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INTERNATIONAL TAXATION

Preface: The Fundamental Problem of
International Taxation

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International taxation is one of the most important but least studied topics in all of tax; indeed, it may be one of the most undeservedly ignored topics in all of law. Combined, U.S. imports and exports now equal roughly 20% of U.S. gross domestic product.¹ For most countries, the figure is even higher: about 45% for Germany and the United Kingdom, 65% for Mexico, and 70% for Canada.² KPMG, which employs some of the symposium authors, counts more tax lawyers in its international tax division than in its domestic tax division. Nevertheless, only half of U.S. law schools regularly offer even one

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1. U.S. DEP'T OF COMMERCE (ECON. AND STATISTICS ADMIN.), STATISTICAL ABSTRACT OF THE UNITED STATES: 2000, at 451 (120th ed. 2000).

2. *Id.* at 831, 853.

course on the subject.³ Most U.S. tax policy analysis assumes a closed universe—that is, a U.S. tax system without boundaries.

One of the reasons the topic is so important in the real world and yet so little loved of scholars is that international tax law is both excruciatingly complex and fundamentally arbitrary. The U.S. rules resemble sedimentary rock—accreting over time, pocked with fossils, and with little structure to aid in understanding. Scholars make their reputations by rationalizing complexity. International tax seems, on its face, to offer little opportunity for productive theorizing. Yet it is this very lack of theoretical foundation that makes the rules so practically important. Our individual tax rules, particularly as to income from goods and services, have been polished to a high sheen against the ideal of a comprehensive tax base, our corporate rules against the ideal of double taxation. As a result, purely domestic taxpayers can often safely live their lives and run their businesses without consulting tax advisors until it comes time to file returns. By contrast, the international tax rules are full of traps for the unwary and opportunities for the well-advised—a context in which practitioners routinely add substantial value and receive commensurate return.

One of the principal reasons for this irrationality is simple: there is as of yet no consensus as to how the tax base represented by the world economy should be shared among the world's roughly 200 nations. Currently, for the most part, each government decides unilaterally what portion of that base to claim. As a result, some parts of the world economy are taxed once, some twice, some many times, and some not at all. The United States attempts to resolve some of the resulting problems by treaty, but (1) we lack treaties with many important trading partners,⁴ (2) treaties merely limit taxation, they do not address problems of otherwise untaxed income, and (3) all of our tax treaties are bilateral and unique. A coherent, multilateral approach to basic tax jurisdiction issues does not seem likely in the near future.

At least as important for American tax scholars is the fact that the U.S. rules are themselves profoundly arbitrary. As a technical matter, the U.S. income tax system uses "source" of income to define the boundaries of this country's assertion of primary jurisdiction to tax.⁵

3. An e-mail survey of ABA-accredited U.S. law schools made under the supervision of one of the authors disclosed that 52% of the 128 schools responding offered at least one course in international taxation in academic year 2000–2001 or 2001–2002.

4. *E.g.*, Taiwan and Brazil.

5. See Robert Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 977–80 (1997); Nancy Kaufman,

United States citizens, residents, and corporations are generally subject to tax on their world-wide income, but are permitted a credit for foreign taxes paid on their foreign source income.⁶ In effect, we assert primary jurisdiction to tax U.S. source income, but tax foreign source income of U.S. citizens, residents, and corporations only if some other country chooses not to do so. Nonresident U.S. citizens may be eligible to exclude entirely the first roughly \$80,000 of their foreign source earned income; again, the availability of this exclusion may depend on whether some other country chooses to tax that income.⁷ Nonresident aliens and foreign corporations are subject to two U.S. income taxes. The first is the ordinary Code Section 1 or Section 11 tax on income effectively connected with a U.S. trade or business ("effectively connected income")

Common Misconceptions: The Functions and Framework of "Trade or Business Within the United States," 25 VAND. J. TRANSNAT'L L. 729, 753-54 (1993); Linda Galler, *An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property*, 52 U. PITT. L. REV. 521, 526 (1991); Robert Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 49 (1989).

