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### **Recommended Citation**

William Barker, *An International Tax System for Emerging Economies, Tax Sparing and Development: It is All About Source*, 29 *U. Pa. J. Int'l L.* 349 (2007).

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**AN INTERNATIONAL TAX SYSTEM FOR EMERGING  
ECONOMIES, TAX SPARING, AND DEVELOPMENT: IT IS  
ALL ABOUT SOURCE!**

WILLIAM B. BARKER\*

ABSTRACT

This Article proposes a source tax system for emerging economies that promotes development by encouraging the importation of capital and technologies while at the same time providing tax revenue for development. Since freer trade and freer factor mobility have made the traditional territorial notion of source taxation obsolete, emerging economies should recognize that source taxation must instead be based on the economic contribution of the developing economy to the earning of the income. Consequently, the source of the normal return from imported capital in all of its forms (money, tangible assets and intangible assets) is not where it is used but where it was created. Therefore, the appropriate territorial tax base is locational economic rents. This solution can be implemented with an expenditure or cash flow tax that could be imposed in two stages: one on corporate rents and the second when those rents are distributed to shareholders. Developed economies should adopt a tax sparing regime that exempts or allows a deemed foreign tax credit for the portion of their resident taxpayers' foreign income that represents locational economic rents. Though the immediate

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gains to both emerging and developed economies will be greatest if the countries undertake their concessions as part of bilateral treaties, significant gains can be achieved through unilateral action.

## 1. INTRODUCTION

Economic forces unleashed by freer trade and the enhanced mobility of many of the factors of production have led to intense tax competition among developed and developing economies alike. Emerging market economies are particularly susceptible to the sirens of tax competition due to their even greater need for the benefits provided by foreign business enterprises. Though the International Monetary Fund ("IMF") and the Organization for Economic Cooperation and Development ("OECD") have amply illustrated the economic harm to emerging economies occasioned by tax subsidies, most economies appear compelled to continue their use.<sup>1</sup> Consequently, many developing countries are substantially reducing their taxation of foreign business enterprises operating in their states through tax holidays, preferences and incentives. In addition, many nations both in the developed and developing world have added tax preferences and incentives to attract highly mobile business income.<sup>2</sup> Finally, tax competition has forced the tax systems of the developed world to provide incentives to their own resident enterprises that invest elsewhere.

If a nation desires to attract foreign capital and business enterprises, it should first examine whether the traditional territorial notion of source, that was formulated in the 1920s<sup>3</sup> in

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<sup>1</sup> See generally G.A. MCKENZIE, DAVID W.H. OSMOND & G. PHILLIP GEARSON, *THE COMPOSITION OF FISCAL ADJUSTMENT AND GROWTH, LESSONS FROM FISCAL REFORMS IN EIGHT ECONOMIES* 8 (1997 IMF Occasional Paper 149); ORG. FOR ECON. CO-OPERATION & DEV., *OECD TAX POLICY STUDIES NO. 4, CORPORATE TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT* 84-85 (2001) (explaining why countries have become reluctant to grant tax sparing in treaties); ORG. FOR ECON. CO-OPERATION & DEV., *TAX SPARING: A RECONSIDERATION* 12-13 (1998) [hereinafter *TAX SPARING*] (explaining why countries have become reluctant to grant tax sparing in treaties).

<sup>2</sup> See generally ORG. FOR ECON. CO-OPERATION & DEV., *HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE* (1998) [hereinafter *HARMFUL TAX COMPETITION*] (describing the development of harmful tax competition between states).

<sup>3</sup> See generally William B. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22 *Nw. J. INT'L L. & BUS.* 161, 182-83 (2002) (describing the historical development of source taxation); Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 *DUKE L.J.* 1021, 1023 (1997) (explaining the importance of the League of Nations'

relation to a quite different economic order, supports this objective. This Article argues that freer trade and freer factor mobility have made this approach obsolete and that emerging economies should recognize that source taxation must instead be based on a more realistic economic connection of the income to the state. The normal return from imported capital in all of its forms (money, tangible assets, and intangible assets) is appropriately sourced not where it is used but where it was created. This is the place of residence of the foreign enterprise—that is, the home country. Consequently, the appropriate source tax base for the host country—that is, the country where the business activity takes place—is locational economic rents.

Thus, this proposal presents a workable strategy for both developed and emerging market economies that will encourage foreign direct investment in economies while reducing the wasteful consequences of tax competition. This strategy will provide a more certain source of tax revenue to emerging economies that can be used for general welfare programs while promoting economically efficient tax relief for foreign business. Finally, it will provide the appropriate base from a truly international perspective for resident taxation of foreign source income.

## 2. THE INADEQUACY OF TRADITIONAL TERRITORIAL TAXATION: HOW HAS THIS COME ABOUT?

The world economy today is moving rapidly toward greater economic integration among nations due to the elimination of many barriers to the international movements of capital and trade.<sup>4</sup>

Free trade is primarily a policy of the developed world that has more or less established open borders to much of the world's products and services. Presently, however, major asymmetries have been created between developed and emerging economies because in many cases emerging economies have not reciprocated by granting equal access to their markets.

The developed world also emphasizes open capital markets, allowing for the free movement of monied capital internationally.

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1928 model bilateral income tax treaties); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996) (explaining the 1920s movement to avoid international double taxation).

<sup>4</sup> See, e.g., Barker, *supra* note 3, at 162-65 (examining the factors that contribute to increased international economic integration).

Capital in the form of physical assets and technologies also is largely free to move across national borders. Thus, many of the factors of production are quite mobile today.

The combination of freer trade and freer factor mobility has permitted multinational enterprises ("MNEs") of developed economies to relocate production of goods and services outside of their home countries while maintaining full access to their extensive markets and those of other developed countries. Consequently, locational decisions with regard to production for worldwide markets present many options for MNEs.

Freer trade and freer factor mobility have created considerable opportunities for emerging economies as well. Their principle advantage over the developed world—reduced costs—can be captured by MNEs. They also offer valuable material and human resources. Additionally, due to a lack of reciprocity, many countries maintain control over import access to their domestic markets, which in the case of many emerging economies, represents a principal reason for an MNE's presence.

### *2.1. The Role of Taxes: The International Tax Environment and the Competitiveness of Multinational Enterprises*

Tax plays an important role in reinforcing the world economic order fostered by the developed world. In particular, both the residence and source international tax systems provide substantial relief for income derived from offshore production of goods and services.

There are two systems adopted in the world today for the treatment of the foreign income of resident taxpayers.<sup>5</sup> The first and oldest system is the exemption system that recognizes only one basis for taxation—the source of the income.<sup>6</sup> Source is strongly associated with the physical presence of the income or an aspect of the transaction producing the income within the territory of the state. The exemption system automatically provides the theoretical solution for eliminating international double taxation of

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<sup>5</sup> See HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 346, 349, 372 (2d ed. 2004) (discussing the source and residence taxation systems); Barker, *supra* note 3, at 180-84 (describing the widespread use of source and residence taxation as the two fundamental systems for taxing international transactions).

