netherlands company was to provide for treaty shopping, to benefit from the protection of the Netherlands treaty.

Today there would be some problems with this structure because there is now a new American/Dutch treaty that has an elaborate "limitation on benefits" or anti–treaty shopping article, which we will discuss in Chapter 9.

The limitation on benefits article tries to prevent treaty shopping from taking place, but it is quite difficult to do so, because loopholes exist even with the limitation on benefits article. Thus by choosing the right jurisdiction and being careful about limitation on benefits and similar rules, you can achieve no withholding for royalties using the 0 percent rate under the treaty.

D. Dividends

We have now discussed three of the major categories of passive income: capital gains, interest, and royalties. The last of the major categories is dividends. Dividends are the most significant problem area, where it is the hardest to avoid the withholding tax. In many cases, treaties reduce the rate of withholding on dividends, since the nontreaty rate is 30 percent and the treaty rate is 15 percent on portfolio dividends. Treaties therefore help to reduce the withholding tax, but do not generally reduce it to zero (although it is reduced to zero for direct dividends in some recent U.S. treaties like the U.S.-U.K. treaty).

This policy, which is deliberate on the part of the U.S. Treasury, is somewhat strange. It seems inconsistent to maintain the tax on dividends while being willing to eliminate the tax on interest and royalties, especially given that interest and royalties are deductible so without a withholding tax, the government does not collect anything. Dividends, by contrast, are not deductible, so the government still collects the corporate tax.

Consider the example of a U.S. corporation that earns 100. The corporation pays 35 in corporate tax and sends the remaining 65 up to its foreign parent as a dividend. The other possibility is that, instead of paying a dividend it pays interest or a royalty; both of these other options are deductible, so the corporation can pay 100 to the foreign parent and eliminate its corporate tax.

It is somewhat surprising that the American treaties exact no withholding tax on deductible payments, but insist on collecting a positive withholding tax on dividends, because one type of payment does not result in the elimination of the corporate tax and the other one does. This is particularly striking because since 2003 the United States has followed the rest of the world in adopting a partial integration system, so that for domestic shareholders there is no full double tax on dividends, but still persists in taxing dividends to shareholders twice as a relic of the classical corporate tax system. A number of recent U.S. tax treaties, including those with

the United Kingdom and Australia, do have a zero rate on dividends to corporate parents; however, no U.S. tax treaty has a zero rate on portfolio dividends.

What can be done in terms of avoiding the withholding tax on dividends? First, using modern financial theory and modern financial instruments, dividends can usually be converted into interest, with the benefit of the portfolio interest exemption. Alternatively, interest may have heightened treaty protection, as opposed to the reduced protection for dividends. Second, a more specific way of doing this is possible with the use of derivative financial instruments, which is a big market development in the past twenty years in the United States and elsewhere.

Suppose a foreign portfolio investor invests in the equity of a U.S. corporation. The U.S. corporation pays $100 of dividend. There is a 30 percent withholding tax (assuming no treaty), so the net of the foreign investor is $70. That's the normal situation, and if the foreign investor is not well advised, that is what will take place.

What do sophisticated foreign portfolio investors do differently? They approach a U.S. investment bank that is sophisticated in using derivative financial instruments, which are basically financial instruments that give a return that derives from the underlying return on some other instrument. And in this case, the investment bank arranges a total return equity swap, which is simply a contract between the foreign investor and the investment bank in which the foreign investor puts money into the investment bank. In return, the investment bank promises to give the foreign investor two things. The first is a payment that is equivalent to any dividends that would be paid on the equity of the U.S. corporation, which is called the dividend equivalent amount. And the second is a payment at the end of the contract that is equivalent to appreciation in the value of the stock. In return, the investor promises to pay the investment bank if the stock goes down in value. The instrument is called total return because the investor gets the whole return on the underlying equity.

Over the course of the contract, the bank pays the investor the dividend equivalent amount, which is equivalent to what the underlying company's stock pays in dividends. The bank will hedge, or insure, its investment by actually holding the equity of the company. If the company pays a dividend, it pays that dividend to the bank and the bank pays a corresponding dividend equivalent amount to the investor. At the end of the contract, either the bank will pay the investor if the shares have gone up from the original investment, or the investor will pay the bank if they have gone down.

If the initial investment was 100, the dividend equivalent amounts are simply the amounts of the dividend. The appreciation or depreciation depends on the value of the stock when the investment is terminated. The investor basically receives all the economic return of an investment in the equity. Because he gets the equivalent of dividends paid by the company, he receives any potential appreciation and also receives no protection from depreciation. In this case, the investor is in the equivalent economic position to a direct holder of the equity of the company. The investor does not have the right to vote the stock, but for a portfolio investor this generally does not matter because the number of votes is small.

Foreign investors therefore may invest in a total return equity swap issued by a U.S. investment bank. And this is by now a totally commodified area where any small person can come and do this in any normal branch of any U.S. bank or any U.S. investment bank. The contracts are completely standardized; the investor simply fills in the name of the company on the form. Transaction costs are generally very low, with only a small fee paid to the bank.

In this case, what happens when there is a dividend payment? When there was a real dividend payment from the U.S. corporation to the foreign investor there was a 30 percent withholding tax, and the net return was only $70. In this case, the U.S. corporation pays $100 of dividend to the U.S. investment bank that holds the actual equity. There is no withholding tax on this payment because it is a U.S.-to-U.S. payment and does not cross the border. The U.S. investment bank thus has $100 of dividend income. However, it also will pay $100 of dividend equivalent amount to the foreign investor, and that amount is deductible. So it has income and it has a deduction. These two match – it doesn't have any net income – except for the commission that it will take.

Most important, there is no withholding tax on the dividend equivalent amount. Why? The technical answer is that the regulations state that the source for payments on derivative financial instruments is the country of the recipient, because the U.S. financial industry persuaded the IRS to adopt this rule in order to encourage people to come to it to invest in this fashion. The Treasury knows about this, because it has been going on for a long time, and if they wanted to, they could have said that a dividend equivalent amount is to be treated the same as a dividend, because it is the economic equivalent of a dividend and therefore should be subject to a withholding tax. In fact, there already is an example of this in which a foreign holder of securities lends them to a domestic U.S. person and receives dividend equivalent amounts during the period of the loan, while the U.S. borrower

receives the actual dividends. In that context, the Treasury and the IRS have issued regulations that classify dividend equivalent amounts as dividends and require withholding.

Why was this not done in the equity swap context? It was probably done to attract foreign investors into the U.S. equity market. It seems likely that the IRS does not fundamentally believe in the dividend withholding tax, but cannot get Congress to repeal it the way it repealed the interest withholding tax. The IRS therefore gets around the regulations in a more sophisticated way, resulting in unsophisticated foreign portfolio investors falling into the trap and paying the tax. The result, however, is very beneficial toward sophisticated taxpayers, and one that is basically sanctioned by the Treasury and by the Internal Revenue Service.

Thus, the withholding tax contains so many loopholes that there is almost nothing left to hold it together. Where, then, does the IRS collect the $4 billion that they do collect from the withholding tax? This sum is basically collected from payments of dividends by American subsidiaries to foreign parents. If an American subsidiary pays such a dividend, it will be subject to withholding, a tax that cannot be avoided for a number of reasons. First, the most obvious way to avoid paying a dividend would be to pay interest instead. That interest, even though it is not portfolio interest, may be protected by treaty from withholding. But an anti–thin capitalization rule restricts the ability to get everything out by way of interest. After a while, the interest becomes not deductible, treated essentially like a dividend, though still not subject to withholding tax if it is protected by a treaty. It is thus impossible to transfer everything through interest.

The capital gain option is also available, but sometimes the parent company wants to keep its U.S. subsidiary rather than to sell it, but still wants to get the money out.

The last remaining option seems to be the equity swap, which involves the possibility of holding onto the shares but entering into an equity swap on another category of shares. There would be one category of non–dividend paying shares and another category of dividend-paying shares, and an equity swap on the latter. Then there would be equity swap payments that are foreign-source income and not subject to withholding. This, however, is not possible because of IRS objections to a situation where the foreign investor actually holds the equity of the underlying corporation at the same time of the equity swap. The IRS would argue that a dividend really was paid on the voting shares, the investment bank was merely a conduit, and that dividend should be subject to withholding.

III. CONCLUSION

The $4 billion in revenue therefore results from dividend payments from U.S. subsidiaries to foreign parents. The question remains as to whether it is worthwhile maintaining the whole elaborate structure of the withholding mechanism for $4 billion in revenue. In particular, the withholding regulations that came out a few years ago are exceedingly complex and impose significant burdens on taxpayers. Would it not be better to give up on withholding altogether?

Of course, there is another solution to the problem, which may be better in some ways, which is to repeal all of these exceptions. Then the IRS would collect a lot of money. However, this would reduce the competitiveness of investment in the United States. The best solution is perhaps some type of coordinated effort, perhaps by the OECD, which includes the United States, Japan, and Europe. If the OECD members were to impose a coordinated withholding tax on interest, it would probably be successful; so far, they have not been able to work together in this fashion.

Interestingly, the U.S. portfolio interest exemption is probably harmful tax competition as defined in the OECD in 1998. This exemption was designed purely to get money away from other countries and into the United States, which was precisely the target of the OECD harmful tax competition initiative. However, the OECD did not really address the specific issue of the U.S. exemption, and instead decided to put aside the question of taxation of savings (interest income) to a later date.

The OECD's largest attempt to address harmful tax competition is their attempt to shut down the tax havens or to force them to cooperate with exchange of information. It is difficult to solve the global problem through exchange of information policies because if even one or two small countries do not cooperate, the system fails. Targeting the withholding tax seems more promising: it only requires the cooperation of the big money centers, because most countries are too risky to attract big investment. Such a coordinated effort seems promising and possible among the major money centers of the United States, Japan, and Europe, and it is possible that they will choose to cooperate in a coordinated solution in the future.

5

Taxation of nonresidents: Business income

I. IN GENERAL

The previous chapter discussed the taxation of passive income. This chapter will discuss the taxation of active or business income, that is, income whose source is under the taxpayer's control. The first thing to realize is that a significant change was made to attract foreign investors in the mid-1960s, when again, because of the Vietnam War, the United States needed a great deal of foreign capital. This change was as follows. Before 1966, the basic dichotomy was that foreign investors, nonresidents, were taxed on passive income (FDAP) at 30 percent on the gross, subject to all of the exceptions, whereas active income was taxed on a net basis with progressive rates. This continued after 1966, but the test for which rule applied changed.

What is the test as to whether you are under the active income umbrella? The test is whether you have a "trade or business" in the United States. That is the language of Code 871(b). We will discuss later what exactly that means, to have a U.S. trade or business. But the interesting question is, suppose you have one (and it is as we will see very easy to have one, a very minimal level of activity would qualify you) – which income then becomes subject to the active side?

Until 1966, the United States had what is called a "force of attraction" rule, which is the rule that the UN model treaty and most developing countries prefer. Force of attraction means that, when you have a trade or business (which is a term analogous, although not equivalent, to "permanent establishment" in the tax treaty context), all income from within the United States is attracted to the trade or business. That is why the rule is called "force of attraction."

Force of attraction means the following: Suppose you have a great deal of investment income in the United States – that is, you invest in securities, in stocks and bonds of American corporations. You also have a small American trade or business – for example, you rent out a couple of apartments; which puts you in the rental, or apartment management, business. Under the

pre-1966 rule, the moment you are found to have the trade or business, all of your American income would jump over from the passive side to the active side. That is, instead of being taxed on a gross basis, it would be taxed on a net basis. The original reason for that was that, in the absence of a U.S. trade or business, it is difficult to audit you because you are not physically present in the United States. Once you have a trade or business in the United States, the IRS can audit you, and therefore you are taxed at net rates for everything. Now under 1966 conditions, the net rates were over 90 percent. Thus, it was practically always better to be on the gross side, given that for passive income there usually are not a lot of deductions. You need to have a very high level of deductions before it is worthwhile to be on the net side.

This force of attraction led to a bad result for taxpayers, which is why, in the cases that we will discuss later, taxpayers were fighting desperately to avoid having a U.S. trade or business. They wanted to keep all of their income out of the force of attraction rule, and over to the passive side, in order to pay a tax of 30 rather than 90. As we discussed earlier, now that rates have changed, this choice is no longer so clear. As of 1966 the force of attraction rule has been repealed, and instead the rule now is, only the income that is "effectively connected" with the U.S. trade or business is under the active side. And all other U.S.-source income, passive income, is still taxed at 30 percent – as long as it is not effectively connected.

This is why I said that the choice is to a large extent dependent on the taxpayer. First of all, whether you have or do not have a U.S. trade or business is up to you. It's easy and inexpensive to set one up – a small one. Second, if you do have one and you want to be on the active side, it is relatively easy to channel your passive income through your business to make it effectively connected, if that is what you want – because the presumption of all of these cases is that you want to avoid being on the active side. Therefore, the IRS tries to push you over to the active side, as it tries to do in the cases we will discuss later. Now you can use all of these cases against them, if you want to be on the active side, because the rate relationship has changed. It may frequently be the case that you prefer the net rates to the gross rates on your passive income – as an extreme example, suppose you were in the 15 percent bracket; clearly you would want to avoid 30 percent withholding. And the way to do it is to set up a small U.S. business and to make sure that your income is effectively connected with it. We will discuss later what that means, but it is not that difficult to do.

That is the history. There is almost no force of attraction anymore. There is a very limited residual remnant of force of attraction that is sometimes

significant, especially in the electronic commerce context: a provision that says that income that is not FDAP, but is also not capital gains, would still be subject to force of attraction. That is, if you have a trade or business, it will be treated as effectively connected. That basically means a situation where you have a trade or business but you also sell inventory to the United States, and it is U.S. source. Those sales of inventory will be treated as effectively connected to the U.S. trade or business, because it is neither FDAP nor capital gains. For example, suppose you have two businesses. One has a permanent establishment, a fixed presence in the United States. The other one does not. The concern would be that the one that does not, which may be much bigger but may do everything through the Internet, by electronic commerce, may be drawn into the smaller one that has a permanent establishment.

II. TRADING IN STOCK OR SECURITIES

I will now illustrate this by a few cases. The first one involves a famous figure in Chinese history, Chang Hsiao Liang. He was a warlord in the 1920s and 1930s and is famous for the "Xi'an incident," in which he kidnapped Chiang Kaishek and forced him to sign an agreement to fight against the Japanese. Mr. Chang died in 2002 in Hawaii, at the age of over 100. He had been a notorious warlord during the turbulent 1930s, operating mostly in northern China and Manchuria. In the incident that led to the case, Mr. Chang met an American by the name of Cochran in Manchuria and decided for good reasons that it might be safer for him to put his money into the United States rather than leaving it in China during the years of the war with Japan. So he transferred more than $3 million to the United States, which was a great deal of money back then. Then, of course, for a very long period, he was out of touch with his American agent – because Chiang Kaishek had had Mr. Chang imprisoned, and he was unable to come to the United States. He never set foot in the United States during the whole period of the war. From 1932 to 1946, a long period of time, Mr. Chang's money was sitting in the United States, being managed by Mr. Cochran as Mr. Chang's agent.

Mr. Cochran did a very good job and managed to grow the money tremendously – and he took a commission, which was fixed by the agreement. He managed the investment by buying and selling stock in various corporations. The question was whether this amounted to a trade or business in the United States. Because this was during the days of the force of

attraction rule, then even if you could say that not all of it was related to the trade or business, if you could show that Mr. Chang had a trade or business in the United States, then automatically all of his income would be subject to the net rates, which were over 90 percent at the time, as opposed to 30 percent. So the revenue difference was very large; Mr. Chang would have to pay much more tax if this was a business than if it was not. But the court analyzed the transactions by the agent. (As this indicates, you can have a business through an agent, a point that we will return to later – just as you can have a permanent establishment through an agent, if the agent is considered dependent.) The transactions were analyzed even though this particular agent was essentially independent, in the sense that there was no control exercised – there was no communication between the agent and the principal.

Mr. Chang could have been deemed to have had an actual business in the United States through the operation of Mr. Cochran. However, the court analyzed the actual transactions and felt that they were more in the nature of investing activity than an active business, despite the frequency with which stock was sold. But most was sold after reasonable periods of time, and it wasn't active enough. Thus, the courts held in favor of the taxpayer.

This test, the frequency with which stock is sold, is inherently very unsatisfactory, but this problem has now been resolved: there is now a clear provision in the Code itself that says that all investment activity in the United States, no matter how active it is and whether it is for somebody else or your own behalf, is not a trade or business. So you cannot have a U.S. trade or business by virtue of pure investing activities, whether you do it on your own behalf or on behalf of others. This is just one example of how the term *trade or business* works.

III. U.S. TRADE OR BUSINESS

It is important to realize that neither the term *trade or business* nor the term *effectively connected* is defined anywhere in the Code. It is necessary to go to the court cases in order to understand what these terms mean.

A. The physical presence test

Leaving aside investment activity, which never crosses a threshold, what is the threshold for having a U.S. trade or business? In the tax treaties, there is the notion of *permanent establishment*, which is fairly well developed. Permanent establishment excludes many things such as warehousing and

auxiliary activities. Generally speaking, the *permanent establishment* threshold is much higher than *trade or business*. That is true even in treaties that follow the UN model, which, because it is much more pro-source, has a lower permanent establishment threshold than the OECD model. For example, in the UN model, for a temporary construction site to be a permanent establishment, it need only last six months or more. In the OECD model it must last for more than a year. There are many other differences, but *trade or business* is a much lower threshold than even the UN model, making it very easy for the United States to exert source-based taxation on active business. As stated previously, whereas in the case of passive income it is very easy to avoid American tax, in the case of active income you must work quite hard to avoid American tax, which (as discussed earlier) is congruent with the benefits principle and the international tax regime.

What is the threshold? The first thing to establish is the physical presence test, which is now extremely important because the rise of electronic commerce makes it relatively easy to avoid physical presence. The classic case is called *Piedras Negras*, the name of a city in Mexico that is located just across the Rio Grande from Eagle Pass, Texas. A radio station formerly broadcast from Eagle Pass – in English, of course – but then the Federal Communications Commission refused to renew its license. So the station simply crossed the river into Mexico and continued to do business in exactly the same way as before. It was no longer subject to FCC regulation, but it continued to broadcast in English. Its revenue came from advertising in English that was placed by American advertisers who were buying time on the program. Every day, the station would send someone over to Eagle Pass to collect the money in a hotel room and bring it back to Mexico.

The IRS argued that the advertising revenue was U.S.-source business income and that the station had an American business. However, the Fifth Circuit Court of Appeals held, by a 2-to-1 majority, that the station did not have a U.S.-source income, or a U.S. trade or business. The court said that, although as an economic matter the English-language broadcast was designed for the American market, there could be no business unless there was some kind of fixed physical presence in the United States. Without a tangible physical presence, there can be no American business, and no American-source business income.

Under current concepts, this is not entirely clear: the radio station may have made a mistake by sending somebody over and renting a hotel room on a day-by-day basis. One could argue that that hotel room was their fixed presence. But now, of course, it is possible to avoid that, too. You need not have a fixed presence to collect money. The obvious modern analogy that was widely pointed out when electronic commerce became a reality is the

situation where merchandise is sold from a server that is located in some other country, but is accessible on Web sites all over the United States. Do the owners of the server have a trade or business because they are selling vast quantities to the American market? The answer, based on *Piedras Negras*, is no.

This is not just anybody's answer; it was the answer that was given by the U.S. Treasury Department when it issued its study of taxation of electronic commerce in 1996. The Treasury declared that in order to have a permanent establishment under treaties, but also a U.S. trade or business under domestic U.S. law, you need to have a fixed physical presence in the United States. This is why they predicted that with the advent of electronic commerce, source-based taxation will eventually disappear.

I doubt that: e-commerce has not eroded source-based taxation as much as the Treasury thought it might. But certainly this has some disturbing potential if you consider it carefully. In any case, however, it is clear that to have a U.S. trade or business, you must have some physical presence, just as you need a permanent establishment for source-based taxation of business income under the treaty network.

Beyond that issue, an interesting and important question is, how much physical presence is needed? Agents can be a physical presence, but so, sometimes, can machines. For example, the OECD has taken the position that if you place your server in the United States, even though there are no people with it, that can be a permanent establishment and therefore it can be a U.S. trade or business. But that is not very realistic, because nobody needs to put a server in any high-tax jurisdiction. Servers can be anywhere. So that makes little trouble for taxpayers.

Sometimes, though, the situation is more difficult. The case that I am most familiar with involves nodes for satellite communication. The question is, when the satellites are in the sky and nodes are on the ground, is that enough to constitute the kind of physical presence required for a U.S. trade or business? And the answer is, maybe. A special rule for communications usually says no, it should be subject to pure residence-based taxation, but it also says the source is half U.S., half foreign source, if there is a U.S. fixed presence. There is still some room for debate and interpretation on this point, which is one threshold you need to pass.

B. Case examples

Beyond that though, the threshold becomes very low. This can be illustrated by another World War II case, involving a Swedish count who, like

Mr. Chang, never set foot in the United States during the war. His name was Lewenhaupt. Through an agent, he had a few properties that he had inherited from the American side of his family. The agent bought one property and sold two others. The court, somewhat surprisingly, held that this level of activity, which is quite low compared to Mr. Chang's hundreds of stock transactions, is sufficient to constitute a U.S. trade or business. Today, after 1979 as we will see, real estate is always a U.S. trade or business, even selling one real property. But that wasn't the case around World War II, and it is very significant for holding that a very low level of activities, buying and selling a couple of inherited pieces of real estate, is sufficient to constitute a U.S. trade or business, even when it's done through an agent without any physical presence. Lewenhaupt himself was in Sweden and wasn't able to get to the United States during the war at all.

Clearly, the threshold is very low. The standard advice given by New York law firms is this: Some cases say that having one piece of real estate for rental income purposes is not a U.S. trade or business, and though it's clearly a physical presence, that is not enough. However, having two may be enough: two is the line. One is pure investment. Two is a real-estate business. That line may make little sense, but this is the conservative advice based on the *Lewenhaupt* case and similar cases.

On the other hand, it is sometimes possible to have a great deal of activity without really having a U.S. trade or business. One interesting example is *Spermacet Whaling*. An American corporation, Archer Daniels Midland, was in the business of buying and selling oil from sperm whales. Some Norwegian joint venturers were experts in hunting the whales and collecting the oil. Initially the two groups thought of forming a partnership, a joint venture, which would catch the whales, collect the oil, and sell the oil to ADM. An enormous profit would be made, because there was a huge shortage during the years after World War II. However, this initial plan was eliminated for tax reasons: because this was a partnership, the profits would immediately flow to the United States, ADM being an American company.

The next step was to form a company, Spermacet Whaling, which was a Panamanian company and was intended to do the work. However, they needed a ship, which was owned by a British company that refused to charter the ship to the Panamanian company: Panama was not a signatory of the International Whaling Convention, which was even then enforced and which limited the hunting of whales.

So, another American company, a U.S. subsidiary of ADM, nominally chartered the ship – the American company did nothing else beyond this nominal ownership. Spermacet Whaling did all the actual business, except

that the oil, again nominally, was owned by the U.S. subsidiary. Spermacet Whaling was paid a "fee" for doing the actual business activity: all the profit from the oil except $25,000 that was left to the U.S. subsidiary as a commission. This meant that 99 percent of the profit was paid as a fee to the Panamanian corporation, and $25,000 was left in the United States.

The technical issue was whether the Panamanian company had a U.S. trade or business. The court held that it did not: the business was done on the high seas, and there was no physical presence or connection in the United States. The court said that Spermacet earned their whole fee, and the U.S. company was not a shell. It was a real company that had other business activities. Therefore, the courts did not recast the transaction in any way, or ignore the separateness of the two companies. The plan was respected, and all of this profit escaped U.S. tax altogether – an astonishing result.

C. Agency

Two agency cases are worth mentioning at this point. One is simple and unsophisticated. It involved a Canadian person who sold postcards in the United States. He would ship them over, they would be displayed in various places where newspapers were sold, and any that were not sold would be shipped back to him. The Canadian would receive the proceeds. Not surprisingly, the court held that considering these facts, he did not transfer ownership to the American news vendors; he maintained ownership, because all the risk of loss was still on him, and the cards would be returned to him. Therefore, it was not a capital gain transaction or anything done out of the United States; the Canadian was engaged in a U.S. trade or business. The newspaper agents were simply his dependent agents for this purpose.

The other case shows what can be done with sophisticated tax planning: the so-called *Taisei* case, which involved Fortress Re, an American insurance company. A group of four Japanese insurance companies entered into an agreement with Fortress, the American company, in which Fortress reinsured a tremendous amount of insurance business that the Japanese companies did in the United States. That is, the Japanese companies would underwrite various U.S.-located risks, and then Fortress would act as agent and reinsure these risks. First there was a primary insurance contract, and then it would be transferred over and a reinsurance contract would be issued. It is important to note that none of these companies owned any stock in Fortress: Fortress was an independent company, so this was not a transfer pricing situation.

The IRS argued that Fortress was an agent for these Japanese companies, and therefore the companies should be taxed as having a U.S. trade or business. It is relevant to know that, as with any other purely financial transaction, purely insuring U.S. risks is never a U.S. trade or business. The fact that the risks are in the United States does not make the transaction into a U.S. trade or business. None of the large premium income that was earned by the Japanese companies would be taxed. For the reinsurance business, they would certainly not be a U.S. trade or business, because they would not have sufficient presence.

However, the IRS argued that under the terms of the Japan-U.S. treaty, Fortress was really a dependent agent of these four companies because it was acting only for them, and for nobody else. All of its money came from them, and it was clearly following their orders. However, the companies were very, very careful not to document anything, so the IRS could not show that the four Japanese companies really controlled Fortress. Nominally, in the documents, they did not, except for an overall limit on how much Fortress could reinsure. In other words, there was an upper limit, but the court deemed that Fortress had complete flexibility. There was no legal control, of course, because the Japanese companies owned no Fortress stock. Reading the case, however, creates an impression that in fact Fortress was much more controlled than that. Yet in the end, the court held that Fortress was not an agent of the companies, and therefore there was no permanent establishment and no U.S. trade or business.

What the combination of this case and *Piedras Negras* and similar cases show is that it is possible to engage in a tremendous multibillion-dollar level of activity in the U.S. market without having a U.S. trade or business. You must simply avoid two things. First, there must be no physical presence. And second, there must be no dependent agency relationship. These are the two key points. If you avoid both of these, then no matter how much money you make in the United States, you don't have a U.S. trade or business. On the other hand, if you do have either a fixed presence in the United States or a dependent agent who follows your orders, you will have a U.S. trade or business.

IV. EFFECTIVELY CONNECTED

The next question is, how much income is effectively connected to a U.S. trade or business? What does it mean for income to be effectively connected with a U.S. trade or business? There is not much guidance in the Code to

answer this question, although there is a bit more than there is for defining a U.S. trade or business. The Code contains a two-prong test that involves the assets and the people of the business: Are the assets that belong to the U.S. business assets that produce the income in some way? Or are the people who are located in the United States and who are employees of the business, or connected with the business or the dependent agent, for example, the ones who produce the income? For example, if you have sales agents who are located in the United States, the key question, in terms of producing the income, is, who has the ultimate authority to conclude the sales contract? According to this analysis, that is the action that actually produces the income. The agent can do everything necessary to solicit the contract, but to avoid having a U.S. trade or business, final approval must be reserved to the foreign home office, who actually executes the contract.

Similarly, in the asset test, the question is, are the physical assets that are located in the United States related to the production of the income? This can be illustrated by an example, which is based on a joint venture between MCI and British Telecom. The joint venture was set up so that the joint venture was overseas; their business was selling international communications, to multinational enterprises in particular. The idea was to isolate the American income in a U.S. subsidiary, an American company, that would earn all the American-source income and, of course, pay tax on it. But all the rest of the activities worldwide would be in other subsidiaries or in the joint venture itself, which would do all the R&D and would not be associated with the United States.

There was, however, one major practical problem: the person who was chosen to be the CEO of the joint venture happened to reside in the United States, in Virginia, and he absolutely refused to move. He would not, for this purpose, move to England or any other place outside the United States.

So the analysis was as follows. First, was there any way for the joint venture itself to avoid having a U.S. trade or business? The answer was, essentially, no, because if the CEO is in the United States, he cannot be regarded as an independent agent; he is clearly representing the business and making all the decisions for it. There is no way to avoid having a U.S. trade or business under this analysis.

Then the fear was, what about the question of effectively connected income? Consider the "people test." You can certainly argue that the CEO is the person who, more than anybody else, is involved in creating all the income of the entire operation. If that is so, the fear was that the entire income of the joint venture would be characterized as effectively connected

with this single person in the United States and would be transferred over and taxable by the United States.

The solution was to create a "management company" in the United States whose only employee was this CEO. He provided management services to the joint venture in exchange for a fee. The argument was that whatever value was added by the CEO was incorporated in this management fee, which was essentially his salary. Of course this involved paying some additional U.S. corporate tax on the fee, in addition to the individual tax the CEO paid on his salary, but it was not that much because the actual salary was deductible. The key element was trying to separate out the joint venture vehicle from the United States.

The idea was to try to conduct as many operations as possible outside the United States – to limit the activities inside the United States, if any, to one American corporation that would have to pay taxes on just those activities but would be separate. Note that one rule that is universally accepted and well established in the treaties, and accepted in this context, too, is that merely controlling a local subsidiary does not create a permanent establishment or a trade or business, even though it is part of the same group. The idea is to separate the U.S. business income into a U.S. company; all the rest of the business is conducted offshore, and all other contact with the United States is minimized as far as possible otherwise. All the people who must work in the United States should be employees of the U.S. company. All the assets that must be employed in the United States should be assets of the U.S. company. You should try very hard to avoid sending people who are employed by the joint venture company, or assets that are used by this company, into the United States. If you keep your distance from the United States as far as you can, you are safe – again with the exception that if you are doing pure investment or trading in securities activities, you can be onshore. It doesn't matter; you don't have a trade or business no matter how active you are, even if your office is in New York and you do all your trading there. However, if you are doing any other kind of active business that is not pure investment activities, you are potentially in trouble if you put too much of your business onshore in the United States.