Some maintain that the United States effectively uses a residence-based jurisdictional test with respect to investment income. See, e.g., Alvin Warren, *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 132-35 (2001); Reuven Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) [hereinafter Avi-Yonah, *Electronic Commerce*] ("The Benefits Principle . . . assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions."); Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1305 (1996) ("International consensus allocates active business income to the jurisdiction from which it derives (the source jurisdiction) and passive income to the jurisdiction in which the investor resides (the residence jurisdiction)."; the United States follows the consensus de facto); Alvin Warren, *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 599-600 (1995). The mechanical structure of the system, however, is source-based.

Surprisingly, this role of the sourcing rules is not always explicitly acknowledged. The ALI Income Tax Project on International Taxation noted that "source jurisdiction is considered primary," but failed to elaborate this premise any further. AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 7 (1986). The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity 397 (May 29, 1985) [Treasury I] recognized that "the source of income rules define the circumstances under which the United States is willing to concede primary jurisdiction to a foreign country to tax U.S. citizens and residents on income because that income is deemed to be earned in that foreign country." Treasury I did not, however, assert such a role for the source rules generally. Nor is such a role acknowledged in the leading treatises and casebooks. See, e.g., JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 5.1 (2d ed. 2000); BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS ¶¶ 65.1.1-65.1.3 (1998); CHARLES GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 12, 61-62 (1997); RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 12-19 (2001); MICHAEL MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 1-1 to 1-4 (1992); CHARLES KINGSTON, INTERNATIONAL TAXATION 15-23 (1998).

6. BITTKER & LOKKEN, *supra* note 5, at ¶ 65.1.2; I.R.C. §§ 901, 904.

7. I.R.C. § 911.

or ECI). The second is a flat 30% tax, with many exceptions, collected from the payor on U.S. source income other than ECI or income from sales.⁸ This second tax, of course, is explicitly restricted to U.S. source income. Although the first is not, nonresident aliens and foreign corporations who pay tax on ECI are, again, permitted a credit for foreign taxes paid on their foreign source ECI.⁹ In effect, therefore, the sourcing rules define the boundaries of the United States' assertion of primary jurisdiction to tax for both domestic and foreign taxpayers.

Unfortunately, the U.S. sourcing rules are as obscure and arbitrary as any in the Internal Revenue Code, attracting even less scholarly attention than other international tax issues. Dividends from the stock of U.S. corporations, for example, are generally U.S. source,¹⁰ but gains from the sale of the same stock by nonresident aliens and foreign corporations are generally not,¹¹ even though both represent income from precisely the same type of investment. Conversely, gains from the sale of the stock of foreign corporations by U.S. citizens and residents are U.S. source,¹² while dividends paid by those same foreign corporations are not.¹³ Gains from the sale of inventory are sourced, in effect, where the risk of loss passes,¹⁴ a factor largely under the control of the parties to the sale. As one of our Symposium articles explores in greater detail, the source of telecommunications satellite income depends in significant part on where the papers of incorporation for the subsidiary owning the satellite are filed. The result is an environment in which aspects of a transaction that are relatively unimportant in any substantive sense can determine whether income streams fall within or beyond the boundaries of the United States' assertion of primary jurisdiction to tax.

Many countries, said to use "territorial" systems because they tax only income from sources within their territories, rely even more heavily on sourcing to define the boundaries of their tax systems. Unfortunately, there is inadequate consensus with respect to sourcing rules.¹⁵ Moreover, sourcing is not the only technique used to define tax system boundaries. Value added tax (VAT) systems generally divide up

8. I.R.C. §§ 871, 881, 882.

9. I.R.C. § 902.

10. I.R.C. § 861(a)(2)(A).

11. I.R.C. § 865(a).

12. *Id.*

13. I.R.C. §§ 861(a)(2)(B), 862(a)(2).

14. I.R.C. § 865(b).

15. *See, e.g.,* HUGH AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 431-58 (1997).

the same economic pie by looking to the place of ultimate sale or provision of goods or services—a factor far less subject to arbitrary taxpayer manipulation.¹⁶ Professor Avi-Yonah has suggested adoption of a similar regime for the income taxation of electronic commerce.¹⁷ States within the United States, facing the same problem at a subnational level, generally use a residence-based system for individuals¹⁸ and a unitary system with formulary allocation for businesses.¹⁹ Unitary taxation applies allocation formulae, typically based on employment, sales, and property, to the whole of an interjurisdictional tax base;²⁰ California experimented unsuccessfully with such a system in the 1980s.²¹ At least one commentator has suggested that the United States unilaterally adopt such a system;²² the European Union, interestingly enough, is actively considering such a system, at least with respect to its internal base.²³ An even more radical solution would be revenue sharing, where administration is collective and the resulting revenues are then returned to participating jurisdictions by formula.²⁴

16. See ALAN SCHENK & OLIVER OLDMAN, *VALUE ADDED TAX: A COMPARATIVE APPROACH IN THEORY AND PRACTICE* 31, 78, 227 (2001).

