The President's Advisory Panel's Recommendation to Move from a Worldwide Tax to a Territorial Tax System

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THE PRESIDENT’S ADVISORY PANEL’S RECOMMENDATION TO MOVE FROM A WORLDWIDE TAX TO A TERRITORIAL TAX SYSTEM

Claire Wade*

I. INTRODUCTION

IMAGINE that you are on the board of directors of an international manufacturing and distributing corporation. The Chief Executive Officer proposes a move of the manufacturing facility to a foreign country where skilled labor is available at half the cost. This savings could be passed on to the customer and would lead to greater profits. You consider the following questions: would the savings in labor really save the corporation money; what about the foreign taxes that the corporation would have to pay; would the United States also tax the income, essentially double-taxing the corporation and offsetting any savings on labor; or, would a foreign tax credit apply, and if so, how much of a credit would apply; would the corporation be considered a controlled foreign corporation (CFC), or domestic service corporation? You decide not to take advantage of the availability of foreign labor, deciding that any cost benefit would be negated by the increased taxes. Or worse, you decide not to move the manufacturing facility, even though the move would reduce customer cost and increase your profits, because the foreign tax laws are just too complex.

Now imagine that you are a congressional representative deciding whether to approve a new tax policy that would switch from a worldwide tax system, which has been in place since the existence of income tax in the United States. On one hand, you want to promote economic efficiency and believe that can best be done with a territorial tax. On the other hand, you do not want to erode your tax base because a diminished tax base means less tax revenues. Which system is going to best promote your goals—a worldwide tax or a territorial tax? Consider factors that might influence your decision: the methods other countries use, the system that is simpler, and the system that is least prone to shelters and

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abuse. Additionally, consider what your constituencies may think of the policy and whether you need to re-write the entire international tax regime, or merely update the current system to achieve your goals.

Since the Sixteenth Amendment to the U.S. Constitution took effect in 1913, the United States has employed a worldwide tax system where U.S. citizens pay taxes on income derived from domestic and foreign sources. The worldwide tax regime employed by the United States has evolved over time, from a deduction for foreign taxes paid, to a full credit for all foreign taxes paid, to a complex set of rules used to determine which foreign income was subject to U.S. taxes and how much of the foreign taxes paid could be credited against U.S. taxes. Now, ninety-two years later, the President's Advisory Panel has recommended that the United States move from this worldwide tax system to a territorial tax system. The President's Advisory Panel recommended the switch based on "the President's instructions to emphasize simplicity, fairness, and to remove impediments to growth."3

This article will first briefly explain the history of the U.S.'s system for the taxation of foreign income. Then, the article will describe some of the main thrusts of the current system and the President's Advisory Panel's recommended changes to the current system. Next, the article will give an overview of the main arguments both for and against the change from an international tax to a territorial tax regime.

II. THE HISTORY OF THE U.S. TAX SYSTEM’S TREATMENT OF FOREIGN TAX EARNED

The United States taxes all of its citizens on all of their income earned, whether they live in the United States or not, and whether it was earned in the United States or not.4 This worldwide tax system has been in place since 1913.5 While the tax code has seen nearly 15,000 changes since then, the system for taxing foreign income—the use of a worldwide tax

1. MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 158 (Foundation Press 2003) [hereinafter GRAETZ, FOUNDATIONS].
4. Marc Rosenberg, How a Taxing Problem Has Taken Its Toll: A Common Person's Guide to an International Taxation Dispute, 20 B.U. Int'l L.J. 1, 6 (2002); see also Reuven S. Avi-Yonah, INTERNATIONAL TAX AS INTERNATIONAL LAW, 57 Tax L. Rev. 483, 484 (2004) (explaining that this principle was upheld by the Supreme Court in Cook v. Tait, 265 U.S. 47 (1924) "because of the benefits the United States provides its citizens even if they live overseas"); GRAETZ, FOUNDATIONS, supra note 1, at 15 (stating that, “[t]he United States is the only industrialized country in the world that taxes its citizens on their worldwide income, even if they reside outside the country.”).
5. GRAETZ, FOUNDATIONS, supra note 1, at 158.
A. THE REVENUE ACT OF 1918 (1918 ACT)

The foreign tax credit, a dollar-for-dollar reduction in U.S. income tax for foreign tax paid, first appeared in the 1918 Act. The foreign tax credit was unilaterally instituted by the United States in the 1918 Act. Prior to the 1918 Act, U.S. law allowed taxes paid to a foreign government to be deducted from income. The mere deduction of foreign taxes from income is a form of double taxation, because it taxes the same income at both the international and the U.S. level (with a slight deduction in the amount taxed). For example, if a taxpayer had $100,000 of foreign income and, for the sake of simplicity, assuming that the foreign tax rate is 20 percent and the U.S. tax rate is 25 percent, prior to the 1918 Act the taxpayer would have paid $40,000 in taxes on that income (40 percent), and after the 1918 Act the taxpayer would only pay $25,000 (25 percent) on that same income because of the tax credit.

As opposed to a deduction, which reduced the amount of taxable income, the foreign tax credit allowed a taxpayer to offset his U.S. tax bill by the amount of foreign tax paid. A credit “for income, war-profits and excess-profits taxes paid . . . to any foreign country, upon income derived from sources therein” could be used to offset U.S. income taxes, allowing taxpayers to reduce their tax bill by more than the amount of income tax they would owe on that foreign income. Taxpayers with substantial foreign income could even eliminate their U.S. tax bills. In the example above, if the taxpayer had $100,000 of U.S. income in addition to his foreign income, and the U.S. tax rate was reduced to 15 percent, the taxpayer would pay less in U.S taxes than if the foreign income

6. Cover letter from The President's Advisory Panel on Federal Tax Reform to John Snow, supra note 3.
7. Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1041 (1997) [hereinafter Graetz, Original Intent]; see also GRAETZ, FOUNDATIONS, supra note 1, at 165 (noting that, in 1918, the United States also wanted to encourage foreign investment because "[a] variety of American economic and diplomatic interests required that a substantial quantity of American capital be channeled to rebuild post-war Europe").
8. GRAETZ, FOUNDATIONS, supra note 1, at 158.
10. Graetz, Original Intent, supra note 7, at 1045; see also GRAETZ, FOUNDATIONS, supra note 1, at 163 (double taxation was not a big issue at the time because tax rates were so low, but during World War I tax rates were increased to finance the war effort).
11. Graetz, Original Intent, supra note 7, at 1054.
13. Graetz, Original Intent, supra note 7, at 1054; see also GRAETZ, FOUNDATIONS, supra note 1, at 163 (stating that, in 1918, the top U.S. individual tax rate was 77%, and the top U.S. corporate tax rate was 10% plus an additional 8% to 60% in excess profits tax).
TABLE 1. – TOTAL TAX: A FOREIGN TAX CREDIT VERSUS A DEDUCTION FROM INCOME FOR SIMILARLY SITUATED TAXPAYERS

<table>
<thead>
<tr>
<th></th>
<th>Foreign Tax Credit</th>
<th>Deduction From Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign Income Tax</td>
<td>$20,000</td>
<td>$20,000</td>
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<tr>
<td>Foreign Tax Deduction</td>
<td>0</td>
<td>$20,000</td>
</tr>
<tr>
<td>Foreign Taxable Income</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>U.S. Tax</td>
<td>$25,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>$20,000</td>
<td>0</td>
</tr>
<tr>
<td>Total U.S. Tax</td>
<td>$5,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Total Tax</td>
<td>$25,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

and the foreign taxes were ignored altogether or if the taxpayer had no foreign income.