V. SUMMARY: TAXATION OF NONRESIDENTS AND THE INTERNATIONAL TAX REGIME

We have now discussed how, in general, the taxation of nonresidents works. To return to our original design of the international tax regime, we are

discussing nonresidents who are taxed on domestic-source income only. We have now covered both sides of this, passive and active. Passive income, mainly FDAP, is the kind that is subject to gross-based taxation. As we have said, because of the myriad exceptions to the rule of withholding taxation, passive income is subject to very low tax at source in the United States. Active income, which is effectively connected with a U.S. trade or business, is subject to net-based taxation. As we have seen, if you do have this kind of income, taxation is rather more difficult to avoid, and the effective rate is higher. All of this is congruent with the benefits principle.

VI. THREE SPECIFIC RULES

A. Real property

There are three more particularized rules, which are more recent additions to the Code, that we must still cover before we finish this topic of inbound taxation. What has been described so far was in place by the mid-1960s and has not really changed since then. But there are three particularized problems that have been the focus of attention since then, we will now discuss them and the issues that they represent.

The first one is real property. Real estate in the United States is now subject to its own special regime. During the 1970s the United States was in an economic recession and several other parts of the world were flourishing, in particular the oil-producing countries and Japan. In the late 1970s, many Arab and Japanese investors put their excess money into the United States. Among the things that they brought were major pieces of American real estate, which were then at quite high prices: for example, the famous Pebble Beach Golf Club in California, and Rockefeller Center in New York. Both of these were bought by the Japanese for a great deal of money. Americans, although they were then in a rather depressed mood, felt that the foreigners who were benefiting at their expense were also getting their treasures for a low price. Americans feared that the new foreign owners of these properties would be able later to sell them and make a huge profit – on which, because it was capital gains for foreigners, they would pay no U.S. tax.

So in 1980, just before Ronald Reagan was elected president and changed things rather for the better, a law was passed called the Foreign Investment in Real Property Tax Act, or FIRPTA. This law simply subjected nonresidents to tax on capital gains from all sales of American real estate as if it were effectively connected with a U.S. trade or business – whether or not the seller

actually had one. The gain is taxed at the net rate: capital gains cannot really be taxed on a gross basis because you don't know whether there is a gain until you calculate the actual return and offset the basis.

To give a simple example, consider a nonresident who simply owns U.S. real estate, which of course includes buildings and anything else that is attached to land. When it comes to a sale, it doesn't matter whether the buyer is American or foreign: any buyer of American real estate must obtain a certification from the seller that the seller is a U.S. resident for tax purposes. If this certification is not forthcoming, the buyer is obligated to withhold 10 percent of the amount realized, that is, the sale price, and send it to the IRS.

This withholding is not like the 30 percent gross base withholding that we discussed earlier, because it's not final. It can't be final because this sale may be at a loss. But it is now the obligation of the nonresident to go to the IRS, file a return, and then either pay more money or get some of it back, depending on how much profit there was actually on the transaction. Unless this tax is paid, the change in title to the real estate, from the seller to the buyer, cannot be recorded. So the buyer has a very strong incentive to actually collect. This shows that capital gains of foreigners can be taxed if there is a real desire to do so.

This is not so bad: it is the law, people can abide by it, and it's more or less manageable. The problem was that from the beginning, from the original enactment, people realized that this rule can be very easily avoided if people are allowed to put a U.S. corporation between themselves and the U.S. real estate. Then instead of selling the real estate, you simply sell the shares of the corporation. Sale of stock in a corporation is an ordinary capital gains transaction, which is not subject to tax by virtue of the source rule. So in addition to taxing the sale of U.S. real estate, there is a concept in the law called a U.S. real property holding corporation, which is defined as any American corporation (defined formally as having a place of incorporation in the United States) over 50 percent by value of whose assets are U.S. real estate. If this definition is met, that is, if more than half the value of the assets of the corporation consists of American real estate, then this corporation is now a U.S. real property holding corporation, which means that the sale of its stock is subject to the same rule as the sale of the underlying real estate.

Why is this a problem? It is a problem because in many cases it is not so easy to determine whether 50 percent by value of assets is U.S. real property. The assets must be valued. Many corporations, for example, have headquarters buildings in the middle of Manhattan. Those buildings are extremely valuable, worth many millions of dollars. Most of these corporations have

so many other assets that this does not pose a problem. But again and again there are cases where it is at least questionable whether the headquarters by itself may be worth more than half the value of the corporation – simply because real estate in the middle of Manhattan is so expensive.

The result is that for many very ordinary stock transactions by nonresidents, it is necessary to analyze whether 50 percent or more of the value of the corporation results from American real estate. This is a real headache, because an assessor must be hired to value all of the assets of the corporation, which results in a lot of transaction costs.

FIRPTA may not be justified as a policy matter, for two reasons. First, if you are a nonresident and you really want to profit from U.S. real estate, you need only substitute a foreign corporation to hold the real estate. Although the foreign corporation cannot sell the underlying real estate, its stock can be freely sold without being subject to FIRPTA. This is why most nonresident individuals do not invest directly in U.S. real estate; they use foreign corporations as the investment vehicle. They can then safely sell the stock without being concerned about FIRPTA, because sales of stock in foreign corporations are not subject to this rule: the corporations are regarded as nonresidents themselves.

Second, the underlying purpose of the law appears somewhat strange. As it turned out, the Japanese lost a great deal of money on both Pebble Beach and the Rockefeller Center, so they never made a gain that was subject to any tax. Also, the whole notion that there is something problematic about foreigners buying American real estate seems strange: in my view, there is a greater potential for problems if foreign investors buy American corporations, because then they can take whatever is productive and transfer it overseas. Rockefeller Center can't be moved overseas, nor can Pebble Beach. If there is any asset that is fixed to the United States in every way, it is real estate. I don't see the point of taxing foreigners on real estate and not taxing them on other capital gains, such as the gains on a share of IBM.

B. The branch profit tax

The branch profit tax was enacted in 1986. It is important, among other reasons, because it is an American invention that (perhaps unfortunately) has now become common in other jurisdictions such as Germany. The branch profit tax is a popular way of taxing foreigners. This may be correct, but in the American context I have some doubts.

Let's look at the reasons for enacting the branch property tax. Suppose we have a foreign parent with a U.S. subsidiary. Compare with it a foreign parent with a U.S. branch, which is not a separate legal entity. Remember that now that we can "check the box," this is very easy. They can both be LLCs as a legal matter, but you can simply check the box to treat one as a corporation and check the box to treat the other one as a branch. So before 1986, when this rule was enacted, what would happen in this scenario? The subsidiary would earn U.S. income of 100 and pay corporate tax of 35. It would have 65 left over. It would distribute whatever is left over as a dividend to its parent, 65. On that it would have to pay withholding tax of 19.5, assuming no treaty reduction – this is 30 percent – and it would net 45.5. On the other hand, in the case of the branch, the U.S. income is still 100, let's say with the same corporate tax. Because this is now effectively connected income of the U.S. trade or business and corporate tax must be paid on it, from that perspective it makes no difference. But now notice that when there is a remittance, a repatriation of the remaining 65 over to the parent, there is no withholding tax because there is no dividend. These two are the same legal entity. You cannot pay a dividend from a branch to the home office. A dividend must be from one corporation to its shareholder. This is an interoffice remittance within the same corporation. As a result, there is no withholding tax, and the net is 65.

Obviously, before 1986 there was a huge difference between the two, and there was a big advantage to investing in the United States through branches. This was to some extent alleviated by the fact that investing through branches entails a risk that investing through subsidiaries does not, which is why most multinationals prefer subsidiaries, the exception being banks because of regulatory requirements. But most multinationals do most business through subsidiaries rather than branches because a subsidiary shields the parent from liability, as the branch normally does not. However, that problem has also now been resolved with the rise of limited liability companies and "check the box," because the branch can be a limited liability company that simply checks the box to be a branch. There is the same insulation from liability in both cases, but you get a much better tax result for a branch than for a subsidiary.

Because of that, in 1986, the law was changed in the following fashion. The net U.S. assets of the branch, at the beginning and the end of the tax year, are examined to see whether they have gone up or down. Suppose on January 1, the branch has assets of 100. On December 31, the branch has assets of 120. One must also ask what the earnings of the branch were

during the year. Let's assume that the branch's earnings during the year are 50. Now, you take the beginning number – the beginning balance sheet, the net assets at the beginning of the year – and add the earnings during the year, the amount the branch accumulated. This gives 150. You compare this number to whatever is left in the United States at the end of the year, namely 120 in this case. In this case, you see that the number has gone down. That is, 100 plus 50 is more than 120. Presumably, then, the branch has remitted 30 back to the home office. There can be other explanations – for example, that they invested these earnings and lost some money – but the presumption, which is not even rebuttable, is that if these earnings have not remained in the United States, then they have been sent back. Of course these earnings have already been subject to corporate tax. These are posttax earnings. But the point is to try to catch the hidden dividends.

So if, at the end of a year, the number for net U.S. equity is less than the beginning net equity plus the earnings, the difference is treated as a dividend equivalent amount. In this case it is simply subject to the same withholding tax as an actual dividend. The result is that, after 1986, an actual remittance such as this from branch to home office is subject to withholding tax, just as the actual dividend would be, and the net will be the same in both cases.

The idea is to equalize the treatment of foreign parents with subsidiaries and the treatment of foreign parents with American branches by treating them both the same way. It is done by figuring out whether the branch has kept its accumulated earnings at the end of the year, or whether they have gone down. If the branch has kept them, there is no tax because that is like paying no dividend. But if the branch has sent them back, then there is a tax: the same withholding tax that would apply to a dividend, including any treaty-based reduction in the dividend withholding tax. Thus, in a treaty situation, there is the same withholding tax that would apply to a real dividend sent to the same treaty country. If in this situation the earnings at the end of the year are 150 or more than that, suggesting a contribution of money to the branch, then there will be no tax. This applies to 160 or any other number above 150. For any number less than 150, tax must be paid on the difference at 30 percent of the amount.

Fundamentally, this is another attempt to enforce the double taxation of corporations. We have discussed this before: the United States is insistent on keeping the taxation of dividends relatively high even in the treaty context (although this may be changing, as we will discuss in Chapter 9).

Although it certainly seems appealing to level the playing field between subsidiaries and branches, some questions do arise. Suppose you distribute

a real dividend. First you are subject to one level of corporate tax on your earnings, and then there is the withholding tax on dividends. As we have said, this tax cannot really be avoided. There is one level of corporate tax, and in the absence of the branch profit tax, there is no tax on any remittance. It is true, then, that you've saved one level of tax. Essentially one way of thinking about the branch profit tax, which after all is on a nonexistent dividend, is that it really is a substitution for a tax on a U.S.-source dividend from a foreign parent to foreign shareholders. Because this tax cannot be collected, you collect it on the branch. If that is the case, then clearly the branch profit tax cannot be collected in cases where a treaty prevents the United States from collecting tax on foreign-to-foreign payments – which is true for most U.S. treaties.

The United States recognized this problem in 1986. The Treasury immediately said that the branch profit tax would not be collected in those situations where a treaty forbids collecting a tax on dividends from parent to foreign shareholders, but that in those cases the treaties would be renegotiated. This created a situation where some people in the world were subject to branch profit tax because they didn't have such treaties, and other people were not. To prevent this from leading to treaty shopping, Congress enacted a special qualified resident rule in the branch profit tax that said that this treaty-based exemption from the branch property tax applied only to qualified residents of the other treaty country. This was defined as an anti–treaty shopping or limitation of benefits provision and was called a "treaty override."

Treaty overrides will be discussed in more detail in Chapter 9, but essentially, the American position, which is almost unique in the world, is that a law passed by Congress can unilaterally override tax treaties, because of a strange interpretation of the U.S. Constitution. Whether or not there was an anti–treaty shopping provision in a given treaty, one would be imposed. And that is what they did.

Years have now passed since 1986, and essentially all of the treaties have been renegotiated to allow for the imposition of a branch profit tax. Presumably concessions were made to the other countries in return.

Is it really worthwhile to exert so much effort to collect the second level of tax in the United States – the shareholder-level of tax – when in all cases the corporate-level tax has already been collected? I am doubtful, especially given that the United States now has a partial integration regime domestically (by applying a reduced rate to dividends). Remember that the whole withholding tax collects only about $4 billion per year. In my mind, this is the most extreme example of Congressional overreaching: this

strange insistence on collecting two levels of tax on foreigners who invest in the equity, but not at all in the debt, of American corporations.

C. The earnings stripping rule

The earnings stripping rule is the most recent addition to the Code in this area, dating only from 1989 and further amended in 1993. These are relatively recent rules. We are now comparing what happens with dividends to what happens with interest.

Consider a parent with a U.S. subsidiary, owning 100 percent of its equity with no debt. Also consider a parent with a U.S. subsidiary capitalized 99 percent with debt. In the first case, if S earns 100, it pays corporate tax of 35. It pays a dividend of 65 to P. Assume that a treaty is in force, giving a 5 percent treaty rate. So there is a withholding tax of 3.25. The net after tax is 61.75, assuming for a moment that P pays no residence-based tax because they get a credit for all of these other taxes, or because P is from an exemption country that does not tax foreign-source dividends.

This is not a very good result – not terrible, perhaps, because of the reduction in the withholding tax rate by treaty, but not so great. But see what happens in the second case, where there is debt. S earns 100. At this point, S also owes a lot of money to P. So S pays 100 of interest to P. That interest is of course deductible, so S pays no corporate tax at all in the United States. In addition, because of the treaty, assuming that this is similar to the U.S. model, there is no withholding tax on the interest at all because the treaty allows for a 0 percent withholding rate. The portfolio interest exemption does not apply here, because the parties are related, but you can get a treaty rate. The majority of treaties would not have withholding, so the net after tax is 100.

This is what Americans call earning stripping, and others call thin capitalization: the idea that you eliminate both levels of tax completely – both the corporate tax and the tax on the dividend, which is an individual tax – by using debt rather than equity. Earning stripping is a very familiar problem in international taxation. Most countries have some mechanism to prevent this, but strangely perhaps, the United States did not have any rule like this, any limitation on thin capitalization, until 1989.

In the 1980s, however, there was a big wave of corporate takeovers financed primarily by debt, and in addition quite a few that were done by overseas companies. The big difference between the 1980s and the 1990s in the United States was that most of the acquisitions in the 1980s were done using borrowed cash. Most of the acquisitions in the 1990s, and still today, are done using stock rather than cash. So, in 1989, Congress decided

that something had to be done about this. There was some discussion of restricting debt deductibility altogether, but it was decided that this was too dangerous. Instead, only a particular provision that really applies only to foreigners was put in place. This was the so-called earning stripping rule, which is summarized as follows.

The earning stripping rule applies to payments of interest by American borrowers to "tax-exempt related parties." Why is that the language? The idea was to apply it to situations where there is a foreign parent and a U.S. subsidiary, and where in addition to the equity there is also debt. They did not write it that way because every treaty that was ever entered into by the United States and every other tax treaty has a nondiscrimination provision written into it. Under the nondiscrimination provision, you are not allowed to discriminate in your tax treatment against companies from the other country. They must be treated in the same way as domestic companies. So Congress could not really have written a rule that applied only to payment of interest to foreigners. Instead they said that the rule would apply to payments of interest to tax-exempt related parties.

What is meant by "related parties"? The idea was to discourage foreigners from taking over American companies. So the rule applies only to payments to corporations that control. *Related* is defined as ownership of over 50 percent of the stock of the subsidiary.

Why "tax-exempt"? Here the notion was to apply this rule also to domestic entities that are exempt from American taxes. A foreign parent is not subject to American taxes because it is foreign. Similarly, domestic entities such as all universities, most hospitals, and all churches are tax-exempt. In fact, it is estimated that about 40 percent of all shares of American companies are held by tax-exempts. The largest are the pension funds, which have all the savings of most Americans: those funds own the most equity in American companies. This is a huge sector.

What is strange about this, and what makes it clear to me that this is more of a sham than reality, is that although it is true that tax-exempts in the United States hold a great deal of equity in American corporations, it is also extremely rare for them to hold a controlling interest in those corporations. They are not interested in controlling. They are interested in investing. An entity such as Harvard University owns stock in hundreds and hundreds of American companies, but not a single one of these investments is more than 5 percent of the stock. Tax-exempts don't want to own for-profit companies. They want to invest their money.

It is almost unheard of to have a tax-exempt related entity in the domestic sense. Congress was really getting at foreigners. This really amounts to a violation of the nondiscrimination provision, but Congress deliberately put

it in language that would not appear to be discriminatory on its face. Now, did they have to be so indirect about it? I'm not sure. The truth of the matter is that thin capitalization is a provision that is very well entrenched, and you can certainly argue that it is a legitimate form of discrimination – an accepted, customary international-law exception from nondiscrimination. If you don't have anything like a thin capitalization rule, then all of your tax base can disappear, both corporate-level and shareholder-level tax. So it is not just a matter, like the branch profit tax, of protecting the double tax; this is protecting any tax by the source country. That is legitimate, and other countries do it, too – without necessarily hiding it so much.

The rule applies to payment of interest to tax-exempt related parties. There is a safe harbor, as it is called – a way to get out of it completely. It applies only if the corporate taxpayer's debt-to-equity ratio exceeds 1.5 to 1. If the ratio is more conservative than that – if you don't have more than 150 percent of debt to equity – then you escape this provision completely. And surprisingly, perhaps, quite a few American subsidiaries of foreign multinationals are conservative enough to maintain themselves within the safe harbor. But most multinationals have a significantly higher number than this.

Thus, the provision actually eliminates or restricts the deductibility of what is called excess interest expense. An excess interest expense is interest to tax-exempt related parties – not interest to a bank or anybody else – that exceeds 50 percent of the corporation's taxable income. If there is an excess, you can carry it forward or back.

How does this work? Here is a very simple example. Suppose this U.S. subsidiary has 100 of income, and suppose it must pay interest expense to its parent of 60 in any given year. At this point, you simply do a calculation: 50 percent of 100 is 50. You then compare this 50 to 60, which is the amount of interest that is paid to a tax-exempt related party, namely P. Because this number, 60, is greater than 50, there is an excess interest expense of 10 that cannot be deducted. The idea is to allow subsidiaries to eliminate up to half of their income through interest deductions to foreign related parties, but not more than that. The other half must remain subject to American tax. This is done on an average basis with carryover provisions, but that is the basic concept.

The idea is to prevent earning stripping by restricting the deductibility of interest. Strangely, Congress did not do anything about recharacterizing this interest as dividends – that is, the interest can still flow out without any attempt to collect tax on it. Other countries do it differently: they first of all cap the ability to deduct, but they also say that anything above the cap is

simply a dividend, and they collect withholding tax on the dividend. They still call this interest and accept it as such; they simply don't allow it to be deducted at the corporate level. It is allowed to flow out free of withholding tax if a treaty protects you at the shareholder level. Now, if a treaty reduces the tax rate on interest, a proportionate part of the interest is treated as tax-exempt: if the 30 percent interest is reduced to 10 percent, two-thirds of the interest is treated as exempt. This is for purposes of defining what is a tax-exempt related party.

The key provision, however, was added in 1993 and is really interesting: the guarantee provision. Loans by parents to subsidiaries are not a good thing, because the interest is potentially subject to this rule. So what do people do? The subsidiary instead borrows money from the bank, and pays interest to the bank, instead of to the parent. This interest is not subject to the rule because it is not paid to a tax-exempt related party. The bank is not related, nor is it necessarily tax-exempt; it could be a U.S. bank.

The problem now is that the subsidiary's credit rating usually is worse than the parent's, because the parent is much bigger than the subsidiary. Thus, to obtain better terms and pay a lower rate of interest, what typically happens is that the foreign parent guarantees the loan. That is, as the guarantor, the foreign parent tells the bank that if for some reason the subsidiary is unable to repay the loan, the foreign parent will make sure that the interest is paid and that the loan is eventually paid back.

Such guarantees are not good, because under the rule enacted in 1993, the guarantee is treated as if the bank has really made the loan not to the subsidiary, but to the parent, which then proceeded to lend the money to the subsidiary. Therefore the interest does not flow directly, but rather flows through the parent. Such an interest payment is of course subject to the rule, which thus also applies to interest payments to other parties that are guaranteed by tax-exempt related parties, such as a loan from an unrelated U.S. bank to a U.S. subsidiary guaranteed by its foreign parent.

Two points are rather striking about this. First, it is interesting that concerns about earning stripping apply even if this bank is an American bank – which it very frequently will be, because the borrower is a U.S. subsidiary, and it's easy to borrow domestically. Why is this so striking? The interest income is taxable income to the U.S. bank, so really no earning stripping is going on: whatever is deductible by the subsidiary will be taxable to the bank. From that perspective, we might wonder why Congress didn't restrict this rule to foreign banks. It may perhaps be because U.S. banks don't pay a lot of tax, and in particular can claim bad loan reserves and other things that other taxpayers cannot. The fact that, as a rule, American

banks are not very good taxpayers is one reason why Congress may have written the earnings stripping rule as it did.

The other thing that is remarkable is that in 1989 Congress went to great lengths to pretend that they were not really talking about foreigners, but rather about all tax-exempts. This was not true, but at least Congress tried to present a façade to the world as if they were not discriminating against foreigners. This is not particularly believable, because it's very rare for domestic tax-exempts, such as universities or pension funds, to control – that is, to be a related party to – for-profit U.S. corporations. The guarantee provision completely negates the façade, because it is unheard-of for a U.S. domestic tax-exempt to guarantee the borrowings of a for-profit corporation. A tax-exempt would not put themselves in that position, because it is completely irrelevant to their nonprofit purpose. They would risk being engaged in a for-profit business, which is a very bad thing for them: they would pay tax on their dividends, for example. Thus, it never happens.

On the other hand, it is of course standard practice for foreign parents to guarantee the loans of their U.S. subsidiaries. *Guarantee* is defined extremely broadly to include unwritten and formal guarantees, standby letters of credit, assurances that a positive level of equity will be maintained, and the like. This was designed because of the practice of Japanese parents in particular to issue informal guarantees, not in writing, that were respected and honored in practice. Thus it is a very, very broad definition.

The entire situation does not make a lot of sense: the pretense that we are not discriminating against foreigners in that regard. On the other hand, consider what other countries are doing. Japan, for example, is completely straightforward about it. They have a thin capitalization rule, and it applies to loans made to Japanese corporations by controlling foreign shareholders. They don't try to pretend that this is anything but loans by foreigners to Japanese subsidiaries. There is a debt equity test that applies if the debt-to-equity ratio, both related-party overall borrowings, exceeds 3:1. This is a fairly low ratio, and it simply disallows any deduction of interest that exceeds the ratio. There is an exception if the taxpayer can establish that comparable Japanese companies have higher ratios.

This Japanese rule has many advantages. First, it is not hypocritical. It doesn't try to pretend that it is doing something that it doesn't really do. It clearly discriminates against foreigners; it is designed to apply only to foreigners. The British have a similar rule, as do the Germans and the French, although the EU member countries must apply it to domestic taxpayers as well because the European Court of Justice (ECJ) applies (erroneously, in my opinion) a broad reading of nondiscrimination. Almost every country

in the world that I am aware of has some kind of thin capitalization rule, because otherwise you lose your corporate tax base, which it is essential to preserve. That is one advantage.

The other advantage of the Japanese version of the rule is that it is very simple. It simply sets a straight ratio: anything above 3:1 is not deductible. Other countries, as discussed earlier, go further than that and say that not only is such interest not deductible, it is also a dividend subject to dividend withholding tax. That offers a significant advantage over the American rule: it is simple and easy to plan for.

It is also more strict and more restrictive of business practices. This is why the exception exists: if you can show that comparable Japanese companies have higher debt-to-equity ratios, then you can substitute these ratios. This is a much more straightforward way of doing it. Most countries in the world do something like this, and it is perfectly fine. In my view it does not really violate the nondiscrimination article in tax treaties. It is a customary international-law exception to nondiscrimination, based on the actual practice of most countries.

6

Transfer pricing

Transfer pricing lies at the heart of the international tax regime because that regime is based on the distinction between residents and nonresidents. The easiest way to avoid residence-based taxation is to shift income from a resident to a nonresident, and the easiest way to do that is transfer pricing.

We will introduce the idea of transfer pricing through an example. Consider a situation with two corporations, called P and S, where P owns S. P manufactures widgets at a cost of 20 and sells them to S, and then S distributes the widgets at a cost of 20 and sells them to unrelated customers for 100. First let us calculate the total profit on this transaction. Total profit is calculated by taking the ultimate amount paid (in this example, 100) and deducting from it the various costs (in this case, distribution costs of 20 and manufacturing costs of 20). Thus the total profit in this case is 60. If P and S are in the same country, the situation is simple because they are both subject to tax on this profit in the same way at the same rate. If they are both in the United States, they both file an income tax return showing 100 of gross income minus 40 of deductions equals 60 of taxable income, and they would pay the 35 percent tax on that taxable income.

Now consider the situation in which P and S are located in two different countries: for example, P is in China and S is in the United States. In this case, it becomes crucial to determine the price that S paid P for the intermediate sale, which is known as the transfer price. Transfer price is officially defined as the price charged for the transfer of goods or services between two related parties.

What is the transfer price in our example? Here we have what is called the profit continuum, which in this case ranges from zero to 100 (where 100 is the total sales price to the unrelated buyer). However, let us assume that P is not willing to operate at a loss, and therefore is not willing to accept a price less than 20. Therefore the profit continuum logically starts at 20 rather than zero. And what is the maximum price S would be willing to pay for the product? Remember that S also has costs of 20 and it is selling the product for 100; S cannot pay more than 80 to avoid operating at a loss.

The difference between the minimum price of 20 and the maximum price of 80 represents the total profit, and transfer pricing determines how this profit is distributed between P and S. P and S are indifferent to the transfer price because ultimately, P owns S; both P and S are owned by the same shareholders.

So what is the deciding factor in setting the transfer price? Perhaps not surprisingly, the deciding factor then becomes the tax rate in the two countries. Even a small difference in the tax rate can lead to a very significant value in setting up the price. Let us assume that P is subject to tax at 35 percent and S is subject to tax at 30 percent, which is a relatively small differential. Because P is the one that has the higher tax, the companies would want to put as little profit in P and as much profit in S as possible, and therefore would set the price around 20. If the price is set exactly at 20, P will report an income of 20 with a deduction for manufacturing costs of 20 and will net zero. S will report an income of 100 with a deduction of 20 for its own costs and a deduction of 20 for goods bought from P, for a net of 60. Thus by setting the transfer price at 20, the companies have shifted the entire 60 of real profit to S, which is beneficial because S is subject to a lower tax rate.

What if the situation were reversed and P was subject to the lower tax rate? The transfer price would be set at 80. P would show income of 80 and costs of 20 for a net of 60, and S would show an income of 100, costs of distribution of 20, and costs of goods of 80, with a net of zero. Thus the transfer price determines which country will get the profit.

What can be done in this situation to ensure that countries are able to collect corporate taxes? The provision that deals with this issue in the United States is section 482, which dates back to the 1920s. This section is at the same time very simple and also surprisingly complex, and it is the most general section and the most sweeping grant of power to the IRS of any section in the Internal Revenue Code. The code states that in any case of two or more organizations, trades or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, owned, or controlled directly or indirectly by the same interests, the IRS can do whatever it needs to do in order to prevent evasion of taxes or to clearly effect the income of the related parties.

Notice that there is no definition of control in this section of the code. This is very unusual; for example, remember that in the earning stripping rule, in order to be related one company had to own 50 percent or more of the other one. In the case of transfer pricing, however, the IRS has the flexibility to try to find informal control in various ways. The IRS may

distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if it determines that such distribution of portion is necessary in order to prevent evasion of taxes, or clearly to reflect the income of any of such organization, trade, or business.

It is interesting to note that although in general in the United States the burden of proof rests on the taxpayer, in this case such wide discretion is granted to the authorities that the courts routinely find that the IRS has abused this discretion, and in that case the burden of proof shifts onto the IRS.

What methods are used to investigate this type of case? There are three classic methods that are used in transfer pricing cases, developed by the United States in the 1960s and incorporated in the OECD transfer pricing guidelines; however, these classic methods fail in almost all cases and have since been updated. Since the mid-1990s we have had a newer set of regulations and a new set of OECD guidelines, which perhaps work better.

To illustrate those methods, consider a situation in which P is selling to S and you know the ultimate sale price to unrelated parties, but you don't know what the transfer price should be. You would like to know what would have been the price that P would have charged S, had P and S not been related to each other: Had they not been related, they would have cared how much profit each of them received and would have negotiated some kind of agreement at "arm's length," in the market as unrelated parties. The gold standard in transfer pricing matters is therefore to find what is called the arm's-length price.

How can this gold standard be found? Suppose that P, in addition to selling this good to S, its subsidiary, also happened to be selling the same good to an unrelated buyer So, for resale to the same customers in the same market. In this case, the price paid by So is called a comparable uncontrolled price, or CUP. In this case you take the CUP price as the real price, and then determine the profits to P and S based on the CUP price. If, for example, the CUP price was 50 and the price that was charged to S was 20, you move the price to 50 so that 30 of the profit goes to P and 30 goes to S.

There is an international consensus that CUP is the best method when it is possible. However, it is very uncommon for a true CUP to exist. Most parent companies do not sell both to subsidiaries and to unrelated buyers in the same market; it is costly to set up subsidiaries, and parent companies generally prefer to sell through local distributors when at all possible. In general, parent companies set up subsidiaries to protect a trade secret (even a patent if protection is not high in the market country) or brand-name integrity. Thus selling to S usually helps to internalize some cost that

otherwise would be incurred. And once the company does that, it does not also sell to So at the same time. Thus CUP almost never exists.

A somewhat more likely scenario is that another supplier Po is selling the same product to an unrelated buyer So. Although the good does not come from our P, it comes from another manufacturer selling the same product to another distributor in the same market. Thus if Po sells to So at a price of 50, we could use 50 for our purposes as well. This situation may seem much more common than the CUP scenario, but it is less common than it might seem because, as we mentioned before, P and S have some reason to be affiliated with each other. Thus their relationship gives them a competitive advantage in the market, and they should be able to drive Po and So out of the market. This is the predominant theory of why multinationals exist in the first place, dating back to Nobel prize–winning economist Ronald Coase's 1937 article "The Nature of the Firm," which argues that people operate through firms because they need to protect something through the hierarchical structure of the firm, and this is true for multinationals as well. Thus we see that this second method is also somewhat uncommon.