17. See generally Reuven Avi-Yonah, *Electronic Commerce*, *supra* note 5, at 507. For a criticism of Avi-Yonah's proposals, see Stanley Katz, *International Taxation of Electronic Commerce: Evolution Not Revolution*, 52 *TAX L. REV.* 655 (1997).

18. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶¶ 20.03, 20.04 (2001).

19. *Id.* at ¶ 8.03 (explaining that separate accounting is generally permitted only if formulary allocation does not fairly represent the extent of the taxpayer's business activities in the state). See generally *id.* ch. 8.

20. See generally John Warren, *Income Taxes: Principles of Formulary Apportionment*, *BNA TAX MGMT. PORTFOLIO* No. 1150 (1995).

21. In the face of European opposition, California was forced to retreat from a pure unitary system by adding a "water's-edge" election. See Roy Crawford & Russell Uzes, *California Franchise and Corporation Income Taxes*, *BNA TAX MGMT. PORTFOLIO* No. 1910, at 37–39 (2000).

22. See, e.g., Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 *TEX. L. REV.* 1401, 1407–09 (1996).

23. *TaxEXPRESS* (Oct. 29, 2001) (restricted online tax news service published by the Federation of Tax Administrators and the Multistate Tax Commission, copy on file with the authors).

24. Revenue sharing has been used in the United States to finance both state and local governments. See, e.g., OFFICE OF STATE AND LOCAL FIN. (DEP'T OF THE TREASURY), *FEDERAL-STATE-LOCAL FISCAL RELATIONS: REPORT TO THE PRESIDENT AND THE CONGRESS* viii–ix (1985); J. RICHARD ARONSON & JOHN L. HILLEY, *FINANCING STATE AND LOCAL GOVERNMENTS* 48–85 (4th ed. 1986). It is perceived as solving a problem known as "vertical fiscal imbalance," summarized by George Break as follows: "Whereas tax revenues can be most equitably and efficiently raised by the higher levels of government, . . . the proceeds can often be spent most effectively at the lower levels of government." GEORGE F. BREAK, *FINANCING GOVERNMENT IN A FEDERAL SYSTEM* 80 (1980); see also House Comm. on Gov't Operations,

The interaction of these various boundary definitions can produce peculiar results. Take, for example, income from sales. As we have noted, VAT systems generally tax by place of sale. This means they tax imports but exempt exports. The U.S. self-produced inventory sourcing rules, by contrast, require that the portion of sales profits attributed to production activity be sourced by place of production while permitting the portion attributable to sales activities to be sourced by place of passage of title—a factor largely within taxpayers' control. The effect is that products manufactured in the United States and exported to VAT jurisdictions are likely to be double-taxed, at least in part. The production activities will be taxed in the United States while the entirety will be taxed again in the VAT jurisdiction. Conversely, products manufactured in VAT jurisdictions and exported to the United States will be undertaxed; the exporting nation relinquishes jurisdiction entirely while the United States only taxes a fraction of the resulting profits. In effect, this particular interaction results in a subsidy for VAT-to-U.S. sales and a corresponding disincentive for U.S.-to-VAT sales.

