POINT & COUNTERPOINT: TAX ON WORLDWIDE INCOME

INTRODUCTION: Although U.S. taxpayers are subject to U.S. taxation on worldwide income, they can defer U.S. taxation of income from foreign business operations by conducting these operations through foreign corporations. This makes the system a hybrid—neither truly worldwide nor truly territorial. The participants in this issue's Point/Counterpoint agree that the current hybrid system is undesirable but differ on why. Cliff Fleming, Bob Peroni and Steve Shay want to see an end to deferral. They feel that all income from the activities of U.S. taxpayers ought to be taxed currently by the U.S., whether that income is earned directly by a U.S. person or indirectly by a corporation controlled by a U.S. person—true worldwide income taxation. By contrast, Herm Bouma feels that foreign business income earned by corporations should never be subject to U.S. taxation—he favors territorial taxation for corporations. As our economy slows and as debate on the extraterritorial income exclusion panned by the WTO continues over the coming months, the debate over the proper level of U.S. taxation of foreign income is sure to continue. The arguments made here by Messrs. Fleming, Peroni, Shay and Bouma will help to chart a course through that debate.

POINT: THE UNITED STATES SHOULD TAX U.S. CORPORATIONS ON THEIR WORLDWIDE INCOME

by J. Clifton Fleming, Jr., Provo, UT, Robert J. Peroni, Washington, DC, and Stephen E. Shay, Boston, MA

The major approaches by which the tax system of a country (the "residence country") can handle income earned by its residents in a foreign country ("foreign-source income") are a worldwide system and a territorial, or exemption, system. In a true worldwide system, a residence country imposes its regular income tax on foreign-source income when it is earned. Of course, the foreign country where the income was produced (the "source country") also imposes a tax. To ameliorate the resulting double taxation, the residence country credits the source country tax against the residence country tax (the "foreign tax credit"). But to protect its tax base from erosion by credits for high source country taxes, the residence country caps the credit at the amount of residence country tax. If, however, the source country is a low-tax jurisdiction, the foreign tax credit allows the residence country to collect a "residual tax" equal to the amount by which the residence country tax exceeds the source country tax.

Under an exemption system, the residence country imposes no tax on its residents' foreign-source income. In other words, foreign-source income is exempt from the residence country tax and bears only the source country tax.

The United States operates a worldwide system that deviates from the optimal model described above in one critical aspect. If U.S. residents earn income through active business operations carried on by foreign corporations in low-tax source countries, the U.S. residents generally pay no residual U.S. tax until they either receive dividends or sell their shares. This phenomenon is referred to as "deferral." Deferral obviously decreases the present value of the U.S. residual tax. When this value reduction is combined with certain other features of the U.S. international tax regime (i.e., complex foreign tax credit nuances and defective rules for determining foreign-source net income), well-advised corporations can frequently reduce the U.S. residual tax on their repatriated foreign-source income to zero. Stated differently, the U.S. worldwide system, with deferral, frequently provides an exemption system result (zero U.S. tax on foreign-source income). We believe that the United States should repeal deferral so that the U.S. residual tax is collected as the foreign-source income is earned.[1]

The United States currently faces a policy dilemma: should it adopt a "real" worldwide system by repealing deferral or should it replace its present quasi-exemption system, which is maddeningly complex, with a hopefully simpler explicit exemption system? This policy dilemma can be resolved only by first determining whether the United States should tax U.S. corporations on their foreign-source business income. We believe that it should because failure to tax such income critically distorts the investment decisions of U.S. corporations and violates the ability-to-pay principle.

If the United States had a real worldwide system (i.e., without deferral), the federal income tax would be a neutral factor in a U.S. corporation's decision to establish a new operation either in the United States or in a low-tax foreign country. By contrast, the current U.S. system, and an exemption system as well, create a bias favoring the low-tax foreign location. In the worst case, this bias causes a foreign investment to be preferred even

1 *See* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior. For example, assume that USCo is a U.S. corporation considering a new business that will produce a ten percent return, before U.S. income taxation, if the business is located in the United States, and an eight percent return, before U.S. income taxation, if the business is established in a foreign country. Assume further that the United States will tax USCo at a flat 35 percent rate and that the foreign country will impose a zero rate under an investment incentive regime. If the United States had a real worldwide system (no deferral of residual tax), USCo would face a 35 percent tax rate if it located the new business in the United States and a 35 percent cumulative tax rate (zero foreign tax plus 35 percent U.S. residual tax) if it established the new business in the tax haven. Consequently the after-tax rates of return would be 6.5 percent for the U.S. location (.10 x [1-.35]) and 5.2 percent for the foreign location (.08 x [1-.35]). Thus, the U.S. location's comparative before-tax superiority (.10 ÷ .08 = 1.25) would continue to exist after-tax (.065 ÷ .052 = 1.25) and USCo's location decision would be unaffected by the U.S. tax system.