Two other methods exist for determining transfer pricing; they also rely on finding relatively precise comparables, but somewhat less precise than CUP. The first is called cost-plus and the second is called resale price, and they are basically the same method but they start with two different parties. Cost-plus involves starting with P, with costs of 20. Then you ask what companies similar to P typically expect as a profit margin compared to their costs. You then multiply the original cost by the profit margin: if this type of firm usually charges a price double its costs, then the correct price in our example should be 40 (double the costs of 20).

Resale price is exactly the same thing except that it starts from the reselling price. In this case, the distributor (reseller) also faces costs of 20. To find a transfer price, we consider the profit margin for other similar resellers; let's say that it is 50 percent of their costs, so that means we can expect the distributor to net 30 (150 percent of 20), and therefore the price should be 70. Thus resale price and cost-plus use the same general way of calculating transfer pricing, with cost-plus starting from the manufacturer and resale price starting from the distributor. Transfer prices determined in the distributor's country generally use the resale price and in the manufacturer's country use the cost-plus price. These pricing techniques are relatively simple but require a comparable firm to determine comparable profit margins.

The transfer pricing mechanisms just described became widely used in the1960s and were incorporated into the OECD transfer pricing guidelines in 1979. They are still considered the gold standard of transfer pricing,

and some countries, Germany in particular, do not believe that any other method has validity. However, statistics show that these three methods cannot be applied in over 90 percent of cases; the exclusion of other methods has led to unreasonable taxpayer victories in some cases and unreasonable IRS victories in other cases. Taxpayers have had an enviable record of victory in transfer pricing cases in the United States, having won virtually all of the big litigated cases.

Let us consider a relatively simple case from 1969, *U.S. Gypsum*. This case involves a U.S. company and its two subsidiaries, one in Canada and the other in the United States. The second subsidiary was called a Western Hemisphere Trade Corporation (WHTC), and it benefited from an export subsidy and therefore paid very little American tax. In this example, the raw material, gypsum, was mined in Canada. The gypsum was sold in Canada, and then it was resold in the United States. However, because both Canada and the United States are high-tax countries, this was not very tax effective. It would not really matter in this scenario what the transfer price was because, both countries being high-tax, you would not gain very much.

Instead, the companies arranged for the sale to go through the WHTC. So Canada would sell gypsum to the WHTC, and then it would be sold to the United States. Let us consider how this trade actually worked. The gypsum was brought to a dock at the port in Canada, where a ship belonging to the U.S. company waited to pick it up. The gypsum on the dock belonged to the Canadian company; it belonged to the WHTC for the one second that it was falling from the dock to the ship, and it started belonging to the U.S. company the moment it hit the ship. The WHTC didn't have to do much work in order to get the gypsum from the dock to the ship. Under this fact pattern it may be not surprising that the court held that WHTC didn't do anything to earn the profit allocated to it, and therefore the court reallocated the profit to the United States.

Although this case seems somewhat extreme, in essence it is not that different from the modern foreign sales corporation cases in which subsidiaries in tax havens are used to absorb profits, although the duration of the nominal title is generally a bit longer than one second. However, the ownership of the goods by foreign sales corporations and the contribution that they make to the actual operation is really not that much different from this case.

The next example involves DuPont, a major American chemical company, and represents the last time that a big American multinational lost a transfer pricing case in a major way. This case also provides background for the enactment of a large part of the antideferral rules that are discussed

in the next chapter. DuPont used to manufacture chemicals in the United States and then resell them through subsidiaries in Europe. Again, all of these countries are high-tax countries, and DuPont would have to pay tax either in the United States or in the European country of sale, depending on the transfer price. Thus DuPont set up a subsidiary in Switzerland, a tax haven country, and called the subsidiary DISA. The American companies sold to the Swiss company, which then sold to France, Germany, and the United Kingdom. Once again, the key was the two transfer prices: if the final sale price was 100 and costs of production and distribution were 20, the sale price to the Swiss company should be 20 and the sale price to the individual European subsidiaries should be 80 so that the Swiss company receives the profits of 60. Many regions of Switzerland have no tax at all, so with the right planning, these profits will be subject to no tax at all. Throughout the case, DuPont fought very hard to try to treat this within the accepted regulations and show that it could find comparables for these prices; the IRS won the case largely because of an internal memo from DuPont stating the intent to construct a subsidiary in a tax haven in an attempt to sell at less than arm's-length prices. At the time of the case, there were no penalties for transfer price manipulation by corporations, and therefore DuPont had little to lose through this maneuver. This is the mindset that multinationals generally have, but it is relatively rare that they put it on paper; after this case, it is even less likely that a company will make the mistake of writing its intentions down in this way. In addition, Congress legislated a 40 percent penalty for transfer pricing under arm's-length amounts, with the idea that if a company loses, it not only pays the same amount as it would have paid had it reported the same price, but it also pays the penalty. In addition, taking a position on the chance that you might not be caught is called playing the audit lottery and can lead to ethical charges if you are caught.

Let us consider a taxpayer victory involving U.S. Steel, the large American steel company now known as USX. The company mined iron ore in Venezuela and then sold the ore in the United States, where it was reworked into steel and resold. In order to transport the iron ore from Venezuela to the United States, U.S. Steel created a subsidiary called Navios in Panama that bought ships and transported the ore to the United States for a fee. Navios also performed transportation services for other steel companies, including another American company called Bethlehem that shipped iron ore from Venezuela to the United States.

Navios charged exactly the same price to Bethlehem and to U.S. Steel, creating the appearance that it was not providing its parent company with a special transfer pricing scheme. However, there were two important

differences between the business deal with Bethlehem and the deal with U.S. Steel, even though the service and price were the same. First, Navios had an assured customer for its operations in the case of U.S. Steel, and thus did not have to face the risk of being idle. Navios invested a lot of money into buying the biggest ships in the world, something it probably would not have done without the assurance that the customer base existed. In the case of Bethlehem, by contrast, each shipment was negotiated separately. The second difference between the two business arrangements was that the quantity of ore shipped for U.S. Steel was a thousand times greater than for the other companies; thus it appeared that Navios provided services for other companies simply to establish a comparable uncontrolled price.

The IRS argued that U.S. Steel overpaid in its business dealings with Navios in order to register greater profits in Panama, a tax haven: U.S. Steel should have been able to negotiate a lower price with Navios because Navios did not absorb any risk in the business deal, and also U.S. Steel should have been able to negotiate a volume discount. The court, however, decided that the parties must find a comparable uncontrolled price, and in this case the comparable uncontrolled price could be found in the dealings between Navios and other steel companies.

The court's opinion, however, does contain elements of ambiguity. In at least one portion of Judge Greeley's opinion, he argues that quantity and risk are important considerations in comparability decisions and that the court must investigate a reasonable charge for a business deal involving the same quantity transported and risk assumed. If this is indeed the inquiry, then the fact that other steel companies paid Navios the same rates was irrelevant. However, transactions are rarely comparable in the strict sense used by Judge Greeley; following this line of reasoning in every case would strongly bias the law against the taxpayer, because finding a comparable business transaction would be nearly impossible. In this case, however, Judge Greeley's strict interpretation of the rule did not prevail, and the court held in favor of the taxpayer that the business transactions with other American steel companies represented comparables for the sake of the transfer pricing regulations.

The following example of transfer pricing involves Bausch & Lomb and is a more modern example decided by the same court as the previous example. Bausch & Lomb is based in the United States but has a subsidiary in Ireland, which is famous for using preferential tax rates to attract American companies. Bausch & Lomb U.S. transferred some very valuable manufacturing process information to the Irish subsidiary that allowed them to manufacture contact lenses at a cost of $2.50 per lens. The lenses were manufactured

in Ireland and sold to the United States at $10 per lens, where they were resold to consumers. Other contact lens manufacturers in Ireland also sold lenses to other distributors at $10 per lens; however, without Bausch & Lomb's manufacturing information, their manufacturing costs were $7.50 per lens. Bausch & Lomb was thus able to save a large amount of money on manufacturing costs and therefore had a much higher profit margin.

However, Bausch & Lomb argued in court that the other manufacturers represented a perfect comparable, given that they were selling the same product in the same market at the same price. The court (the same court that had decided U.S. Steel twenty years earlier) agreed with this argument and allowed them to charge the same thing, effectively putting the entire value of the manufacturing information in Ireland.

The *Bausch & Lomb* case illustrates the difficulties of attempting to find a true comparable price. It is clear that Bausch & Lomb had a much higher profit than the unrelated parties in the market, and it is probable that these unrelated parties would stop existing in the long term, because they would not be able to compete with Bausch & Lomb. In addition, it is difficult to determine where the profit actually belongs if a comparable price is not to be found; in this case, the IRS claimed it all belonged to the United States, because the American view is that profits of R&D belong to the country that conducted the R&D. Bausch & Lomb successfully claimed that it all belonged in Ireland, where the manufacturing took place. In reality, the profit should probably be divided between the two countries, because the profit is added profit resulting from the existence of the multinational, and it is exactly this profit that would be lost if the multinational were divided up. Thus the additional profit created by multinational corporate ventures is exactly the profit that the court attempts to divide by using comparables; however, these comparables never fully represent the situation because the profit itself does not exist for the "comparable" unrelated parties, but rather exists only because of the multinational corporate venture.

The following case is another example of the failure to find an appropriate comparable involving a number of U. S. pharmaceutical companies. These companies conducted R&D in the United States and deducted it there, and set up a subsidiary in Puerto Rico to coordinate sales around the world. Although Puerto Rico is a possession of the United States, it has its own tax system and there is a provision in the Internal Revenue Code that exempts profits earned in Puerto Rico from American tax; the local tax is very small, so Puerto Rico is a tax haven. The pharmaceutical companies would transfer the patent to the controlled Puerto Rico subsidiary in exchange for more stock, which meant that the exchange was

tax-free. Then the company would sell the drug all over the world, making large profits. The problem in these cases was that the R&D was conducted in the United States and thus the development risk was located there, but earnings were guaranteed not to accumulate there because the patent was transferred to Puerto Rico before the drug was marketed. In each of a whole series of cases involving pharmaceutical companies, the IRS tried to show that the profits should have been registered in the United States, but the IRS lost every time; in each case, the court held that because the patent was in Puerto Rico, the profits belonged to the subsidiary in Puerto Rico, regardless of where the patent was developed.

In some cases, the court would force the pharmaceutical company to pay some kind of royalty, but the rates were inadequate. In order to avoid this, however, Congress in 1986 added a final sentence to section 482, which is the only change that had been made to the section since its original enactment. This sentence reads: "In the case of any transfer or license of intangible property [defined very broadly], the income with respect to such a license shall be commensurate with the income attributable to the intangible." This section covers all transfers or licenses of patents, copyrights, and the like to related parties whether they are in a taxable or tax-free transaction; another section covers specifically the kind of tax-free transaction used in this case and is called a "super royalty" or "commensurate with income" rule.

Consider the situation in which a U.S. pharmaceutical company transfers a patent to Puerto Rico. The U.S. company cannot do this without paying a royalty, and therefore transferring for stock is not sufficient. In addition, the royalty must be commensurate with the income produced by the intangible (the sale of the drug in this case). Intangibles are generally transferred without specific knowledge of how much profit they will generate, especially if the transfer is made in the early stages of product development; market potential and product success are often difficult to predict precisely before a product is marketed. The concern was that people would transfer intangibles offshore at the very early stage of their development and set the royalty at a very low rate, and this section addresses that concern by requiring the royalty rate to be adjusted if the intangible becomes more profitable.

The rationale behind this royalty rule is that people acting at arm's length would not have agreed to a fixed royalty if the profit potential were to rise. This proposition is very controversial because it is impossible to tell what people would have done given that such intangibles are never transferred at arm's length. Certain countries, including Germany, argue

that it is impossible to know whether people would have renegotiated and it is possible that they would have been willing to accept a fixed royalty for the duration of the patent. Congress, however, says that royalty payments must be commensurate with income even if doubt exists as to what unrelated parties would have done.

There are, however, a number of ways to mitigate the effect of the law and allow more earnings to accumulate overseas. The first and most important of these is through cost sharing. The "commensurate with income" law applies completely if all of the R&D is done in the United States and then transferred when it is complete; however, if at least part of the R&D is financed from offshore, more of the profits may be attributed offshore through a cost-sharing agreement. For example, under the cost-sharing rule, if 50 percent of the R&D costs fall onshore and the other 50 percent are offshore, the division of profits is similar and can be maintained. In addition, even if the profits rise tremendously in this case, half of the profits continue to accrue offshore and out of the reach of the U.S. taxing authority. This is the most common way around the super royalty rule. The second strategy is to move the intangibles offshore very early in their career, when their potential is as yet undetermined. If a low royalty can be set early on, it may be possible to defend such a royalty later, whereas the chances of defending a low royalty are much less if the transfer is made and the royalty set up once the profitability is well defined.

As we have already discussed, it became clear by the late 1980s that the traditional methods for addressing transfer pricing problems were not sufficient because in the vast majority of cases they were not being applied or were not being applied in a satisfactory way. Both Congress and the IRS felt that taxpayers were being allowed to treat transactions as comparable that were not truly comparable under these methods. In 1986 Congress did two things to address this problem: (1) it enacted the super royalty rule, discussed earlier, and (2) it asked for a Treasury study to determine whether there was another way to solve this problem. The method that they had in mind is called formulary apportionment and is used by the American states; it represents the opposite extreme to arm's length. We discuss it here as a point of comparison.

Recall the first example we presented of transfer pricing in which it is easy to determine what the profit is of the whole group, and the hard part is deciding what the correct transfer price should be to appropriately divide the profit between the related parties. The formulary apportionment method begins with the assumption that the group is a single entity, and it simply ignores the separateness of P and S. It treats them as if they are

part of the same corporation, something that is quite controversial and not accepted internationally. The first step in formulary apportionment is to determine that the companies are a unitary group (not difficult for multinationals that function as a unit) and then calculate the profit for the group as a whole. The next step is to calculate the total net income of the group (income minus costs, which in our previous example was 60: 100 in income minus 20 in manufacturing costs minus another 20 in distribution costs).

Consider an example where the subsidiary is in California, which was one of the pioneers of applying this method internationally, and the parent is in Japan. In the formulary apportionment method, the percentage of profit that belongs in California is determined based on the proportion of the company's business that is conducted in California. This is determined by calculating the percentage of worldwide assets that are in California, the percentage of worldwide payroll that is in California, and the percentage of worldwide sales that are in California. These three percentages are then averaged: if 20 percent of each factor is located in California, the average of the three would be 20 percent; likewise, if the percentages for each factor were distinct but averaged out to 20 percent, the outcome would be the same. This average is then multiplied by the total profits to determine the portion of the overall profits that belong in a particular locality.

Formulary apportionment has the advantage of being simple, clean, and easy, at least at first glance. However, it suffers from the disadvantage that only the American states use this method, and therefore it arguably can result in a lot of double taxation. If everyone else uses the arm's-length method and the states use formulary apportionment, then the same profit may be taxed by the state and other countries at the same time. Critics argue that the states use this method because it maximizes their revenue, although it also has the advantage of avoiding the transfer price debate altogether. Rather than searching for comparables, profit can be allocated based on data readily available from a routine audit.

It is arguable whether these three particular factors are a good proxy for the real business of the group. The payroll and asset factors are designed to represent the productive side of the business, namely the tangible assets in the form of machinery and the like and the human capital. The sales factor is designed to represent the demand side, which includes the contribution of the market and marketing value to the operations of the group. The recent trend is for states to modify this formula so that it is 50/50 between sales and the other factors, effectively giving a double weight to the sales factor in the formula. This alternative weighting formula also creates an export

subsidy, because companies with production activities in the state are taxed somewhat less than those that sell products produced in other states. This effective export subsidy has yet to be tested by the U.S. Supreme Court or by the WTO, although many years ago the Court (probably erroneously) decided that even a single-factor sales formula that taxes only importers and completely eliminates the tax on exporters is legitimate. With these debates in mind, the original three-factor formula seems to be a relatively unbiased method because it does not explicitly subsidize exports or tax imports. However, it may violate customary international law, which embodies the arm's-length standard.

One major argument against the most common formula today, which uses payroll and assets and sales, is that it omits intangibles. Intangibles and intellectual property are part of the value of any modern business and sometimes the major part of it. However, this argument may not be as strong as it first sounds. Intangibles do not get produced all by themselves, but rather are usually produced by laboratories that have physical assets (counted on the assets side) and usually employ people (counted on the payroll side). The more valuable the assets are, the more you have to pay the people that produce them; thus the value of intangibles is indirectly included in the formula. Further, as we discussed in the *Bausch & Lomb* case, it is almost impossible to place intangibles in one physical location, because they relate to the entire group. In this case, it is actually appropriate to ignore them in the formula, because they are shared among all of the locations of the company.

As we have discussed, the method of formulary apportionment is not consistent with the arm's-length standard used internationally. The question arises whether the states, as a matter of international law, are allowed to apply a method that is contrary to what many regard as customary international law. Two articles in the customary international treaties embody the arm's-length principle. The first is Article 7, which relates to business profit and contains the arm's-length principle for branches. For subsidiaries, the arm's-length principle is written into Article 9. The argument exists that formulary apportionment violates the treaties. However, it is unclear that a forum exists within the United States to hear this argument; up to now, the Supreme Court has not agreed to hear it. Two cases were argued before the U.S. Supreme Court on the issue: the first in the 1980s involving an American corporation and the second, more recently, in the early 1990s involving Barclay's Bank, the U.K. corporation. Both of the lawsuits challenged the validity of California's worldwide formulary apportionment method on several grounds. The first argument was based on the

international-law grounds. The second was based on the U.S. Constitution and basically claimed that it violated the Constitution to have this kind of essentially foreign-policy decision made by states. In both cases, however, the U.S. Supreme Court upheld formulary apportionment and ruled in favor of California.

As an American internal matter, the validity of formulary apportionment is well established. On the international level, however, the foreign governments involved were able to exert sufficient pressure on President Reagan and then on the Clinton administration that in both cases they made California change its law. Thus, formulary apportionment currently applies only *within* the United States. Multinational enterprises are taxed by California and the other states under the arm's-length principle, as if they were a foreign operation under section 482.

The international situation changed somewhat when Congress, in 1986, asked the Treasury to study new methods. In 1988 the Treasury came up with the white paper that embodied these new methods, which were revised a number of times and eventually adopted as final regulations in 1995. Within a few weeks of the U.S. adoption of the regulations, the OECD put out new transfer pricing guidelines that embodied the same methods, forming a classic example of how the United States and the OECD often coordinate positions. The United States and the OECD regulations differ very slightly in some specifics but in general are almost identical.

The new regulations included two major changes. The first and most obvious one is the addition of two new methods, which are described next. The second one, which is also important, is that the old regulations specified the order in which the arm's-length method had to be applied: the first option was to use CUP, then resale price, and then cost-plus. Only after attempting those three options were you allowed to use something else. In the new regulations that is no longer the case. Instead, this method uses the "best method rule" and requires use of whichever method best approximates the arm's-length price and requires the fewest adjustments to the comparables. Any method from the given list is permissible, and it is even possible to use unlisted methods, although this is uncommon because if you do and are caught, and the method you used does not hold up, you are subject to penalties. Thus, under the new regulations, both the taxpayer and the IRS are free to use whichever of the listed methods they like the best.

Here we turn to the two new methods for determining arm's-length price that were included in the 1995 regulations. The first one of these methods, which is probably the favorite of the IRS, is the comparable profit

method (CPM). In the comparable profit method, you take a group of companies that are very broadly similar to the company of interest, meaning the company whose prices or profits you are trying to audit. The U.S. Department of Commerce publishes something that is called the Standard Industrial Classification, which tries to classify all businesses into categories. These categories can be extremely broad: high-tech industries, for example, are one category.

For all companies that are within a particular category, the IRS takes the tax return data for each company and calculates the profit margins for all of these companies and arranges them on some continuum from 0 to 100 percent (from least profitable to most profitable). If the sample is high enough for every category – and the sample size is always high because of the breadth of the categories – then statistically, the observations always arrange themselves in a normal distribution in a bell curve (a well-known phenomenon in statistics). Then they calculate the 25th and 75th percentiles for this particular distribution (the 25th percentile is the point below which 25 percent of the observations fall). The area between the 25th and 75th percentiles is the arm's-length range. The IRS looks at the data for the audited company and asks whether the profit result falls within the arm's-length range. If it does, then the company is considered to have passed the arm's-length test. If it falls on either side of this range, the IRS will force the company's profits to the exact midpoint. Notice that this puts a huge premium on being within the range, because if you are just inside the range, they will not take any adjustments. If you are just outside the range, however, they will adjust you all the way to the midpoint. A small change in reported profit can therefore make a large difference in taxes paid if this change falls near the 25th or 75th percentile for profitability.

From the taxpayer perspective, this technique is somewhat difficult because the tax return data is only available to the IRS. Tax returns are confidential, so the IRS can do this very easily, but it is much more challenging for the taxpayer. This is where the big accounting firms step in. Each of them has a very, very broad range of tax returns available to them because they audit a lot of companies, and each therefore has a proprietary database that they can use to do this same thing. This method really forces taxpayers to have the big accounting firms calculate CPM for them, because they lack access to the data to do it themselves.

The other incentive for going to the big accounting firms is that at the same time that Congress adopted this method, they also adopted very strong transfer pricing penalties representing 40 percent of the underpayment. The way to avoid penalties is to show that you have contemporaneous

documentation of your transfer pricing method; even if the court finds that your transfer pricing method was not reasonable, you would still avoid a penalty as long as you can show that your method was developed based on contemporaneous documentation. *Contemporaneous* means "not with hindsight"; thus you cannot try to make up some method after the IRS catches you, but you must set the method at the time that you set the prices. Multinationals therefore go to the big accounting firms and ask them to develop contemporaneous documentation of CPM to protect their transfer pricing.

Notice that this method has diverged substantially from the arm's-length method, because the standard of comparability used is so weak, and this divergence has caused some controversy internationally. Because the Americans use a standard industrial classification (SIC), which is extremely broad, the companies that have the same SIC code are really not similar to each other in any meaningful way except that they happen to be in the same industry. The IRS claims that because it uses large numbers, statistically, the outliers will be in the extreme quartiles and will therefore not be considered in the calculation. In addition, the IRS claims that because it is looking for robust statistics, the larger the number of observations, the more likely it is that they are correct. The OECD has accepted this method under the name of "transactional net margin method" (TNMM). The only major difference between the OECD method and the U.S. method is that the OECD insists that it be applied transaction by transaction and not globally, which is not a very important distinction: it is very hard to do transfer pricing transaction by transaction because of the sheer number of transactions.

The second method approved in 1995 is more radical and is called profit split. Profit split is probably the taxpayer's method of choice, although most companies also use CPM as a defensive measure. The way profit split works is very simple. The first step is to calculate the profit continuum that needs to be split (in our original example, this would be between 20 and 80). The next step is to conduct a functional analysis of the parties, which is an examination of the functions performed by P and by S. This step is very easy in our original example: P is the manufacturer and S is the distributor. They then assign to P the normal profit that would be assignable to manufacturers and they assign to S a normal profit that would be assignable to distributors, based on comparables. This calculation determines the distribution of normal profits; however, there will usually be a residual profit over and above the amount that can be allocated either to P or S based on their normal functioning as distributors or manufacturers. This residual is the result of the multinational being a multinational rather than a group of

unrelated parties; it is the extra profit that results from internalizing costs and avoiding costs that other parties have to bear.

How is the residual divided between the parent and the subsidiary? The United States departs from the OECD in this respect. The United States says the residual is always the result of intangibles, patents, copyrights, know-how, and the like, so we have to look at where these intangibles were developed and assign a residual accordingly. That usually results in the residual being allocated to the United States, because that is where most patents and copyrights are developed. The OECD argues that the residual may not always be the result of this kind of intangible, but rather it could be the result of some unknown factor that make the multinational particularly profitable. The OECD also argues that even if the extra profitability is due to an intangible, the profits from the intangible do not necessarily need to accrue in the country of development. However, the OECD guidelines do not provide any advice on how to divide the profits. The OECD guidelines thus force companies to guess on this division; I think it is necessary to split the residual in some way among the parties on a case-by-case basis. Because no public cases have been litigated and no opinions issued that have used any of these new methods, it is unclear exactly how they will be applied in litigated cases.

It is interesting to note that profit split does not rely on comparables at all, but rather relies fundamentally on the taxpayer's own results. In that sense it is similar to formulary apportionment, although it is still accepted as an arm's-length method because it is in the OECD guidelines. The OECD guidelines specify a preferred order to use the methods given, and this method is listed as a matter of last resort: avoid using it unless it is absolutely necessary. The United States, by contrast, considers this to be like any other method, to be used at will. However, this and all other methods except formulary apportionment are within the international consensus because they are accepted as arm's length, although that classification is questionable because profit split does not use comparables to determine what unrelated parties would have done.

Notice that as you move toward determination of profit, as opposed to transfer prices, your comparables become less accurate. To put it another way, the farther away you are from the comparable uncontrolled price, the less accurate your comparables become. The CUP comparables are the most comparable. The comparable profit method is less comparable, and profit split is not comparable at all.

These modern transfer pricing methods are better than the old methods, in the sense that they are much more flexible and applicable to modern

business. It remains to be seen whether they indeed can be applied to the most complex businesses. For example, the business of functional analysis requires a classification of each company's function. In a modern multinational, functional analysis is becoming harder and harder to perform because the development of electronic commerce, the Internet, and modern communications combined with the ease of transportation and the fact that many businesses provide services in easily transferred intangibles means that functions can be divided much more easily and distributed around the world. You can imagine that Microsoft, for example, whose products can be transmitted electronically, might break up the development of a new program all over the world and then work around the clock and transmit the result from place to place, making functional analysis extremely difficult to perform.

Perhaps the most important development of all is called advance pricing agreements (APAs). This is also an American innovation that has since been accepted in other countries. In an APA, the company sits down with the IRS and negotiates an advance pricing agreement instead of doing its transfer pricing and documentation and then waiting until the IRS complains. This method is attractive both to companies and to the IRS because it saves substantial litigation costs for both parties. To date, more than 150 APAs have been signed, although that somewhat overstates their prevalence because many of the agreements are between the IRS and the same companies rather than different multinationals. It is interesting to note that APAs can be multilateral, meaning that the United States is willing to negotiate APAs together with the taxpayer and tax authorities of other parties. These multilateral agreements are especially beneficial to the taxpayer because they ensure that no double taxation will take place.

The following example is a classic instance of a multilateral APA that involves a practice called global trading. Global trading is trading of securities twenty-four hours a day. This is done by executing trades in the three financial centers of the world: New York, Tokyo, and London. These cities are located around the globe such that, together, they are open twenty-four hours a day. In global trading, you open in the morning in Tokyo and you trade in Tokyo until it closes, at which point London opens. Then you trade in London as long as London is open, and when London closes, New York opens. When New York closes, Tokyo opens, and you begin the cycle again. Global trading involves only three tax authorities because the trades are executed in three countries.

The first two APAs involving global trading were concluded by Barclays and by Mitsubishi Bank of Japan. These APAs consider the total profit from

the global trading operation and divide it among the various countries using a formula with three components: (1) the amount of financial capital employed in each country (the amount of capital the banks put into the operation), (2) payroll in each location, and (3) volume of transactions in each location. Perhaps this reminds you of something. This is reminiscent of the three-factor state formula used in formulary apportionment with parallels between capital and assets, payroll and payroll, and transactions and sales. The remarkable aspect of the case is that no one complained that it violated arm's length, although complaints about formulary apportionment abound. These criticisms may have been avoided because the IRS position is that it is not bound by regulations in treaty negotiations and can therefore negotiate freely without regard to arm's length. The OECD transfer pricing guidelines also agree with the APA method as long as all parties agree. APAs therefore avoid many of the problems of other transfer pricing methods; however, there are few industries where it is possible to limit the number of tax authorities as is possible in global trading negotiations.

The only major problem with APAs in the United States is they have to be confidential, because companies bring business information in advance and do not want this information leaked to competitors. However, in the United States we have a law called the Freedom of Information Act, which means that the government can be sued, and has been sued, to reveal the contents of APAs. The argument against the secrecy of APAs in this case is that it is unfair to small taxpayers that the government would enter into agreements with big, rich taxpayers to determine how much these taxpayers should pay, whereas small taxpayers have to live with the audit process. This argument was appealing because of its populist motivations, but it was troublesome because it had the potential to bring an end to the APA program, which is arguably the best development in transfer pricing since the guidelines were established. When it recently became evident that the IRS was going to have to make APA information public, Congress intervened and enacted legislation to protect the privacy of APAs. Congress has the power to repeal or amend the laws that it makes, however, so the future of APAs remains somewhat uncertain.

However, even now APAs remain underutilized as relatively few taxpayers, especially multinationals, have set up such agreements. Perhaps what is necessary to convince companies that APAs are the best option and for transfer pricing to disappear as a major problem is for the IRS to have a number of significant victories. Such victories, which are expensive for taxpayers, might persuade taxpayers to enter into APAs rather than wait and litigate cases they have a real potential to lose. The IRS has not won

many major cases since 1980, although the recent $3.4 billion settlement of a transfer pricing case against Glaxo may indicate that change is coming.

However, the IRS still loses important cases. For example, a case from 2001 involves a company called United Parcel Service, which is the largest American shipping company and is privately owned. UPS warns customers not to ship highly valuable items: it offers only minimal insurance because of its low rates. However, the company does offer additional insurance for purchase, as long as the customer declares the value of the item and pays an extra fee. UPS formed a subsidiary in Bermuda and initially self-insured its shipments through this Bermuda subsidiary; the insurance premiums were quite high, so they had a lot of income from this insurance venture. After some time, however, UPS transferred the insurance over to an independent insurer, and customers then paid shipping insurance premiums to the independent insurer. Then, however, this independent insurer reinsured all of its business with the Bermuda subsidiary; primary coverage was from the independent insurance, but ultimately the responsible party was the Bermuda subsidiary. The independent insurer had a lot of income, but also a lot of deductions, and net income was low. The IRS did not argue this case under transfer pricing guidelines, but rather claimed tax fraud, arguing that the independent insurer didn't really exist, but instead was a conduit to allow UPS to continue to insure its product and transfer the funds to Bermuda. The IRS claimed that the income should accrue to UPS in the United States.