TABLE 2. – TOTAL TAX: AN UNLIMITED FOREIGN TAX CREDIT WHEN THE FOREIGN INCOME TAX RATE IS HIGHER

<table>
<thead>
<tr>
<th></th>
<th>Foreign Tax Credit</th>
<th>Ignoring Foreign Income &amp; Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign Income Tax</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>U.S. Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total taxable income</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>U.S. Tax</td>
<td>$30,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>$20,000</td>
<td>0</td>
</tr>
<tr>
<td>Total U.S. Tax</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total Tax Paid</td>
<td>$30,000</td>
<td>$35,000</td>
</tr>
</tbody>
</table>

B. THE REVENUE ACT OF 1921 (1921 ACT)

The 1921 Act created source rules for determining what income was foreign, and limited the amount of foreign tax credit that a taxpayer could receive to the amount of the taxpayer’s U.S. tax liability equal to the percent of income derived from foreign sources. The foreign tax credit limitation would allow the taxpayer in the above example to use the foreign tax credit to offset only one-half of his total U.S. tax liability because one-half of his income was derived from foreign sources. The purpose of

this change was two-fold. First, this prevented people from escaping tax liability on U.S. source income, while still preventing double taxation on foreign income.\textsuperscript{15} Second, by making taxpayers bear the full burden of their foreign and domestic taxes, Congress encouraged businesses to locate in the United States, where the tax rate was generally lower.\textsuperscript{16}

While the 1921 Act aimed to curb abuse by preventing people from escaping tax liability on U.S. source income, it created the opportunity for abuse under the new source rules. The United States determines the nationality of a corporation based on the country of incorporation, and the income of a U.S. parent company's foreign subsidiary was not subject to U.S. tax under the source rules.\textsuperscript{17} The foreign subsidiary's income was not viewed as earned by the parent company, but as earned by the foreign subsidiary, which was not subject to U.S. income tax.\textsuperscript{18} The U.S. taxes were deferred on the foreign subsidiary's income, and the U.S. parent company was taxed only if and when "it received these profits as dividends or it sold the stock of the subsidiary."\textsuperscript{19} Companies used this deferral rule to avoid U.S. taxes on income attributable to U.S. sources by attributing and accumulating that income in the foreign subsidiary instead.\textsuperscript{20} The U.S. company could set up a foreign subsidiary in a country with a lower tax rate than the United States and sell their products to their subsidiary at or just above cost. When the foreign subsidiary eventually sold the product, all of the profit from the product would be attributable to the foreign subsidiary instead of the U.S. parent company.\textsuperscript{21} This method was employed by "Jacob Schick, the inventor of the Schick disposable razor, [who] transferred his patent to a Bermuda corporation that accumulated the royalties" tax free.\textsuperscript{22}

\textbf{C. The Revenue Act of 1962 (1962 Act)}

The CFC concept was introduced by the 1962 Act in an effort to curtail the abuse by U.S. parent corporations deferring or avoiding payment on their U.S. taxes vis-à-vis foreign subsidiaries.\textsuperscript{23} The Senate declared their intent to eliminate tax haven devices, defining a "tax haven device" as one that "exploits the multiplicity of foreign tax systems and interna-
tional agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad." Thus, the 1962 Act left the deferral system largely intact, and targeted only CFC's with tax haven income, also known as Subpart F income.

Subpart F income included passive income and diversionary transaction income. Passive income deferral was disallowed because Congress "believed that no rationale existed for generally delaying the taxation of foreign subsidiary passive income because passive income failed to create competitive business concerns," and because "deferral created an irresistible temptation to shift liquid passive assets offshore because the underlying economic earnings from these assets remained the same regardless of location." Deferral on diversionary sales and services income—income resulting from a sale or services between a CFC and a related party that "lacks any economic nexus to the CFC's country of incorporation"—was likewise disallowed because they were seen as artificial diversions between related parties with no economic meaning. Consequently, the CFC's U.S. shareholders were subject to taxes on their proportionate share of the foreign subsidiary's Subpart F income, and could no longer defer those taxes.

D. THE 1969 DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION (DISC LEGISLATION)

The DISC Legislation was enacted in 1969 as an attempt by Congress to create an international tax system more akin to a territorial tax. Congress defined a DISC as "a domestic corporation, a substantial portion of whose gross receipts arise from, and whose assets relate to, exporting activities." Under the new legislation, tax on the DISC's income from exportation was deferred until the happening of one or more events. If the DISC distributed that income to shareholders, the shareholder disposed of their DISC stock, the DISC liquidated, the corporation no longer fell under the definition of a DISC, or the corporation

24. Graetz, Foundations, supra note 1, at 223 (citing the 1961 hearings).
25. Id. ("However, Congress stopped short of ending deferral for all U.S.-owned foreign subsidiary income. The 1961 hearings convinced Congress that the Administration's more generalized antideferral approach would have placed legitimate U.S.-owned businesses at a competitive disadvantage.").
26. Id.
27. Id.
28. The sale of personal property by a CFC creates subpart F income if: (i) the CFC purchases personal property from, or sells personal property to, a related party (the related-party requirement); and (ii) the CFC neither produces the property within its country of incorporation, nor is the property ultimately sold for use, consumption, or disposition within the CFC's country of incorporation (the lack-of-economic-nexus requirement).
29. Rosenberg, supra note 4, at 7.
30. Id. at 9.
31. Id.
32. Id. at 9-10.
terminated its DISC election.\textsuperscript{33}

The European Union (EU) considered the DISC legislation to be an export subsidy, and therefore a violation of the General Agreement on Tariffs and Trade (GATT).\textsuperscript{34} The EU believed the DISC legislation to be an export subsidy "because 'it allowed indefinite deferral of direct taxes on income from exports earned through business activity conducted in the United States.'"\textsuperscript{35} In 1981, the GATT Council agreed with the EU and declared the DISC legislation to have the characteristics of an illegal export subsidy.\textsuperscript{36} In their 1981 declaration, the GATT Council also:

established a clear-cut territorial test for determining whether a particular income tax measure constitutes an export subsidy; namely, that income attributable to activities taking place outside the territory of the taxing country need not be taxed, and that a decision not to tax such income does not give rise to an export subsidy.\textsuperscript{37}

This ruling gave the United States clear guidelines for how to tailor the DISC legislation so that it would not be considered an illegal export subsidy by the GATT Council.\textsuperscript{38}

\textbf{E. The Deficit Reduction Act of 1984}

Congress enacted the Deficit Reduction Act of 1984, which created the Foreign Sales Corporation (FSC) to replace the DISC legislation.\textsuperscript{39} A FSC was defined as "a foreign corporation set up by a U.S. parent corporation in order to handle export activities," which was generally "a wholly owned subsidiary of a U.S. producer [that] sells the products supplied by its U.S. parent corporation."\textsuperscript{40} A portion of the FSC's income was not taxable in the United States, with the non-taxable portion remaining exempt from taxation even when distributed to the U.S. parent corporation.\textsuperscript{41}