<sup>6</sup> See AULT & ARNOLD, *supra* note 5, at 372 (describing the exemption system, using France as an example).

income by assigning income to only one jurisdiction. In practice, however, there is considerable conflict between nations due to the multiplicity of sourcing rules.<sup>7</sup>

The second system is residence taxation, the system adopted in the United States, the United Kingdom, and Japan,<sup>8</sup> which taxes the worldwide income of residents of a country. The resident system necessarily conflicts with territorial taxation. Fairness to taxpayers dictates that double taxation by more than one nation should be eliminated. The world consensus reached many years ago requires the home nation to adopt an approach to the elimination of double taxation. This is founded on the general principle that residence should defer to the primacy of source jurisdiction. In order to accomplish this, the home country could allow a tax credit for foreign taxes paid or a deduction for foreign taxes paid. The international norm is to allow a foreign tax credit.<sup>9</sup>

These two systems have vastly different approaches and underlying philosophies. The equity of worldwide taxation is that all residents should pay the same tax no matter where their income is earned. The equity of the exemption system is that each nation should have the exclusive right to tax income arising within its borders.

This profound theoretical distinction is largely an illusion, however. Exemption systems do begin with a large competitive advantage for resident businesses with foreign operations. Exemption systems theoretically ensure that residents' activities are carried out on a "level playing field" in the foreign country. Yet the perceived necessity as seen by worldwide countries to empower their residents to be competitive in foreign undertakings undermines the general principle of worldwide taxation in that operations undertaken by residents through foreign enterprises are tax-deferred. Under a residence-based system like the one used in the United States, as long as home country MNEs use the form of foreign corporations to carry out their activities, income is deferred

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<sup>7</sup> See Barker, *supra* note 3, at 202-12 (explaining the difficulties in defining source).

<sup>8</sup> See William B. Barker, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 CATH. U. L. REV. 7, 16-17 (1996) (exploring the origins of income taxation in the United States and the United Kingdom).

<sup>9</sup> See, e.g., ORG. FOR ECON. CO-OPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (2003) [hereinafter OECD MODEL TAX CONVENTION] (providing a model to clarify taxation of taxpayers engaged in international activities).

until repatriated and, upon repatriation of the profits, the enterprise is still entitled to a credit for foreign taxes previously paid.<sup>10</sup> This treatment is equivalent to an interest-free loan to the MNE of the residual home tax due.<sup>11</sup> In both foreign tax credit and exemption systems, the benefit is maximized the longer the tax deferred or tax saved remains outside the home's taxing jurisdiction since the investment return from that savings is deferred or exempt.

When generally contrasting foreign tax credit systems with a pure exemption system, it is apparent that the taxpayer is treated more favorably under an exemption system than under a deferral system. There are many elements in foreign tax credit systems that have the power to equalize the scales of competition, however. In foreign tax credit systems, the taxpayer usually can average the income and taxes paid in all foreign jurisdictions (known as the overall foreign tax credit limit) with the outcome that where the MNE is engaged in business in high tax jurisdictions (those with greater taxes than the home country), the MNE may be in an excess credit position eliminating any residual tax on income earned in low tax jurisdictions like emerging economies offering tax incentives. The present system, in which emerging economies grant tax benefits to MNEs, may be characterized as foreign aid to developed economies since the developing economies are subsidizing the activities of MNEs in highly taxed developed economies. Since there is no residual tax, the result of an excess credit position is theoretically the same as that of an exemption system. Though an MNE in an excess limit position (where its creditable taxes are less than its home country tax liability) is not effectively exempt, it does receive the benefit of deferral. One extremely effective strategy for firms with an excess limit<sup>12</sup> for increasing the amount deferred that is not available (at least in the United States for those with excess credits) is to finance their investment in tangible assets in low tax jurisdictions with interest borrowed and sourced in the home country and currently

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<sup>10</sup> See 26 I.R.C. § 881 (2000) (providing for taxation of foreign corporations unconnected to U.S. businesses); I.R.C. § 902 (2000) (providing for indirect foreign tax credit for dividends paid by foreign corporations).

<sup>11</sup> Wilson E. Schmidt, *U.S. Capital Export Policy: Backdoor Mercantilism*, INT'L TAX AND PUB. FIN. XX, 34 (1975). The residual tax is the tax due the home country after the application of the foreign tax credit.

<sup>12</sup> This strategy may also be available for taxpayers residing in exemption countries.

deductible against home country income. In the United States, the tax law allocates a portion of U.S. source interest expense to foreign sources, thus reducing the foreign tax credit limit.<sup>13</sup> Taxpayers in an excess limit situation are not adversely affected by this provision.

The trend toward convergence is not one-sided, however. Though some capital exporting nations began with a pure exemption method for eliminating double taxation, they too are gravitating in the other direction toward residence-based taxation. As "exemption" nations abandoned currency control and became capital-exporting nations, and as tax competition for capital and business heightened, developed economies recognized the critical nature of international tax principles and the importance of adopting at least some principles of residence-based international taxation. Consequently, the detrimental impact of tax competition has been largely analyzed and addressed from the perspective of the developed economies.<sup>14</sup> A primary emphasis was placed upon taxation of residents' foreign source capital income. Today, there are few developed countries that exempt residents' foreign source portfolio income.<sup>15</sup> The closer residence and exemption systems become, the more important the details of how the deferred or exempt tax base is defined and calculated in assessing the relative competitiveness of nations' MNEs become.

In addition to passive income, foreign source business income has also been targeted by many nations because of the sizable gaps in source taxation. The general threshold for the source taxation of business income is that the activity must be carried out through a permanent establishment in the host.<sup>16</sup> Free trade plus this high

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<sup>13</sup> See 26 I.R.C. § 864(e) (2000) (providing rules for allocating interest); I.R.C. § 904 (2000) (enumerating a limitation on credit).

<sup>14</sup> See generally HARMFUL TAX COMPETITION, *supra* note 2 (discussing the harmful effects of tax competition on largely industrialized countries); see also Barker, *supra* note 3, at 169-71 (describing initiatives of the European Union and the OECD to combat harmful tax competition).

<sup>15</sup> Though some developed countries historically adopted the principles of territorial taxation only, today these countries do not exempt all foreign source income of residents. The typical pattern is to distinguish between active business income, which is exempt, and portfolio income, which is not. See AULT & ARNOLD, *supra* note 5, at 372-75 (explaining the distinction between active business income and portfolio income). Harry Grubert claims that "[n]o industrialized country exempts royalties and interest." Harry Grubert, *Comment on Desai and Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Setting,"* 53 NAT'L TAX J. 263, 264 (2005).