Initially the courts held in favor of the IRS, but this decision has since been reversed. The Court of Appeals held in favor of UPS, finding that the case was the legitimate business decision of an independent insurer. The court found it irrelevant that there was reinsurance in Bermuda (where the money accumulated tax-free). It is possible that the IRS could have been successful in the case arguing on transfer pricing (section 482) principles, because the Bermuda subsidiary did not perform any real function. On the other hand, transfer pricing has limited usefulness in this situation because the actual transaction prices are set at arm's length between unrelated parties; prices are set in the market between the customers and the insurer. Premiums might be high, but that is arguably due to market forces and customers' willingness to pay. According to the court, the fact that the money ultimately ends up in Bermuda might be unfortunate, but insuring American risks is fundamentally not a U.S. trade or business and does not give rise to any tax liability. This case thus ended in a significant taxpayer victory, and we are still awaiting the IRS victory that will persuade people to enter into an APA.

The final topic we will cover in this chapter is blocked income. Blocked income is income that is earned but cannot be paid because of a foreign government regulation. The example we will consider took place some time ago and involves Procter & Gamble, an American multinational that manufactures household products such as detergent, disposable diapers, etc. Procter & Gamble has operations all over the world, but this particular case involved the Swiss and Spanish subsidiaries; the Swiss subsidiary licensed technology to the Spanish subsidiary, and the Spanish subsidiary used that technology in its business in return for a royalty payment. However, this took place in the time of Franco in Spain, and at that time the Spanish government prohibited multinationals from paying royalties out of Spain, taking the view that royalties sent taxable income and investment out of the country. Thus the income was blocked even though there was an agreement between the subsidiaries that the transfer of technology would be accompanied by a royalty payment.

If the royalty had been paid, it would have been subject to tax in the United States because royalties are considered passive income: there would have been a deemed dividend from Switzerland to P&G, because in this case it is not possible simply to leave the money in a tax haven. The IRS therefore claimed that, even though the royalty was not actually paid, under transfer pricing principles it is not possible to have a royalty-free license, and therefore Procter & Gamble should be responsible for paying tax on the royalty it was supposed to receive under the agreement. The IRS stated this in terms of arm's-length pricing, arguing that as the unpaid royalty should be viewed as an arm's-length royalty, even though no money actually changed hands. The court, however, did not accept the IRS argument and held in favor of Procter & Gamble.

The company and the Court relied on an old Supreme Court case involving a U.S. company (although this was a domestic case, transfer pricing applies within the United States as well). The company in this previous case had two subsidiaries, one a bank and the other an insurance company. The bank persuaded some of its customers to take out insurance with the insurance company, and the insurance company was paid premiums. The IRS came in and said really it was the bank that did all the work: the insurance company simply wrote the insurance, whereas the bank persuaded the customers to take out the insurance. The IRS argued that some of the premium income really belonged to the bank. However, at the time there was a law in the United States (which was recently significantly relaxed) that made it illegal for banks to write insurance or to be in the insurance business. The Supreme Court held that the IRS did not have authority under

section 482 to allocate these premiums from the insurance company to the bank because banks are not allowed to receive insurance earnings.

This was then applied in the *Procter & Gamble* case to the foreign royalty situation. The company claimed, and the Court agreed, that Spanish law prohibited the payment of this royalty and therefore it would be illegal, under section 482, to do a transfer pricing adjustment that pays a royalty prohibited by foreign law. The Court agreed that foreign law should prevail even though the royalty was legal under American law. This is now an important issue because there is a significant difference between the original U.S. case and the later foreign case. This difference stems from the fact that in the domestic case, the holding was based on a U.S. law. In the Procter & Gamble case, however, the holding is based on a foreign law, and what constitutes a foreign law for this purpose is somewhat flexible and problematic.

The last case we will consider here involves Aramco, a consortium of the big American oil companies. Aramco is an American company, but most of its business is conducted in Saudi Arabia, and it also has refineries in other places, including Indonesia. ExxonMobil, Texaco, and the other big oil producers are partners/shareholders of Aramco. During the high oil prices of the 1970s, the United States asked Saudi Arabia to help it stabilize oil prices. The Saudi Minister of Oil at the time wrote a letter to Aramco requesting it to cap its oil selling price at a certain price per barrel. Aramco complied with this request by selling oil to the refineries in Indonesia at the low price. The refineries refined the oil and sold it to Texaco and the rest of the major oil companies at the world price, unaffected by the minister's request, and the major oil companies sold the oil to customers at the world price. In this case, the arm's-length price is very easy to establish because oil is a commodity that trades on the market.

This case was important to the IRS because Aramco was a U.S. company (with profits taxed in the United States) but the refining company in Indonesia was a foreign subsidiary (with profits benefiting from deferral). There was therefore no current tax on the difference between the prices at which the refineries bought and then sold the oil. This difference, the so-called Aramco advantage, was the biggest tax deficiency ever litigated in the American courts ($9 billion). The IRS claimed that the refinery company should have paid the world (market) price of oil to Aramco, and Aramco claimed that it was forbidden from doing that by the Saudi Oil Minister's letter. Aramco argued that although the letter was not legally binding, it was important to comply with the minister's requests because it depended on the Saudi government for the rights to get the oil. The letter

was deliberately unclear: it was addressed to Aramco, so it was left unclear whether it applied to the Aramco subsidiary that sold the oil at the world price. Wrongly, and perhaps surprisingly, the courts unilaterally held in favor of Aramco, relying on the *Procter & Gamble* case as precedent. There were many such cases because each individual U.S. oil company (Texaco, ExxonMobil, etc.) had its own case, and every single case went against the IRS.

This series of cases is noteworthy because it shows the misuse of precedent. The original case centered on a well-accepted American domestic law passed by Congress. In the *P&G* case, this was transferred over to a Spanish law; the law was specifically applicable to P&G, although the case raised concerns that P&G had helped to negotiate the law, which was to its own advantage. The problem with applying the original precedent automatically to foreign laws is that it is impossible to know the extent to which the taxpayer had a hand in procuring the enactment of the law. It becomes even more problematic in the Aramco context because, rather than even being a foreign law, the case now revolves around a letter addressed to only one taxpayer. The Aramco precedent is troubling and very powerful because, at the extreme, it implies that any taxpayer who dislikes a section 482 adjustment can go to a foreign government and ask for a letter saying that a royalty cannot be paid. In principle, this precedent is enough to completely eliminate the super royalty rule.

The new regulations specifically address blocked income. These regulations state that if you have a blocked-income situation, you must file a return stating the blocked income, and, although the company does not have to report it for tax purposes while it is blocked, the company must pay the royalty and the tax with interest if the income should become unblocked in the future. However, this is one instance where the regulations are clearly contrary to all the legal authorities; every single court case that was decided following the Supreme Court case is on the other side, so taxpayers should feel secure in relying on these cases in defiance of the regulations. Thus because of the misinterpretation of the original Supreme Court case, the United States is in the unfortunate situation that if a company can find a favorable local rule that creates blocked income by prohibiting it from making a payment, that the company is free to take advantage of that favorable rule.

7

Taxation of residents: Investment income

In this part of the book, we consider outbound tax rules, which apply to tax residents who derive income from overseas. The fundamental problem in the outbound tax situation is that U.S. residents are taxed on U.S.-source income as well as foreign-source income, because residents are taxed on all income "from whatever source derived." One way to get around this is to set up a foreign corporation; setting up a foreign corporation is very easy now that you can simply "check the box" to make it a corporation, and getting foreign classification is easy because any corporation that is not incorporated in the United States is automatically foreign. In addition, the foreign-source income must be shifted from the U.S. resident to the foreign corporation; this is possible only for foreign-source income, because both residents and nonresidents are taxed on U.S.-source income.

The foreign company faces delayed taxation on this income in one of two ways. The first instance of taxation occurs when a dividend is distributed. In this case, the income is foreign-source income because it is a dividend from a foreign corporation, but it is taxable because it is payable to a U.S. resident. The other instance of taxation occurs when shares of the corporation are sold. In this case, the income is capital gains, which is considered U.S.-source income and therefore is also taxable. Under current American law, capital gains from a sale of shares would be subject to a significant preferential tax rate of approximately half the regular rate. Both instances of taxation are under the control of the taxpayer, as the taxpayer can decide when to distribute dividends or sell shares of the company. As long as the taxpayer chooses to exercise neither option, taxation is deferred or postponed until one of the options is exercised. The practical effect of deferral is to reduce the present value of taxes due. If deferral lasts long enough, the present value approaches zero; thus a deferral can approach an exemption over a long enough period of time. Put another way, deferral is equivalent to exemption of the interest on the amount deferred. Thus as long as no dividends are paid and the stock is not sold, the foreign-source income can remain overseas and earn further interest that is exempt

from American tax. If this deferral lasts long enough, the interest eventually dwarfs the principal amount completely.

This has been a problem for quite some time because the structure of U.S. taxation is built on the division between residents and nonresidents. By definition, nonresidents can only be taxed on U.S.-source income. Thus, as long as it is possible for residents to transfer the foreign-source income to nonresidents, the problem arises in which residents can avoid tax on foreign-source income. This problem is particularly acute in the United States because a foreign corporation is defined formally, making it extremely easy to create nonresident corporations without significant transaction costs and without the risk that the IRS would reclassify the corporation as a U.S. resident.

If this situation is left completely unchecked, it means that anybody who has transferable income from foreign sources (mostly the rich) does not have to pay American tax on that income. Over time, Congress responded by enacting an impressive array of antideferral regimes; until 2004 there were six such regimes in the Code, and even after simplification in 2004 there are three.

We will briefly discuss all six regimes, but with special emphasis on the three that remain after the 2004 simplification. We will discuss the regimes in the chronological order in which they were implemented. Each antideferral regime covers something but does not cover everything; thus Congress felt the need to add on to it, creating the next regime. The oldest regime, which still applies today, is known as the Accumulated Earnings Tax and was passed in 1921. This tax has domestic origins. For most of the history of the American income tax, the individual net rate was much higher than the corporate net rate, although currently the top rate for individuals (35 percent) is the same as the corporate rate. This historical pattern gave rich individuals an incentive to leave money inside corporations so that the money could accumulate at a lower tax rate inside the corporation. To overcome this, Congress in 1921 passed the Accumulated Earnings Tax, which taxes earnings that are unreasonably accumulated inside a corporation at the top individual rate rather than at the corporate rates. Although this law was not originally implemented as an antideferral regime, it can also apply to the situation in which foreign-source income is accumulated inside a foreign corporation. The IRS does attempt to apply the accumulated earnings tax to corporations, but it is not very strong because it depends on the proof of motivation; the burden of proof is on the IRS to show that the earnings were accumulated unreasonably, which means that a court has to second-guess the business judgment of the owner of the business as to

the level of earnings that it is really necessary to maintain in the corporation. Courts are extremely reluctant to do that in the United States, and thus there are very few cases where the IRS was able to show unreasonable accumulation of earnings.

The next two regimes, which no longer apply but are important to understanding the origins of current law, were added in the mid- to late 1930s. These regimes are two acts known as the Personal Holding Company and the Foreign Personal Holding Company, which were both enacted in 1937. These acts were a response to stories about wealthy Americans putting domestic or foreign-source income into corporations domestically or overseas to avoid paying taxes. One famous example of this is the inventor Jacob Schick, who invented the disposable razor; there are still razors sold under the Schick brand name all over the world. He transferred the patent for the disposable razor to a Bermuda company, and all the royalty income accumulated offshore, tax-free. In addition, many of the directors of the J. P. Morgan Bank did the same type of thing. All of this was happening at the height of President Roosevelt's New Deal, and the president was very much against the rich avoiding taxes.

Both the Personal Holding Company and the Foreign Personal Holding Company are incorporated pocketbook regimes designed to penalize rich individuals who put foreign-source income in foreign corporations. These regimes targeted passive foreign-source income from a foreign corporation that is controlled by five or fewer U.S. individuals, and thus potentially applied to any situation where foreign corporation was controlled (more than 50 percent of the shares are owned) by five or fewer U.S. individuals. The personal holding company regime taxed the corporation itself at the individual rate if the company was a personal holding company, which was a company controlled by five or fewer individuals more than 60 percent of whose income is passive. The foreign personal holding company regime did not tax the foreign corporation at all (in 1937 it was not believed that it was possible as a matter of international law for the United States to tax a foreign corporation on foreign-source income), but instead it created a deemed dividend, a hypothetical dividend of all passive income. The idea behind the foreign personal holding company regime was that the controlling U.S. resident has the ability to force the company to pay a dividend at any time. Therefore the United States took the situation to be the same as if a dividend of all the passive income had been paid to the U.S. resident and then the resident put the money back into the corporation to explain why the money was still in the corporation. When a real dividend was paid later, the IRS

credited the tax that was already paid. This strategy avoids double taxation while attempting to avoid the possibility of tax deferral.

Although the personal holding company was meant to apply only to domestic corporations, Congress never specified this explicitly because Congress assumed that it did not have the jurisdiction to tax a foreign corporation on foreign-source income. Today this jurisdictional limitation is less clear, and therefore until 2004 both regimes potentially applied. In 2004, Congress abolished the foreign personal holding corporation regime and clarified that the personal holding company regime does not apply to foreign corporations.

These two regimes apply only to corporations that are controlled by five people or fewer. The next regime applies to all corporations controlled by large shareholders (individual or corporate) who are U.S. residents. This is the most important regime for corporations, and it is known as "subpart F" based on the section of the code where it is found. Subpart F, which contains sections 951 to 960 of the code, was enacted in 1962 by the Kennedy administration. This is the provision that applies to foreign subsidiaries of American multinationals and makes their passive income (as well as some other income types) taxable currently. Subpart F is very controversial because it is the only regime that applies to corporations where the parent is an American publicly traded multinational rather than an individual.

The fifth regime is less important and was known as the foreign investment company provision. Implemented at the same time as subpart F, it was designed to apply to foreign mutual funds that were beginning to compete with American mutual funds for American investors. This regime converted earnings from capital gains to ordinary income so that investors in foreign mutual funds did not receive a significant benefit. It was abolished in 2004.

The sixth regime, which is current, dates from 1986 and is known as the passive foreign investment company (PFIC). The PFIC is the only regime that does not require American control of the corporation and is designed to apply to the small-portfolio investor who earns passive income from a small ownership interest in a foreign corporation. This sixth regime (PFIC) and the third regime (subpart F) are the two most important regimes today, with subpart F applying primarily to corporations and PFIC applying to investors with noncontrolling interests. The outbound antideferral rules fall into three fundamental categories, a design that is common to the United States and many other countries. This type of rule is important because it

keeps the wealthy from channeling their income through other countries as foreign-source passive income, forcing wage earners within the country to bear the majority of the tax burden. The three types of antideferral rules are the controlled foreign corporation regime (such as subpart F), the foreign investment company regime (such as PFIC), and the incorporated pocketbook regime (such as the foreign personal holding company).

CFC regimes are the most important and apply to controlled foreign corporations with over 50 percent American ownership, and generally only to corporate shareholders. They generally apply only to the low-tax passive income of those enterprises because deferral (or exemption) of active income is allowed; the result is that no deferral or exemption is given to the corporate shareholder, although usually through direct inclusion, not a deemed dividend.

Foreign investment company regimes, also known as foreign investment funds, are foreign investments in passive investment vehicles overseas such as mutual funds. They do not require a minimum level of control. Therefore, at the extreme, it would be possible to own 0.000001 percent of the shares and still be subject to the regime, whereas CFC regimes require ownership of at least 50 percent of shares. Foreign investment company regimes apply to all shareholders (corporate or individual), although a recent change in U.S. law states that the PFIC regime does not apply when the CFC regime applies, making the PFIC mostly applicable to individuals.

The third type of regime, the incorporated pocketbook regime, requires control by one of the shareholders, five of whom must be in the United States. The incorporated pocketbook regime applies only to individuals and to low-taxed passive income and results in current taxation through the shareholders. The difference between these three types of regimes is that CFC regimes are for corporations, whereas the other two are for individuals.

I will now discuss the passive foreign investment company (PFIC) regime. This is the most recent regime, enacted in 1986, and as noted earlier it was added to apply to noncontrol situations, that is, situations where Americans invest overseas in passive income-producing vehicles without controlling them, because all the other regimes up to 1986 required control. How does it work? Suppose you have a U.S. shareholder who owns a very small percentage of the shares of foreign corporations and the rest is held by the public in the United States or abroad. Here there is only one test – that is, there is no control test, only a passive income test: whether either 75 percent of the income is passive or 50 percent of the assets produce passive income. If you meet either of these, then this foreign corporation is a PFIC and the PFIC rules will apply to you. Now what will that mean? Here the

key problem is that you do not have control, so the U.S. shareholder cannot make the foreign corporation distribute a dividend. Thus there is a real practical problem of forcing taxation on a deemed dividend when you cannot make the corporation distribute the deemed dividend because you only have a very small percentage of the shares, and small shareholders cannot force dividends. Because of that, the code does not require you to pay tax currently on a deemed dividend; instead, it gives you three options. One is a deemed dividend if you can make a corporation distribute the dividend to you; or even more simply, if it is not a question of finding the cash to pay the tax, and if you can make the corporation give you information about how much income it had and how much is attributable to your shares, then you are allowed to declare and pay tax from a deemed dividend. That is usually the option that most taxpayers would prefer because it is much simpler and results in a lower tax burden than the other two. However, it is an option that is not available to many U.S. shareholders because they cannot force the foreign corporation to reveal the information that is necessary to file a tax return. So this option is really only available if the majority of the shares are held in the United States, which is frequently not the case for these passive investment vehicles.

There are two other choices: interest charge and mark to market. Under the interest charge option, when the corporation ultimately distributes a real dividend, you spread the amount of the dividend over the entire period that you owned the shares, and then calculate interest from the time you bought shares to the time of the dividend as if you received dividends throughout on a current basis. For each period you can calculate an interest charge on the tax, so you can defeat the benefit of deferral. This is a horrendously complicated matter; with a good computer program you can of course do it, but that costs a lot of money. If you are just a small investor in a PFIC, it is not worth your while to go through the calculations, which are quite complex, because the interest rate varies from time to time, and the tax rate that applies may also vary from time to time – and you have to factor both of these things into the calculation. This choice is very much a disaster area to be avoided if at all possible.

What most people do in order to avoid this interest-charge method is to use the third option, if that is available, which is called mark to market and only came in a few years ago. What *mark to market* means is that if the shares are publicly traded on a stock exchange, then instead of trying to tax you on the underlying income of the PFIC, the passive income, the IRS taxes you on the change in the value of the shares from the beginning of the year to the end of the year, and if there is a loss, they give you that

loss. The advantage of that is that it is simple to calculate: you simply open the *Wall Street Journal* or any other newspaper that gives stock exchange tables and determine the value of the stock when you bought it or at the beginning of the year and its value at the end of the year. If it went up, you file a return and pay tax on that difference. There are, however, two big disadvantages to this method. One is that the stock must be traded. Not all PFICs are publicly traded, and if they are not, then you cannot use this method. Second, you must pay tax on phantom income that you do not receive, especially when the stock market goes sharply up and then down: this means that you pay tax early and then have losses later, but you are not necessarily able to offset one against the other. Furthermore, even if you do, you do not get a refund with interest – just a refund. Many taxpayers do not like this method very much, because it means they must pay tax on phantom income (income that they have not really earned; *unrealized income*, to use the technical American term).

Thus, PFIC really is a rather drastic regime: it leaves you with three options, none of which is very appetizing. Deemed dividend is probably the best – which is strange, because usually people hate having to pay tax currently – but it avoids the other two. However, it is frequently unavailable even for publicly traded entities, because the shareholder does not have the information necessary to file a tax return, and shareholders will not be able to force the company to tell them. If that is the situation, you are stuck with the other two, and it is not an appetizing choice: either you must pay an interest charge that is quite complicated to calculate and costly, or you must rely on the mark-to-market system, which applies only to publicly traded entities and initially requires you to pay tax when there is no real gain to you. None of this is very good, and it is quite burdensome for shareholders to try to comply with.

Another question, of course, is how successful the IRS is in enforcing the PFIC regime. It is a crime not to declare ownership of foreign corporations, but the extent of evasion is unknown. If shareholders want to comply with the law, they must determine that they are really PFICs, so they must do the passive income/passive asset calculations; passive assets in particular are problematic, because you must value the assets as well as determine what portion of the assets are really passive and what portion are active. The best advice is to try to avoid PFICs as much as possible. The key is to try to make sure there is enough active income to prevent the potential PFIC from having too much passive income or too many passive assets. It is usually the asset test that is harder to avoid.

Is all of this worthwhile to small investors? I have some doubts. On the other hand, you can imagine that some investors in PFICs have a great deal of money invested in them, especially in some of the hedge funds, and in those cases perhaps the regime is worth it. Personally I would like to see some kind of *de minimis* rule – for example, that if there is less than $1,000 in income from a PFIC, one can forget about the PFIC regime.

There are two more important points about PFICs. The first one is that there is a particularly bad rule in the regulations that can be summarized by saying, "Once a PFIC, always a PFIC": if for any given year a company reaches either of the test standards, it remains a PFIC forever, no matter how active it becomes. You are still taxed only on the passive income of the PFIC, but after that it does not help you to be below the threshold. You need to avoid PFICs for any year during your holding period; it is a PFIC to the shareholder who held it during the bad year. The other matter is important for foreigners who want to come temporarily to the United States – something that not many people are aware of. Suppose you are a foreigner (a nonresident) and you have all of your investments in various vehicles that earn passive income and that therefore are potentially PFICs (foreign corporations that earn passive income). Now you are planning to come to the United States for one year for business. So, for that year, you are going to be a U.S. resident and a U.S. shareholder of PFICs. You may not think this matters much, because the PFIC is not going to pay you any dividends during that year, and there will be nothing to pay interest charges on. However, they catch you. The way they catch you, if you observe the law, is the only example under U.S. tax law of an exit tax, which many other countries have. They say that when you leave the United States – when you stop being a resident after the year in which you spent more than 182 days present – they deem you to have sold your shares in the PFIC the moment you leave. This creates a deemed dividend situation – that is, the sale is like a deemed dividend, and therefore they will tax you with the interest charges on the earnings of the PFIC for that year. This is something that really should be avoided. I have seen situations where people gave their PFIC stock away to relatives before they came to the United States and got it back from them after they returned to the United States in order to avoid this. It is not enough to put it in a trust, because they look through trusts, but if you genuinely give it away to somebody, that is safe. Essentially, you do not want to become a U.S. resident while you are holding PFIC stock.

The most important antideferral regime for American multinationals is the subpart F regime, and we will spend the rest of the chapter on this.

Subpart F is called that because it is subpart F of part N, which is the international section of the income tax code. It applies to what are called controlled foreign corporations or CFCs. The classic situation to which subpart F applies is a U.S. parent with a controlled 100 percent foreign subsidiary, that is, a corporation according to "check the box." This is a classic subpart F situation, and this entity is a CFC. The foreign corporation must be controlled, that is, over 50 percent held by vote or value by "U.S. shareholders." *U.S. shareholder* in this case is a defined term, because each U.S. shareholder must own at least 10 percent of the voting stock of the CFC. Attribution rules apply: for example, if you have an eleven-shareholder group that ratably owns 100 percent of a foreign corporation, is this a CFC? The answer is no, because each of them will only own about 9 percent of the foreign corporation. Thus, even though as a group together they own 100 percent of the foreign corporation and the whole foreign corporation is controlled from the United States, clearly as long as the attribution rules do not attribute stock between them – they are not members of one family, for example, or they are not all part of one single corporate group with ultimate control in the same parent – if they are truly separate, you do not have a CFC.

The most important example is the case of an exact 50/50 joint venture with a non-U.S. partner. As long as you make sure that it really is 50/50 by vote and by value, then you are all right: it is not a CFC and subpart F does not apply to you. That is very important because, as we will see, American multinationals go to great lengths to try to avoid subpart F if they can. However, let me mention one particular situation that is problematic. If the joint venture is exactly 50/50 and if there is only one class of voting stock, that is not a problem. Sometimes, though, there are differences in what the two parties in the joint venture contribute to it, and you may have a situation where there is more than one class of stock; for example, there is the basic common stock, but in addition you also issue each side some preferred stock that does not carry a vote but carries some value with it. Here the problem is that you want to watch out for fluctuations in value, because the test is by vote or value. You should be careful, if these are two different classes of preferred, to prevent situations where because of value fluctuations, the preferred owned by the American party together with the common exceeds 50 percent of the value. In particular, consider a situation in which the American party contributes some intangible property and wants to make sure that, as the value of this intangible becomes better established and the profit potential becomes better established, the American party receives that upside. So, they write into the joint venture agreement a provision

saying that if the intangible they contributed turns out to have a great deal of profit potential, they will receive more in some way. The risk is that if they do that, they will turn this joint venture into a CFC and subject it to subpart F, because the preferred stock will become more valuable over time.

It is possible to try to play games with this, but you do not want to carry it too far. Consider the case of a company named Garlock, which tried to be too clever. Garlock U.S. had a Panamanian subsidiary that earned a lot of passive income, and it wanted to avoid subpart F. At the time, the rule was written so that the test was only by vote, not by value: over 50 percent by vote. Garlock decided to give a trusted investor, voting preferred, 51 percent by vote; however, this preferred had a limited dividend, 8 percent, so that by value the 49 percent by vote of the stock held by Garlock was probably 90 percent by value of the company. Garlock essentially agreed with the trusted investor that they would always vote together. The investor was in it for the 8 percent dividend and did not care about the vote. Thus, despite holding nominally 51 percent of the vote, the investor agreed always to vote with Garlock on all matters. The investor appeared to have given away control, but in reality did not. This was struck down by the court in the opinion because it had no substance.

The rule has now been changed, so that over 50 percent by vote or value is clearly a CFC even without worrying about these legal technicalities. The only way to really avoid subpart F is to make sure that not more than 50 percent of the vote or the value is held by large American investors (over 10 percent each); you can have a situation where 49 percent or even 50 percent exactly is held by one large American investor and the rest is held by small investors and still not have a CFC, because you have to be at 10 percent investor individually, 10 percent by vote. Why by vote? That gives you a seat on the board: usually if you have 10 percent by vote you can influence policy, including payment of dividends.

Given this definition of a CFC, what is the result if a company is deemed to be a CFC? The result is current taxation, through a deemed dividend to the U.S. shareholder at the end of the tax year, of all the subsidiary's subpart F income. That is, if you have a CFC, and it has subpart F income (which we will define shortly, but is essentially passive income that is earned by the CFC), this will trigger a deemed dividend at the end of the tax year of the parent. Whichever is the last day of the fiscal year, on that day whoever is the shareholder of the CFC at that point receives a deemed dividend from the CFC of all the subpart F income, and then there is a deemed contribution of the income, because the income remains in the CFC: there is no real

dividend. If there is a real dividend after that, you get credit for the tax that you have already paid; you need not pay tax on that dividend again.

As I said earlier, the deemed dividend mechanism was chosen because the Treasury did not think they had the authority to tax the CFC directly on foreign-source income. I think that is rather unfortunate, and today there are many proposals for change because the current rules lead to a lot of complexity. This is especially problematic when, for example, there is a chain of thirty CFCs going down, and the deemed dividends must be jumped up the chain. The situation becomes very complicated. It is much easier to simply imagine the U.S. parent earning the subpart F income directly as if on a flow-through basis, without worrying about deemed dividends and the like. That would mean losses would also carry through, which currently they do not – only income. In any case, however, that is the mechanism that was chosen back in the 1960s.

What is subpart F income? The most important category is passive income, namely dividends, interest, grants, royalties, and capital gains, but there are some important exceptions to this. The first, which is very important nowadays, is an exception for rents or royalties derived from an active business; this is particularly important in the high-tech area, where most income is in the form of royalties. Active royalties – that is, royalties earned from the active business of licensing computer software, for example – are not subpart F income, and you must work to make yourself qualify under that definition; but this is not the kind of royalty that they were thinking about. Then there is an exception that is also very important for dividends, interest, and royalties that are derived from another CFC. This is in order to enable U.S. parents to create holding company structures. Consider a U.S. parent that wants to be in a foreign country and will have two different businesses in this foreign country: foreign subsidiary A and foreign subsidiary B. However, you have a problem under this structure. They are both CFCs, but that does not matter because they are both going to be engaged in active business, and active business income is not subpart F income. The problem is, how are you going to transfer the money from one subsidiary to the other? The normal way to do it is to send a dividend up and then make a contribution down, but if you send a dividend into the United States, that would subject you to withholding tax as well as to current American tax on the dividend. So instead you set up a holding company, and then you can transfer dividends up and contribute down without crossing the border, so there is no American tax and no withholding tax.

The problem arises when you send the dividend. This holding company will have no income other than dividend income, and that dividend income

is passive income and subject to subpart F, so there would be a deemed dividend to the United States parent. To prevent this, originally a same-country exception was enacted, which said that that dividends and interest derived from companies that are incorporated in the same country as the recipient are exempt from subpart F. Thus you can send a dividend up and then contribute it, and this will not be subpart F income. In 2006 this exception was broadened to include all passive income flows from other CFCs, not just in the same country, because as we will discuss later, that result could be achieved using "check the box."

Another important exception was enacted in 1996 over very strong objections by the Clinton administration, which tried to veto it several times. This is a general exception for banking, finance, and insurance businesses. These simply do not have subpart F income, even if their income is nominally passive, such as interest income. This is an interesting debate. In general, the rationale behind rules such as subpart F is couched not so much in terms of equity, but in terms of economic efficiency, and the guiding principle is what is called capital export neutrality, or CEN. Capital export neutrality means that ideally you want investors to be indifferent between investing in the United States and investing overseas, and you should not let the tax factor influence their decision to invest overseas rather than in the United States. The argument that the Kennedy administration made against deferral (originally they proposed to abolish deferral altogether, but this was cut back in Congress to the current rules, which essentially limit deferral to active income) was that it is a bad thing to encourage U.S. parents to invest abroad because investment abroad will qualify for deferral and therefore be subject to a lower effective tax rate, assuming that there is low source-based taxation, than an investment in the United States; this violates capital export neutrality because it gives a tax incentive to invest abroad rather than in the United States. This was also when the United States still had a major balance-of-payments issue, that is, much more capital was flowing out than was coming in, and that was part of the explanation as well. From a capital export neutrality perspective, you really should tax these offshore businesses. But the contrary argument was this: if American multinationals are going to be taxed on the foreign-source income of their subsidiaries, that will make them less able to compete against German or French multinationals, which receive an exemption on foreign-source income of their subsidiaries.