Once again, in 1997, the EU challenged the legislation, calling it an illegal export subsidy.\textsuperscript{42} And again, the appellate body ruled against the United States, holding that "[b]ecause the FSC regime produces lower taxes for those taxpayers who elect this treatment than otherwise would have been due, holding everything constant but the FSC election, it violated the [Agreement on Subsidies and Countervailing Measures]."\textsuperscript{43}

\begin{thebibliography}{99}
\bibitem{33} Id.\textsuperscript{a}
\bibitem{34} Id. at 10.
\bibitem{35} Id. (quoting Charles H. Gustafson et al., Taxation of International Transactions: Materials, Text, and Problems P 11, 130, at 664 (West Group1996)).
\bibitem{36} Id.
\bibitem{38} Id. at 62.
\bibitem{39} Id.
\bibitem{40} Rosenberg, supra note 4, at 11.
\bibitem{41} Id. at 11-12.
\bibitem{42} Paul B. Stephen, Sheriff or Prisoner? The United States and the World Trade Organization, 1 Chi. J. Int'l L. 49, 63 (2000).
\bibitem{43} Id.
\end{thebibliography}
III. THE WORLDWIDE TAX SYSTEM: THE CURRENT SYSTEM EMPLOYED BY THE UNITED STATES

A "pure territorial tax system" would impose an income tax only on income earned within its borders, which would eliminate any possibility of double taxation. The foreign tax credit promotes the current system's "goal of avoiding double taxation [on foreign income] without subsidizing the tax systems of other countries," while "fostering international trade and global investment." Double taxation is currently avoided with the foreign tax credit, and the limitation on the foreign tax credit prevents the subsidization of foreign taxes.

Conversely, a pure worldwide tax system would tax the residents of a country on all of their income regardless of where it was earned. If the United States employed a pure worldwide tax system, the foreign tax credit would be simple, and there would be few provisions of the Internal Revenue Code (I.R.C.) pertaining to foreign income. But, the United States does not use a pure worldwide tax system. No country uses a pure system of either worldwide or territorial taxation. Instead, there is a spectrum of taxation that ranges from territorial to worldwide.

A. SOURCE RULES

In the United States, source rules determine whether a foreign taxpayer's income will be subject to U.S. income tax. The source rules also determine the income a taxpayer may claim as foreign tax credit for foreign taxes paid. The core U.S. source rules can be found in sections 861 through 863 and 865 of the I.R.C. Section 861 categorizes U.S. source income. Section 862 categorizes foreign source income. Section 863 categorizes income that is partially U.S. source income and partially foreign.

44. GRAETZ, FOUNDATIONS, supra note 1, at 14 ("In a pure territorial system, there is no need for a foreign tax credit, because exemption generally eliminates the possibility of double taxation of foreign income.").
45. Andersen, supra note 12, at 169.
46. Id.
47. GRAETZ, FOUNDATIONS, supra note 1, at 13.
48. Id.
49. Id.
51. GRAETZ, FOUNDATIONS, supra note 1, at 40.
52. Isenbergh, supra note 50, at A-12.
53. GRAETZ, FOUNDATIONS, supra note 1, at 40; see also I.R.C. §§ 861-863, 865 (West 2004); Isenbergh, supra note 50, at A-13 ("The statutory rules cover interest, dividends, compensation for services, rents and royalties, gains from sales of property, income from insurance underwriting, and social security benefits," but do not cover "alimony, gain from cancellation of indebtedness, income from noncompetition covenants, compensatory damage recoveries, exemplary damage recoveries, expropriation gains, insurance recoveries, prizes and awards, scholarship grants, treasure trove and like windfalls, and unemployment compensation.").
54. I.R.C. § 861.
55. I.R.C. § 862.
eign source income.56 Finally, section 865 lays out the rules for determining whether income resulting from the sale of personal property is foreign source income or U.S. source income.57

Determining the source of income can be very complex in the case of a multinational corporation.58 Consider the case where:

[A] company manufactures and sells bicycles. Its owners live in Japan; its factory is in Mexico; its main offices are in Canada; its principal sales office is in the U.S., where most of its bicycles are sold; and it is incorporated in Bermuda. The geographical source of income from its bicycle sales is far from clear. On one hand, the Japanese owners supplied the capital to create the company, and the U.S. provides its principal market. But Mexico provides the bulk of its labor, Canada is the locus of its management, and Bermuda provides the legal arrangements enabling the company to exist.59

In all cases, including the one above, the character of the income must be determined before its source can be determined.60 Then, based on the character of that income, the residence of involved parties must be determined.61 After the income is characterized, the source rules determine the source of income based on the economic activity that produced that income.62 Where the income is clearly derived from a foreign territory, the source rules generally rule that the foreign territory is the source for tax purposes.63 When income is derived from intangible assets, such as patents, the source rules may use a range of apportionment, ranging from conventional to arbitrary.64

The character of income must be determined before the source of that income can be ascertained because different source rules apply to different types of income. For example, if the income is characterized as interest, the source of that income is determined based on who pays the interest.65 Therefore, if the interest is paid by a U.S. resident or corporation, the income is considered to be U.S. source income.66 But if a foreign person or corporation pays the interest, the income is deemed

56. I.R.C. § 863.
57. I.R.C. § 865.
58. GRAETZ, FOUNDATIONS, supra note 1, at 41.
59. Id.
61. GRAETZ, FOUNDATIONS, supra note 1, at 41.
63. Id.
64. Id.
65. See also GRAETZ, FOUNDATIONS, supra note 1, at 41.
67. Id.
foreign source income under the source rules. There are several exceptions to this rule. The first exception is that if a foreign branch of a U.S. bank pays interest to the U.S. taxpayer, the income is deemed foreign source even though the payer is a U.S. corporation. Another exception is interest paid by a resident alien or a U.S. corporation that derives 80 percent of its gross income from foreign sources; although the interest is paid by a U.S. resident or corporation to a U.S. resident, under the source rules, that interest is foreign source income.

Another set of rules applies if the income is characterized as a dividend. Dividends from U.S. corporations are usually considered to be U.S. source income, while dividends from foreign corporations are usually considered to be foreign source income. The only exception to this rule is triggered when a foreign corporation is paying a dividend and 25 percent or more of that foreign corporation’s gross income was “effectively connected with the conduct of a U.S. trade or business.” In that case, the amount of foreign source income and U.S. source income will be deemed to be in accordance with the ratio of that income connected with the U.S. trade or business and the corporation’s total income. For example, if a taxpayer were to receive one hundred dollars in dividends from a foreign corporation, which derived 24 percent of its gross income from activities connected with a U.S. business, all of that income would be considered foreign source income. But if that same taxpayer received one hundred dollars in dividends from a foreign corporation, which derived 26 percent of its gross income from activities connected with a U.S. business, twenty-six dollars of that income would be considered U.S. source income, and seventy-four dollars would be considered foreign source income. There are different sets of source rules if the income is from personal services, rentals and royalties, or gain from the sale of property.