<sup>16</sup> See OECD MODEL CONVENTION, *supra* note 9, art. 5 (defining "permanent



threshold for source taxation has allowed MNEs to gain free access to developed countries' markets without significant taxation of the income attributable to production undertaken in lower-tax jurisdictions. Both exemption and residence tax countries have recognized that they needed to shore up their tax bases if they were to preserve the integrity of their tax systems. To do this, they also focused on residence principles and on the role tax havens play.<sup>17</sup> Most developed nations have adopted Controlled Foreign Corporation ("CFC") legislation, which is aimed at ending the deferral or exemption of certain foreign income.<sup>18</sup> Depending on a nation's approach, CFC legislation targets income that can be described as passive income (as opposed to active business income), income earned by conduit enterprises, income from highly mobile sources, or income earned in low-tax jurisdictions (where the taxes do not satisfy a home country's minimum threshold or the countries are included on a prescribed list).<sup>19</sup> Where either deferral or exemption is eliminated under CFC-type legislation, the value of tax incentives provided by emerging economies to MNEs is redirected to the home country's treasuries. Even with CFC legislation, however, the tax advantages of offshore activities are still large.

Consequently, the definitions and scope of the passive-active distinction adopted in each country can have a profound effect on the actual revenue generated by a country, whether a foreign tax credit or exemption country. Studies have persuasively shown that in the case of the United States, switching to a dividend exemption system for the business income of foreign corporations would dramatically increase the taxes paid by MNEs to the United States.<sup>20</sup> This would indicate that foreign tax credits earned from

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establishment" for purposes of the Model Convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on").

<sup>17</sup> This was the focus of the OECD study, *HARMFUL TAX COMPETITION*, *supra* note 2.

<sup>18</sup> See 26 I.R.C. § 961 (2000) (stating the U.S. tax provisions on adjustment to basis of stock in controlled foreign corporations). See generally AULT & ARNOLD, *supra* note 5, at 377-86 (describing the limitations various developed countries have imposed on exemption or deferral of income of foreign corporations).

<sup>19</sup> See generally AULT & ARNOLD, *supra* note 5, at 377-86 (discussing income characterization strategies using country-specific examples).

<sup>20</sup> E.g., Rosanne Altshuler & Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798 (2001) (stating that dividend exemptions will

active business income offset the tax on foreign passive income. In exemption-based systems, the non-taxation of foreign business capital income can have a similar effect. This income, however, does not always end up increasing the tax base of emerging economies even where their tax rates are low. MNEs are adept at using tax haven regimes to relocate income or to translate income from otherwise passive sources into exempt or deferred active business income.<sup>21</sup> The effect of these home country actions is a direct subsidy to its MNEs. Indeed, all of these tax saving factors can be amplified by self-help transfer pricing devices that shift income to its most advantageous source by overcharging or undercharging for goods, services and capital.<sup>22</sup>

One last feature that reduces the advantage that exemption systems have over foreign tax credit systems is the impact they have on corporate dividends in integrated systems. Where income is exempt at the corporate level, the portion of the dividends paid to non-corporate shareholders rarely receives the benefit of tax relief.<sup>23</sup> In a foreign tax credit regime like the United States, there is no differential treatment of the dividend to non-corporate shareholders according to its source.<sup>24</sup>

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likely increase effective tax rates); *see also* Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J. 811, 811 (2001) (arguing that dividend exemption will likely raise tax revenue).

<sup>21</sup> *See, e.g.*, Katz Fifth Interim report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, *Basing the South African Income Tax System on the Source or Residence Principle—Options and Recommendations* para. 8.1.1. (March 7, 1997), available at [www.treasury.gov.za/publications/other/katz/5.pdf](http://www.treasury.gov.za/publications/other/katz/5.pdf) [hereinafter Fifth Report] (noting the ease with which taxpayers can transform passive income into exempt dividends or defer taxation).

<sup>22</sup> Most nations have anti-avoidance provisions to prevent transfer pricing abuses. *See* 26 U.S.C. § 482 (2006) (providing for the U.S. government's discretion in allocating income and deductions among businesses owned by the same interest in order to prevent tax evasion); *see also* MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 400-35 (2003) (discussing anti-avoidance provisions in general).

<sup>23</sup> *See* BEN TERRA & PETER WATTEL, EUROPEAN TAX LAW 172-73 (3rd ed. 2001) (providing that states often impose an equalization tax on profit distributions that have not already been taxed domestically).

<sup>24</sup> The United States is presently a split rate system, taxing dividends like capital gains at a fifteen percent rate. 26 U.S.C. § 1(h)(1)(C) (2006). The U.S. extends this treatment to the dividends of certain foreign corporations qualified by treaty and to foreign corporations traded on an established securities market in the United States. 26 U.S.C. § 1(h)(1)(C) (2006).

## 2.2. *The Interplay of Developed and Emerging Economies' Tax Systems*

Other factors that should be included in the competitive mix are the treatment by both home and host of charged and self-charged expenses for overhead, royalties and interest. It is common practice for host nations to deny branches deductions for portions of the MNE's expenses for overhead, research and development, and interest.<sup>25</sup> Obviously, most enterprises will use separate enterprises in these cases, but it is not unusual that actually charged expenses will be denied.<sup>26</sup> The denial of these costs results in a shift of income to the host. This is tax exporting and dis-incentivizes nonresident business. The deductibility of these expenses must also be assessed from the perspective of the home's tax laws. Where the home country allocates these costs to foreign source income, thus shifting income to domestic sources, international double taxation is not avoided both in the case of foreign tax credit and exemption systems. In some cases, however, where the home effectively permits the home enterprise to treat these costs as costs deductible against domestic income, the home nation is complicit in the income shift which clearly understates home country income and overstates foreign income in the host.<sup>27</sup> This latter treatment may even be an intended tax subsidy by home nations to MNE operations abroad.

Interest plays a critical role in determining the income allocated to the host. The greater the percentage of debt finance, the smaller will be the income tax base due to the deductibility of interest. This interest income is often exempt or lightly taxed when paid to nonresidents. It is also a common strategy of MNEs to increase the value of deferral by utilizing earnings to retire debt.<sup>28</sup> Where the

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<sup>25</sup> See, e.g., AULT & ARNOLD, *supra* note 5, at 401 (observing that countries generally do not recognize self-charged expenses for payments between Host branches and Home enterprises). France is one country that does allow the administrative expenses of a Home enterprise to be allocated to a French branch. *Id.* at 402.

<sup>26</sup> See Robert J. Patrick, Jr., *U.S. Tax Treaties with Developing Countries*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 307, 318-30 (Robert Hellawel ed., 1980) (describing different international tax regimes). See also Fifth Report, *supra* note 21, para. 5.5.5 (describing the UN Tax Model Convention's denial of deductions for expenses charged to a head office).

<sup>27</sup> See AULT & ARNOLD, *supra* note 5, at 366 (citing France as a country that does not require the allocation of an enterprises interest expense between exempt and nonexempt income).