In the end, it was decided to limit subpart F essentially to passive income. The rationale for that was that passive income is very mobile – multinationals can earn it wherever they want – and it is not very clearly linked to

competitive market conditions, that is, to competition with other multinationals. On the other hand, active income is less mobile and therefore subject usually to higher rates of tax overseas, and deferral is less of an issue if there is source-based taxation; deferral loses its appeal. The value of deferral is to avoid current American taxation, but if you have to pay tax to some other country on a current basis and the tax rate is similar, then there is little to gain from deferral. The argument concerned active income – business income, such as manufacturing income. First, this is where competition with other multinationals is the most important. Second, it is hard to earn active income in places where it is not highly taxed because it is not very mobile; you cannot take your factory and move it from place to place very easily. Therefore, countries like to tax such income at source, and it is subject to high tax rates. Passive income, on the other hand, can be moved very easily, and thus it is subject to low tax rates; therefore, deferral is very attractive.

This is where the debate about active banking, finance, and insurance comes in. The banking and insurance lobby said, we are really earning active income – our interest income, if we are a bank, is really active – because this is what we do: we make loans and we earn interest income. That is our business. So this is business income, and you should not penalize us by treating it as passive income for subpart F purposes.

The Clinton administration responded: the distinction between active and passive is being made because active is more mobile than passive; we grant you that your interest income is active, but banking, finance, and insurance are also notoriously mobile. That is why they are all located in the Caribbean islands, and they are not subject to tax at source. So you should not get deferral.

This went to Congress, and Congress passed a law that was temporary, but has now been extended and made permanent over the president's strong veto. This exception illustrates some of the dividing lines: if you think that the line should be active versus passive, then this exception should be in the law; but if the line is low tax versus high tax or mobile versus not mobile, I am less sure that this exception should be in the law. In any case, it is in the law.

There is one other exception, the high-tax exception. If the foreign tax rate on your CFC is 90 percent of the U.S. tax rate, then you are out of subpart F. The current U.S. tax rate is 35, 90 percent of which is 31.5; any foreign tax rate over that qualifies. (Note that this is the effective rate, so you have to calculate how much actual tax you pay to the foreign country compared to how much income you have.) The reason for this exception is

that deferral is not very attractive under these circumstances, and it is not much of a problem, because you are paying the foreign tax anyway; if you brought the income back, it would not be subject to much U.S. tax because of the foreign tax credit.

Finally there is the *de minimis* exception: if the lesser of either 5 percent of the CFC's income or $1 million is subpart F income, you are out of subpart F. Unfortunately, for most multinationals this is a ridiculously small exception, though it may help some individual investors who own stock in CFCs. There are proposals to increase it substantially, but this is what the law says at the moment.

The most important and controversial provision in subpart F is the base company rule, which gives rise to most of the court cases and most of the planning. What is the base company rule about? The base company rule is about the *DuPont* case, which we went over in Chapter 6. DuPont set up a Swiss subsidiary whose only function was to buy things from DuPont and then resell them to various other European subsidiaries in other countries, such as France and Germany, for resale to ultimate consumers. DuPont did this because Switzerland is a tax haven, and by paying low prices to DuPont (U.S.) and paying high prices to the Swiss company, DISA, it was able to accumulate all of the profit in Switzerland tax-free. This was before subpart F, so DuPont did gain deferral on it. As we saw in Chapter 6, ultimately, after twenty years of fighting, the IRS won a court case that said as a matter of transfer pricing, this income should be transferred over to DuPont and taxed. However, it took twenty years, and it was enormously time-consuming and expensive for the IRS to win this case. Thus, long before the actual court decision came down, the IRS was able to persuade Congress that it needed something to fight this kind of scheme. This is how the base company rule came into effect.

The base company rule says that: (1) if there is a purchase from or sale to a related party (in the DuPont case, the purchase was from and the sale was to a related party by a CFC) – that is, if a CFC is buying or selling to a related party that is a company in the same group – and (2) if the purchase and the sale are outside the CFC's country of incorporation – that is, if you choose a country such as Switzerland, which is a low-tax country, and the CFC is only there in order to reduce taxes – and (3) if there is no significant modification of the product by the base company – that is, the Swiss company was buying and selling the same thing, it was not doing anything to it, it was not really adding value, it was just a conduit – then the income is base company income, and as base company income it is subpart F income, which means a deemed dividend up to DuPont and current

American tax. This is the base company rule. American multinationals hate this rule, and they try very hard to avoid it by every means available. They claim it makes them uncompetitive with multinationals from countries that do not have this kind of rule, because generally other subpart F–type regimes, CFC regimes, are less stringent than the American one – although how much less stringent is very much a topic of debate.

I will show how this works with another case that illustrates some of the ways in which American multinationals can avoid subpart F. This is the notorious *Brown Group* case from just a few years ago. Brown Group is an American multinational, and one of the things that it does is to import footwear into the United States. It set up a corporation in the Cayman Islands that clearly was a CFC. The purpose of this corporation was to buy shoes from Brazil, where they were manufactured by an unrelated producer, and then resell those shoes to the United States. There they would be resold by Brown Group to customers in the United States. If this was all that was done, then this is clearly a subpart F base company situation: the Caymans corporation is a CFC, it is buying shoes from unrelated parties but selling them to related parties, and both the buying and the selling are taking place outside its place of incorporation. Thus the only function of the Caymans corporation is to accumulate profit in the Cayman Islands resulting from the difference in price. There is no other function – it is not modifying the shoes in any way – so therefore it will have subpart F base company income and there would be a deemed dividend to Brown Group. This is what Brown Group wanted to avoid, so they did not do it this way. Instead they did something a little bit more sophisticated – although it is not entirely clear that they did it deliberately as a tax matter, because there were also nontax reasons to do it that way.

A buyer who was the go-between, the intermediary between Brown Group and the Brazilian manufacturers, wanted a cut from the profit on the sale of the shoes. Brown Group could not employ him because he wanted too much, so instead they set up a partnership called Brinco with this individual. Now, instead of the Caymans company buying and selling the shoes, it was the partnership that bought the shoes and then resold them to Brown Group in the United States. A partnership under American tax law is not a taxpaying entity by itself; it is a pass-through vehicle. It can be used, of course, to conduct business, but it does not pay any taxes; instead, the distributive share of partnership income is attributable and is allocated to its partners, and that share is taxed to the partners.

What then happened, under American tax law, was that the profit of the Brinco partnership was attributed 98 percent to the Caymans corporation as

a distributive share of partnership profit. What was the result? It turned out that there is nothing in subpart F explicitly saying that when you do things through a partnership, the character of the income as base company income is maintained to the Caymans corporation. So what Brown Group claimed in court, ultimately successfully, is that what the Caymans corporation, the CFC, got was just a distributive share from a partnership, not base company income, because base company income by definition has to be earned by a foreign corporation – by a CFC. Subpart F income in general has to be earned by a corporation, not by a partnership. Because this was a partnership, and not a corporation, it could not earn subpart F income itself, and what the Caymans corporation earned was not subpart F income because it was distributive share of the partnership's income. There is a list in the Code of things that keep their character from the partnership level to the partner level, but this is not one of them.

The opinion is very long, because there are many different judges and many different opinions. In the tax court initially the taxpayer won; then they went to the whole tax court (all the judges sitting together) to try to figure out a way to make subpart F apply. The majority held for the IRS, but ultimately on appeal the court ruled for the taxpayer.

If this result holds, the base company rule is dead, because there is nothing easier than doing it this way, especially now with "check the box." All CFCs will never do base company transactions themselves; all that DuPont needed to do, for example, is to set up a partnership under the Swiss subsidiary with some local partner, and all of the base company income now becomes partnership income and not subject to subpart F.

Most people in the United States feel that this was too aggressive, and that the appeals court was wrong. The key question is whether the character of the income was the same in the hands of the partnership as it was in the hands of the Caymans corporation. The IRS has now issued regulations to overturn the result in *Brown Group*. However, the outcome is not clear: the status of regulation in the United States depends on the valid interpretation of the law; the law was not changed, and because the Code was not changed, the next taxpayer will probably argue that the controlling legal authority is the court case that interprets the law, and that case (*Brown Group*) says that this is not subpart F income. The fact that the IRS has, with hindsight, adopted regulations to change the result does not change it, and the regulations are invalid. My own view is that it would have been better for the IRS to try to get Congress to change the law, because if the law is not changed, if this is a valid technique, this is such a big loophole that the base company rule has basically disappeared.

Another problem with the base company rule can be illustrated by a case called *Ashland Oil*, which involves the application of what is called the branch rule. The branch rule originated in the following situation: Suppose you have a French CFC, which buys goods from the U.S. parent and sells it to unrelated buyers outside France. This would be base company income. But that does not get you anything, and France is a high-tax country anyway. Instead, you set up a branch in Switzerland (a branch, not a subsidiary; if this was a subsidiary it would be a CFC itself and the rule would apply). Now you manufacture goods in France and you transfer them to your Swiss branch, and then the Swiss branch does all the selling outside Switzerland. It sells in France and other countries, and the money accumulates in the Swiss branch. France has a territorial system of taxation, so France will not tax the Swiss profits of the Swiss branch; these profits will now sit in Switzerland and will accumulate. On the other hand, from an American perspective, the branch is part of the CFC. Therefore, the argument is, we are not really selling outside the country that we are manufacturing in, because we are manufacturing and selling in France; the Swiss branch is to be disregarded. Moreover, even if it was otherwise, there is no purchase and resale for related parties, because the transfer to the branch is not a sale; it is a transfer from home office to branch, not a transaction that is covered by the base company rule – even though clearly in spirit it is something that is supposed to be covered by the base company rule.

Because of that transaction, there is a particular provision in subpart F that applies the base company rule to branches. In this kind of situation, the rule treats the Swiss branch as if it were a CFC. Then, of course, the transfer is really a sale, whether or not any money was paid. You are buying and selling outside the country of incorporation from a related party, and then selling outside the country of incorporation, and so it is base company income.

Ashland Oil involves a clever way of getting around the branch rule. The U.S. parent had a CFC in Liberia, another tax haven. The CFC did not do anything, but it entered into an agreement with a Belgian company unrelated to it that it would provide it with some know-how and materials, and in exchange the Belgian company would manufacture, on a contract basis, the finished product for a cost-plus return. These manufactured products would then be sold to customers outside Liberia, and the difference between the price paid by the end customers, which was high, and the price paid to the Belgian company, which was low, would sit in Liberia. The IRS argued that this was a base company situation: You are really not doing anything in Liberia, you are doing everything in Belgium, and we want to treat this

Belgian company as a branch of the CFC. And, as a branch, we will treat it as if it were a CFC; then you are buying from a related CFC outside your country and reselling outside the country, and it is base company income.

The court said no, that is not what the rule is about. First, the Belgium company is an independent company. It is not a branch; the American company does not own it; it is completely independent. This is all a contract manufacturing situation and is all at arm's length; you cannot make this into a branch. Second, in the original French/Swiss situation the manufacturing was done in France and the sales moved on to Switzerland, and in that situation the Swiss company was the branch. Here the IRS is trying to say the American company is setting up a manufacturing branch, whereas in the original situation it was the Swiss sales branch that was suspect. This was not what the law was intended to cover. It was intended to cover sales branches run through low-tax countries.

Now, I believe the CFC is much like a sales branch: it is not doing any manufacturing, only selling, and so it is pretty similar to the Swiss branch. But the IRS was stuck with trying to argue that the Belgian company was a branch when it was not, and ultimately the IRS gave up: they issued a ruling that they would respect the result of *Ashland Oil*.

Doing this avoids the spirit of the base company rule: you can enter into contract manufacturing agreements that put most of the profit in Liberia, because the Belgian company is willing to accept some small markup over its costs, raw materials, and the know-how is provided to it. Therefore, under these kind of modern conditions, where the know-how is most of the value, the profit can sit in Liberia exempt from subpart F.

That is what the base company rule is about, and in these situations it can be avoided relatively easily. The current situation is that most of subpart F (the part about all the definitions of CFC and the part about passive income) is relatively uncontroversial, now that the exception for banking, finance, and insurance is in place. I think that this part is likely to remain unchanged. However, the base company rule is subject to constant attack, and companies are really trying to find ways to avoid it. They claim that it makes them uncompetitive. The end result is trying to write the base company rule out of subpart F.

Would that be a good thing or a bad thing? That depends on your viewpoint, but it is interesting to look just briefly at how this is done in another country that is basically territorial, because the fundamental argument of the United States is that it competes with other countries. If you consider France, for example, you will see that they have rather strict rules that sound quite similar to the American rules (although they have been somewhat

relaxed recently in response to the same competitiveness argument). Here are the French rules: They have a controlled foreign corporation regime or foreign investment regime that applies to branches and applies to investments of 10 percent or more, a very low number, in the share capital of any foreign corporation. There is no control requirement, just a 10 percent or more investment. This results in current taxation of all the income to the French corporate taxpayer on the first day of the month following the end of the foreign entity's tax year, no offset by domestic losses, no offset against domestic income, and it is applied if the foreign branch or entity is not subject to income tax or subject to tax at an effective rate that is significantly lower than the French rate. The general rule is that any branch or subsidiary of a French corporation that is subject to tax abroad at a rate that is significantly lower than the French rate is subject to current French taxation. However, there is an important exception, which is the active business exception: if the taxpayer can establish that the activities of the foreign branch or entity do not localize profit in a low-tax jurisdiction (this is essentially like the base company rule, and it applies if the foreign business engages in actual industrial or commercial activities performed predominantly in the local market), the CFC regime does not apply. Thus, if you have a French company, you need to show two conditions: that the local tax rate is below French rate, and that there is no local active business. If both of these conditions are met, there is no deemed dividend; you are just taxed directly, and everything flows through to the French parent. This sounds drastic, as tough as subpart F. Of course, the devil is in the details, and it all depends on how it is applied.

There are, however, a couple of significant differences from the American rule. One is that in the American rule in subpart F there is no talk almost about what the local tax rate is; you use all kind of proxies for it, such as passive versus active income (active income would typically be subject to high taxes because it is less mobile, and therefore you can grant deferral), but there is no explicit reference to these foreign tax rates, except for the high-tax exception; there is no low-tax inclusion. Other countries such as France, Sweden, and Japan explicitly look at what the foreign tax rate is, and if the foreign tax rate is significantly lower than their tax rate, that kicks you into the rule. I wish the Americans had done the same, but the problem was, the United States was first and everybody else followed, so they could learn from the United States. The second point of comparison is that there is a rule about local active business. Thus, even if the tax rate in the CFC's country is very low, if the business is really local – and it is a rather flexible rule – then you are out of the provision. This sounds to me fairly similar

to subpart F. If that is true, and if Germany and the United Kingdom have the same rule, then I am not sure I understand what the fuss is about: that suggests that most countries really do have rules that are similar to or as tough as the American rules, and therefore the competitive argument that the American rules make the American multinationals noncompetitive is not valid.

You can certainly hear arguments: many American companies were taken over by foreign companies, including big industrial companies, the biggest one recently being Daimler's takeover of Chrysler. Now Juergen Schrempf, who was the head of Daimler Chrysler, testified before the U.S. Congress and was asked why Daimler Chrysler was a German company and not an American company. As I see it, there are many reasons for that, including that the German government would not let Daimler be taken over by an American company. However, Schrempf said that a major reason was to get out of subpart F. Recall that subpart F applies only to CFCs of American companies, so if you have a U.S. parent, all the companies that grow under it are CFCs. But now suppose that a foreign company takes U.S. P over, so it becomes a subsidiary. Now, if you continue to grow CFCs, you also have the ability to grow new companies abroad, and these companies will not be CFCs, because they are ultimately owned from Germany and not from the United States. They do not have large American shareholders; they may have public American shareholders, but those do not count.

This is the argument that foreign companies are taking over American companies because this enables further growth of the business outside subpart F, and it certainly is not totally impossible. Another example would be inversion transactions: Suppose a U.S. corporation is held by the public. One way of avoiding subpart F is to set up a new foreign company in some convenient place such as the Bahamas and have the new foreign company exchange its shares for the shares of U.S. P. Now, that new foreign parent company can grow new companies abroad without subpart F. This kind of transaction is called an inversion transaction: you flip the company over. Instead of having an American parent, you have a foreign parent, and the American parent becomes a subsidiary. The result is a lower tax rate, and they claim that it is all about avoiding subpart F. So the point is not clearly settled, but certainly there is some evidence that avoiding subpart F really does drive business decisions. However, the extent to which this happens is unclear.

The most recent developments around subpart F came about because of Notice 98-11, a notice that was put up by the U.S. Treasury in 1998. It described two ways in which American companies were using the "check

the box" rules (which were quite new then) to undermine the purposes of subpart F. The two transactions are similar; both involve what is called hybrid entities, that is, entities that are treated one way for American tax purposes and another way for local tax purposes. This is now very easy to do because of check-the-box, which enables you very easily to treat entities as corporations or as branches depending on how you want to look at them from an American perspective, whereas locally they will be something else. In the notice, the first example has a U.S. parent with a CFC, and an entity below the CFC that for American purposes is treated as a branch but for local purposes is a corporation. Let us say that the CFC is in Germany and the hybrid entity is in Luxemburg, which has much lower tax rates than does Germany. Suppose that the German CFC is engaged in active business operations, so it earns active business income. This income is not subpart F income, but is subject to high German tax (this was before the most recent German tax reform; German tax rates then were among the highest in the world on active business income, over 50 percent). So there is a problem, because the CFC is subject to a tax that is significantly higher than the American tax rate. Even if the CFC were to send a dividend to the United States and get the foreign tax credit, that leads to excess credit: some of the German tax will not be creditable because it is too high. So what do they do instead? They borrow money from the Luxemburg branch, and the CFC then pays interest to the Luxemburg branch. Now what happens? For German purposes, this branch is not a branch but rather a separate corporation, and the loan is a perfectly valid loan; the interest is perfectly valid interest and subject only to the German thin capitalization rule, which is fairly generous; this interest is all deductible. The result is that the German CFC now is able to reduce its effective tax rate from 50 to 25 or at least below 35, and because it has much less income to report in Germany, it now is able to credit all its German taxes when it sends the dividend up.

But what about subpart F? What about all of this interest income that is earned by the Luxemburg corporation? Is this not exactly what subpart F was designed to prevent? If the Luxemburg corporation is a CFC, then the interest income is passive income, and there would be a deemed dividend into the United States of the interest, and you have not gained anything. The interest is not taxable in Luxemburg. We have "check the box" to make this entity, which is a corporation for German and Luxemburg purposes, a branch of the CFC for American purposes. Now, branches cannot lend money to home offices and home offices cannot pay interest to branches; you cannot lend money to yourself. Therefore, for American purposes there is no loan, there is no interest, and thus there is no subpart F income and no

CFC in Luxemburg: this simply does not exist for American purposes. The result is no subpart F income. (Today, this result will be reached because payments of interest from one CFC to another are ignored.)

The second example is basically just a variation on the first example. You have U.S. P and in this case it has two CFCs in Germany, CFC 1 and CFC 2. CFC 2 is the one that is earning the active income in Germany; CFC 1 is the one that arranges the Luxemburg branch. Now what happens is that the Luxemburg branch once again lends money to CFC 2, which pays it interest. So, once again, for German tax purposes this is a separate corporation in Luxemburg, and the interest is perfectly deductible against German tax, thereby reducing the active income of CFC 2 to a much lower percentage. Therefore the effective tax rate will also be lower than 35 percent, making it potentially eligible for the foreign tax credit. However, for American purposes what happens is that the Luxemburg branch is again disregarded under "check the box"; you check the box to treat this branch as part of this CFC. As a result, the loan is treated as if it were coming from CFC 1 to CFC 2, and the interest is treated as part of CFC 2 to CFC 1, instead of through Luxemburg. Because the interest is flowing from one CFC in Germany to another CFC in Germany, it qualifies for the exception for same-country interest (today, the interest is exempted under the general exception for intragroup payments).

This is the more aggressive structure, because clearly the same-country exception was deliberately designed to apply to companies in the same country: it is presumed that companies in the same country are all subject to the same tax rate, which is presumed to be high. Now whether this presumption is accurate depends on the facts; in fact, as we will see in regard to the foreign tax credit, it is not at all clear that all types of income in the same country are subject to the same tax rate. Many countries have schedular systems where, for example, income from labor is taxed high, income from capital is taxed low, income from businesses is taxed high, income from interest is taxed low, and so on, even though it is all in the same country. A single high rate, however, is the assumption that the Americans had in mind when they wrote the same-country exception into the rule, and in this case, if the interest had really been paid from Germany to Germany, it would indeed have been subject to tax, although perhaps at the lower rate. Doing it through the Luxemburg branch clearly violates the spirit of the same-country exception, because that is the whole point: the branch is in Luxemburg, which is not the same country, and Luxemburg is a tax haven; it does not tax interest at all. Nevertheless, because of "check the box," you are able to get the German deduction, which reduces your German effective

tax rate, and for American tax purposes you can ignore the existence of the Luxemburg branch.

Treasury realized that it may have made a mistake in extending the "check the box" rule so easily to international provisions. But by then it was too late: these rules went into effect in 1996, so there was a whole year before Notice 98-11 in which companies began doing these things. Check-the-box was out of the bottle, and Treasury could not stuff it back in: it was too popular with taxpayers to reverse. Instead Treasury issued a notice that for both of these transactions, it was going to apply the branch rule, and it was going to make these branches into CFCs. Once these branches are CFCs, then of course the whole point comes out of the transaction, because if the first branch is a CFC, then it has interest income, and if the second branch is a CFC, then it has interest income as well, and neither of these interest incomes qualify for exceptions because they are not in the same country as anybody else. As a result they all are subpart F income and trigger a deemed dividend without even any foreign tax credit attached to it, because Luxemburg does not tax the interest.

This created a tremendous uproar by the American multinationals. They complained to Congress that what the Treasury was doing was unfair: the multinationals were only trying to reduce the high German tax rates to something more reasonable. If anyone needed to complain, it was really the Germans whose taxes were being avoided. They did not complain, and they allowed the multinationals to deduct this interest, and the multinationals complied with their rules. So why was the U.S. Treasury now trying to penalize them for these transactions? The multinationals asked, ultimately, when do we send the dividend up? If we pay less tax to Germany, that means that we will pay more tax to the United States because of the foreign tax credit. So, we are not trying to avoid any American tax now, and ultimately if these earnings are going to be sent out as dividends, we may pay more tax to the United States in the long run. So why is Treasury bothering us?

Congress was very receptive to this argument and put a great deal of pressure on the Clinton administration to change the rules. The result was that in Notice 98-11 they issued the rules and in Notice 98-35 they essentially cancelled the rules. This happened just a few months later, and they withdrew Notice 98-11. They did not withdraw it completely, because that would have been losing too much face; instead they said, we will issue regulations that implement these rules, but the effective date of these regulations will not be before five years after the regulations are finalized. The bottom line is that nobody really believes that these rules will be implemented.

Now, regardless of this, what do we think about the substance? Fundamentally, the problem here is precisely that subpart F was not really devised for modern realities in terms of business planning in particular. Let us take a third example: Suppose you have a U.S. parent with a CFC in China, and the CFC benefits from a tax holiday on all of its income for a few years. This is something that should be brought up to the United States. Could subpart F be applied to this income? Now, in terms of current law the answer is clearly no; there is no subpart F income in this situation because this income is all active. You could make the argument that this is similar to the notice situation in Germany; here again we have a CFC earning active income, and what the U.S. taxpayer did by clever planning is reduce the German tax because of these interest deductions to the branch, which for American purposes does not exist. For American purposes this situation is the same as a CFC in another country that simply grants a tax holiday. If we say that this is not a subpart F situation because it is active income, and active income is not covered by subpart F, then why should the U.S. Treasury have to worry about this situation, where by using self-help the American multinational creates a situation in which the CFC has active income and pays no local tax? As long as the local tax authorities do not worry about it, the U.S. Treasury should not worry about it, either.

However, there is another question: whether something should not really be done about the situation with the tax holiday. That is much more controversial, of course. However, you can make the argument that the point of the international tax regime is to ensure that there is one level of tax on all income of multinationals (i.e., to apply the single tax principle). By that standard, this situation is a bad one, because there is no source-based taxation but also no residence-based taxation because of deferral. This is not what the regime is supposed to be about: if there is no source-based taxation, there should be current residence-based taxation. On the other hand, the developing countries would make a tax-sparing argument: if the Americans tax this income currently, then we will have lost the benefit of our tax holiday and would just be transferring revenues from our treasury to the American treasury. That is perfectly accurate, too – but the question is, should the American treasury be subsidizing the Chinese investment? This question has been argued for a long time, but the principled position of the United States at least in theory is that it does not care: it is going to tax, whether or not there is a tax holiday. That is why we do not grant any tax-sparing credits. What we do give is deferral: the CFC in China pays no current American tax, nor does the U.S. parent pay any current American

tax, despite the fact that it also pays no current local tax at source. In addition we grant cross-country averaging so that this low-tax, active income can be averaged for foreign tax credit purposes with high-tax income such as income from Germany; these can be combined to create a single layer of 35 percent eligible for the foreign tax credit.

The question of whether the notice was justified or not is still very much open to debate. According to the purists, it is clear that especially in this case it is undermining the purpose of subpart F: the purpose of subpart F in the same-country exception area is to tax this passive interest income, and you are essentially making this passive income go away through the use of "check the box." But, more broadly, as a policy matter, the real question is, should subpart F really be based on this active/passive distinction, or should it be based, as in other countries, on whether the income was taxed overseas? As we have seen in France – and the same goes for Japan, Sweden, and some other countries – there is an explicit reference to the overseas tax rate. But even if there is, we also saw that the French will also not tax this situation even though there is a tax holiday in China, because this is active business income in the local market. To the extent that it is localized, it is real activity; they will not tax it for the same reasons that the Americans and other people do not tax it: reasons of competition. Ultimately you can imagine a world – and perhaps it is a better world – in which all residence countries tax foreign-source active income that is not taxed somewhere else. That is, all tax holidays are eliminated. In order to decide that, you need to make a policy judgment that tax holidays are a bad thing for the source countries. That is also problematic, but can be discussed.

In any case, you can imagine a world in which residence countries tax all CFCs currently on all income (and about 85 percent of multinationals are headquartered in OECD member countries, so if the OECD member countries wanted to get together they would catch most of them and they would be able to tax them to the extent they are not taxed somewhere else). This is clearly the situation that would best preserve CEN. Would it be better for the world? That remains to be seen. If you think that giving tax holidays is not a good thing for developing countries, then perhaps that would be better; more precisely, if you think that developing countries only give tax holidays because of competition with other developing countries, then perhaps this would eliminate the competition, and that would be a good thing because developing countries would then be able to collect revenue.

The debate around Notice 98-11 has rekindled a whole reevaluation of subpart F in the United States, and there two very thick volumes have been

published. One is by the National Foreign Trade Council (the biggest lobbying group of American multinationals), in which they argue vociferously for restricting subpart F to passive income on grounds of competitiveness. In the very last days of the Clinton administration, December 2000, the Treasury issued a 216-page study of subpart F that essentially defended the current system and explained the rationale behind its thinking that the notice was appropriate. However, since then several tax laws have been passed with no significant change enacted in subpart F. This suggests that these two perspectives have cancelled each other out.

8

Taxation of residents: Business income

In this chapter we will focus on the taxation of residents on active income, and the central focus will be on the foreign tax credit. The foreign tax credit may be the most important element in U.S. multinational tax planning, and it is important to understanding the ways in which companies structure their operations. In addition, as a general international tax matter, every country that has a global tax system and hopes to avoid double taxation must give a foreign tax credit.

A foreign tax credit is different from a deduction. A deduction is an item that reduces gross income to net taxable income and therefore has a worth equal to the tax rate. For an American corporation with a tax rate of 35 percent, each dollar in deduction is worth 35 cents. By contrast, a credit is an item that reduces the actual tax paid. For the same American business in the 35 percent bracket, a dollar of credit is worth one full dollar. Thus, even though the American foreign tax credit is elective, a credit is preferable to a deduction in almost all cases.

Consider an American corporation with a foreign income of 100 subject to foreign tax at a rate of 35 percent and U.S. tax at a rate of 35 percent. The company's U.S. gross income before deduction is 100, and its U.S. net income is 65 (the original 100 less the foreign tax). The company is taxed on its U.S. net income at the U.S. rate of 35 percent, meaning it owes 35 percent $\times$ 65 = 22.75 in U.S. taxes. After the company pays both foreign and U.S. taxes, its net income is 42.25.

Now assume that the company is eligible for a foreign tax credit. It still has foreign income of 100, foreign tax of 35, and U.S. gross income of 100. Now, however, U.S. net income is also 100 because we are considering a credit rather than a deduction. The company is taxed on the full amount of foreign income before tax, which means that the U.S. tax is tentatively 35. However, the company is able to credit the full foreign tax – that is, reduce tax paid to the U.S. government dollar for dollar for the amount to the foreign country – and in this case ends up owing no tax to the American

government. Thus under the tax credit the company has 65 in after-tax income rather than 42.25 under the deduction.

A number of steps must be taken to receive the foreign tax credit. First, the credit is elective, so a company must elect to take the credit. After that, a company must meet three criteria, because the credit is considered an extraordinary benefit to taxpayers – it eliminates U.S. revenue. The first requirement is that the tax actually be paid to the foreign government. The second requirement is that the tax be paid by the taxpayer. The third requirement is that the tax be creditable. If the company does not meet the first two requirements, it receives neither a credit nor a deduction; if it does not meet the third requirement, it receives a deduction but not a credit.

Here we consider each requirement in more depth. The first requirement is that the foreign tax be paid. This resolves itself into more specific subquestions. First, was there a payment to the foreign government? This question seems relatively simple, but in order to prove that a payment was made, the American regulations require a receipt showing the amount paid, the date, and that it was paid to the government. The date is particularly important because the amount paid is generally listed in foreign currency and the date allows that foreign currency to be matched with a specific exchange rate. This is not always possible: consider the situation of withholding tax imposed on the American taxpayer but collected by some foreign withholding agent. In that situation, the receipt will be furnished to the withholding agent and not to the taxpayer, because it is the withholding agent that makes the actual tax payment to the government. Further, sometimes there is no receipt at all, either because the taxpayer forgot to get it or because the foreign government would not issue it. In the case of *Continental Illinois Bank*, Continental (a large, sophisticated corporate taxpayer) was not able to obtain receipts for payment made by its withholding agent. Instead, it produced letters from the borrowers stating the tax paid and the date. The government and the court rejected this method; in the language of Judge Posner, this is a foreign tax credit, not a foreign fraud credit. Allowing credits without receipts creates the incentive for taxpayers to collude with foreign persons to inflate the amount of tax without paying any actual tax.