The current source rules have been criticized for allowing widespread manipulation. The source rules are frequently manipulated by either re-characterizing income or shifting types of income to different sources. The “most notable example” of shifting a type of income to a different source “is the title passage rule for sales of inventory property, under which parties can elect a low-tax jurisdiction for title passage as a
way to select the country of source of the income from a sale."\(^{75}\)

**B. The Foreign Tax Credit**

Because U.S. citizens are taxed on their foreign income at both home and abroad, the United States gives a foreign tax credit to mitigate or eliminate the effect of double taxation.\(^{76}\) A country may mitigate the effects of double taxation in the following three ways: "(1) by allowing a deduction of source-country taxes; (2) by exempting source-country income from residence-country taxation; and (3) by crediting source-country taxes against residence-country taxes."\(^{77}\) The first method, a deduction, is the least generous because the mere deduction of foreign taxes from income provides little relief from double taxation.\(^{78}\) With a deduction the same income is taxed twice, once at the international level and then again at the U.S. level, with only a slight reduction in taxable income.\(^{79}\) The second method, exempting foreign income from residence-country taxation, is the most generous because it eliminates the possibility of double taxation, and is better known as a territorial tax system.\(^{80}\) The third method, a credit, is the method used by the United States.\(^{81}\)

The foreign tax credit can offset some or all of the U.S. taxes imposed on the foreign income so that, at a minimum, U.S. taxpayers pay taxes at the U.S. tax rate and, at a maximum, at the foreign tax rate.\(^{82}\) This credit is available to U.S. citizens, U.S. corporations, and resident aliens, and it is available for foreign income taxes directly paid or accrued.\(^{83}\) For example, if a U.S. taxpayer who earns income from a foreign country and pays foreign taxes at a rate of 15 percent (when the U.S. tax rate is 25 percent), then that taxpayer pays at least the same rate as a U.S. taxpayer with the same amount of income:

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75. *Id.* at 55-56, 59 (if the sales source "rules had been replaced with activity-based rules . . . , the U.S. income tax liability of multinational U.S. exporters would have increased by between $1.8 and $2.1 billion in 1990." (citing DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON THE SALES SOURCE RULES 2 (1993))).

76. *Id.* at 157; *see also* Gustafson, *supra* note 65, at 254 ("The issue of double taxation is regarded as the most pervasive and troublesome problem in international taxation.").


78. *Id.*; Rosenberg, *supra* note 4, at 1045.


82. *Id.*

TABLE 3. – TOTAL TAX: THE EQUALIZING EFFECT ON TAXPAYERS WITH FOREIGN INCOME VERSUS DOMESTIC INCOME WHEN THE DOMESTIC RATE IS HIGHER

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer With Foreign Income</th>
<th>Taxpayer Without Foreign Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income</td>
<td>$100,000</td>
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<tr>
<td>Foreign Income Tax</td>
<td>$15,000</td>
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</tr>
<tr>
<td>U.S. Income</td>
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<td>$100,000</td>
</tr>
<tr>
<td>Total taxable income</td>
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<tr>
<td>U.S. Tax</td>
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<tr>
<td>Foreign Tax Credit</td>
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<tr>
<td>Total U.S. Tax</td>
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<td>$25,000</td>
</tr>
<tr>
<td>Total Tax Paid</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

On the other hand, a U.S. taxpayer who earns income from a foreign country with a tax rate of 50 percent, when the U.S. tax rate is 25 percent, pays, at most, the higher rate on their foreign income:

TABLE 4. – TOTAL TAX: WHEN FOREIGN TAX RATE IS HIGHER, TAXPAYER WITH FOREIGN INCOME PAYS TAXES AT THAT HIGHER RATE

<table>
<thead>
<tr>
<th></th>
<th>Taxpayer With Foreign Income</th>
<th>Taxpayer Without Foreign Income</th>
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<tbody>
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<tr>
<td>Foreign Income Tax</td>
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<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>$25,000</td>
<td>0</td>
</tr>
<tr>
<td>Total U.S. Tax</td>
<td>0</td>
<td>$25,000</td>
</tr>
<tr>
<td>Total Tax Paid</td>
<td>$50,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

Currently, the foreign tax credit is applied by grouping all of a taxpayer’s foreign income together and all of their foreign taxes together.84

84. Graetz, Foundations, supra note 1, at 159 (In 1921 there was an overall limitation on the foreign tax credit. In 1932 the foreign tax credit was changed so that a taxpayer had to use whichever resulted in a smaller credit, an overall limitation or a per-country limitation. In 1954 the overall limitation was repealed and the per-country limitation was used exclusively until 1960 when, once again the overall limitation was an option. This time, either the overall limitation or per-country limitation could be used, but the taxpayer could use whichever was more favorable. Finally, in 1976, the per-country limitation was repealed, which brought the exclusive use of the overall limitation).
This is called the overall limitation method. Congress has also used a per-country limitation, where a taxpayer separately calculates the foreign tax credit for each country they have paid taxes. Using the overall limitation method, taxes paid to foreign countries with higher rates are averaged with those taxes paid to foreign countries with lower rates, creating a cross-credit between the higher and lower tax rates. For example, assuming a U.S. tax rate of 25 percent, a U.S. taxpayer who earns one-third of her income from a foreign country with a tax rate of 50 percent, one-third from a foreign country with a tax rate of 10 percent, and one-third from the United States will have a larger foreign tax credit and pay less in taxes when the overall limit is applied.

### TABLE 5. – TOTAL TAX: THE DIFFERENCE BETWEEN AN OVERALL LIMIT AND A PER COUNTRY LIMIT ON THE FOREIGN TAX CREDIT

<table>
<thead>
<tr>
<th></th>
<th>Overall Limit</th>
<th>Per-country Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income (Country #1)</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign Income Tax (50%)</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Foreign Income (Country #2)</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign Income Tax (10%)</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total U.S. Taxable Income</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>U.S. Tax</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>$50,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Total U.S. Tax</td>
<td>$25,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Total Tax Paid</td>
<td>$85,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

With an overall limit, the total foreign income is multiplied by the U.S. tax rate to determine the maximum credit. Here, the foreign income is $200,000 and the U.S. rate is 25 percent, so the foreign tax credit is the smaller of $50,000 or the foreign taxes actually paid. Therefore, the maximum credit is $50,000, resulting in a U.S. tax liability of $25,000 after applying the foreign tax credit using the overall limitation method. In contrast, with a per-country limitation, the foreign income from each country is multiplied by the U.S. tax rate to determine the maximum credit per country. In the above example, the foreign income from each

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85. Id.
86. Id. at 158-59.
87. Id. at 159.
88. The per-country limitation was more favorable in circumstances where the taxpayer had losses in one country and income in another. The foreign taxes on the income were creditable without any reduction for the losses, whereas under an overall limitation foreign losses may offset foreign income and reduce the total creditable foreign taxes.

Id. at 159 n.1.
country is $100,000 and the U.S. rate is 25 percent, so the foreign tax credit for each country is the smaller of $25,000 or the taxes paid. As such, the foreign tax credit for Country #1 would be $25,000 and the foreign tax credit for Country #2 would be $10,000, for a total credit of $35,000. Subtracting the $35,000 from the $75,000 U.S. tax results in a $40,000 U.S. tax liability under the per-country limitation method. The overall limitation will always result in a foreign tax credit that is equal to or more than the foreign tax credit computed on a per-country basis, thus making it more favorable to U.S. taxpayers.