<sup>28</sup> See James R. Hines, Jr., *The Case Against Deferral: A Deferential Consideration*, 52 NAT'L TAX J. 385, 400 (1999) (stating that MNEs typically undercapitalize

finance is provided by the enterprise, this interest often ends up in tax haven finance subsidiaries.<sup>29</sup> Many countries have enacted thin capitalization rules which act to classify part of the related-party debt as equity to prevent this over-reliance on debt.<sup>30</sup> The policy is to ensure that a certain amount of the profits are distributed to shareholders as income from equity capital, which is not deductible, as opposed to debt capital which is deductible. The debt-equity problem is often compounded because while nations still impose some withholding taxes on dividends paid to foreign persons, more and more nations do not tax interest paid to foreign persons. In some emerging economies, however, the absence of thin capitalization rules can be the result of a conscious policy to subsidize a foreign enterprise.<sup>31</sup>

As will be more fully demonstrated below, thin capitalization rules are a poor choice of remedy because they are out of sync with an economic approach to the host taxation of both dividends and of interest. Dividend distributions can represent either the normal return of shareholders' capital or economic rents. As economic rents, they are appropriately taxed by hosts. As return on capital, they should be treated the same as interest. But the income tax approach to interest that allows a full deduction for the amount paid (the nominal rate) presents an unjustified result. Internationally, the accepted treatment of interest accepts the nominal rate, which includes the real return on capital plus the return for inflation, as the appropriated deduction from the income tax base. Under conditions of inflation debtors repay with cheaper money, thus, the inflationary component of interest does not represent a real cost. Creditors receive their principal with diminished value, thus, the inflationary component of interest is not real income. As a second-best solution, the trade-off between over-taxed lenders and under-taxed borrowers may be satisfactory

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undertakings so that once profitable, they will not have to repatriate these earnings).

<sup>29</sup> See *id.* at 401 (noting that every year, about half the taxes on income earned by foreign subsidiaries of American corporations is deferred).

<sup>30</sup> See AULT & ARNOLD, *supra* note 5, at 411-14 (describing rules various countries have implemented to curb debt financing of nonresident-owned domestic corporations).

<sup>31</sup> Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments, and Multinational Companies*, CESifo Working Paper No. 1613, 2005, available at <http://ssrn.com/abstract=875308>, at 7.

where both lenders and borrowers are taxed at the same rates by the same system, but where borrowers are under-taxed by hosts and lenders are not taxed by hosts at all, significant distortions occur that substantially reduce the tax base of hosts. Thus, full interest deductions represent a substantial subsidy to MNEs by hosts.

### 2.3. *Developing Economies, Source Taxation, and Tax Sparing*

Developed countries, however, often ignore their role as source countries in promoting tax competition.<sup>32</sup> They can more readily sacrifice source taxation, bilaterally and unilaterally, because they have strong residence systems. At the same time, they often have somewhat effective systems for the taxation of nonresident business income at least where such business activity requires a substantial presence in that country. They can even be somewhat aggressive in taxation because they provide significant markets for the consumption of the foreign enterprises' products and services. Emerging economies do not share the same economic factors. Most rely on territorial taxation and are only slowly adopting residence principles.<sup>33</sup> This was often because territorial taxation was the heritage of colonial rule. For example, the English mandate for its colonies was that only income arising in the colonies came within the "colonial jurisdiction" to tax.<sup>34</sup> South Africa, which, as a former British colony, had adopted strict territorial tax principles, did not adopt the residence principle until 2000 after the overthrow of apartheid.<sup>35</sup> Because most developing economies have been slow to adopt residence principles, some have been victimized by the flight of capital of their residents.<sup>36</sup>

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<sup>32</sup> See, e.g., Barker, *supra* note 3, at 172–73 (noting that significant U.S. tax incentives adopted in the Economic Recovery Act of 1981 increased the flow of capital to the United States).

<sup>33</sup> See Fifth Report, *supra* note 21, para. 1.3.4 (stating that Brazil and Argentina have recently adopted residence-based tax systems).

<sup>34</sup> Report of the Inter-Departmental Committee on Income Tax in the Colonies Not Possessing Responsible Government, (Dec. 1922), Cmd. 1788, at 5. See also William B. Barker, *Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa*, 109 PENN ST. L. REV. 703, 713–14 (2005) (describing the United Kingdom's colonial tax policies).

<sup>35</sup> Barker, *supra* note 34, at 714, n.71.

<sup>36</sup> See Barker, *supra* note 3, at 194 (discussing the impact of capital mobility on the taxation of capital imports).

Their principle character is that of a capital-importing nation, however, whose primary tax emphasis is the source taxation of both residents and nonresidents alike.<sup>37</sup>

Thus, emerging economies strongly assert their entitlement to traditional territorial jurisdiction.<sup>38</sup> In addition, they often assert that this tax base belongs to them exclusively and that developed countries should limit residence principles.<sup>39</sup> The assertion is made that developed countries should either exempt income sourced in developing countries or provide tax sparing credits. This position directly conflicts with the trend in developed countries which pushes for the dominance of residence.<sup>40</sup>

Tax sparing is a device used both by countries taxing worldwide income, which allow a foreign tax credit, as well as exemption countries, which allow a foreign tax credit for certain kinds of income (like dividends) that are not exempt.<sup>41</sup> The object is to permit developing economies to reduce their income taxes under an incentive scheme for foreign taxpayers without having the residence country collect the spared tax. Thus, developed countries agree by treaty to permit their resident taxpayers an additional credit for the amount of tax spared by the developing country. Where the home country's tax is greater than the actual plus the spared tax of the host, the home country still receives a residual tax.

Full exemption systems promote this goal by implicitly recognizing a nation's exclusive right to source taxation. Tax sparing, on the other hand, is an exception to resident taxation. The home country agrees to relinquish its right to the extent that the source country decides to reduce its normal tax burden to accomplish important societal goals. Tax sparing is conceived not as a device for accomplishing inter-nation justice, but rather as a

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<sup>37</sup> See, e.g., Klaus Vogel, *Worldwide v. Source Taxation of Income – A Review and Reevaluation of Arguments (Part II)*, 16 *INTERTAX* 310, 311–12 (1988).

<sup>38</sup> For a general account of the history of this debate, see M.B. RAO, *DOUBLE TAX TREATIES BETWEEN DEVELOPING AND DEVELOPED COUNTRIES* 98–100 (1983).

<sup>39</sup> Developing economies often require tax sparing (or exemption) before they will enter into treaties with developed economies. See *TAX SPARING*, *supra* note 1, at 19–20.

<sup>40</sup> The OECD Model Tax Convention on Income and on Capital (2003), for example, gives much less weight to the source principle than to the residence principle. *OECD MODEL TAX CONVENTION*, *supra* note 9.

<sup>41</sup> Examples of the former are the United Kingdom and Japan; examples of the latter are Germany and France. See *TAX SPARING*, *supra* note 1, at 68–69.

device to aid an emerging economy. Due to the inherent conflict between source and residence, the sacrifice is not one-sided, however, for the premise of tax sparing is that the host is giving up what it is entitled to, so the home will also.