By contrast, if USCo can avoid paying U.S. tax on the foreign profits (either because USCo engages in deferral planning under the current U.S. system or because the United States adopts an exemption system), USCo will be choosing between after-tax returns of 6.5 percent (.10 x [1-.35]) in the U.S. location and 8 percent (.08 x [1-0]) in the tax haven location. Thus, the effect of the current U.S. system, and of an exemption regime, is to create a strong incentive for USCo to make the economically inferior foreign investment.

Those who believe that zero U.S. taxation of USCo's foreign-source profits (with the above distortion) is the right result rely principally on a competitiveness argument that is usually stated as follows: local businesses in low-tax foreign countries pay only the low local income tax on their in-country profits. The same is true of foreign corporations operating in the low-tax country but resident in a country that exempts foreign source income from residence country tax. Without deferral or exemption, USCo would be unduly disadvantaged when competing against these foreigners in low-tax foreign countries because in addition to the foreign tax, USCo would pay a current U.S. residual tax on its foreign profits, while the foreigners would pay only the low foreign tax. Therefore USCo should be given a countervailing reduction in the U.S. residual tax by being allowed to, at least, defer that tax. Better yet, the United States should exempt USCo's foreign-source income.

This argument is not a request for the United States to give USCo relief from international double taxation. The foreign tax credit already addresses that issue. Instead, this is a request for tax system assistance that is not available to earners of U.S.-source income. This appeal for preferential treatment of foreign-source income should be closely scrutinized. In our judgment, such scrutiny reveals that there is no persuasive case for relieving foreign-source active business income from U.S. income tax.

This is principally because the claims that continuation of deferral, or adoption of a U.S. exemption system, are necessary to keep American businesses on a competitive footing in foreign markets are rendered dubious, at best, by the extensive overseas success of American businesses. Moreover, a program of aiding American corporations by relieving their foreign-source income from U.S. tax is a poorly-structured tax assistance measure. This is because the tax assistance is (in the case of deferral), or would be (in the case of exemption), fully available to U.S. corporations that have little competition in low-tax foreign countries because they are selling patent- or copyright-protected goods. In addition, deferral is, and exemption would be, fully available to a U.S. corporation whose principal competitor in a low-tax foreign country is another U.S. corporation.

Moreover, we question the validity of defining U.S. competitiveness in terms of U.S. multinational profitability instead of an improved living standard for U.S. citizens. When competitiveness is viewed in this latter way, the linkage of public investment in education to improved U.S. competitiveness is, for example, far more immediate and powerful than is tax assistance to enhance the returns of U.S. multinationals. We conclude that the better approach is for the United States to tax the foreign-source income of U.S. corporations as it is earned by repealing deferral and rejecting exemption.

Advocates of deferral and exemption argue that regardless of the points made above, zero tax is correct because it is possible for an entity to be a U.S. corporation subject to the worldwide taxation regime that we advocate when the corporation is not a U.S. entity in substance. The case that is often put forward is that of an entity that is incorporated in a U.S. jurisdiction but that has no U.S. assets and no U.S. shareholders and that earns all of its income abroad. This is a relatively rare case and when it occurs, is usually the result of informed planning. In any event, we would address this point by amending the Code to substitute a specific level of U.S. shareholding as the test for whether an entity is a U.S. corporation.

Closely related to this point is the suggestion that if U.S. corporations are taxed in a rigorous way, they will incorporate their new product developments in foreign countries and defer U.S. tax on their profits until dividends are paid home to the U.S. corporation. The repeal of deferral that we advocate would invalidate this strategy.

Finally, advocates of deferral and exemption argue that if U.S. corporations are taxed in the way that we suggest, U.S. residents will simply buy the shares of foreign corporations operating under more benign taxing regimes. We have previously advanced a proposal for coping with this tactic by, in essence, expanding the current PFIC provisions.[2]

In addition to our arguments above, "real" worldwide taxation (i.e., no deferral) is supported by the ability-to-pay fairness concept. This concept asserts that all income should be treated the same regardless of its geographical source. Interested readers are directed to our forthcoming (late fall 2001) Florida Tax Review publication entitled *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income.*

COUNTERPOINT: THE UNITED STATES SHOULD NOT TAX U.S. CORPORATIONS ON THEIR WORLDWIDE INCOME

*by Herman B. Bouma, Washington, DC**

The main arguments for taxing U.S. corporations on their worldwide income relate to the benefits purportedly afforded to such corporations in the United States (such as the protection of U.S. business law and access to U.S. capital markets) and to the possible adverse consequences of a territorial system for investment in the United States. However, these do not constitute valid reasons for taxing U.S. corporations on their worldwide income, and therefore U.S. corporations should be taxed in the same way as foreign corporations, *i.e.,* on a territorial basis.