C. DEFERRAL OF U.S. TAXES

Unlike a person who invests and earns money abroad and is subject to U.S. income tax on that income (offset only by the foreign tax credit), a person doing business abroad through a foreign corporation does not pay income tax on that income until it is repatriated to the U.S. person or the person sells the stock in that corporation.89 Although the income is eventually taxed, this deferral can lead to a large savings and a decrease in the effective rate of income taxes paid because of the time value of money.90 For example, if a foreign corporation earns $1 million in year one, but can defer paying tax on that money until year ten when it repatriates that money to the United States; assuming the U.S. taxable rate is 25 percent with an inflation rate of 3 percent, the U.S. taxpayer reduces her tax liability to $186,023.48 in present dollars. This represents a savings of $63,976.52 or a reduction in the taxable rate from 25 percent to 18.6 percent.

TABLE 6. – PRESENT VALUE: THE DIFFERENCE BETWEEN PAYING TAX NOW AND PAYING TAX LATER

<table>
<thead>
<tr>
<th></th>
<th>Paying Year 1</th>
<th>Paying Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income Repatriated to U.S.</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>U.S. Tax</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Present Value</td>
<td>$250,000</td>
<td>$186,023.48</td>
</tr>
<tr>
<td>Effective Rate</td>
<td>25%</td>
<td>18.6%</td>
</tr>
</tbody>
</table>

The tax savings that the deferral creates, if not limited, establishes an incentive for taxpayers to invest abroad in tax-free or low-tax countries and defer the repatriation of income.91 To mitigate the benefits of deferral, Congress created anti-deferral regimes targeting individuals generat-

89. GUSTAFSON, supra note 65, at 399.
90. Id; see also FINAL REPORT, supra note 2, at 103.
91. GUSTAFSON, supra note 65, at 400; FINAL REPORT, supra note 2, at 103 ("This creates an incentive for the foreign subsidiary to retain the earnings as long as possible and distorts other business and investment decisions.").
ing income through foreign subsidiaries, which mitigate the effects of
deferral through constructive dividends.92

The first limitation, "the foreign personal holding company provi-
sions," was created to prevent wealthy individuals from channeling pas-
sive investments through foreign countries to avoid or defer the payment
of U.S. income taxes.93 The foreign personal holding company provisions
were also intended to prevent U.S. taxpayers from converting ordinary
income into capital gains income (which is taxed at a lower rate) by ac-
cumulating income in foreign corporations and then passing the income
to the taxpayer as a dividend or as a gain on the sale of stock.94 These
provisions treat stockholders of foreign personal holding companies as
receiving a constructive dividend on their proportionate share of the cor-
poration's undistributed income.95 By imposing a constructive dividend,
the code prohibits deferral and thus eliminates the benefits that go along
with deferral.96

Similarly, deferral is limited by placing a constructive dividend upon a
person owning 10 percent or more of a CFC.97 A CFC is one that is
incorporated abroad with 50 percent or more of either the voting power
or stock value owned by U.S. shareholders.98 The status of a CFC is de-
termined each year, so a foreign corporation may fall under the purview
of this statute one year and not the next.99

Another limitation on deferral is the foreign investment company pro-
visions.100 These provisions were intended to catch taxpayers who
avoided the CFC constructive dividend status by keeping their ownership
of a foreign corporation below 10 percent.101 Instead of imposing a con-
structive dividend, the foreign investment company provisions trigger or-
dinary income instead of capital gains when the foreign investment
company shares are sold.102 Although this does not eliminate deferral, it

92. GUSTAFSON, supra note 65, at 400.
93. Id. at 400 (a foreign personal holding company is one where 50% or more of the
voting power or value is held by five or fewer U.S. individuals, and has 50 or 60%
or more of the income deriving from certain types of income such as passive in-
vestment income).
94. Id. at 401 (Typically, earnings were accumulated in countries with very low to no
income taxes "such as Switzerland, Bermuda, Panama, the Bahamas or Liberia.").
95. Id. at 400-01.
96. Id. at 401.
97. Id. at 403; GRAETZ, FOUNDATIONS, supra note 1, at 227 (a constructive dividend is
placed on certain types of undistributed income, "subpart F income," which in-
cludes "foreign base company income . . . ,insurance income . . . , and certain
income relating to international boycotts and other violations of public policy.").
98. GUSTAFSON, supra note 65, at 407; I.R.C. § 957(a) (West 2004).
99. GUSTAFSON, supra note 65, at 407.
100. Id. at 505.
101. Id. ("The definitional provisions triggering the constructive dividend treatment for
controlled foreign corporations and foreign personal holding companies still left
many possibilities for U.S. investors to avoid current U.S. taxes by investing in
foreign corporations.").
102. Id.
eliminates the tax benefits of deferral by taxing the gains at the higher ordinary income rate instead of the lower capital gains rate.

A further limitation on deferral is the passive foreign investment company.103 There are two types of passive foreign investment companies, qualified electing funds and nonqualified funds.104 On qualified electing funds, a taxpayer may either include their share of the passive foreign investment company earnings not currently received in their current gross income, or elect to defer payment of tax on those earnings, and pay interest on the deferred amount.105 On nonqualified funds, the taxpayer pays tax on the income realized, plus an interest charge equal to the value of deferral.106

IV. THE PROPOSAL: A TERRITORIAL TAX SYSTEM

The President’s Advisory Panel on Federal Tax Reform (Panel) was created by President George W. Bush107 in January 2005.108

The President instructed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth. Since then, the Panel has analyzed the current federal income tax system and considered a number of proposals to reform it...[T]he Panel evaluated a number of reform proposals to find out whether they would meet the President’s goals for current and future generations of Americans.109

The Panel made two recommendations “to reduce economic distortions and improve the fairness of the U.S. international tax regime by creating a more level playing field that supports U.S. competitiveness.”110 The two recommendations were the “Simplified Income Tax Plan” and the “Growth and Investment Tax Plan”:

The Simplified Income Tax Plan would exempt dividends paid from the active earnings of controlled foreign corporations and foreign branches of U.S. corporations from U.S. taxation to provide a simpler and more even treatment of cross-border investment by U.S. multinational corporations. Under the new system, territorial taxation of active foreign business income would be available to all U.S. multinational corporations, not just those that are able to “self-help” themselves to this result or its functional equivalent. The new system is designed to make U.S. businesses more competitive in their foreign operations, while reducing the extent to which tax planning allows some multinationals to achieve more favorable results than

103. Id. at 403.
104. GRAETZ, FOUNDATIONS, supra note 1, at 231.
105. Id.
106. Id.
108. FINAL REPORT, supra note 2, at xiii.
109. Id.
110. Id at 501.
TABLE 7. – SUMMARY OF THE PANEL’S REFORM OPTIONS FOR BUSINESSES

<table>
<thead>
<tr>
<th>Provisions</th>
<th>Simplified Income Tax Plan</th>
<th>Growth and Investment Tax Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rates</td>
<td>Taxed at individual rates (top rate has been lowered to 33%)</td>
<td>Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%</td>
</tr>
<tr>
<td>Recordkeeping</td>
<td>Simplified cash-basis accounting</td>
<td>Business cash flow tax</td>
</tr>
<tr>
<td>Investment</td>
<td>Expensing (exception for land and buildings under the Simplified Income Tax Plan)</td>
<td></td>
</tr>
<tr>
<td>Large Business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rates</td>
<td>31.5%</td>
<td>30%</td>
</tr>
<tr>
<td>Investments</td>
<td>Simplified accelerated depreciation</td>
<td>Expensing for all new investment</td>
</tr>
<tr>
<td>Interest paid</td>
<td>No change</td>
<td>Not deductible (except for financial institutions)</td>
</tr>
<tr>
<td>Interest received</td>
<td>Taxable</td>
<td>Not taxable (except for financial institutions)</td>
</tr>
<tr>
<td>International tax system</td>
<td>Territorial tax system</td>
<td>Destination-basis (border tax adjustments)</td>
</tr>
<tr>
<td>Corporate AMT</td>
<td>Repealed</td>
<td></td>
</tr>
</tbody>
</table>

* Id. at 62.