Tax sparing and special home country exemptions for emerging economies, however, are diametrically opposed to the purpose behind CFC and other international anti-avoidance legislation that insists that resident taxpayers should be subject to tax somewhere. That is why the debate in the developed world as to the wisdom of tax sparing has proceeded on the general premise that tax sparing is foreign aid.<sup>42</sup> Advocates assert that developed nations have a duty to aid developing economies and that they are not doing enough. While recognizing the inefficiencies of providing incentives to MNEs to provide aid to other nations, they note that until we substantially increase aid, this is better than nothing.<sup>43</sup>

The original objection to tax sparing was that it "violates the principle of equity in the investor's country since any exemption or tax sparing violates the principle of taxation in accordance with ability to pay."<sup>44</sup> Though the United States has considered tax sparing and other tax incentives for providing aid to emerging economies over the years, none have ever been adopted.<sup>45</sup> For

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<sup>42</sup> See generally TAX SPARING, *supra* note 1, at 19 (discussing world views on tax sparing). For a recent reexamination of tax sparing, see Paul R. McDaniel, *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 GEO. WASH. INT'L L. REV. 265 (2003), which examines whether the United States should amend its international tax rules in ways that might encourage U.S. companies to invest in developing countries.

<sup>43</sup> A strong advocate of this position has been Professor Karen Brown. See, e.g., Karen B. Brown, *Transforming the Unilateralist into the Internationalist: New Tax Treaty Policy toward Developing Countries*, in TAXING AMERICA 214 (Karen B. Brown & Marie Louise Fellows eds. 1996); Karen B. Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries*, 23 U. PA. J. INT'L ECON. L. 45 (2002) (proposing that the United States adopt a network of treaties with Sub-Saharan Africa that provides a tax exemption from specified income from African sources).

<sup>44</sup> Stanley S. Surrey, *International Tax Conventions: How They Operate and What They Accomplish*, 23 J. TAX'N 364, 366 (1965).

<sup>45</sup> For a detailed history of Congressional consideration of tax sparing and other types of tax aid for emerging economies, see Robert Hellowell, *United States Income Taxation and Less Developed Countries: A Critical Appraisal*, 66 COLUM. L. REV. 1393, 1406 (1966) (discussing the use of the federal income tax system to promote the economic development of the less developed world). The United States-China Tax Treaty does have a provision that requires the United States to provide tax sparing to its residents doing business in China if it adopts tax sparing for any

many years, however, tax sparing was adopted in the tax treaties between many developed and developing economies because it was considered a practical way to aid developing economies and it increased the competitive position of nations' MNEs.<sup>46</sup> Today, however, nations are engaged in a re-evaluation of tax sparing due to growing doubt as to its efficacy.<sup>47</sup> The perceived problems are many. In many cases, the countries aided by tax sparing are much more advanced today and may not need it. Taxpayers have learned to avoid considerable taxes by shifting residence to treaty partners. To remedy this, nations have adopted much more complex and targeted provisions. Indeed, the complexity of tax sparing has created uncertainty among MNEs as to tax sparing's value.<sup>48</sup> The most important consideration, however, is the growing evidence of tax sparing's underlying premise that emerging economies are being helped by tax sparing is incorrect. Instead, emerging economies are being harmed because tax incentives work poorly. The evidence strongly indicates that it encourages repatriation of earnings, tax competition and a substantial loss of revenue without appreciably increasing investment.<sup>49</sup>

### 3. THE EFFECTS OF TAX COMPETITION AMONG EMERGING ECONOMIES ON DEVELOPMENT

The basic approach suggested by the International Monetary Fund ("IMF") for developing countries is that they promote "growth of stocks of physical and human capital or increased technological development."<sup>50</sup> Key to sustained development is the ability of the government to finance or supply the public goods and services that the private sector does not supply due to market failure, like investments in health, education, and the public

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other country. United States-People's Republic of China Income Tax Convention, *Notes of Exchange*, para. 2 (April 30, 1984).

<sup>46</sup> TAX SPARING, *supra* note 1.

<sup>47</sup> *Id.* at 21-30.

<sup>48</sup> *Id.* at 31.

<sup>49</sup> *Id.* A particularly dramatic example of the ineffectiveness of incentives was the Canadian experience that estimated that it took \$1.00 of foregone revenue to equal \$0.80 of new investment in Canada that would not otherwise have been made. *Id.* at 26.

<sup>50</sup> MCKENZIE ET AL., *supra* note 1, at 4.



infrastructure.<sup>51</sup> Thus, development depends on the dual goals of increasing capital and increasing tax revenues.

Thus, one principle emphasis for development must be on raising revenue through taxes. As compared with developed OECD nations where revenue as a share of Gross Domestic Product is an unweighted average of 34.3%, the unweighted average for non-OECD Asian and non-OECD African countries was 18.9% and 19.7% respectively.<sup>52</sup> Indeed, many African countries have revenue to GDP ratios of *less than 10%*.<sup>53</sup>

The IMF message to developing countries is simple. The observed consequence of emerging economies granting tax incentives is substantial revenue loss without an appreciable increase in investment.<sup>54</sup> Political stability plays a more important role in encouraging investment than do tax incentives.<sup>55</sup> Nations need to provide an environment that encourages business activity, which includes a fair and efficient system of laws and increased infrastructure development. South Africa gleaned this evidence and adopted this premise for the reform of its tax system after the fall of apartheid.<sup>56</sup>

The IMF findings are supported by other works that conclude that tax incentives and preferences and tax holidays are ineffective because they are redundant.<sup>57</sup> This is so because the investment would normally have been made anyway except in the case of marginal investments. Marginal investments that are profitable only due to tax breaks may be particularly harmful to developing economies because they increase the costs of government goods and services without defraying expenses through taxes, and can utilize host resources without adding appreciably to the local economy.<sup>58</sup> In addition, those MNEs resident in countries like the

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<sup>51</sup> *Id.* at 4, 5-6.

<sup>52</sup> INTERNATIONAL MONETARY FUND, FISCAL REFORMS IN LOW INCOME COUNTRIES, EXPERIENCE UNDER IMF SUPPORTED PROGRAMS 12 (1998).

<sup>53</sup> *Id.* at 56, 57.

<sup>54</sup> MCKENZIE ET AL., *supra* note 1, at 8.

<sup>55</sup> *Id.*

<sup>56</sup> Fifth Report, *supra* note 21, paras. 1.1.2, 2.1.3.

<sup>57</sup> See SCHMIDT, *supra* note 11, at 55-56; ALEX EASSON, TAXATION OF FOREIGN DIRECT INVESTMENT 21 (1999) (citing studies that tax incentives for investment are relatively ineffective as they rarely determine investor behavior).

<sup>58</sup> This has been referred to as capital congestion, where marginal investments could well overburden limited host resources. See generally John D. Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon?*, available at

United States, which are in an excess limit situation for foreign tax credit purposes, may not perceive tax holidays as a benefit, despite the option of deferral.<sup>59</sup> Perceptions, even if inconsistent with reality,<sup>60</sup> are important because, to be effective, incentives should get businesses to act differently.