Further complicating the problem is the inherent complexity of the real world. Consider the following transactions:

A Dutch multinational builds a power plant in Mexico to supply power to the Mexican and California markets. Two U.S. companies are building the pipelines that will run through Arizona and California and ultimately reach Mexico to supply fuel to the plant.²⁵

A Japanese multinational provides Hindi-language television content to India and other Hindi-speaking locations via a satellite built by a U.S. multinational, uplinked from a ground station in Singapore, and physically located outside the earth's atmosphere.²⁶

Federal-State-Local Relations: Federal Grants in Aid, H.R. Rep. No. 2533, 85th Cong., 2d Sess., at 24 (1958) ("The most productive tax sources can only be reached equitably and efficiently by the Federal Government, due to the national character of industrial organization and the threat of interstate tax competition."). It has been used even more widely in other countries. See, e.g., BRIAN GALLIGAN, A FEDERAL REPUBLIC: AUSTRALIA'S CONSTITUTIONAL SYSTEM OF GOVERNMENT (RESHAPING AUSTRALIAN INSTITUTIONS) 214-38 (1995); David Perry, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change*, CANADIAN TAX PAPER No. 102, at 117-72 (1997).

25. *InterGen Signs Power Purchase Agreement for Rosarito Power Facility*, BUS. WIRE, July 18, 2000, available at LEXIS, Nexis Library, US News Combined File; see also *InterGen, La Rosita*, <http://www.intergen.com/rosarito.html> (2001).

26. See Sony India Ltd., *Welcome to Sony India Ltd.*, <http://www.sony.co.in/television.html> (2001). Television viewers can access Hindi program information at <http://www.setindia.com.html>. See also *Sony to Develop Software in India*, INDIAN TECHONOMIST, <http://dxm.org/techonomist/news/16apr96.html> (Apr. 16, 1996).

A Bermuda-based multinational (the former employer of one of this issue's authors) offers a global network of submarine and terrestrial fiber-optic cable to enable its customers to meet their communications needs through a high-speed broadband network.²⁷

In each case, multinational participants generate income streams from multiple jurisdictions. The parties themselves divide up those streams by contract. The possibly relevant taxing jurisdictions, however, must divide up the resulting tax base pursuant to generally applicable rules. In formulating those rules, they must deal with the prospect, not present in a purely closed tax universe, that competing jurisdictions may game-play against the rules, offering more favorable tax treatment in order to obtain other advantages. Typically, the rule-making bodies operate at a serious informational disadvantage; taxpayers often have a substantially more complete understanding of the way competing tax systems interact.

This *Loyola of Los Angeles International & Comparative Law Review* Symposium issue is the first in what we hope will be many symposia on international taxation. Our purpose is to provide a more visible forum for U.S. scholars and practitioners who are willing to tackle the difficulties of this vitally important topic. Initially, we expect to publish more technical, less theoretical pieces. But over time, our hope is that theoretical order may emerge out of technical chaos.

Our first attempt is representative of the technical international tax issues that currently affect global business. Two articles focus on the problem of tax competition. Telford and Ures provide an overview of the approaches that developing and developed countries take when using their tax systems to attract investment, highlighting the use of tax holidays and targeted tax incentives by countries to attract industrial investment. Deprez takes a more critical look at the same issue, exploring the benefits of tax incentives to the country offering them from an econometric perspective.

On a different note, Gisby and Keller explore the challenges faced by the international communications industry and other related industries in responding to regulations proposed by the Internal Revenue Service. These regulations represent a first attempt by the IRS

27. See George A. Chidi, Jr., *Global Crossing Completes World Network*, NETWORK WORLD FUSION NEWS, <http://www.nwfusion.com/news/2001/0622globcross.html> (June 22, 2001). Information about Global Crossing's business can be accessed at <http://www.globalcrossing.com.html>.

to prescribe particularly challenging rules—rules for the taxation of industries whose businesses completely transcend jurisdiction. This article illustrates many of the pitfalls of the relatively arbitrary U.S. approach to defining the boundaries of a national tax system.

One of the most popular attractions at the Disney theme parks is “It’s a Small World.” The ride culminates with a scene depicting people from all the cultures of the world dancing and singing together in what can best be described as a global cultural *mélange*. While the social and political benefits of this *mélange* have yet to be achieved, it is clear that the global business community has been operating in just such a global village for some time.

Tax policy has yet fully to adapt to this extraordinary development. While business is already truly global, the world’s tax regimes are still largely parochial and uncoordinated. As a result, tax considerations routinely drive the structuring of international businesses and transactions. The resulting dead-weight loss to the world economy must be staggering. The task of reducing that dead-weight loss probably represents the next major challenge to the international economic community. We hope to participate in meeting that challenge.