The Growth and Investment Tax Plan would use domestic consumption as a tax base. This tax system is designed to improve incentives for foreign multinationals to invest in the United States, just as it would improve incentives for domestic investment by domestic investors more generally. The system also levels the playing field between domestic production and imports by assuring that all goods and services consumed in the United States face the same consumption tax burden. Using domestic consumption as a tax base strengthens tax administration by helping to prevent tax avoidance schemes involving foreign parties.112

Essentially, the Simplified Income Tax Plan recommends switching to a territorial tax system, and the Growth and Investment Tax Plan recommends switching to a destination-basis tax system.113

111. *Id.*

112. *Id.* at 105; BLACK’S LAW DICTIONARY 1496 (8th ed. 2004) (Consumption tax is “[a] tax imposed on sale of goods or services to be consumed.”).

113. FINAL REPORT, supra note 2, at 62.
While a worldwide tax system taxes a U.S. citizen on income earned abroad while giving them a foreign tax credit for taxes paid to the foreign country, a territorial system ignores foreign income for U.S. tax purposes and only imposes U.S. taxes on income earned within the United States.\textsuperscript{114} A territorial tax system eliminates the need for the foreign tax credit, because exempting foreign income generally eliminates any possibility of double taxation.\textsuperscript{115} For example, using the first example where a taxpayer had $100,000 of foreign income, and the foreign tax rate was 20 percent and the U.S. tax rate was 25 percent, under the worldwide tax regime the taxpayer's total tax would be $25,000 compared to the $20,000 that would be paid under a territorial tax regime. Under the territorial tax regime, the U.S. taxpayer would fare better, having saved a total of $5,000, or 5 percent, in tax liability for a single year.

**TABLE 8. – TOTAL TAX: THE DIFFERENCE BETWEEN A WORLDWIDE TAX SYSTEM AND A TERRITORIAL TAX SYSTEM**

<table>
<thead>
<tr>
<th></th>
<th>Worldwide Tax</th>
<th>Territorial Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign Income Tax</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Foreign Income Repatriated to U.S.</td>
<td>$100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>U.S. Taxable Income</td>
<td>$100,000</td>
<td>0</td>
</tr>
<tr>
<td>U.S. Tax</td>
<td>$25,000</td>
<td>0</td>
</tr>
<tr>
<td>Foreign Tax Credit*</td>
<td>$20,000</td>
<td>0</td>
</tr>
<tr>
<td>Total U.S. Tax</td>
<td>$5,000</td>
<td>0</td>
</tr>
<tr>
<td>Total Tax Paid</td>
<td>$25,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

V. REASONS FOR THE PROPOSED SWITCH

The Panel reasoned that the switch from a worldwide tax system to a territorial tax system would "reduce economic distortions and improve the fairness of the U.S. international tax regime by creating a more level playing field that supports U.S. competitiveness."\textsuperscript{116} However, there are more issues to consider than economic efficiency alone, including:

- the greatly increased mobility of wealth, and its increased sensitivity to tax differentials, resulting in tax competition between countries, both to attract a larger share of the global tax base and to secure a larger share of the resulting tax revenues; the apparent increasing difficulty of collecting taxes on 'international income'; and the need,

\textsuperscript{114} Id. at 103.
\textsuperscript{115} Graetz, Foundations, supra note 1, at 14.
\textsuperscript{116} Final Report, supra note 2, at 105.
and the technological capacity, for increased cooperation between national tax authorities.\footnote{117} It is also important to consider the complexity of a new tax plan, and its effects on implementation, enforcement, and compliance. Even the Panel admits in their report that “[e]fficiency, competitiveness, and revenue concerns, as well as considerations such as fairness and administrability, all influence international tax policymaking and often are in conflict.”\footnote{118}

A. ADVANCING WORLDWIDE ECONOMIC EFFICIENCY

The main argument for a territorial tax system is that it “promotes economic efficiency better than a worldwide tax system, because a territorial system treats all investment within a particular source country the same, regardless of the residence of the investor.”\footnote{119} Empirical evidence has shown that significant tax savings influence where new investments are made.\footnote{120} Therefore, tax policy can be used to encourage or discourage foreign investment.\footnote{121} Alternatively, tax policy can remain neutral and let efficiency reasons encourage or discourage foreign investment.\footnote{122} While economists promote a free market approach of keeping policy neutral and allowing individuals and corporations to make investment decisions without the influence of taxes imposed, some politicians may prefer to discourage foreign investment to give the impression of supporting American companies and domestic jobs.

There is some debate over what neutrality means in the context of income from foreign investment.\footnote{123} There are three competing types of neutralities that are related to worldwide economic efficiency: capital export neutrality, capital import neutrality, and national neutrality.\footnote{124} A worldwide tax system arguably promotes capital export neutrality better than a territorial tax system because it does not interfere with the decision between investing at home or abroad.\footnote{125} With capital export neutrality, a resident will pay the same amount of taxes whether they invest at home or abroad. Thus a resident is impartial about the choice between a domestic or foreign investment, provided they yield the same

\footnotesize


\footnote{118} Final Report, supra note 2, at 103.

\footnote{119} Graetz, Foundations, supra note 1, at 15-16.

\footnote{120} Gustafson, supra note 65, at 16 (“[T]here is no consensus among economists or other tax policy analysts about many important issues.”).

\footnote{121} Id.

\footnote{122} Id.

\footnote{123} Id.

\footnote{124} Graetz, Tillinghast Lecture, supra note 9, at 270; cf. Gustafson, supra note 65, at 16; Graetz, Foundations, supra note 1, at 23 (“Achieving such efficiency typically is said to involve two kinds of neutralities,” capital import neutrality and capital export neutrality.).