Though these are important observations on the efficiency of tax incentives, they may not be convincing to developing economies. The ever-growing data supports the conclusion that tax incidence has become a more and more important factor for MNEs in locational decisions, and developing countries respond.

Most studies before the 1990s found that the tax implications of foreign investment were a relatively minor consideration in most Foreign Direct Investments ("FDI") decisions. By contrast, studies since 1990 have indicated that tax is becoming an increasingly important factor in locational decisions. Recent quantitative evidence indicates that investment and financing is quite sensitive to tax treatment because of the increasing mobility of the factors of production, which yields a wide range of choices to business taxpayers. While this is particularly true in the financial services sector, manufacturing as well has become much more export-oriented, and correspondingly more sensitive to tax rates.<sup>61</sup>

It also simply makes sense that where incentives are offered by neighboring countries with similar endowments sought by MNEs, hosts must reciprocate if they wish to remain competitive.<sup>62</sup> Moreover, when dealing with foreign investment in general, since

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<http://ideas.repec.org/a/eee/pubeco/v88y2004i6p1065-1091.html> (discussing the role of capital tax competition in creating or mitigating inefficiencies in the private and public sectors).

<sup>59</sup> See Eli M. Noam, *Commentary*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES, *supra* note 26, at 211 (arguing that "tax holidays may reduce the incentives for investment by U.S. firms").

<sup>60</sup> Fewer host taxes, however, may be deferred home country taxes that do benefit these MNEs. See discussion *infra* Section 4.

<sup>61</sup> Barker, *supra* note 3, at 198 (footnotes omitted). The OECD also recognizes that incentives influence behavior. See CORPORATE TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT, *supra* note 1, at 10.

<sup>62</sup> A recent comparative study of the investment patterns of Japan and the United States indicates that Japanese firms are much more likely to concentrate FDI in countries with which Japan has tax sparing agreements than are U.S. firms. James R. Hines, Jr., "Tax Sparing" and Direct Investment in Developing Countries 3-4 (Nat'l. Bureau of Econ. Research, Working Paper No. 6728, 1998), available at <http://www.nber.org/papers/w6728>. It certainly makes sense that in choosing between alternative locations, the additional profit resulting from a combination of low taxes and tax sparing could be a powerful inducement.

investors operate under conditions of asymmetric information (less in the host than at home), tax incentives that are widely advertised in the literature may be an obvious way of attracting investment.<sup>63</sup>

Thus, developing countries that desire the benefits of foreign capital, the benefits of increasing employment, and the technological advancement it brings, are compelled today to grant concessions to MNEs. This is a fact of modern economic life, and many developing countries perceive that they are helpless even though the harm that is being done can be enormous.

Tax competition as it exists today distorts decisionmaking and results in an inefficient allocation of resources worldwide, but this is not the sole fault, nor even the primary fault, of emerging economies. The more important causes are home governments and MNEs themselves.<sup>64</sup> Home governments normally relinquish a substantial portion of their potential residence tax base to MNEs through exemption or deferral of the tax on non-repatriated earnings. Anecdotal evidence indicates that MNEs aggressively pursue tax breaks from emerging economies. MNEs are individually driven even though they may ultimately lose more by dramatic reductions in the goods and services provided to them by nations' governments.<sup>65</sup> The impact, however, on developing economies can be catastrophic. Taxes obtained from MNEs may not be sufficient to cover the cost of public goods and services provided to them by the host government.<sup>66</sup> Prices, especially in the case of labor, increase, affecting the competitiveness of local businesses which do not receive the incentives. These

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<sup>63</sup> EASSON, *supra* note 57, at 19. See also Robert Hellawell, *supra* note 45, at 1421 (discussing the role of tax treaties in encouraging foreign investment).

<sup>64</sup> See Rosanne Altshuler & Henry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments, and Multinational Companies* 3 (Soc. Sci. Res. Network, Working Paper Series No. 1613, 2005), available at <http://www.SSRN.com/abstract=875308> (discussing the role of home countries and governments attracting foreign investment).

<sup>65</sup> Firms benefit from the public inputs, which are the public goods and services provided to businesses. Firms lose where the foreign taxes on residents would have been used for public inputs. See Wilson & Wildasin, *supra* note 58, at 4 (stating that firms benefit from public expenditures such as infrastructure investment).

<sup>66</sup> In general, governments should recover from firms the costs of providing public goods and services to them. This is called marginal-cost pricing. See *id.* at 5 (defining marginal-cost pricing as the pricing where "any tax on a unit of investment equals the cost incurred by the government in providing public goods and services"); see also Section 5, *infra*, for a discussion of the role this plays in setting taxes.

consequences are accepted by emerging economies based on the assumption that the benefits of increased employment, "technology," and skilled labor imports outweigh these disadvantages.

Unlike the developed countries which control large tax bases made up of labor income and consumption, emerging economies rely on smaller bases and typically obtain in revenue a much smaller percentage of GDP. By granting preferences and incentives, emerging economies give up a substantial portion of their traditional tax base. IMF studies have documented that widespread tax exemptions have led to low tax ratios which are major fiscal factors in contributing to fiscal crises in emerging market economies.<sup>67</sup>

#### 4. THE OUTLINE OF A SOLUTION

There is no way to sugarcoat the realities of tax competition. Emerging economies cannot expect much help from developed economies because emerging economies' tax systems contain numerous gaps and tax arbitrage points that encourage extreme competition among them. The policies of developed countries are unlikely to change because the present tax system supports the present goals of the developed world of open markets for goods, services, and capital while preserving the competitiveness and dominance of MNEs. Developed economies, indeed, are also caught in a trap of tax competition which is, however, largely of their own making. In addition, the tax systems of developing economies, as was shown in Section 3, have various elements of undertaxing and overtaxing at the same time. The incidence of taxation is unpredictable, leading to significant uncertainty for investors. This is true even though the existing systems often do not effectively tax foreign persons and only haphazardly raise revenue. What emerging economies need to do is understand tax competition and learn to reduce its harmful aspects. The problem, simply put, is that emerging economies do not have a model to rely on that demonstrates the efficient use of their tax systems to provide the critical ingredients for development, including

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<sup>67</sup> See Richard Heming, Michael Kell, & Alex Schimmelpfennig, *Fiscal Vulnerability and Financial Crises in Emerging Market Economies*, 104-13 (Int'l Monetary Fund, Occasional Paper 218, 2003) (examining fiscal crises and responses in Pakistan, Russia, Ukraine, and Brazil).

increasing and retaining investment and at the same time increasing tax revenue.