The second subquestion is whether the amount paid was actually a tax. This question is especially relevant in situations involving oil-producing countries. When a country has oil deposits and gives permission to a foreign company to extract oil, the payments that it will collect from the American company are more in the nature of a royalty than a tax. The history of

this requirement was that in the 1940s, when the Americans first started to extract large quantities of oil from Saudi Arabia, they had to pay a non-creditable royalty to the king of Saudi Arabia. In the 1950s, someone decided to change the label of the payment from a royalty to a tax. The IRS then took the position that it was not a tax despite the label, and therefore that it was not creditable. However, the U.S. State Department in the 1950s and 1960s insisted that those taxes be creditable; this was a way to give foreign aid to the Saudis when the Saudis were a very important American ally in the Middle East but it was difficult to provide direct aid because of the war with Israel. In the 1970s, the IRS prevailed, and since then the regulations have stated that a tax is a governmental charge that applies to a large class of people and cannot be a payment for a specific benefit.

The third and fourth questions are related to each other. The third question, known as the refund rule, is whether the foreign government kept the money that was paid in taxes. The fourth question, known as the subsidy rule, is whether the government conferred a benefit to the taxpayer because of the tax payment. In that sense, the subsidy rule is similar to the previous question of whether the money paid was actually a tax, with the technical difference that the subsidy involves a real tax that is partially refunded through a specific benefit, whereas the previous case involves monies paid in exchange for some kind of benefit. The line between these two situations is not easily drawn, but in both cases the taxpayer is not eligible for a credit.

A related issue regards the soak-up tax, which is only collected if a credit is available in the other country. The American rule states that a tax is not creditable if it is conditioned explicitly on the availability of the credit; in particular, this applies to taxes exclusively on American investments. In some countries, the size of the American investment is so great compared to other foreign investment that it is possible to apply a generally applicable tax to all foreigners with the goal of targeting the Americans who are eligible for the credit. It is considered discriminatory to explicitly target Americans, but it is allowable by international law to have a generally applicable tax on all foreign investors. Thus the soak-up tax rule only applies when the tax is specifically conditioned on the availability of the credit, regardless of the underlying rationale for implementing other more general taxes.

The second rule asks whether a tax was actually paid by the taxpayer, regardless of who actually bears the tax burden. The regulations state that a tax is creditable to the taxpayer on whom foreign law puts the formal legal obligation to pay the tax or on whom foreign law imposes the tax. The following example illustrates this rule through a loan situation involving gross versus net taxation. Consider an American bank that gives a loan to

a foreign borrower. The loan can be stated in two ways. The first is for the bank to charge a certain interest rate, say, 12 percent, less any foreign taxes imposed. Thus if the principal is 100 and the foreign tax is 25 percent, the lender actually gets 9. Loans are not usually done this way because American banks are usually in a strong bargaining position. The typical contract is written so that the American bank receives a set percentage regardless of the foreign tax rate. This is called the gross-up provision and is meant to shift the burden of the tax from the lender to the borrower.

It would seem that such an explicit provision stating that the lender does not bear the tax would lead to a loss of the foreign tax credit. This does not happen, however, because the technical taxpayer rule states that the credit is available to whoever is the taxpayer under the foreign law, which is always true for the lender in this case. The borrower may be the withholding agent who collects the tax and transmits it to the foreign government, but it is still a tax imposed on the American lender. Under the technical taxpayer rule, the economic incidence of the tax is not important; rather, what matters is where foreign law imposes the burden of the tax as a legal matter.

Consider the following example of the operation of the technical taxpayer rule. This case, known as the *Biddle* case, is the Supreme Court case that created the rule. *Biddle* involved a British corporation with individual American shareholders. These were individual shareholders and thus they were not eligible for an indirect credit because they did not own 10 percent or more of the shares, and therefore could not credit taxes paid by the U.K. corporation directly (we will discuss the indirect credit later). At the time, the British system included a corporate tax that was paid by the corporation and then a credit to shareholders for that tax upon payment of a dividend. In this case, most of the British shareholders were eligible to get the credit against their individual tax liability for the corporate tax. Thus the British shareholder could, for example, declare income of 100. If the corporation paid 35 in corporate tax and the individual tax rate is 40, the shareholder would declare the whole 100 of income and would calculate his U.K. tax liability (in this example, 40); he would then take a credit for the corporate tax associated with his dividend. Thus the British shareholder's net tax would be 5.

A foreign shareholder, such as an American, would not receive the credit for the corporate tax already paid. In the *Biddle* case, the American shareholders argued to the American court that they should be entitled to a foreign tax credit for the U.K. tax that was imposed on the corporation. They argued that the British treat this tax as an advance payment of the individual tax liability, and the corporation functions as a mere

withholding agent. The Supreme Court disagreed, saying that although the British system treats the corporate tax as a tax on shareholders, corporate tax integration does not exist in the American system. In addition, under British law the corporate tax is still imposed on the corporation, because the corporation is ultimately legally responsible for paying the tax. This case established the technical taxpayer rule, since incorporated into the regulations, which states that the important question is which entity is liable under foreign law.

The third requirement is that the tax be creditable. The U.S. government gives credit only for direct taxes, because it believes that this increases the likelihood that the tax will be borne by the company. Most particularly, no credit is available for consumption and value-added taxes, which are deductible but not creditable. Under a consumption tax, the government presumes that the tax is borne by the consumer, although it is difficult to show that this is true. The more underlying rationale may be simply that if the government agrees to forego tax revenue to prevent double taxation, it is only willing to do that when that double taxation falls on a comparable base.

The American position is that the tax credit is an extraordinary gift, and the government is not willing to provide it for taxes that are not sufficiently similar to the American income tax. This requires a definition of the kind of tax that is sufficiently similar to the American income tax. The regulations have a three-prong test. The first requirement is a realization requirement: no tax is required for income that represents the unrealized appreciation of assets. Thus, although the general definition of income (attributable to Henry Simons) is consumption plus savings, and therefore would include appreciation in home value or increases in stock value, the American definition includes only realized income when these assets are sold. In many other countries, income is taxed according to the Simons definition, meaning that income is taxed as it accrues rather than when it is realized. However, although this difference poses a potential problem with the realization requirement, it almost never causes a problem in practice because the requirement is satisfied if the income is not taxed twice (once when it accrues and again when it is realized).

The second requirement is the gross receipts requirement. This requirement states that the base of the tax cannot be broader than the American base; in other words, gross income cannot be defined more widely than the U.S. definition of gross income. One example of this difference in definition regards the Norwegian oil tax, which was levied on 120 percent of the actual base of sales. Countries sometimes artificially increase the tax

base in order to compensate for the difficulty in establishing or auditing deductions. This can make it difficult for American taxpayers to receive a foreign tax credit, although in practice such inconsistencies are relatively rare.

The most problematic of the requirements is usually the third, which is known as the net income requirement. This requirement states that the foreign definition of net taxable income must be similar to the American definition – meaning that the foreign government must give the same deductions that the U.S. government would give, which frequently creates a problem. One example of this is known as the *Inland Steel* case, which involved a tax on mining operations levied by the province of Ontario, Canada. This tax allowed deductions for all actual operating expenses of the mine, such as depletion, but not for payments to the owners, such as dividends and interest. This difference disqualified the tax from being credited at the time, although a later case showed as a statistical matter that other deductions sufficiently compensated for the disallowed deduction.

Another case involved deductibility of wages and the tax treaty with Russia. Old Soviet law provided a high disallowance of deductions on excess wages. When the tax treaty between the United States and the new Russia was being negotiated, Russia hoped to disallow deductions for wages above a certain level to discourage excess wage differentials between management and ordinary workers. The United States did not agree with such a treaty, and Russia eventually eliminated the restrictions on the deduction. Immediately after the treaty was put into place, Russia implemented a 100 percent tax on excess wages, which the United States regarded as an act of betrayal; however, for political reasons, the United States did not negate the treaty.

Another example involves Bolivia, a small Latin American country that depends heavily on American investment. In the early 1990s, a group of American advisors convinced Bolivia to adopt a corporate cash flow tax, a type of corporate consumption tax that has been repeatedly proposed but rarely implemented. The corporate cash flow tax substitutes for the regular corporate income tax and requires that corporations pay tax on receipts minus outlays. A major difference between the corporate cash flow tax and the regular corporate income tax is that it allows a deduction for all expenditures, including capital expenditures, at the time of purchase. This means that corporations are only taxed on supernormal (inframarginal) returns, which are returns above the average in a competitive market, and are not taxed on normal investment in the market. There are two ways to deal with financial flows (loans and interest payments) under a cash flow tax. The first way is to ignore them, not considering loans to be income

and not considering interest to be deductible. The other way, which is mathematically equivalent, is to include loans and income but to allow a deduction for both interest and principal payments. Bolivia decided to adopt the simpler version that ignored loans altogether. However, the IRS said that this tax would not be creditable because it lacks a deduction for interest and violates the net income requirement. Bolivia then proposed the second scenario, allowing an interest deduction and a principal deduction, and considering loans as income. The IRS again claimed that the tax would not be creditable, because it includes loans as income, something that differs from the U.S. rules, and therefore violates the gross income requirement. The end result was that Bolivia did not implement the corporate cash flow tax at all because of the importance of American investment.

My own view is that this third requirement should be abolished. As long as the tax was paid by the taxpayer, it should not matter if the tax was an income tax in the American sense of the term. The distinction between income taxes and other taxes was built on the idea that the incidence of direct taxes is different from that of indirect taxes – an idea that is no longer accepted by tax scholars. Perhaps the best way to address this problem is to eliminate the third requirement. Barring that, however, one proposed method of lessening the problem is to allow a credit for any tax whose base is narrower than the American base. Under such a system, the value-added tax would not be creditable because wages are not deductible in value-added tax, but the Bolivian cash flow tax would be creditable because its tax base is narrower.

Next we consider the foreign tax credit limitation. Every country that has a foreign tax credit must have a limitation, although the limitation need not be the particular kind used in the United States. The following example illustrates why such a limitation is necessary. Consider a taxpayer with 100 in U.S.-source income and 100 in foreign-source income. The foreign tax rate is 50, which is higher than the American tax of 35. The taxpayer calculates his tentative U.S. tax as 35 for the domestic-source income and 35 for the foreign-source income. Without the limitation, he takes the foreign tax credit and applies it to the total tax (which is 70). Because the foreign tax of 50 is higher than the American tax of 35, the taxpayer is able to credit the additional 15 paid in foreign tax to the 35 that he owes in domestic tax. The result is a net U.S. tax of 20 on the U.S. income and zero on the foreign income. The taxpayer's net after-tax domestic income is 80 and his net foreign income is 50, which combines to a total net income of 130. Notice that the total net income is the same as it would have been if the taxpayer had earned 200 domestically in the United States; the taxpayer is

therefore indifferent between investing in the United States and investing in the foreign country, despite the higher foreign tax rate. In the case where the taxpayer has no U.S.-source income, without the limitation, the U.S. Treasury would be expected to refund the taxpayer the difference between the foreign and the U.S. tax.

Two problems arise in the situation without a foreign tax credit limitation. First, the United States is opposed to a foreign tax that eliminates U.S. taxes on U.S.-source income. This opposition relates to the division of constitutional authority in the United States. Because treaties are negotiated by the president and ratified by the Senate, whereas tax laws have to be passed by both houses of Congress, the House of Representatives does not want foreign tax credits to reduce the tax rates that it sets for Americans. The second problem, which is even more important, is that unlimited foreign tax credits create the incentive for other countries to raise their taxes excessively. Consider the foreign country in the previous example whose tax rate is set at 50. This country knows that a credit is available and decides to increase its tax rate to 70. In this case, the taxpayer still has a total net income of 130: before the change, it had a domestic net of 80 plus a foreign net of 50, and after the change it has a domestic net of 100 plus a foreign net of 30. The foreign country is better off because it collects 70 rather than 50. The only party that is worse off is the United States, which collects zero in residual tax rather than 20 as in the previous example. Thus without the limitation, the foreign country can increase its tax rate at the expense of the American government.

Although the U.S. income tax did not include a foreign tax credit limitation when it was implemented in 1918, the limitation was added in 1921 for the reasons just given. The overall limit is set out in section 904(a). The limitation is calculated by taking the U.S. tax paid and multiplying it by the foreign-source income divided by the worldwide income. U.S. taxes paid can also be written as U.S. tax rate times worldwide income. This manipulation brings us to the actual formula that is applied, which states that foreign tax credit limitation equals U.S. tax rate times foreign-source income. This limitation means that no credit is given for taxes above the U.S. tax rate.

Here we apply this limitation to the previous example. The taxpayer still has 100 in foreign-source income and 100 in U.S.-source income. The foreign tax rate is 50 and the U.S. tax rate is 35. The taxpayer is therefore allowed to credit 35, but not the extra 15 that exceeds the U.S. tax rate. Put another way, the foreign tax credit limitation equals 35: 35 percent times foreign-source income of 100. The taxpayer's maximum credit is 35, and

the extra 15 is not creditable. Thus the taxpayer has a net domestic income of 65 and a net foreign income of 50 for a net total income of 115.

It could be argued that the foreign tax credit limitation is discriminatory because it means that taxpayers have an incentive to invest in the United States and not in a foreign country whenever the foreign rate exceeds the American rate. However, this limitation is generally considered necessary despite the violation of capital export neutrality because of the incentive for foreign governments to raise tax rates at U.S. government's expense.

Given that the foreign tax credit limitation exists, the question is how to work with it. One important element is the level of foreign-source income. The foreign tax credit limit is set at 35 percent of foreign-source income; if the taxpayer can generate more foreign-source income, the limit grows. In this example, if the taxpayer generates another 40 in foreign-source income, his limit would be higher and he would be able to credit the whole foreign tax. Thus American taxpayers, in addition to foreign taxpayers, care greatly about the source of their income.

The other way to deal with the foreign tax credit limitation is to reduce the effective foreign tax rate. The foreign tax rate of 50 in our example is not the nominal tax rate, it is the amount that is actually paid to the foreign country. If the taxpayer can reduce that amount, he can credit more and his effective foreign tax rate will be lower and closer to the U.S. rate. The way to lower the foreign tax rate is to use the formality of most foreign tax systems to manipulate the amount of tax owed.

Lastly, the taxpayer can average various sources of foreign income to reduce his average foreign tax to below the limit. There are a number of potential ways for the U.S. government to deal with this situation. One possibility is to do nothing about averaging and allow taxpayers to do whatever they want. The other possibility is to try to segregate high-tax from low-tax sources; at the extreme, it could require every item of income to be subject to its own limitation. In addition, there are two other types of limitations that have both been employed. The first is to consider each country separately, so income from each country is subject to its own limitation, with the advantage that the taxpayer cannot average high-tax with low-tax countries. The disadvantage, however, is that the taxpayer can still average high-tax with low-tax income from the same country. The other alternative, which is currently used in the United States, is to allow mixing by countries but to disallow mixing within categories of income. This alternative assumes that some categories of income, such as active income, are subject to high tax, whereas other categories, such as passive income, are subject to low tax. Yet another possibility is to have a per-country limitation and superimpose

income categories over it. This was rejected in the United States because of its complexity and because American multinationals wanted to be able to continue averaging.

The categories of income for foreign tax credit purposes are called baskets. The rationale behind the basket system is illustrated by the following example. Consider an investor in an excess credit position, meaning that he invests in a country with a tax rate higher than the American rate. This investor has foreign-source taxable income of 100, and the foreign tax rate is 50. The tentative American tax is 35, and therefore the foreign tax credit limitation is 35. His U.S. tax liability is zero, but his total tax liability is 50 because he pays 50 to the foreign country. His after-tax income is 50 and he has an excess credit of 15, which represents the amount by which the foreign tax exceeds the American tax. This amount cannot be credited because it exceeds the foreign tax credit limitation.

This was the position of many American multinationals after 1986, when the American corporate rate was dropped by about 10 percent. In that position, the multinationals could choose between making an additional investment in the United States and making another investment in a low-tax foreign country. If the company invests in the United States, it has 100 in taxable income from high-tax foreign country A and 100 from the United States. Its foreign tax is still 50, and its U.S. tentative tax is 35 on the U.S. income and 35 on the foreign income. The foreign tax credit limitation is unchanged because the company has the same amount of foreign-source income. The company gets a foreign tax credit of 35 and therefore owes 35 to the U.S. government for its U.S.-source income.

However, suppose instead that the company chose to invest in foreign country B with no tax. The multinational has the same 100 from foreign country A, but now has another 100 from foreign country B. The foreign tax is 50 in foreign country A and zero in foreign country B. U.S. tentative tax is still 35, but notice that the foreign tax credit limitation has grown from 35 to 70 because the total foreign-source income has increased to 200. The multinational is now able to credit the whole foreign tax because its limitation is 70. The company shows 200 in its tax return with tentative American income tax of 70. The company receives a credit for 50 of that, which was already paid out in foreign tax, and is left with only 20 of American tax. This creates a significant incentive for taxpayers in an excess credit situation to look for low-tax foreign-source income.

This is a violation of capital export neutrality because it creates an incentive to invest abroad rather than in the United States. In addition, it means less tax is collected by the United States: in our example, the United States

collected 20 as opposed to the original 35 from the multinational. The United States has made multiple attempts to limit the ability of taxpayers to average income in this way. Until 1986, the United States had a per-country limitation, which meant that tax rates could not be averaged across countries. In the 1980s, however, it became possible to have low and high tax from the same country; in particular, active income was typically high-tax but interest income was typically low-tax. Thus the Treasury proposed a basket system in addition to the per-country limitation in 1985. The multinationals objected to the complexity of the dual system, and the compromise was to use the basket system instead of the per-country system.

The current U.S. system allows companies to segregate foreign-source income by category. Until 2004 there were nine categories, including one category for active income; in that category, companies may average tax rates in different countries, as there is no per-country limitation. In addition, there were separate categories for passive income, interest income, income from financial services, shipping income, and other categories that are liable for low taxation. The limitation had to be applied to each of those categories separately.

To illustrate the importance of the different baskets, note that there was a separate basket for high withholding tax interest, which is interest income that is subject to withholding tax at 5 percent or more; that interest is separated from low withholding tax interest. This division profoundly affected a tax treaty between the United States and Mexico. In treaty negotiations, the United States lobbied for a zero withholding tax provision consistent with the American model position. Mexico, however, wanted a rate of 10 percent or more. However, the United States and Mexico agreed to set the withholding tax at 4.9 percent in order to avoid the high withholding tax interest basket. American lenders, and in particular Citibank, argued that if the rate exceeded 5 percent and they could not credit the Mexican tax, they would reduce lending to Mexican borrowers. Thus the basket system has had significant effects beyond the traditional tax system.

Consider the following example, which casts doubt on the basket system. In this example, the taxpayer begins by investing in country B, a low-tax country. This taxpayer earns 100 of taxable foreign-source income and does not owe any foreign tax. U.S. tentative tax is 35, and the foreign tax credit limitation is 35. However, there is no foreign tax credit because there is no tax, and therefore the tax owed to the U.S. government is 35. This taxpayer has an excess limitation of 35, meaning it can credit additional foreign taxes of up to 35. At this point the taxpayer may choose between investing in the United States and investing in foreign country A, which has the high tax

of 50 percent. If the company invests in the United States, it earns 100 in country B and 100 in the United States. The foreign tax is still zero, and there is no foreign tax credit because there is no foreign tax. The net tax is 35 on the foreign-source income (owed to the U.S. government) and 35 on the U.S.-source income, for a total tax liability of 70.

Notice what happens if the company invests in foreign country A, with a tax rate of 50 percent. In this case, the foreign income from country A is 100 and the foreign income from country B is also 100. The foreign tax is 50, and the tentative U.S. tax is 70 (35 on the income from country A and 35 on the income from country B). The company's foreign tax credit limitation has grown to 70 and its foreign tax credit is now the full 50 paid in tax to country A. Thus the position of the investor remains unchanged: he has an after-tax income of 130. The main idea is that the taxpayer is indifferent between investing in the high-tax country and investing in the United States. Thus it is only taxpayers in excess credit who are hurt by the basket system, whereas taxpayers in excess limitation are equally well-off under either system.

This is a very important lesson for countries that grant holidays for active income. These holidays achieve the intended purpose of benefiting the American taxpayer for two reasons. The first reason is deferral. If a multinational business venture has active business income, that income is eligible for deferral and there is no current American tax. The second reason is that active income is not subject to the baskets, and therefore it is possible to average between the low-tax income in one country with a tax holiday and the high-tax income in another country without one. As shown in the example of the taxpayer with excess credit, such a taxpayer does have an incentive to invest in the low-tax foreign country because that enables him to credit the whole income. The tax holiday thus has a positive impact on the American taxpayer as long as the taxpayer has high-tax foreign income somewhere in the world.

This basket system is arguably not worth the complexity that it creates. First, if averaging in the absence of baskets allows for violation of capital export neutrality, averaging is still a problem in the basket system. Second, the limitation is a violation of capital export neutrality. Finally, the basket system achieves its intended purpose only for taxpayers in an excess credit position; taxpayers in low-tax foreign countries receive no incentive to invest in the United States. Since 1986, most American multinationals have reduced the average foreign tax rate they face so that they are no longer in an excess credit position. Perhaps the best system would be to have an overall limit and forget about averaging, which is not really worth trying to

prevent. In 2004, the number of categories of income was reduced, so that now only active income cannot be averaged with passive income.

Our next topic is the operation of the indirect credit. To illustrate the indirect credit, consider the situation where there are two taxpayers, one of whom is a branch and the other a subsidiary, which is a CFC. Both the branch and the subsidiary pay foreign tax. However, the branch will be eligible for a foreign tax credit because the tax is imposed on the taxpayer, whereas the subsidiary will not normally be eligible for the credit because the foreign tax is imposed on the subsidiary, a separate entity from the taxpayer. The subsidiary receives deferral while the branch does not, but if the subsidiary pays a dividend, it would seem to make sense for the positions of the subsidiary and the branch to be equalized.

Because of this consideration, the United States enacted an indirect credit (section 902) stating that a branch is eligible for a direct credit under section 901 because the credit is for a tax that was imposed on the taxpayer. The indirect credit is a credit that is only available for corporate taxpayers that own 10 percent or more by vote of the shares of an underlying corporation. It works in the following manner. There is a formula that provides for a taxpayer credit based on the amount of foreign tax multiplied by the amount of dividends received divided by accumulated profit, minus the foreign tax. This formula is necessary because there may not be a distribution of the whole accumulated earnings, and if this is true, the taxpayer should not get credit for all of the earnings because some of those earnings are still deferred.

Consider the following example of indirect credit. Suppose a taxpayer earns 100, pays foreign tax of 35, and distributes the remaining 65 as a dividend. The formula calculates credit as foreign tax (35) times amount of dividend (65) divided by foreign profit (100) minus foreign tax (35), which means that the taxpayer can credit the whole amount of the foreign profit. If, however, the company distributed a dividend of only 50, this resolves to 35 over 50 divided by 65, which means that only a proportion of the tax is credited.

A real-world example of indirect credit, known as *American Chicle*, involved a corporation that argued, before the formula was added to the regulations, that it should get a credit for the whole tax even though it distributed only part of the profits as a dividend. The Supreme Court held that the indirect credit is available only for the portion of the income that was distributed, because otherwise companies would receive a deduction and a credit for the same tax.

The indirect credit provision brings with it various complications, one of which is illustrated by the *Goodyear* case argued before the Supreme Court. Goodyear, the U.S. tire manufacturer, owned Goodyear U.K. in England. Goodyear U.K. had some accumulated profits that it distributed as a dividend, and it then claimed indirect foreign tax credit for U.K. tax. In 1973, the United Kingdom gave a large refund to Goodyear U.K. that eliminated any taxable income that it had in previous years, so it received refunds in those years, too. However, those were the years in which Goodyear U.K. sent the dividend to U.S. Goodyear. Because the amount of tax that it paid in the United Kingdom was tied to the amount of accumulated profit, calculated under the British principles, the amount of tax paid *and* the amount of accumulated profits should be reduced. However, the IRS argued that the British calculation of taxes and accumulated profits was unimportant; rather, the important calculation was regarding the dividend, which was paid to an American company and needed to be calculated on American terms.

If the Goodyear case had involved a branch, the branch's income would be calculated based on U.S. rules. There would have been no need to calculate a dividend, because it would have been a branch. But suppose that under American rules there was no income and under foreign matters there was income, meaning that there was a tax. The United States does not provide a foreign tax credit without foreign-source income, leading potentially to double taxation. Goodyear made this argument in favor of being allowed to use British or foreign definitions of accumulated profits, because the tax is calculated based on the foreign definition. However, the Court held that the dividend must be determined according to American principles, because otherwise the law would benefit people who invested in subsidiaries more than people who invested in branches. Because the purpose of the indirect credit was to equalize subsidiaries and branches, the Court said that all calculations must be made according to American law even if this results in possible double taxation. The importance of the Goodyear case is that the American definition of accumulated profits must be used in calculating the formula.

In some cases, the mechanical application of this rule would lead to very strange results. One such example involves the *Vulcan* case. Vulcan was a Saudi Arabian corporation, a joint venture between the U.S. parent and the Saudi parent. Under Saudi law, Saudi nationals (including corporations) do not pay income tax, but rather pay zakat, an Islamic noncreditable tax. In joint ventures between Saudis and foreigners, the corporate profit must

be divided into the part allocable to the Saudi partner and the part allocable to the American partner. Income tax is applied only to the income that is allocable to the American party, and the noncreditable tax is applied to the Saudi income. In this case, the business relationship was not a partnership, but rather was a corporation, resulting in indirect credit with a dividend, and the issue in the case was how to calculate accumulated profits. The IRS argued that accumulated profits under *Goodyear* should be defined in American terms; in American terms, accumulated profit is the profit of the whole enterprise, even though part of the profit was subject to income tax and the other part was not. The IRS argument would have resulted in a much smaller percentage of the tax being creditable.

The tax court found that the IRS had gone too far; it agreed that *Goodyear* established that American principles should be followed, but in this case the foreign system was so different that an exception must be made. The court decided that American taxes should be calculated based on the proportion of income that was allocable to the American party, just as if the business relationship had been a partnership.

The last example we will consider for indirect credit involves the Xerox Corporation, a large American manufacturing company that produces copying equipment. Xerox had a subsidiary that in turn had its own subsidiaries. These subsidiaries were governed by the British system, which stated that a dividend payment from a British corporation to a foreign shareholder is subject to the ACT (Advanced Corporate Tax). The ACT is tied to the amount of the dividend and operates like a withholding tax on dividends. In general, this ACT amount is applied as an offset to the corporate tax. Suppose that a British company disburses a dividend of 65, subject to an ACT of 20. The corporate tax is 35. In this case, a credit is available for the ACT, and the corporate tax owed is reduced from 35 to 15.

The United States negotiated a treaty with the United Kingdom in 1975 that mirrors the ACT system and explicitly states that the ACT is creditable. However, another UK provision states that if no corporate tax is paid by the corporation (it may have foreign tax credits or net operating losses), the ACT may be applied to corporate tax paid by subsidiaries, even though the subsidiary has not distributed its earnings. The IRS said that the ACT is not creditable in this situation because even though it was collected from the company, it was then used to offset corporate tax on earnings that have not been distributed and are subject to deferral. The taxpayer successfully argued that under the terms of the treaty it is always allowed to credit the ACT.

The surprising aspect of this decision relates to the technical explanation of the treaty, a document written by the treaty negotiators and submitted to the Senate to explain how the treaty is supposed to work. The technical explanation in this case clearly stated that no credit should be given when the ACT was applied to subsidiaries. Second, when the problem arose, the United States negotiated with the British protocol to the treaty and explanatory letter, concluding that the timing of foreign tax credits under the treaty should be determined entirely under domestic law. Because the current situation was a matter of timing, the Americans thought that the matter had been resolved.

Despite this, the court sided with the taxpayers. First, it rejected the technical explanation as controlling on the grounds that there is no evidence that the British had ever seen it; this argument is questionable because countries that negotiate tax treaties with the United States know about the technical explanation and generally examine it themselves. The court agreed, according to the explanatory letter, that the timing of the credit should be governed by domestic law; however, it found that the real issue was not timing, but rather whether the ACT was collected as a tax. Finally, the court relied on affidavits with sworn statements by the British and American treaty negotiators that the real intent was to allow the credit under these circumstances. This last tactic was very unusual, because generally the intent of the treaty is determined by the actual treaty and the technical explanation, and the hindsight recollections of negotiators are not considered.

The question arises of how much income is trapped by deferral. That is, how many American multinationals that have subsidiaries with low-tax foreign-source income subject to deferral do not redistribute this income back to the United States because it would trigger a tax that would otherwise be deferred? Statistics show that American multinationals in general repatriate a relatively low percentage (less than 17 percent) of their overall foreign earnings. Analysts hypothesize that the other earnings are trapped; this would be an argument for repealing deferral, because it would encourage people to bring earnings back to the United States. In 2004 a temporary one-year rule was adopted allowing multinationals to repatriate earnings and pay only 5.25 percent tax on the dividend, and very large amounts were repatriated.

In situations where corporations can average, they may choose to bring the income back because there is no additional cost in doing so. The tax director of an American multinational with a hundred or two hundred subsidiaries expends a lot of effort to achieve maximum deferral and maximum foreign tax credit. An exceptional tax director would be able to take

advantage of all possible deferments and, on the rest of the income, would pay foreign taxes but never American taxes. American multinationals are required to publish their effective tax rates in their financial disclosures and must show how much worldwide tax they pay. Before 1986, this percentage was approximately 20 percent of financial income; in 1986, this number jumped to 30 percent when a number of loopholes were closed; since 1986, it has again fallen to 20 percent, in part because of the corporate tax shelter movement.

Corporate tax shelters are one of the most recent phenomena in United States tax law. They involve what was traditionally the role of corporate tax advisors, lawyers, and accountants: to come up with methods to reduce taxation. Since about 1995, a new phenomenon has emerged that involves people in accounting firms and investment banks taking the initiative to look at the Code and the regulations and think about ways in which taxpayers can reduce their taxes before the taxpayers actually approach them. These people approach their corporate clients and attempt to persuade them to adopt these strategies, whose only business purpose is to reduce taxes. Then the accounting firm or investment bank collects the fee for selling the product. This strategy is not against the law, but it is possible that it will not withstand IRS scrutiny; this may depend on the scheme not being discovered, which raises ethical questions. However, the corporate tax shelter movement has become very large, and its success is evidenced by the reduction in effective taxes as a percentage of book income since 1986.