\footnote{125} Graetz, Foundations, supra note 1, at 14.
rates of return before taxes.\textsuperscript{126} This neutrality standard has been generally favored by the U.S. Treasury Department.\textsuperscript{127} But capital export neutrality is not easy to achieve because if the source country imposes a higher tax than the country of residence, the country of residence would need to give a credit for the full amount of source country tax to achieve capital export neutrality.\textsuperscript{128} It would be unreasonable to expect the country of residence to give a credit for foreign tax paid in excess of the domestic tax because that would be tantamount to the country of residence subsidizing the source country's treasury.\textsuperscript{129} Because the United States does not have a pure worldwide tax system, and there are limitations on foreign tax credit, capital export neutrality is diminished, making the taxation system less efficient.\textsuperscript{130}

With capital import neutrality or competitive neutrality, all of the companies in a particular industry, operating in a given country, would be taxed at the same rate.\textsuperscript{131} This neutrality standard has generally been favored by multinational business enterprises.\textsuperscript{132} There are three conditions required to achieve capital import neutrality: "the source country must tax domestic and foreign investors in the same manner; no non-resident withholding tax should be imposed; and the residence country should not tax foreign-source income; i.e., it should employ the exemption method."\textsuperscript{133}

National neutrality "ensures that total returns on capital . . . are the same whether the investment is made in the United States or abroad."\textsuperscript{134} This neutrality standard has generally been favored by labor unions "because they believe that this approach discourages U.S. corporations from moving their operations abroad and thus maximizes domestic employment."\textsuperscript{135} Under the national neutrality standard, a U.S. taxpayer would owe the same amount to the U.S. treasury regardless of whether the tax-

\begin{flushleft}
\textsuperscript{126} Graetz, Tillinghast Lecture, supra note 9, at 270; Gustafson, supra note 65, at 17 (“Stated differently, under capital-export neutrality, the U.S. investor pays the same total (U.S. and foreign) tax on all income, regardless of where the income is earned.”).
\textsuperscript{127} Gustafson, supra note 65, at 17; Graetz, Foundations, supra note 1 at 25-26 (“The idea that CEN [Capital Export Neutrality] should be the linchpin of U.S. international tax policy was first voiced by the Kennedy administration in connection with its 1962 international tax proposals, proposals that led to the adoption of Subpart F.”).
\textsuperscript{128} Easson, supra note 118, at 423.
\textsuperscript{129} Id.
\textsuperscript{130} Graetz, Foundations, supra note 1, at 14, 24 (“To fully implement CEN, the foreign tax credit should not be limited to the residence country's tax rate; income of foreign subsidiaries should be taxed currently by the residence country, and no cross crediting of foreign taxes on income taxed differently at source should be allowed.”).
\textsuperscript{131} Gustafson, supra note 65, at 17.
\textsuperscript{132} Id. (multinational business enterprises have used this neutrality standard to argue that all foreign source income should be exempt from U.S. taxes “to increase the competitiveness of U.S. enterprises operating abroad.”).
\textsuperscript{133} Easson, supra note 118, at 426.
\textsuperscript{134} Gustafson, supra note 65, at 17.
\textsuperscript{135} Id. at 18.
\end{flushleft}
payer earned that income at home or abroad. With this standard, "foreign taxes should be deductible (rather than creditable) because net foreign-source income after payment of foreign taxes should be equal to net U.S.-source income before payment of U.S. tax." While this standard would increase U.S. tax revenues, it would not encourage the most efficient use of international resources.

Another consideration in the promotion of economic efficiency is tax fairness. There are two measures of tax fairness, horizontal equity and vertical equity. Horizontal equity occurs when two similarly situated taxpayers have the same tax burden. On the other hand, vertical equity occurs when a taxpayer with more income has a greater tax burden than a taxpayer with less income. Capital export neutrality is horizontally equitable because all U.S. taxpayers with the same amount of income (similarly situated) have the same tax burden. Capital export neutrality is also vertically equitable because the taxpayer pays tax on their total income. Conversely, capital import neutrality is not horizontally equitable because it could result in two taxpayers with the same income level bearing different tax burdens if their income comes from different sources.

The system of worldwide taxation "likely distorts economic decisions to a greater extent and is more complex than a system that simply exempted active foreign business income from U.S. tax." The source rules and system of deferral creates an incentive for corporations to arrange their affairs to avoid the payment of U.S. income tax, rather than to make the most economically efficient decisions.

There is no consensus on what economic efficiency is; therefore, there is no way to determine how to best accomplish economic efficiency. A worldwide tax system arguably promotes capital export neutrality because it results in the same U.S. tax liability regardless of the source of

136. Id.
137. Id. at 17.
138. Id. at 17-18.
139. Id. at 23; Graetz, Foundations, supra note 1, at 19 ("The credibility of our tax system depends upon the perception that revenue is being raised fairly and that the intended tax base is protected from avoidance.").
140. Gustafson, supra note 65, at 23.
141. Id.
142. Id.
143. Id.
144. Id. at 24.
145. Id. at 23.
146. Final Report, supra note 2, at 104.
147. [T]he tax planning opportunities engendered by the complicated rules surrounding deferral may allow some corporations to help themselves to results that are more favorable than territorial taxation. As a result, the active foreign income of some multinationals is taxed more heavily under the current system than it would be in a predominately territorial system, while similar income earned by other multinationals is functionally exempt from U.S. tax through "self-help."

Id.
the income.\textsuperscript{148} It can be argued, however, that a territorial tax best promotes capital import neutrality because it prevents different companies in an industry within a country from being taxed at different rates merely because the company is a resident of a foreign country.\textsuperscript{149}

B. Simplification

A territorial tax is seemingly simpler because instead of applying a myriad of complex rules to foreign income, it simply ignores it. In fact, some economists believe that the complexity of the worldwide tax system "discourages U.S. companies from bringing foreign profits home."\textsuperscript{150} According to the Panel, "[d]espite its complexity, the current U.S. system raises relatively little revenue, at a high cost, from the foreign income of U.S. multinational corporations."\textsuperscript{151} Complex rules make compliance more difficult for taxpayers by increasing compliance costs and also make administration more difficult and costly for the service.\textsuperscript{152} The foreign tax provisions are some of the most complex provisions in the entire U.S. tax code.\textsuperscript{153}

The switch from a worldwide tax to a territorial tax would eliminate the need for foreign tax credits, anti-deferral regimes, and source rules, some of the most complex features of the current international tax system in the United States.\textsuperscript{154} But, if the United States switched to a territorial tax system, a new set of rules would need to be adopted to curb the deterioration of the tax base, rules that may mitigate any reduction in complexity gained from the switch.\textsuperscript{155} The Panel admits that with either a worldwide

\textsuperscript{148} GRAETZ, FOUNDATIONS, supra note 1, at 14.
\textsuperscript{149} Easson, supra note 118, at 426.
\textsuperscript{151} FINAL REPORT, supra note 2, at 104 (noting that "arranging affairs to avoid U.S. taxation of foreign earnings is costly for U.S. multinationals, and these costs differ across companies. The result is a system that distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning.").
\textsuperscript{152} GUSTAFSON, supra note 65, at 24.
\textsuperscript{153} Id.
\textsuperscript{154} GRAETZ, FOUNDATIONS, supra note 1, at 16.
\textsuperscript{155} Id.; see, e.g.,

The Simplified Income Tax Plan also would modify the definition of business subject to U.S. tax to ensure businesses that enjoy the benefit of doing business in the U.S. pay their fair share. Under current law, residency is based on the place a business entity is organized. . . . This rule may give businesses an incentive to establish legal place of residency outside the United States to avoid paying tax on some foreign income. . . . To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." The new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort.