Under the Internal Revenue Code, a business entity that is a corporation for tax purposes is a "U.S. corporation" if it was "created or organized in the United States or under the law of the United States or of any State." Section 7701(a)(4). Pursuant to section 7701(a)(5), if a corporation is not a U.S. corporation, then it is a "foreign corporation."

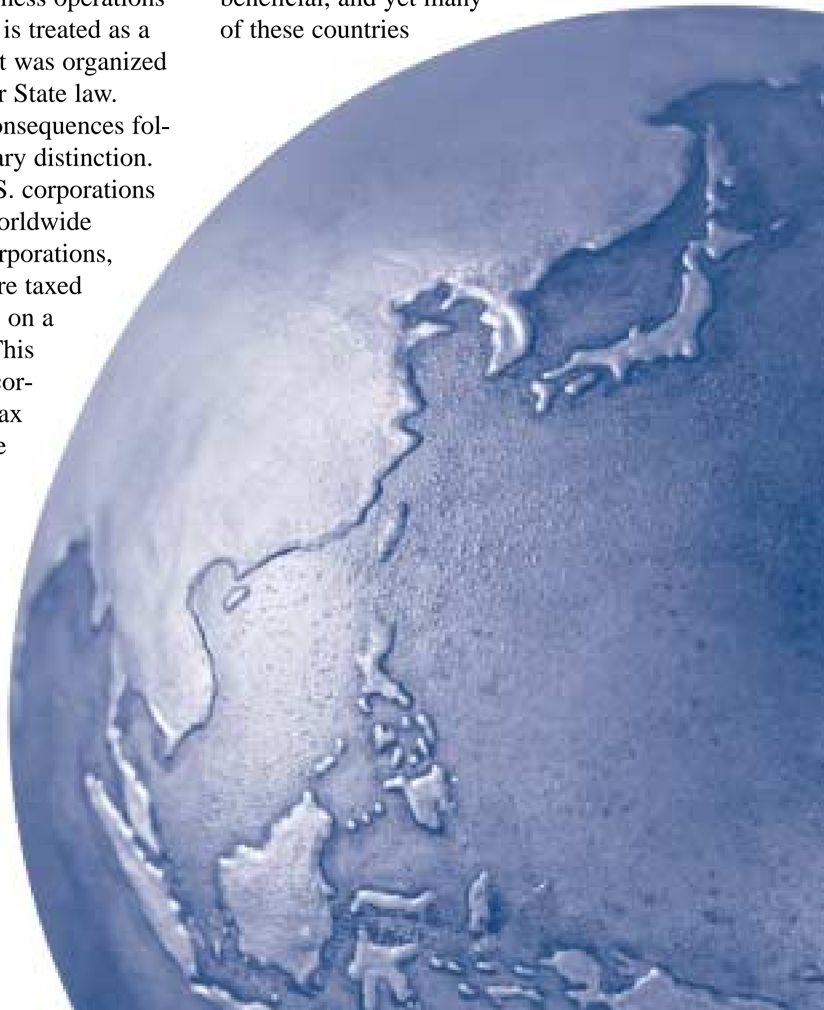
Whether a corporation is a U.S. corporation has absolutely nothing to do with the location of the corporation's property, employees, or business operations. Rather, it is based entirely on the jurisdiction in which the corporation was organized. Thus, a corporation that has all of its property, employees, and business operations in the United States is nevertheless treated as a foreign corporation if it was organized pursuant to a foreign law. Similarly, a corporation that has all of its property, employees, and business operations in a foreign country is treated as a U.S. corporation if it was organized pursuant to a U.S. or State law.

Significant tax consequences follow from this arbitrary distinction. Under the Code, U.S. corporations are taxed on their worldwide income. Foreign corporations, on the other hand, are taxed by the United States on a "territorial basis." This means that foreign corporations pay U.S. tax only on their income effectively connected with the conduct of a U.S. trade or business ("ECI") and on certain income that is not effectively connected with the conduct of a U.S. trade or business but is U.S.-source income ("U.S.-source non-ECI"). U.S. and foreign corporations with otherwise identical operations can thus have dramatically different U.S. tax liabilities, simply based on where they were organized.

Several reasons have been proffered in justification of this extreme dichotomy between the U.S. tax treatment of U.S. and foreign corporations.

First, it has been argued that the application of the business law of the United States or of a State ("U.S. business law") to a U.S. corporation justifies taxing it on its worldwide income. It is true that being organized pursuant to a law of the United States or of a State generally results in the application of U.S. business law, which may be considered beneficial to the corporation. However, that does not justify taxing the U.S. corporation on its worldwide income.

Many foreign jurisdictions also have business laws that are beneficial, and yet many of these countries



2 *See* Peroni, Fleming, & Shay *supra* note 1, at 507-12.

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