Consider the following example of corporate tax shelters involving Compaq Corporation, the computer manufacturer. An investment bank called 21st Century Securities advised Compaq to buy Royal Dutch Shell for 100. A minute later, Compaq received a dividend of 15, and then another minute later, Compaq sold the stock for 85. The key to the transaction was that the dividend was subject to a creditable Dutch withholding tax of 5. Compaq was therefore able to apply this credit against other foreign-source income that was low-tax. It is clear from this transaction that Compaq did not bear the economic burden of the tax, because it bought the stock for 100 and received the same 100 back in dividends and stock sales. Thus the tax of 5 paid to the Dutch government clearly did not come out of Compaq's pocket. The tax was economically borne by the person who bought and sold the stock, because the selling price and the buying price did not reflect the tax. Why were these parties willing to absorb the tax? The parties were tax-exempt institutions that could not get a tax credit; this transaction therefore essentially involves the buying and selling of foreign tax credit from a company that is not able to use it to a company that is able to use

it. The Tax Court decided in the *Compaq* case in 1999 that even though such a transaction is allowable according to the technical taxpayer rule, the credit was disallowed because no business purpose existed for the transaction. Even before this, in 1998, the IRS issued notice 98-5 disallowing the credit where the transaction exhibits no profit potential (this notice has since been withdrawn, but the principle still applies).

Although the court probably reached the correct result in this case, it exhibits several problems, which led to the taxpayer winning on appeal. First, a very similar case decided in 2001 came to the opposite conclusion. In that case, a company called Alliant engaged in exactly the same type of shelter as Compaq; it was the same transaction involving the same company and investment bank. Even though the facts were the same, the court decided in *Alliant* that the transaction was allowable and refused to disallow the credit. In *Alliant*, the court said that business purpose is irrelevant; the important consideration is not economic incidence of the tax but rather which party has legal liability for the tax. Second, this case calls into question the scope of the IRS's power. Many transactions are conducted with limited profit potential. Banks, in particular, engage in many transactions with limited profit potential because of the small difference between the interest collected and paid, even if such a transaction is in the bank's business interests. However, it is important to understand that, in principle, a transaction involving the foreign tax credit with no potential for economic gain is subject to potential IRS attack.

More broadly, the question is, what should be done about the corporate tax shelter phenomenon in general? The current IRS approach is limited because it involves attacking the shelters individually and does not address the source of the problem. In addition, the penalties imposed in these cases are relatively low and do not represent a sufficient deterrent.

One aspect of American business that exacerbates the tax shelter problem is that American corporations are required to keep two sets of books, one for tax purposes and the other for financial disclosure. The reason for the dual accounting system is that each set of books fulfills its own purposes: taxes are meant to collect revenue for the government, and financial disclosure is meant to provide accurate information to shareholders and other credit investors. It makes some sense to keep financial records separate, especially because financial accounting tends to be more conservative and encourages accountants not to overstate income. However, it seems clear that the system provides perverse incentives to American management, which is ultimately responsible both for the tax reporting and for the financial disclosure. American management cares deeply about financial disclosure,

and especially about earnings per share, because that amount also determines their own compensation and the stock price.

However, because of the distinction between tax and financial disclosure records, American managers are free to reduce their taxes without hurting the earnings per share. They can report high profit and high income to the shareholders while reporting low profit and low income to the IRS. In many other countries, tax and financial disclosure records are linked, giving managers the incentive not to understate profits for tax purposes or overstate them for financial disclosure purposes.

It is extremely difficult to solve the tax shelter problem on a case-by-case basis. In the *Compaq* case, for example, the solution would be to change the technical taxpayer rule, which would be almost impossible to do appropriately because it is difficult to determine who bore the economic burden of the tax. The IRS method of disallowing transactions with low profit potential is also problematic because it is difficult to define what profit potential is too low. Thus a broader approach to addressing corporate tax shelters may be necessary to resolve the perverse incentives in the system.

9

The United States and the tax treaty network

This chapter will discuss tax treaties. The United States has just adopted a new model tax convention (2006), replacing the 1996 model. Commentary on the OECD model is updated constantly; thus, although the original current version of the OECD model dates from 1992, it is really a 2006 document because of the updated commentary.

Like any tax treaty, the U.S. model treaty is entitled "Convention Between the United States of America and Foreign Country for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income." This title provides us with quite a bit of information. First, the model treaty was published by the United States and therefore embodies the American position. However, the model may not be similar to any treaty that the United States has ever signed, because the model treaty is just the starting point for bargaining with the United States.Second, the title states that the treaty, like all tax treaties, is for the "Avoidance of Double Taxation and the Prevention of Fiscal Evasion." In truth, tax treaties are generally not to prevent double taxation, although they do help in borderline situations, such as cases where income source is disputed. Treaties do not always help in these instances, however. Recall the *Boulez* case, in which the United States thought Boulez provided services and the Germans said the money paid represented a royalty; despite the existence of a treaty, the countries could not agree, and the result was double taxation.

If treaties do not address double taxation, what do they do? Treaties shift tax revenue from source countries to residence countries, because under the generally accepted rules, the source country is allowed to impose the first tax on any revenue deriving from sources within it. In the absence of a treaty, source countries can tax both active and passive income within the country. In addition, source countries are not bound by a permanent establishment or treaty sourcing rule defining what income originates within the country.

Treaties shift the burden of taxation from source to residence country in two ways. The main mechanism for active income is the definition of *permanent establishment*. Treaties generally bar source-based taxation

unless an enterprise of the other state has a permanent establishment in the source country. The main mechanism for passive income is a reduction in withholding its source. The U.S. model treaty reduces taxation on interest and royalties to zero; the only category of passive income that is eligible for source-based taxation is dividends, which are taxed at a reduced rate. The U.S. goal in treaty negotiations is that active income is taxable at the source if it is attributable to permanent establishment, and passive income is taxed more on a residence basis.

This treaty structure works well if the flows of income are reciprocal, but creates a problem for developing countries. In the reciprocal situation, residents of country A derive income from sources from country B and residents of country B derive income from sources of income from country A. In the absence of the treaty, country A will tax the country B residents' source income and country B will tax the country A residents' source income; both countries A and B will probably grant a tax credit or exemption to alleviate double taxation and encourage cross-border investment. The treaty shifts the taxation of some categories of income, particularly passive income, from the source to the residence country. Under the treaty, country B will not tax passive income that goes to country A residents and country A will not tax passive income that goes to country B residents. As long as the capital flows are more or less reciprocal, the treaty reduces the administrative bother of imposing withholding taxes, and the net revenue is more or less the same. The amount that country A loses by not imposing its withholding tax is regained by not having to give credit for the taxes imposed by country B on income its own residents earn overseas.

If the investment flow only goes one way, and investment always flows from country B into country A, then it is much harder to get into a tax treaty because a tax treaty will always transfer revenue from country A to country B. Thus developing countries have traditionally not chosen to enter into treaties with developed countries because the treaties lead to a loss of tax revenue. Thus developed countries such as Germany, Sweden, and Japan have historically had extensive treaty networks with developing countries because they were willing to provide tax-sparing credits, but the United States had few treaties with developing countries until the 1990s. Because of this tax-sparing issue, the United States has treaties with all the OECD member countries but relatively few with developing countries, although the situation has changed somewhat in recent years. One reason for the expansion in treaties with developing countries is that the treaty provides certainty for American investors regarding the tax law of the other country, and most developing countries consider it to their benefit to encourage

American investment. Another reason is that treaties generally include an exchange-of-information provision that allows the developing country to obtain information exchanged from the United States.

Next we consider a few specific items in the U.S. model, some of which differ from the OECD model. One such difference is that the U.S. model treaty “shall not restrict in any manner any benefits now or hereafter accorded by the laws of either contracting state.” In other words, from the American perspective, treaties may never increase taxation, but may only reduce the taxation that would otherwise apply. One reason for this is that tax laws are passed by Congress as a whole, whereas treaties are ratified only by the Senate. A tax increase through a treaty would be unconstitutional because it would never have been ratified by the House of Representatives. A related point is that the United States only allows treaties to reduce foreign taxation of Americans and American taxation of foreigners; treaties cannot affect the way the United States taxes American residents. This provision is written into the savings clause, appearing in most American tax treaties at the end of the first article. The savings clause also states that people who have lost their citizenship for tax-motivated reasons should be treated as if there were no treaty, because the United States argues that treaties are not designed to protect Americans from American tax.

Article 2 of the treaty states that the taxes covered in the treaty are only certain federal taxes. The social security tax, which is a payroll tax, is generally excluded and sometimes is covered by other agreements. Estate and gift taxes are also covered by other agreements. The treaty thus has the largest effect on the imposition of the American income tax. Importantly, tax treaties do not generally protect against any type of state tax. Most states have corporate and individual income taxes, which may impose a high burden. In particular, a foreign company might wish to open an office in New York City to engage in preparatory and auxiliary activities, which is exempt from federal taxation by the permanent establishment article. However, the combined New York state and New York City corporate income tax can be as high at 20 percent, imposing a significant tax burden on the company.

Article 4 covers residence and is important because it defines who is covered by the treaty. In general, groups covered by the treaty are U.S. citizens and residents; tie-breaking rules are included to prevent dual-residency situations. Corporations are deemed to be residents in the country in which they are incorporated, although the United States is often willing to negotiate that point.

Next we turn to a discussion of the substantive provisions. Article 5 covers permanent establishment. This provision is quite narrow in scope;

the permanent establishment threshold is set high because the United States is a developed country interested in reducing source-based taxation of capital-exporting enterprises. Thus a construction facility or an oil drilling facility must be in the country for more than twelve months to be taxed, similar to the OECD model treaty. The article also includes a long list of exceptions and a specific bar against force-of-attraction rules in which income is not attributable to a permanent establishment.

Article 4 covers real property; taxation of real property at source is allowed, including, as under the American rule, corporations, most of whose assets are real property. Article 7 is the business profit article, which talks about taxation of business profits only if they are connected to a permanent establishment; Article 9 is the associated enterprise article, which says that if there is a transfer pricing adjustment and the other country agrees to it, then the other country shall make a corresponding adjustment to prevent double taxation – but notice that the other country must agree. Many transfer pricing adjustments unfortunately are not agreed to by the other country and result in double taxation (source-source double taxation), so this article is of only a little help.

The subsequent articles reduce source-based taxation on passive income, dividends, interest, royalties, and capital gains. These articles are the heart of the treaty, whose main function is to reduce source-based taxation of passive income. Under the American model, the only source-based taxation that is allowed is the tax on dividends; there is no tax at all on interest, royalties, or capital gains. The OECD model, by contrast, permits tax on interest. Under the U.S. model treaty, a tax of 5 percent is allowed on direct dividends (dividends to corporations who own a high percentage of the shares) and 15 percent for portfolio dividends.

The next articles address independent services and other special topics. Article 22 covers limitation of benefits and is a major element in modern American treaties. The limitation-of-benefits article governs cases such as the SDI case that we discussed previously, in which copyrighted software was licensed to The Netherlands and from there licensed to the United States, and royalties were paid from the United States to The Netherlands and from The Netherlands to Bermuda. This was beneficial to the company even though the software was in Bermuda and the ultimate use of it was in the United States, because The Netherlands has a tax treaty with the United States that reduces taxation of the royalties to zero and Bermuda (a tax haven) does not. As we saw in that case, the IRS argued that although the royalties from The Netherlands to the United States were protected by the treaty, the royalties from The Netherlands to Bermuda were also

U.S.-source royalties because of the software's use in the United States. However, the court rejected that argument, saying that if it permitted the taxation of U.S.-Netherlands royalties it would be allowing double taxation if these royalties were not protected by treaty. As previously discussed, this seems like a strange argument, because the treaty shopping occurred only because of the treaty.

Most U.S. treaties did not have elaborate anti–treaty shopping mechanisms before the 1980s, and other countries were able to use those treaties to get reduced withholding taxation. Consider the example of the Netherlands Antilles, a Caribbean tax haven that used to belong to The Netherlands. Before the enactment of the portfolio interest exemption, American companies established Netherlands Antilles subsidiaries and were subject to a zero withholding tax on interest from those subsidiaries through the U.S.-Netherlands tax treaty. In 1984, the United States terminated the extension of the treaty to the Netherlands Antilles and enacted a portfolio interest exemption; at the same time, it instituted a limitation of benefits. These limitation-of-benefits articles are often much more complicated than the model version because other countries want to create loopholes to allow for treaty shopping.

Limitation-of-benefits provisions state that the treaty confers benefits only on individuals who are physically present in the other treaty country and companies that either are publicly traded on a stock exchange of the other country or are privately owned companies that do not pay half or more of their income to a resident of a nontreaty country. The model treaty takes the view that reductions in source income taxation should be accompanied by increases in residence income taxation. For example, the residence article states that if an entity is fiscally transparent in the residence country and is a partnership not subject to residence-based taxation, the entity really belongs to a group of people in another country and is therefore not considered a resident. Thus the treaty attempts to reduce taxation at the source only if taxation increases on a residence basis, although it is unclear that the limitation-on-benefits provisions really achieve this purpose.

The treaty also includes an earning stripping provision that prevents the deduction of too much interest from the United States. Note, however, that the provision applies to interest but not to royalties; companies may therefore strip earnings through royalties without penalty.

The United States is probably correct in insisting on limitation of benefits, although other countries certainly do not agree that they need to abide by the American position. Without limitation of benefits, nontreaty

countries have less incentive to negotiate, because they have a so-called treaty with the world, meaning that they can always benefit from other countries' treaties by entering the treaty network through another country.

Article 24 contains a nondiscrimination provision stating that countries may not discriminate against residents of the other treaty. Article 25 is the confident authority procedure for mutual agreement, which provides for some (generally nonbinding) arbitration in cases where the treaty lacks binding force.

The last important component of the American model treaty is the exchange-of-information provision, which is found in Article 26. The United States believes that this provision is essential if it is to enforce residence-based taxation on its own residents. The United States has been willing to forego the ratification of a treaty rather than ignore this provision. For example, the U.S.-Israel treaty was delayed for almost twenty years because the Israelis were not willing to give sufficient written assurance of cooperation in exchange-of-information requests. The exchange-of-information provision raises important privacy questions: is it necessary to make a specific request for specific information about a specific resident, or is it possible to request information about a group of residents without including names? In addition, bank secrecy provisions mean that often a government might not have the information requested. In addition, no worldwide system of tax identification numbers exists, so it is not necessarily true that information provided by a country would be linked to specific taxpayers.

Now we turn to two topics that are important in treaty negotiation although they are not included in the model treaty. The first topic is tax sparing, reflected in the provisions of Article 22, which requires that foreign tax credit be given only if foreign taxes are actually paid. A number of other countries provide for tax-sparing credits; Germany and Japan, for example, give credit for taxes that would have been collected at source from a permanent establishment or a subsidiary except for a tax holiday. The rationale is that a tax holiday in a global system may simply lead to a taxpayer owing more tax to the residence country. However, this may be an overly narrow interpretation, because the availability of deferral and averaging means that tax holidays usually benefit taxpayers even without tax sparing. Tax sparing has been an especially contentious issue in treaty ratification: the U.S. Senate has been insistent that it will never ratify a treaty that provides for tax sparing, because it can result in zero taxation.

The second issue involves treaty overrides, which are a uniquely American provision with relatively limited scope. The U.S. Congress takes the

position that treaties do not have a status above domestic laws; the treaty is superior if it is implemented after a law, but the law is superior if it is implemented after the treaty. Treaty overrides are based on a supremacy clause in the U.S. Constitution that says that laws and treaties shall be the supreme law of the land. Because *laws* and *treaties* are used in the same sentence, without a specific priority given to one or the other, the clause has been interpreted to mean that laws and treaties have the same status. However, unlike laws, treaties are negotiated with another party; the other party may feel that it is entitled to the benefits of the treaty without the risk that the treaty will be unilaterally changed by the U.S. Congress, and international law seems to support this argument. The American position is based on the argument that treaties are only ratified by the Senate whereas tax laws have to be passed by both houses of Congress, and therefore Congress must be able to supersede treaties.

Although treaty overrides are a contentious issue, the actual number of tax treaty overrides is relatively small. One explicit treaty override was the branch profit tax provision in 1986, which added a limitation-of-benefits rule to preexisting American treaties that did not have such a provision. This override is generally obsolete now because almost all of the treaties that it affected have since been renegotiated.

The most recent example of a treaty override occurred in the context of "check the box." This was the previously discussed situation in which a Canadian company had an American subsidiary with U.S.-source income. The subsidiary repatriated the U.S.-source income to Canada, except that the American subsidiary was treated as a branch by U.S. authorities and was therefore not subject to corporate tax on dividends. The payments from the U.S. subsidiary to Canada were treated as interest that was deductible and subject to a reduced withholding tax. The U.S. subsidiary was treated as a subsidiary for Canadian purposes, and therefore the payments were treated as dividends, which are exempt in Canada.

The United States took the position once again that a reduction in tax on source income should be contingent on an increase in tax on residence income. The United States therefore passed a treaty override stating that taxation will not be reduced for the hybrid entity that is treated inconsistently. Almost immediately, Canada agreed with the interpretation of the treaty and negotiated a protocol to change the treaty. Although this may imply that the treaty override was unnecessary because the Canadians were willing to renegotiate, it takes a lot of money and approximately a year's time to negotiate a protocol, so it was not necessarily inappropriate for the United States to use a treaty override.

Despite the contention surrounding treaty overrides, the United States hesitates to make use of the provision and has been very careful not to override treaties since 1986. In general, the United States attempts to avoid overrides and the appearance of overrides. When the capitalization rule was enacted in 1989, the United States went to great lengths to avoid the appearance of a treaty override by extending the provision to domestic tax-exempt entities.

We now turn to a discussion of specific treaties and their provisions. We will use the U.S.-China treaty as an example of the extent to which the United States is willing to depart from the model treaty. The treaty negotiation was concluded in 1984 and came into effect in the beginning of 1987. This treaty is unique because it is one of the first treaties that the United States negotiated with a developing country; until the 1990s, the United States had difficulty negotiating treaties with developing countries because of the tax-sparing issue. The U.S.-China treaty is significantly different from the U.S. model, and it is more favorable to source-based taxation, demonstrating that the United States was quite willing to alter the model treaty in favor of the treaty country.

Article 1 begins with a discussion of which taxes are covered by the treaty. As usual, the American federal income tax is included, along with a list of Chinese taxes. Many of these taxes were significantly altered by the Chinese tax reform of the early 1990s; although a standard treaty provision states that the treaty applies to substantially similar taxes, it is not clear whether the fundamental changes in Chinese tax law are technically still covered by the treaty. At some point, it will probably be necessary to renegotiate part of the treaty because of changes in tax law in both countries, but this often takes quite a long time.

After the listing of taxes, the treaty includes a definition of residency. In this treaty, the provision shows relatively little concern for dual residency and does not include a tax-sparing clause, although both of these are addressed in protocols after the treaty. The article includes the usual savings clause, which states that the United States can tax its citizens and residents regardless of the treaty; the definition of *resident* is cross-referenced to the United Nations model treaty, the treaty most favorable to developing countries.

The permanent establishment provision in Article 5 of the U.S.-China treaty exhibits features of the new UN model treaty guidelines that are more favorable to developing countries. For example, under the U.S.-China treaty, a construction site becomes a permanent establishment after only six months rather than a year, and an oil rig becomes a permanent

establishment after only three months. The language states that an enterprise of the contracting state shall not be deemed to have a permanent establishment merely because it carries on business in the other contracting state through a broker, a general commission agent or any other agent of independent status, provided that such persons are acting in the ordinary course of their business. The provision continues, stating that when the activities of such an agent are wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of independent status within the meaning if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions. This clause lowers the permanent establishment threshold in a very real way and is not something that the United States would have normally negotiated.

Section 3 of Article 7 in the U.S.-China treaty contains the business profits article. This section contains the usual treaty language stating:

> In the determination of the profits of permanent establishment they should be allowed as deduction expenses which are incurred for the purpose of the permanent establishment including executive, administrative expense. However, the next clause states that no such deduction shall be allowed in respect of amounts of any paid by the permanent establishment to the head office enterprise or any of its other offices by way of royalties or other similar payments, interest or money lent to the permanent establishment.

This second sentence is quite unusual and means that the profits of a permanent establishment in China cannot be reduced by making deductible payments (such as royalties or interest) to a related entity. A similar rule exists in the United States in the branch profit tax, but it is quite unusual to have it included explicitly in a treaty.

A later provision addresses the attribution of profits to the permanent establishment on the basis of deemed profits. This is a common practice by developing countries that find it difficult to accurately establish the profits of enterprise associated with permanent establishments because of transfer pricing. These countries often use presumptive taxation, which means that a country assumes that a business is supposed to have a certain profit based on its line of business, and the country attributes that profit to the business and taxes it accordingly. Such a system is advantageous to the business if it is more profitable than the average, and works against the business if the business is less profitable than the average. The fact that this provision is allowed in the treaty is an achievement for the source country, because it is not something that typically appears in U.S. treaties.

The treaty also includes the usual rules for transfer pricing, "shall make an adjustment if it agrees," and the articles covering passive income,

including dividends, interest, and royalties. The compromise tax rate for those income categories was set at 10 percent on everything, an interesting settlement given that it is higher than the American rate of zero on interest and royalties, but lower than the American rate of 15 percent on portfolio dividends.

Section 5 of Article 9 states that a company that is regimented in a contracting state and derives profit from the other contracting state may not face a tax on the dividends paid on the company imposed by the other contracting state. This is the second-order dividend rule and covers the following situation. Consider a Chinese company with a branch in the United States that derives profits from the United States; this Chinese company has a Chinese shareholder who receives the dividend from the Chinese company. The second-order dividend rule states that the Chinese resident may not be taxed by the United States even if the dividend economically derives from U.S.-source profits.

This provision has an interesting implication for the branch profit tax. The treaty was negotiated in 1984, before the branch profit tax was enacted in 1986. More recent American treaties explicitly permit the branch profit tax to be collected. The U.S. Treasury took the position when the branch profit tax was enacted that it would not be enforced in countries with a treaty that specifically prohibited second-order dividend taxes from being collected. In this case, the branch profit tax was not really supposed to override the treaty, although the United States does collect branch profit tax from branches of Chinese companies despite this language.

Article 12 includes the capital gains provisions of the treaty. This article allows for high levels of source-based taxation of capital gains in comparison with the U.S. model, which normally follows the American practice of permitting taxation only of capital gains that are linked to real property. By contrast, this article allows taxation not just of personal properties that are part of the business assets of the permanent establishment, but also, for example in section 5, gains from the alienation of shares other than those mentioned in paragraph 4, representing a participation of 25 percent in a company which is resident in a contracting state, may be taxed in that contracting state, that is, in the source state.

Thus if an American company owns 50 percent of a Chinese joint venture and sells under the law, China is permitted to tax the set sale under this treaty. The inclusion of this rule was a relatively large win for China in the treaty negotiations, because it means that the United States will not tax in reciprocal circumstances. Treaties can never increase tax in the United

States, so a Chinese company that owns 50 percent of an American company and sells those shares will not be subject to American tax: the United States does not tax foreign-source income under domestic law.

Article 20 includes provisions for the taxation of student income. Students are exempt from tax on grants or awards from educational or other tax-exempt organizations, meaning that a Chinese student who studies in the United States with a scholarship from an American institution or the American government would not be subject to tax under the treaty; in addition, money from a Chinese organization would be tax-exempt because it would be foreign-source. At the time that the treaty was negotiated in 1984, all scholarship money was tax-exempt; scholarship money only became taxable with changes to U.S. domestic law in 1986. The 1986 act specifically states that the taxation of scholarship awards is not a treaty override, so the treaty still prevails.

The treaty includes the usual credit provision without tax sparing. The nondiscrimination provision explicitly allows a deduction of interest and royalties under the same conditions as if they had been paid to a resident of the resident state. The exchange-of-information provision is also relatively standard.

The original treaty did not include a savings clause, nor did it not include a limitation-of-benefits provision; however, a first protocol was negotiated in 1984 together with the treaty that included the savings clause in paragraphs 1 and 2. The protocol also included a provision that the United States would not impose the personal holding company tax or the accumulated earnings tax on a company that is wholly owned by one or more residents of China who are not citizens of the United States. This provision is unusual because it is hard to imagine a dual-residency situation where the provision would apply; it seems that the only situation in which it would apply is for individuals who are green card holders in the United States but who are really residents of China under the treaty tie-breaker. Note also that the provision only applies to accumulated earning tax and personal holding company tax, not to foreign personal holding company tax.

The protocol also includes a provision to restrict taxation of royalties on industrial, commercial, or scientific equipment. The provision states that high-tech royalties of 10 percent can be levied on these payments, but only on 70 percent of the royalty amount; this provision in effect reduces the tax rate to 7 percent.

Paragraph 7 of this protocol is the only treaty-shopping provision that was included the original treaty. This paragraph states that both sides agree

that competent authorities of a contracting state may, through consultation, deny benefits of reduction of withholding tax to a company of a third country if the company becomes a resident of the contracting state for the principal purpose of enjoying benefits under this agreement. This statement is very weak because it requires proof of purpose. The protocol also includes an exchange of note stating that tax sparing will be provided to China if tax sparing is negotiated with another country, which the United States does not plan to do.

The United States and China negotiated a much more elaborate protocol in 1986 that includes the usual limitation-of-benefits provision. It is unclear what the Chinese got in return for giving limitation of benefits in this elaborate fashion; it appears that the limitation-of-benefits provision caused the treaty to become stuck in negotiations, and it was only able to be implemented after the American bargaining position changed as they began to insist on limitation of benefits in all treaties throughout the 1980s.

The general consensus is that the Chinese government was quite successful in negotiating this treaty with the United States. The treaty that was ratified is extremely favorable to the source country as compared to the U.S. model treaty, or even the older 1981 U.S. model treaty. The treaty that was negotiated includes more source-based taxation than the U.S. model and so gives much less to the residence country and more to the source country; because investment flows mostly from the United States into China, the treaty makes investment a bargain for American businesses in China, although the American reduction in withholding tax does not provide as much of a benefit. As compared to a no-treaty situation, the U.S.-China treaty on average probably transfers some revenue from China to the United States.

Despite the fact that the treaty may be more favorable to the United States, it was probably a benefit for China to have entered into this agreement. In general, tax treaties between developing countries and the United States benefit the developing countries despite the absence of tax sparing because tax treaties ensure American investors a certain level of institutional stability in the developing country. Empirical economic studies show that the existence of a tax treaty between two developed countries does not materially affect foreign direct investment, suggesting that treaties between developed countries affect the distribution of revenue between the governments of the two countries. Similar studies of tax treaties between developing and developed countries show that the existence of a treaty has a significant positive effect on the flows of foreign direct investment into the

developing country. These studies lend support to the argument that tax treaties increase investor confidence in the stability of investing in developing countries, and therefore, although the developing country might forego some tax revenue from the treaty, it probably benefits in the long run from the increased foreign direct investment.

10

Tax competition, tax arbitrage, and the future of the international tax regime

In Chapter 1, I laid out the thesis that an international tax regime exists and that it has a coherent structure based on two principles: the single tax principle (that all income should be subject to tax once, not twice or more and not less than once) and the benefits principle (that active income should be taxed primarily at source, whereas passive income should be taxed primarily at residence).

Although the benefits principle is broadly accepted as reflecting the consensus compromise reached under the auspices of the League of Nations in the 1920s,[1] there is a debate on whether there exists an international tax regime [2] (and in particular whether it incorporates a single tax principle[3]). Whether double nontaxation is an appropriate goal of international tax has been hotly debated, for example, in the 2004 Vienna Congress of the International Fiscal Association.

In this concluding chapter, I will survey three relatively recent developments that undermine the single tax principle: tax competition for passive income, tax competition for active income, and tax arbitrage. I will then discuss various reactions to these developments at both the national and supranational levels (primarily through the OECD) and assess their success in curbing the threat to the single tax principle. Finally, I will discuss the implications of these reactions for the debate surrounding the existence of the international tax regime. In my opinion, these reactions prove that an increasing number of important tax administrations, as well as the OECD, believe in the single tax principle and seek to implement it in practice.

[1] See Ault (1992), Graetz & O'Hear (1997).
[2] See Rosenbloom (2000, 2006).
[3] See Rosenbloom (2006).

I. TAX COMPETITION FOR PASSIVE INVESTMENT

Since the United States unilaterally abolished withholding on portfolio interest in 1984, there has been a distinct trend not to tax interest at source, which has spread to other forms of passive income such as capital gains, royalties, rents, and even dividends. In Chapter 4 I explained why a combination of officially sanctioned loopholes (such as the portfolio interest exemption), source rules (such as the rules for capital gains and for payments under derivative financial instruments), and treaty reductions have led to the United States not applying its withholding tax to almost all forms of passive investment income that economically derive from the U.S. market.

The lack of withholding tax combines with the existence of tax havens to make it almost impossible for residence countries to effectively tax passive income. In the absence of withholding tax, source countries have no interest in collecting information on payments of such income to nonresidents. Tax havens have bank secrecy laws, and payments can be made to them from the source country without any information collected that can be exchanged with the residence country under Article 26 of the treaties.

The result is widespread double nontaxation of investment income: no withholding at source, and no effective residence taxation because of no effective exchange of information. It is hard to estimate how much tax is evaded in this way, but Vito Tanzi has estimated that as much as $7 trillion in interest income escapes taxation.[4] For the United States, there is an estimate of an annual revenue loss of $50 billion due to this type of evasion.[5]

However, since 1998 a series of steps have been taken by residence countries to combat this phenomenon. This is reflected in steps taken at the OECD, the European Union, and by national tax administrations. The OECD addressed the problem of tax havens in its 1998 report on harmful tax competition and has exerted significant pressure on tax havens to allow effective exchange of information. It has also adopted a new, much stronger version of Article 26 in its model treaty and has drafted a multilateral exchange-of-information treaty. The EU has adopted the savings directive, which requires member states to cooperate in ensuring that payments of interest and other forms of passive income from one member state to another are subject to either withholding or information reporting. And national tax administrations have concluded exchange-of-information

[4] Tanzi (1995).
[5] Guttentag & Avi-Yonah (2005).

agreements with an expanding number of tax havens. The United States, for example, has such agreements with most of the Caribbean jurisdictions listed as tax havens by the OECD. The United States is also cooperating in exchange of information with the EU by forcing financial institutions to collect information on payments to the EU that are covered by the portfolio interest exemption. Even Switzerland has agreed to cooperate and relax its strict bank secrecy laws.