The remainder of this Article will describe such a model and the case for its adoption. Section 5 will address the economics of source taxation that will indicate the room in which emerging economies actually have to maneuver. This entails a reassessment of the traditional basis of source taxation in light of practicality and economic entitlement. The solution proposed is for emerging economies to give up the income taxation of the normal return from capital, leaving them locational economic rents as the appropriate tax base for MNEs. An income tax on economic rents is equivalent to an expenditure or broad-based consumption tax on corporations. Section 6 deals with the ideal response for the developed world and suggests that in exchange for the exclusive base on income from capital, developed countries should be willing to relinquish their residual tax on foreign source economic rents through either exemption or a full tax sparing credit, leaving emerging economies the exclusive right to tax economic rents. This Section explains, however, why developing economies should unilaterally adopt this model even if some residence systems fail to give appropriate relief to foreign activities.

## 5. A MODEL FOR SOURCE TAXATION OF NONRESIDENT TAXPAYERS

This Article presents a model for emerging economies that makes it possible to understand the tax decisions that are open to them in attracting foreign business to their shores. The model is the product of principles of economic efficiency, the reality of the times, and, just possibly, principles of justice. It starts with an understanding of the roles of residence and source jurisdiction, but it does not depend on solving the resident tax crisis of developed countries. The optimal taxation of foreign MNEs is a problem of source taxation that can be addressed independent of home country jurisdiction.

### 5.1. *An Economic Approach to Source*

The original understanding of source was that of a territorial concept that placed a transaction or economic activity giving rise to income within the borders of a country. Thus, a country that witnessed the income had the power to tax it.<sup>68</sup> Where economies

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<sup>68</sup> See generally Barker, *supra* note 3, at 181 (stating that source jurisdiction

were closed and had currency control legislation in effect, as was generally the case when our present system of international tax principles was formulated,<sup>69</sup> taxation based on such physical power was both theoretical and real. It was supported by a policy favoring emerging economies since source taxation is growth-equalizing whereas residence tax is growth-diverging.<sup>70</sup> Source taxation benefited poorer countries because it assigned a larger share of the tax base to capital importing countries. Today, however, physical power is an illusory basis for taxation of foreign persons since the developed world has adopted the policies of free trade and free factor mobility. MNEs are free to locate business outside the developed world and still have complete access to its markets. This provides MNEs with many choices, and tax incidence has a major effect on the desirability of those options. The physical power to tax the income of foreign persons is meaningless if its use repels the activity it was meant to tax, and it is ineffective if the foreign person can shift the tax incidence to the local economy. This is precisely what happens when emerging economies try to tax nonresidents' capital income. Thus, source as territorial jurisdiction must be supplanted by source as economic origin, which requires a more substantial economic tie that connects the income to the nation.

The economic origin of income<sup>71</sup> is the place that provides the factors that produce the income. Since many of the factors of production of foreign-owned enterprises are imported and can be used in other locations, there must be other factors of production found in a nation that are sufficient to attract foreign-owned economic activities. One general category is the public goods and services provided to the MNEs by host countries. This has led to a

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proposes "that a country has a right to tax income that has 'arisen' in [that] country").

<sup>69</sup> See *id.* (discussing the relationship of the taxpayer to the taxing jurisdiction).

<sup>70</sup> Assaf Razin & Chi-Wa Yuen, *Optimal International Taxation and Growth Rate Convergence: Tax Competition v. Coordination*, 6 INT'L TAX & PUB. FIN. 61, 69 (1999).

<sup>71</sup> The first attempt to define the proper allocation of income worldwide was undertaken by four economists for the League of Nations in 1923. For a discussion of this effort, see Barker, *supra* note 3, at 180-84 (discussing proper allocations in international taxation). The analysis of economic origin herein is different, however.

theory that source taxation's primary justification is as a charge for these benefits—an exchange or cost-benefit principle of taxation.<sup>72</sup>

Since firms benefit from public inputs, it makes sense that emerging economies should charge for the costs of these government provided benefits.<sup>73</sup> It follows that user charges, where feasible, are a direct way to charge for those benefits.<sup>74</sup> When speaking of public inputs like infrastructure development, user charges are rarely feasible. Any charge, however, whether a user charge or a general tax, is a cost (not a cost savings) borne by the firm and cannot in itself be an incentive to locate in a developing country. Moreover, the trouble with taxation in accordance with public benefits received is that it presumes a relationship between the value of the benefits received by the taxpayer and the quantity in the tax base being assessed. There has never been a clear rationale for relating a tax on income to benefit received.<sup>75</sup> This is problematic in a closed system, but is delusional in a system defined by territorial principles of source that is over-inclusive of many kinds of income that can be commonly sourced in other countries under different rules for the same kind of income and that often have stronger non-territorial economic ties in others.<sup>76</sup> Though benefit received is the primary justification for source taxation, there is no way to measure it directly.<sup>77</sup> One can only discover benefit by developing a tax base that reflects it.

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<sup>72</sup> *Id.* at 188. It is Vogel's view that the provision of government goods and services by the Host is the only basis for taxing MNE income, thus affording to the Host exclusive tax over the income. See Vogel, *supra* note 37.

<sup>73</sup> Wilson & Wildasin, *supra* note 58, at 5 (describing marginal-cost pricing as requiring a cost charged on the investment equal to the cost incurred by the government in providing the public goods and services that benefit the investment).

<sup>74</sup> Joel Slemrod, *Are Corporate Tax Rates, or Countries, Converging?* at 4 (Univ. of Mich. Office of Tax Policy Res., Working Paper No. 2001-12, 2001).

<sup>75</sup> See William B. Barker, *The Concept of Tax: A Normative Approach*, in THE CONCEPT OF TAX 35-37 (Bruno Peeters & William B. Barker, eds., forthcoming 2008).

<sup>76</sup> See Barker, *supra* note 3 at 202 (discussing the problems with the present approach to sourcing income in international taxation).

<sup>77</sup> This is the difficulty with those who advocate broad source taxation of business income for the United States under the justification of benefits received. See Stephen E. Shay, et al., *The David R. Tillinghast Lecture, "What's Source Got to Do With It?" Source Rules and U.S. International Taxation*, 56 N.Y.U. TAX. L. REV. 81, 154 (2002) (stating that source rules "lack a strong theoretical or prescriptive content"). The benefit foreign business derives from a host is better measured by source than by territorial connection with the income. See *id.* at 137-38 (arguing that sources rules, while grounded in administrative efficiency, are arbitrary ways

While benefit is the key to source taxation, the concept that taxes should be charged only for the costs of providing public inputs to foreign MNEs is also too narrow to capture the basic factors influencing an MNE's locational decision and the justification for source taxation. While public benefits and taxes are relevant to an analysis of prospective costs associated with the carrying on of the enterprise in the proposed location as factors in the determination of profit, it would be very difficult for an MNE to perform a cost/benefit analysis comparing the value of public goods and services to speculative and varying tax liability. But even if they could, MNEs are not there to earn government benefits, especially if they pay full value through taxes. They are there instead to make a larger profit than they could make elsewhere. It is really the benefit received from a nation state in its totality—that is, the benefit derived from its work force, its infrastructure, and its resources and other natural amenities—that make it possible to make a profit that is derived by the value contributed by that particular country. That is the reason an MNE locates in an emerging economy. It is this “profit” that has an economic origin in the host that is the essence of economically efficient and just source tax jurisdiction.