FINAL REPORT, supra note 2, at 135.
tax system or a territorial tax system, "the rules that determine which types of foreign income are taxed, when the income is taxed, and what credits are available to reduce that tax are complex and can be the source of a great deal of tax planning activity."\textsuperscript{156}

C. OTHER COUNTRIES USE A TERRITORIAL TAX SYSTEM

If all the other countries jumped off a bridge, would the United States jump too? The Panel implies just that, supporting their proposal to switch from an international tax system to a territorial tax system by stating that over "half of the world's major developed economies" no longer use worldwide tax systems.\textsuperscript{157} But many "countries now use predominately 'territorial' tax systems that exempt all or a portion of foreign earnings from home-country taxation."\textsuperscript{158} The only examples cited by the Panel, however, are France and the Netherlands, which "exempt foreign dividends," and Canada, which "effectively administers a territorial system" because it "exempts foreign dividends from countries with which it has tax treaties from home taxation" and "has tax treaties with many countries."\textsuperscript{159}

VI. ARGUMENTS AGAINST A TERRITORIAL TAX SYSTEM

While it is arguable a territorial tax system is more efficient and simpler than a worldwide tax system, there are other considerations.\textsuperscript{160} These other considerations include preserving the tax base and the promotion of equity.

A. PRESERVING THE U.S.'S TAX BASE

The biggest fear with a territorial tax system is that taxpayers will invest their money in tax havens or foreign countries with lower or no income tax.\textsuperscript{161} If investment is shifted away from the United States, and foreign income is not taxed, the amount of income taxed by the United States, the tax base, would be reduced.\textsuperscript{162} A smaller tax basis results in

\textsuperscript{156} \textit{Final Report, supra} note 2, at 103.
\textsuperscript{157} \textit{Id.}
\textsuperscript{158} \textit{Id.} (Note that the President's Advisory Panel does not say that a majority of the world's major developed economies use a territorial tax system, instead they say they do not use a worldwide tax system. They also describe the system as a predominately territorial tax, which indicates that these countries do not in fact use a territorial tax systems).
\textsuperscript{159} \textit{Id.} at 132.
\textsuperscript{160} Taxing citizens and residents on their worldwide income arguably also reflects the notion that citizenship and residency bestow important benefits (e.g., legal and technical business infrastructure, military protection, passport and embassy services) that citizens and residents should be made to pay for, regardless of where they might earn their income. \textit{Graetz, Foundations, supra} note 1, at 15.
\textsuperscript{161} \textit{Id.}
\textsuperscript{162} \textit{Id.}
less tax revenue because there are fewer dollars of income being taxed, but the tax is imposed at the same rate.

A worldwide tax base better preserves the tax base of the residence country than a territorial tax system.\textsuperscript{163} The fear is that, if foreign-source income is entirely exempt from taxation, then resident taxpayers will shift investment and income into tax havens, eroding the residence-country tax base. For this reason, even those countries that employ predominately territorial systems (e.g., France) typically provide for current taxation of certain types of foreign source income that may easily be earned in tax havens—a significant departure from “pure” territorial taxation.\textsuperscript{164}

The U.S. government generates tax revenue based on the amount of income that is taxed, and the need for tax revenue is high on the political agenda. When changes to the tax code would result in less tax revenue instead of more tax revenue “even when supported by sound economic analysis and income tax theory,” the change is met with much resistance.\textsuperscript{165} One solution may be an increase in the tax rate, but any talk of an increase in taxes may be met with even more resistance than the talk of decreased tax revenue.

B. A Worldwide Tax System Promotes Equity

A worldwide tax system is arguably more horizontally and vertically equitable than a territorial tax regime. Horizontal equity is achieved when two similarly situated taxpayers, taxpayers with both the same amount and type of income, pay the same amount in taxes.\textsuperscript{166} By taxing the foreign income and giving a foreign tax credit, a worldwide tax system ensures that a citizen with foreign income will not pay fewer taxes than a similarly situated taxpayer without foreign income.\textsuperscript{167} Vertical equity is achieved when, of two taxpayers with different amounts of income, the one with the greater amount of income pays more in taxes.\textsuperscript{168} By including foreign income in the amount of a citizen’s taxable income, a worldwide tax system ensures that a citizen who has more income pays more in taxes.\textsuperscript{169}

\textsuperscript{163} Id.
\textsuperscript{164} Id.
\textsuperscript{165} In the case of proposals that reduce U.S. taxes on foreign persons, the direct beneficiaries of the proposals (foreign persons) cannot vote. In fact, because foreign persons cannot vote, they are a tempting target for tax increase proposals by U.S. political leaders who need tax revenue but do not want to alienate their voting constituents. \textit{Gustafson, supra} note 65, at 27.
\textsuperscript{166} Id. at 23.
\textsuperscript{167} Id. at 14.
\textsuperscript{168} Id. at 231.
\textsuperscript{169} Id. at 15.
VII. CONCLUSION

While the idea of a territorial tax is interesting to explore academically, that is probably as far as the idea will ever get. Even if it is a great idea, and a seemingly perfect solution to the U.S. tax woes, it will probably never happen for a couple of reasons. First, because of the perceived threat to the tax base, and subsequent increase in taxes, U.S. politicians would probably not support a switch from a worldwide tax to a territorial tax system, and if they did, their constituents would probably not support them. Second, in order for a proposed reform to have a chance at being implemented, it should meet four conditions: “it should not involve too great a change in a country’s total tax yield; it should not require major re-negotiation of existing tax treaties; it should not be excessively complex to draft or difficult to apply; it should be capable of being implemented unilaterally.”170 A territorial tax system does not meet all four of these conditions.

Either the U.S.’s total tax yield will decrease or the tax rate will increase.171 Under a territorial tax system, foreign source income would no longer be subject to domestic taxation. This decreases the total amount of income that U.S. taxpayers must pay taxes on; therefore, holding the tax rate constant, total tax yield will decrease.172 The most obvious way to make up the decrease in tax revenue would be to increase the tax rate.173 In theory, the switch from an international tax system to a territorial tax system would make no difference in tax revenue because the tax payable on the foreign source income is offset by the foreign tax credit. Yet, the foreign tax credit only offsets domestic tax up to an amount equal to the foreign tax paid. If the foreign tax rate is less than the domestic tax rate, U.S. taxpayers are still paying U.S. income taxes.

A territorial tax system would most likely be complex to draft or difficult to apply. Source rules would still be needed to distinguish U.S. source income, which would be taxable, from foreign source income, which would not be taxable. These source rules would have to be drafted even more carefully than they currently are, because a taxpayer would have even more of an incentive to get their income into the foreign source category. The foreign source category would be more coveted than it currently is because instead of receiving deferral or a U.S. tax credit, the income would be totally exempt from U.S. taxation.

170. Easson, supra note 118, at 442.
171. It has also been suggested that the switch would lead to an increase in tax revenues.
173. Response to the Final Report of the President’s Advisory Panel on Federal Tax Reform, (U.S. taxpayers are also concerned that the territorial tax system would lead to an increase instead of a decrease in taxes).
The unilateral implementation of a territorial tax system would almost certainly not pose a problem. The new system would involve the United States not imposing taxes on foreign source income and would not require any action by foreign countries. Foreign countries would probably support the switch because a territorial tax may be viewed as encouraging foreign investment. Additionally, with a territorial tax system, the United States could not be accused of having any types of export subsidies.

175. Rosenberg, supra note 4, at 10.