I have expressed some doubts about whether these initiatives are working. In particular, the actual agreements reached with tax havens tend to fall short of the expanded version of Article 26 envisaged by the OECD. We still lack universal tax ID numbers to help tax administrations use the information that they get. And even one noncooperating tax haven can defeat the whole effort if payments can be routed through it. That is why I still believe that a better solution is a coordinated withholding tax imposed by the OECD members (United States, the European Union, and Japan) and refundable upon a showing that the income has been declared to the residence country. After all, nobody can afford to leave their funds in tax havens; they must be invested in the OECD countries to earn a decent rate of return.

However, the key point here is not whether the effort is succeeding, but that it is made. In my opinion, it is clear that in the view of all thirty members of the OECD (as well as all twenty-five members of the EU, which largely overlap with the OECD), the single tax principle is valid, and double nontaxation of passive income is not acceptable. Otherwise, they would not have reacted to the collapse of source-based taxation of such income after 1984 by trying so hard to tax it on a residence basis (where, in accordance with the benefits principle, it should be taxed).

II. TAX COMPETITION FOR ACTIVE INVESTMENT

As I have explained at length elsewhere,[6] tax competition for FDI has been growing steadily since about 1980 and now means that multinationals can hope to escape any tax on their cross-border income. Suppose a multinational entity is resident in country A, has its production facilities in country B, and sells its products in country C. Country C can only tax the MNE if it has a permanent establishment therein, and in the age of electronic commerce, that may be possible to avoid. Country B typically does not

[6] Avi-Yonah (2000a).

tax the MNE because it is a "production tax haven," that is, a country that refrains from taxing production activities by MNEs while imposing a general corporate tax on domestic corporations. Country A also typically would not tax the resident MNE on a current basis because it is afraid that MNE headquarters will migrate to other countries (either by inversion-type transactions or by takeover by foreign MNEs) and of new MNEs being incorporated elsewhere. As a result, an MNE such as Intel ends up paying no tax at all on its foreign-source income (and if it can deduct stock options, also on its U.S.-source income).

The economic data show that this type of tax competition exists, although it tends to affect more the corporate tax revenues in developing countries (country B in the example) than the developed country (countries A and C).[7] The reason is that OECD countries have been reducing the permanent establishment (PE) threshold[8] and that it turns out that for most MNEs it is hard to avoid having a PE even in the age of e-commerce.[9]

However, in this case also the OECD has been working hard to combat the tax competition phenomenon by putting pressure on both OECD members and nonmembers to abolish the production tax havens, as well as to abandon tax-sparing rules in treaties that foster double nontaxation. In addition, the WTO has been pressuring developing countries to abandon production tax havens that amount to export subsidies, and many Latin American countries have in fact abandoned their production tax haven regimes in the Doha Round. Finally, countries have been taking steps to defend residence-based taxation of their MNEs by adopting or strengthening CFC rules (twenty-six countries now have such rules, which were pioneered by the United States in 1962) and combating inversion transactions (e.g., IRC 7874).

Again, the main point is not whether these efforts have been successful, although at least for OECD members they seem to have stopped the erosion of the corporate tax base that was evident in the 1990s. The main point is that by adopting such measures, OECD members (as well as the WTO) show that they do not believe in double nontaxation of active income and are trying to protect the taxation of such income at source (with residual taxation by the residence country if there is no taxation at source). I believe this trend will continue until effective residence-based taxation by OECD members stops developing countries from engaging in harmful tax competition.

[7] Keen & Simone (2004).
[8] LeGall (2006).
[9] Avi-Yonah (1997, 2001).

III. TAX ARBITRAGE

Tax arbitrage can be defined as transactions that are designed to take advantage of differences between national tax systems to achieve double nontaxation. Thus, tax arbitrage directly negates the single tax principle.

There is no question that Rosenbloom is correct in his assertion that countries did not always care about tax arbitrage. The first U.S. tax treaty was with France in 1937, when France was purely territorial, so the United States reduced its tax at source in the knowledge that the income would not be taxed at residence.

But I believe that developments since 1984 show that the United States and other OECD member countries have reached a consensus that rejects tax arbitrage. In 1984, the United States terminated its treaty with the Netherlands Antilles on the grounds that it should not have treaties with countries that do not tax on a residence basis. Since then, it has been clear that the United States will not enter into treaties with tax havens, and that it views reductions in source-based taxation as premised on the income being taxed by the state of residence. That is why the United States has insisted since 1986 on limitation-of-benefits rules in all its tax treaties, which are designed to prevent reductions in source taxation benefiting nontreaty country residents precisely because such nontreaty residents may not be taxable on a residence basis. Domestically, this rule has been bolstered by court cases and by regulations against the use of conduits to achieve treaty benefits. It has also been adopted by the OECD through changes to the commentary to Article 1 of the OECD model.

The negative attitude of the United States to tax arbitrage and double nontaxation is also evident outside the treaty context. Also in 1984, the United States adopted the dual consolidated loss rule, which is designed to prevent a taxpayer from using one economic loss in two taxing jurisdictions. As Rosenbloom[10] admits, this rule (which has recently been expanded in regulations) makes no sense unless the United States believes that double nontaxation is bad. In the 1990s, the United States took a series of steps to combat specific tax arbitrage transactions based on "check the box," such as IRS section 894(c) (the reverse hybrid rule) and Notices 98-5 and 98-11. Although the specific notices were later withdrawn, the Bush administration continues to fight tax arbitrage, as evidenced by recent regulations on tax arbitrage transactions involving the foreign tax credit.[11]

[10] Rosenbloom (2000).
[11] Reich (2006).

The same negative view toward tax arbitrage can be seen in other countries. A recent article in the *International Tax Review*[12] lists new antitax arbitrage rules being adopted recently in Australia, Canada, Japan, and the United Kingdom; even Ireland (with a corporate tax rate of only 12.5%) adopted such rules in 2006. The U.K. rules are particularly comprehensive and have drawn bitter complaints from tax practitioners, to no avail.

Rosenbloom[13] writes that although an international tax regime may exist, and although tax treaties can be regarded as a "closed" system that condition reductions in source taxation on taxation by the residence country, the single tax principle is still a mirage: "At the level of specific rules, however, there is no mechanism for enforcing, or even attempting to enforce, either the benefits principle or the single tax principle. . . . At the level of individual transactions, in fact, it is hard to discern the existence of any international tax regime at all."

Rosenbloom may be right about that – as a practitioner specializing in tax arbitrage transactions, he should know. But at the policy level, I disagree with his view that "an effort to foreclose cross-border arbitrage opportunities is not and should not be a first-rank policy objective of the United States." We can argue about that "should not," and that is the point of the earlier debate we had on this topic.[14] But in the face of the accumulating evidence to the contrary, it seems to me hard to argue about the "is not": the United States and other OECD member countries are in fact concerned about tax arbitrage and by extension about double nontaxation, both in the treaty context and outside it.

IV. CONCLUSION

This book has attempted to describe the contours of the international tax regime and how U.S. tax law fits into that regime. I have tried to show that such a regime exists and that it is based on the single tax and benefits principles. Moreover, I believe the regime, both through treaties and through actual practice, can be regarded as part of customary international law. Whether or not that last conclusion is valid, it is hard to argue with the proposition that all countries, even the United States, face significant practical difficulties in attempting to depart from the international tax regime.

[12] *International Tax Review* (2006).
[13] Rosenbloom (2006).
[14] Rosenbloom (2000), Avi-Yonah (2000a).

If the foregoing is true, I believe that we can do better. In particular, it would help if countries explicitly articulated that they are trying to adhere to the single tax and benefits principles, and take those principles into account in drafting their tax laws. Moreover, the OECD should take these principles more explicitly into consideration in revising its model treaty and should revise the model so that it functions better to prevent both double taxation and double nontaxation. But that is a topic for another day.[15]

[15] Avi-Yonah, Schoen, & Vann (forthcoming).

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Index

accumulated earnings tax
  anti-deferral regimes, 125–126
  jurisdictional rules, 25–26
  US/China treaty, 179
ACT. *See* advanced corporate tax (ACT)
Adams, T. S., 10, 11–12
advance pricing agreements (APAs), 118–120
advanced corporate tax (ACT), 164–165
agency
  dependent agency, 86–87
  transfer of ownership, 86
Alcoa/antitrust decision, 25
Alliant/tax shelter case, 167
American Chicle/indirect credit example, 162
anti-deferral regimes
  accumulated earnings tax, 125–126
  CFC, 128
  development of, 125
  FIF, 128
  foreign investment company provision, 127
  FPHC, 126–127
  incorporated pocketbook, 128
  mechanisms, 19
  PFIC, 127, 128–131
  PHC, 126–127
  rules example, 106–107
  subpart F, 127
APAs. *See* advance pricing agreements (APAs)
Aramco/blocked income case, 122–123
Archer Daniels Midland/trade or business determination case, 85–86
arm's length standard
  customary international law, 6–7
  formulary apportionment, 113–114
  transfer pricing, 104–105
Ashland/branch rule example, 140–141

Bank of America/value-added tax case, 51
Barba/gambling withholding case, 67
Barclays/formulary apportionment case, 113–114
basket system
  CEN, 161–162
  foreign tax credit limitation, 159–162
Bausch & Lomb/transfer pricing case, 108–109
benefits principle. *See also* single tax principle
  described, 1, 3, 182
  residence-based taxation, 11
  source-based taxation, 11–12
  tax base division, 13
  tax rate divergence, 12–13
Bethlehem Steel/transfer pricing case, 107–108
Biddle/technical taxpayer case, 153–154
bilateral tax treaties, 3, 4–5
Black & Decker/cost of goods sold case, 56–58
blocked income
  consumer products example, 121–122
  described, 121
  oil company example, 122–123
  precedent misuses, 123
  regulations, 123
  royalty payments, 121–122
Boulez, Pierre, 49–51, 169
branch profit tax
  branch/subsidiary investment, 93
  dividend equivalent analysis, 94
  double taxation issues, 94–96
  enactment rationale, 92–93
  net asset/earnings analysis, 93–94
  parent/subsidiary equalization, 94
  treaty override, 95
Brauner, Yariv, 63
Brown Group/base company rule example, 138–139
Bush administration
  tax arbitrage, 186–187
  tax rate changes, 64

business income, non-residents
  active/passive income, 79, 80
  force of attraction rule, 79–81
  international tax regime, 89–90
  present system history, 79

capital export neutrality (CEN)
  anti-deferral arguments, 135–136
  basket system, 161–162
  force of attraction rule, 81–82
  foreign tax credit limitation, 158
  violation issues, 159–160
capital gains
  exclusions, 67–68
  real property, 90–91
  source rules, 43, 68–69
  US/China treaty, 178
  withholding tax, 16
CFCs. *See* controlled foreign corporations (CFCs)
check the box rules
  branch rule application, 146
  hybrid entities example, 143–145
  intragroup payment example, 145–146
  Notice 98–11, 143–145, 146–147
China. *See* US/China treaty
Clinton administration
  check the box rules, 146–147
  formulary apportionment, 114
  research & development rules, 59
  Subpart F exceptions, 135, 136, 148–149
  tax rate changes, 64
Coase, Ronald, 105
Compaq/corporate tax shelter case, 166–167, 168
comparable profit method (CPM)
  arm's length determination, 6–7, 114–116
  profit splits, 117
comparable uncontrolled price (CUP)
  arm's length determination, 114
  profit splits, 117
  transfer pricing, 104–105
  USX/Navios example, 107–108
controlled foreign corporations (CFCs)
  anti-deferral regimes, 128
  customary international law, 28
  developed countries, 3
  nationality-based jurisdiction, 24
  passive income application, 19–20
  residency rules, 32–33
  subpart F regime, 131–133
convertible debt instruments, 72
Cook v. Tait, 22, 29
corporate tax shelters
  business purpose example, 166–167, 168
  dual accounting systems, 167–168
  problems with, 168
  tax reduction strategists, 166
CPM. *See* comparable profit method (CPM)
CUP. *See* comparable uncontrolled price (CUP)

Daimler Chrysler/corporate residency example, 143
deductions, allocation of
  cost of goods sold example, 56
  general rules/steps, 55–56
  interest expense, 60–63
  research & development rules, 58–60
  resident/non-resident preferences, 55
  worthless stock example, 56–58
deemed dividends
  nationality-based jurisdiction, 24–25
  PFIC, 129
  subpart F regime, 133–134
deferral, of taxation, 19–20. *See also* anti-deferral regimes
derivative financial instruments, 75–77
dividends, non-resident. *See also* deemed dividends
  deductibility, 74
  derivative financial instruments, 75–77
  equity swaps, 77
  subsidiary/parent payments, 77
  treaty/non-treaty rates, 74
  withholding tax, 74–75
domestic taxpayers, US tax rules
  deferral, 19–20
  example, 20–21
  foreign tax credit, 20–21
dual residency, 33–34
DuPont/transfer pricing case, 106–107, 137–138

earnings stripping rule
  debt vs. equity capitalization, 96–97
  deductibility restriction, 98–99
  dividend/interest comparison, 96
  excess interest expense, 98–99
  guarantee provision, 99–100
  non-US approaches, 100–101
  safe-harbor provision, 98
  tax-exempt related parties, 97–98

effectively connected income
asset test, 88
described, 87–88
foreign taxpayers, 14–15
people test, 88–89
subsidiary location/control, 89
equity swaps, 77
expatriation, tax-motivated, 31–32

FDAP. *See* fixed or determinable, annual or period income (FDAP)
FIF. *See* foreign investment funds (FIF)
FIRPTA. *See* foreign investment in real property tax act (FIRPTA)
fiscal domicile, 22–23
fixed or determinable, annual or period income (FDAP)
described, 66–67
force of attraction rule, 80–81
income treatment, 15, 18–19
non-resident taxation, 14, 89–90
force of attraction rule
described, 79–80
permanent establishment, 171–172
trade or business determination, 80–82
foreign investment funds (FIF)
described, 128
international tax regime, 3
foreign investment in real property tax act (FIRPTA)
history of, 90–91
policy considerations, 92
foreign personal holding corporations (FPHCs)
described, 24–25
jurisdictional limits, 25–26
foreign tax credit
vs. deduction, 7, 10, 40, 150–151
deferred income, 165–166
double taxation risks, 39–40, 42
general criteria, 151
gross-up provision, 153
importance of, 150
resident vs. non-resident importance, 41–42
source income level, 41
tax rate differences, 40–41
technical taxpayer rule, 152–154
foreign tax credit, credible requirements
corporate cash flow tax example, 155–156
gross receipts, 154–155
net income, 155
problems with, 156
realization, 154
US position on, 154
wage deductibility example, 155
foreign tax credit, indirect credits
accumulated profits example, 163–164
ACT, 164–165
branch vs. subsidiary example, 162
eligibility, 162
formula calculation, 162
foreign tax credit limitation
basket system example, 159–162
calculation of, 157
effective rate reduction, 158
income averaging, 158–159
need for, 156–157, 158
problems with, 157
source income level, 158
tax holidays, 161
foreign tax credit, proof of payment
foreign government receipt, 151
refund/subsidy rule, 152
soak-up tax, 152
tax vs. royalty label, 151–152
foreign taxpayers, US tax rules
active business income, 14–15
active/passive distinction, 14
domestic/foreign taxpayer distinction, 13–14
effectively connected income, 14–15
passive income, 15–19
formulary apportionment
APAs, 118–120
vs. arm's length pricing, 113–114
"best method" rule, 114
CPM, 114–116
CUP, 117
disadvantages of, 112
functional analysis, 117–118
profit division example, 111–112
profit split method, 116–117
US/non-US application, 114
weighting factors/formula, 112–113
Fortress Re/trade or business determination case, 86–87
FPHCs. *See* foreign personal holding corporations (FPHCs)
Freedom of Information Act, 119
Fruehauf/jurisdiction case, 26

Garlock/subpart F avoidance case, 132–133
global trading, 118–119

Goodyear/indirect foreign tax credit case, 163, 164
Graetz, Michael, 12
Gray, Horace, 7–8
green-card holders, 30

Hoffmann-LaRoche/royalty vs. service case, 48–49

income, formal source rules
  aims of, 42
  capital gains, 43
  dividends, 42–43
  interest, 43
  inventory, 43–44
  vs. substantive source rules, 45–47
income, source/character examples
  active/passive income, 52–53
  cancelled indebtedness, 53–54
  category/market evolution, 55
  characterization difficulties, 49
  computer/software transactions, 51–52, 172–173
  country disputes, 49–51
  covenant not to compete, 54
  financial institutions, 51
  new technologies, 54–55
  royalties vs. services, 47–49
  tax treaties, 52–53
income, substantive source rules, 43–44
  aims of, 44
  vs. formal source rules, 45–47
  place of use, 44
  royalties/intangible goods, 44–45
  services, 45
incorporated pocketbooks, 19, 128
Inland Steel/disallowed deductions case, 155
interest, non-resident
  bank loans, 70–71
  budget deficit response, 69–70
  convertible debt instruments, 72
  country-specific complications, 71
  dollar volume (annual), 71–72
  portfolio interest exemption, 70
  source rules, 72
international tax regime, customary law
  arm's length standard, 6–7
  described, 4–5, 187
  foreign tax credits/deductions, 7
  implications of, 7–8
  jurisdiction to tax, 5–6
  non-discrimination principle, 6
  policy considerations, 188
international tax regime, existence
  bilateral tax treaties, 3
  controversy of, 1
  denial of, 2
  domestic law convergence, 2–3
  implications of, 1
  international law convergence, 3
  non-discrimination principle in, 4
  non-resident taxation, 89–90
  tax arbitrage, 187
  thin capitalization rule in, 4
  world economy integration, 3–4
international tax regime, structure. *See also* US tax rules terms
  benefits principle, 11–13, 89–90
  single tax principle, 8–10
investment income
  deferred/delayed taxation, 124–125
  development, 125
  foreign source income, 124
investment income, anti-deferral regimes
  accumulated earnings tax, 125–126
  CFC, 128
  FIF, 128
  foreign investment company provision, 127
  FPHC, 126–127
  incorporated pocketbook, 128
  PFIC, 127, 128–131
  PHC, 126–127
  Subpart F, 127
investment income, branch profit tax
  branch vs. subsidiary investment, 93
  dividend equivalent analysis, 94
  double taxation issues, 94–96
  enactment rationale, 92–93
  net asset/earnings analysis, 93–94
  parent/subsidiary equalization, 94
  treaty override, 95
investment income, capital gains, 68–69
  exclusions, 67–68
  real property, 90–91
  source rules, 43, 68–69
  US/China treaty, 178
  withholding tax, 16
investment income, dividends
  deductibility, 74
  derivative financial instruments, 75–77
  equity swaps, 77
  subsidiary/parent payments, 77

treaty/non-treaty rates, 74
withholding tax, 74–75
investment income, earnings stripping rule
debt vs. equity capitalization, 96–97
deductibility restriction, 98–99
dividend/interest comparison, 96
excess interest expense, 98–99
guarantee provision, 99–100
non-US approaches, 100–101
safe-harbor provision, 98
tax-exempt related parties, 97–98
investment income, interest
bank loans, 70–71
budget deficit response, 69–70
convertible debt instruments, 72
country-specific complications, 71
dollar volume (annual), 71–72
portfolio interest exemption, 70
source rules, 72
investment income, non-residents
active/passive income categories, 64
annual/periodic income, defined, 66–67
capital gains exclusion, 67–68
deductions, number of, 64–65
FDAP, 65–67
gambling winnings, 67
gross/net rate payment decision, 64–65
present system history, 64
tax competition issues, 78
withholding tax, 65–66, 67–68, 78
investment income, real property
asset valuation, 91–92
buyer certification, 91
capital gains, 90–91
FIRPTA, 90–91
policy considerations, 92
rule avoidance, 91
withholding tax, 91
investment income, royalties. *See also* royalties
cascading tax example, 72–73
limitation on benefits article, 73–74
treaty provisions, 72
Islamic non-creditable tax, 163–164

jurisdiction, US tax rules. *See also* nationality-based jurisdiction terms
accumulated earnings tax, 25–26
check the box rule, 35–37
citizenship status, 31
corporate residency, 32–33
customary international law, 5–6, 28
dual residency, 33–34
expatriation, tax-motivated, 31–32
foreign corporations, 34–35
FPHCs, 25–26
Fruehauf case, 26
green-card holders, 30
limited liability corporations, 35–36
medical status, 31
nominal shareholders, 36
partnerships, 35–37
physical presence, 30–31
residency status, 29–30
Sensor case, 26
student/faculty status, 31
summarized, 37
tax havens, 23
territorially based jurisdiction, 27–28
worldwide taxation, 28–29

Karrer, Paul, 48–49
Kennedy administration
anti-deferral arguments, 19–20, 135–136
subpart F enactment, 25, 127
Korfund Company/not compete case, 54

Lepard, Brian D., 7
Lewenhaupt v. Commissioner, 84–85
Liang, Chang Hsiao, 81–82
limited liability corporations, 35–36

model tax treaty. *See* US model tax treaty terms; US/China treaty

nationality-based jurisdiction, corporations
CFCs, 24, 25
corporate income
customary international law growth, 26–27
deemed dividends, 24–25
FPHCs, 24–26
jurisdiction expansion, 26
PHC, 24–26
sanctions, 26
US/UK approaches, 24
nationality-based jurisdiction, individuals
citizenship, 22
defined, 22–23
fiscal domicile, 22–23
physical presence, 22–23
residency, 22–23
tax havens, 23
vs. territoriality-based, 22

Navios/transfer pricing case, 107–108
non-discrimination principle, 4, 6
Notice 98–11, 143–145, 146–147

OECD
  CFC taxation, 148
  coordination with US positions, 114
  double taxation, 185, 188
  model tax treaty, 169
  PE threshold, 184–185
  profit splits, 117
  single tax principle, 182
  tax arbitrage, 186, 187
  tax competition, 78, 185
  tax havens, 183–184
  tax sparing, 170–171
  TNMM, 116
  transfer pricing, 119
  vs. US model, 171–172
O'Hear, Michael, 12
Organisation for Economic Co-operation and Development (OECD). *See* OECD

Paquete Habana/customary international law implications, 7–8
passive foreign investment company (PFIC)
  active/inactive thresholds, 131
  deemed dividend option, 129
  described, 127
  enforcement/evasion issues, 130–131
  interest charge option, 129
  mark to market option, 129–130
  option comparison, 130
  passive income test, 128–129
  US residency status, 131
passive income, US tax rules
  capital gains, 16
  dividends, 17–18
  interest, 16–17
  rents/royalties, 18–19
  withholding tax, 15–16
personal holding company (PHC), 24–26
PFIC. *See* passive foreign investment company (PFIC)
physical presence test
  source income example, 83–84
  thresholds, 82–83, 84
Piedras Negras Broadcasting Co., Commissioner v., 83–84
portfolio interest exemption, 70
Proctor & Gamble/blocked income case, 121–122

Reagan administration
  formulary apportionment, 114
  tax policies, 69–70
real property, non-resident
  asset valuation, 91–92
  buyer certification, 91
  capital gains, 90–91
  FIRPTA, 90–91
  policy considerations, 92
  rule avoidance, 91
  withholding tax, 91
residence-based taxation
  economist preference for, 38
  problems with, 39
Rosenbloom, H. David
  bilateral tax treaties, 3
  international tax regime, 2
  tax arbitrage, 186, 187
Royal Dutch Shell/corporate tax shelter case, 166–167
royalties
  blocked income, 121–122
  cascading tax example, 72–73
  foreign tax credit, 151–152
  intangible goods, 44–45
  limitation on benefits article, 73–74
  Royal Dutch Shell, 166–167
  vs. services, 47–49
  transfer pricing, 110–111, 121–122
  US/China treaty, 72, 179

Saudi Aramco/blocked income case, 122–123
Schrempf, Juergen, 143
Seligman commission, 38
Sensor/jurisdiction case, 26
Shaviro, Daniel, 63
Simons, Henry, 154
single tax principle. *See also* benefits principle
  appropriate tax rate, 9
  and benefits principle, 9
  cross-border income, 9–10
  described, 1, 3, 182
  example, 10
  foreign tax credit, 10
  goal of, 8–9
  personal/corporate tax maintenance, 9
  tax arbitrage, 187
  tax holiday example, 147–148
source rules. *See also* income, formal source rules; income, substantive source rules; residence-based taxation
  customary international law, 63

foreign tax credit, 39–42
resident taxation, 39
resident vs. non-resident importance, 38, 42
source determination, 38
Spermacet Whaling/trade or business determination case, 85–86
stock/securities trading, non-residents, 81–82
subpart F regime
50/50 joint ventures, 132–133
banking/finance/insurance exception, 136
base company rule, 137–138
CEN, 135–136
CFC application, 131–133
de minimis exception, 137
deemed dividends, 133–134
high tax exception, 136–137
income categories, 134–135
policy considerations, 148–149
subpart F regime, American rules
inversion transactions, 143
local active business, 142–143
local/foreign tax rate, 141–142
subpart F regime, base company rule
avoidance of, 141
branch rule example, 140–141
French rules, 141–142
partnership example, 138–139
subpart F regime, check the box rules
branch rule application, 146
hybrid entities example, 143–145
intragroup payment example, 145–146
Notice 98–11, 143–145, 146–147
tax holiday example, 147–148

Taisei/dependent agency case, 86–87
Tanzi, Vito, 183
tax arbitrage
defined, 186
negative views on, 186–187
policy considerations, 187
single tax principle, 187
tax competition, active investment
double nontaxation, 185
multinational enterprise (MNE) activity, 184–185
tax havens, 185
tax competition, passive investment
double nontaxation, 183
residence country initiatives, 183–184
tax havens, 183
tax withholding trends, 183
tax havens
active investment, 185
nationality-based jurisdiction, 23
passive investment, 183
tax holiday
foreign tax credit limitation, 161
single tax principle, 147–148
subpart F regime, 147–148
tax sparing
treaty negotiation, 174
US/China treaty, 179–180
tax treaty model. *See* US model tax treaty terms; US/China treaty
territorially-based jurisdiction, 27–28
thin capitalization rule, 4
TNMM. *See* transactional net margin method (TNMM)
trade or business determination
avoidance of, 87
dependent agency, 86–87
nominal ownership, 85–86
non-US partnerships/joint ventures, 85–86
physical presence test, 82–84
real estate transactions, 84–85
transfer of ownership, 86
trade or business determination, effectively connected concept
asset test, 88
described, 87–88
people test, 88–89
subsidiary location/control, 89
transactional net margin method (TNMM), 116
transfer pricing
arm's length price, 104–105
cost-plus price method, 105
cost sharing rule, 111
country tax rate differences, 103
described, 102
DuPont case, 106–107, 137–138
guidelines, 104, 105–106
profit continuum, 102–103
resale price method, 105
resident/non-resident income shifts, 102
royalty/super royalty rule, 110–111
tax evasion prevention measures, 103–104
transfer pricing, blocked income
consumer products, 121–122
described, 121
oil company, 122–123
precedent misuses, 123
regulations, 123
royalty payments, 121–122

transfer pricing, concept examples
anti-deferral rules, 106–107
assured customer, 107–108
chemical company, 106–107
contact lens company, 108–109
CUP, 104–105, 107–108
export subsidiary, 106
mining company, 106
multinational corporate venture, 108–109
pharmaceutical company, 109–110
profit allocation, 106
steel company, 107–108
transfer pricing, formulary apportionment
APAs, 118–119
vs. arm's length pricing, 113–114
"best method" rule, 114
CPM, 114–116
CUP, 117
disadvantages of, 112
functional analysis, 117–118
profit division, 111–112
profit split method, 116–117
US/non-US application, 114
weighting factors/formula, 112–113

United Parcel Service/trade or business determination case, 120
US/China treaty
accumulated earnings tax, 179
benefits to China, 180
branch profit tax, 178
business profits, 177
capital gains, 178
covered taxes, 176
as developing country example, 176, 180–181
FPHC, 179
information exchange, 179
joint ventures, 178–179
limitation on benefits, 179, 180
non-discrimination principle, 179
permanent establishment threshold, 176–177
PHC, 179
residency definition, 176
royalties, 179
savings clause, 179
second-order dividend rule, 178
student income/scholarships, 179
tax sparing, 179–180
transfer pricing adjustments, 177–178
treaty shopping, 179–180
US Gypsum/transfer pricing case, 106
US model tax treaty
bargaining position, 169
developed vs. developing countries, 170–171
double taxation prevention, 169
persons/entities covered by, 171
reciprocal capital flows, 170
source/residence revenue shift, 169–170
tax increases/reductions, 171
taxes covered by, 171
US model tax treaty, substantive provisions
business profits, 172
earnings stripping, 173
information exchange, 174
limitation on benefits, 172–174
non-discrimination, 174
permanent establishment threshold, 171–172
real property, 172
source-based tax reduction, 172
transfer pricing adjustments, 172
US Steel/transfer pricing case, 107–108
US tax rules, domestic taxpayers
deferral, 19–20
example, 20–21
foreign tax credit, 19, 20–21
US tax rules, foreign taxpayers
active/passive distinction, 14
domestic/foreign taxpayer distinction, 13–14
effectively connected income, 14–15
passive income, 15–19
US tax rules, jurisdiction. *See also* nationality-based jurisdiction terms
accumulated earnings tax, 25–26
check the box rule, 35–37
citizenship status, 31
corporate residency, 32–33
customary international law, 5–6, 28
dual residency, 33–34
expatriation, tax-motivated, 31–32
foreign corporations, 34–35
FPHCs, 25–26
Fruehauf case, 26
green card holders, 30
limited liability corporations, 35–36
medical status, 31
nominal shareholders, 36

partnerships, 35–37
physical presence, 30–31
residency status, 29–30
Sensor case, 26
student/faculty status, 31
summarized, 37
tax havens, 23
territorially-based jurisdiction, 27–28
world-wide taxation, 28–29
US treaty negotiation
tax sparing, 174
treaty override, 174–176
USX/transfer pricing case, 107–108

Vulcan/accumulated profits case, 163–164

Western Hemisphere Trade Corporation, 106
withholding tax
Barba/gambling case, 67
as bargaining tool, 65–66
capital gains, 16, 67–68
dividends, 74–75, 78
passive income, 15–16
real property, 91
tax competition, 183
Wodehouse, P. G., 47–48, 66–67
World Trade Organization, 59–60

Xerox Corporation/indirect credits case, 164–165