Moreover, the narrowly defined benefit theory that taxation is exclusively the charge for public inputs provided to firms robs developing economies of one of the most necessary ingredients for development, that of obtaining sufficient revenue for the welfare of the general populace. The exchange theory of taxation, by definition, requires a quid pro quo and rejects distributive values. However, benefit to the firm broadly defined as the profit derived from the firm's value in addition to exploitation of the host country, is an economically sound base for taxing to provide for the general welfare of the host, thus accomplishing distributional justice.

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of attributing income). In the case of income from capital, the benefit derived is small. Though some small tax may be justified on the basis of benefit, that tax ignores the large benefit that the home provides to the creation of the benefit. See Barker, *supra* note 3 at 185–86, 195–97 (advocating a residence, rather than a source, tax). Finally, even if a large nation with large consumer markets might be able to get away with such tax exporting, ultimately it will be due to the fact that those foreign businesses which stay will determine that it is profitable due to the large economic rents they earn. Emerging economies do not have the economic clout, however, to tax in this manner.



### 5.2. Source and the Factors of Production

What attracts business is the key to understanding a nation's appropriate source tax base. Reliance on a territorial basis can produce illogical results and considerable conflict because income production, especially in the case of capital, can have a plausible physical connection with many different locations. There has never been an accepted logical process for assigning income to a geographical location. Moreover, source rules have been used to promote different policies, including different goals in taxing residents and nonresidents and, in the case of some countries taxing source only, to cure some of the harm caused by lack of resident tax. This has led to inconsistent rules for sourcing the same income even in the same country.<sup>78</sup> If there were a superior rule for determining geographic location, it should be based on a clear and logical relation between the income and benefits derived from the location. Since the physical location of mobile factors of production have no necessary relation with benefit received by an MNE from the host, the location of use of assets presents no economic justification for taxation.

The fact that MNEs are more sensitive to tax regimes and incentives reflects the fact that many of the factors of production are quite mobile, and this leads to a wide range of potential business locations. The effect of the mobility of many of the factors of production on source taxation is demonstrated by looking at monied capital. The clear trend in the world today is for source countries to eliminate or reduce substantially their taxation of interest income and oftentimes dividends.<sup>79</sup> In the case of Foreign

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<sup>78</sup> See Barker, *supra* note 3, at 202 (stating that source rules are often inconsistent); see also INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 42 (Am. L. Inst., Tentative Draft No. 10, 1983) (noting that in the United States, the single set of source rules is not entirely symmetrical for U.S.-source income and foreign-source income), citing *Comm'r for Inland Revenue v. Lever Bros.*, 1946 AD 441 (A) (S. Afr.); *First Nat'l Bank of Southern Africa v. Comm'r for Inland Revenue* 2002(3) SA 375 (SCA) (S. Afr.); *Millin v. Comm'r for Inland Revenue*, 1928 AD 207 (A) (S. Afr.). The over reliance on source can easily create an over extension of the source rules. In Apartheid South Africa, for example, the principles of sourcing adopted by the courts included where the contract was made, where funds were made available to the debtor, the residence of the debtor, and the relevant factual matrix which focused on relevant business activities rather than the specific transactions. These rules provide many different approaches to a finding of South African source. See generally South Africa, 5th Report, *supra* note 21, §§ 1.3.3, 6.3.1.1 (discussing source taxation as a general rule but residence taxation for passive income generated abroad, including royalties).

<sup>79</sup> Barker, *supra* note 3, at 193-94.

Portfolio Income ("FPI"),<sup>80</sup> current evidence indicates that any tax imposed by hosts is simply passed on to the debtor and is born by the host economy.<sup>81</sup> In some cases, international lenders provide loans only after payments of principle and interest are guaranteed by the debtor free of taxes.<sup>82</sup> This is even the case where the lender is a resident of a country where the foreign tax would be passed on to the resident government because of the foreign tax credit.<sup>83</sup> It reflects a fact of modern economic life that much of the world's FPI is supplied by large institutional investors (like American pension plans) that are exempt from tax in their own countries.

The Foreign Direct Investments ("FDI")<sup>84</sup> of MNEs yields a profit that includes a component that consists of the normal return on the enterprise's capital. The taxation of the return on this capital should be analogous to the return on FPI because it too is a highly mobile factor of production. Studies have shown that MNEs, to insure this outcome and the maximization of the benefits of deferral, typically finance foreign operations predominantly with debt;<sup>85</sup> one study has suggested that MNEs obtain as much as 80% of FDI from local borrowing especially in developing economies.<sup>86</sup> While nations have generally conceded the

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<sup>80</sup> FPI can be defined as all private, non-FDI investment made by non-residents. *Id.* at 163.

<sup>81</sup> For example, one study documents the substantial decline in interest rates in Canada and a dramatic increase in foreign capital after withholding of tax on interest earned by nonresidents was abolished. Donald S.J. Brean, *International Issues in Taxation: The Canadian Perspective* 73 (Canadian Tax Paper No. 75, 1984); see also Barker, *supra* note 3, at 201 (stating that economies strive for free trade and enhanced factor mobility); VIO TANZI, *TAXATION IN AN INTEGRATING WORLD* 144 (Brookings 1995) (arguing that top marginal tax rates on labor income should be kept low to discourage talent from emigrating, which has a high social cost); M.B. RAO, *DOUBLE TAX TREATIES BETWEEN DEVELOPING AND DEVELOPED COUNTRIES* 113 (1983) (stating that withholding tax on entire amounts of income transferred abroad shifts the tax burden to the debtor enterprise).

<sup>82</sup> Charles R. Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23 *INT'L & COMP. L.Q.* 292, 303 (1974).

<sup>83</sup> *But see* Stephen E. Shay, et al., *supra* note 77, at 153 (recommending taxing FPI on the basis of the benefit received by the investor).

<sup>84</sup> FDI is foreign investment undertaken by an association, enterprise or individual where the investor owns 10% or more of the equity in the activity conducted. Barker, *supra* note 3, at 163, citing GARY C. HUFBAUER, *UNITED STATES TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM* 63 n. 1 (Inst. For Int'l Econ., 1992).

<sup>85</sup> See Hines, *supra* note 28, at 400 (describing how MNEs have an incentive to undercapitalize their foreign operations initially because they anticipate deferral).

<sup>86</sup> See George F. Kopits, *Effects of Tax Changes on Direct Investment Abroad*, in

impracticality of taxing FPI, many nations still hold to traditional views of taxing the totality of business income.

Obviously, the objects of FDI present a more complex analysis than the determination of the object of FPI. Unlike FPI where income is derived solely from capital:

[I]ncome is derived internationally by businesses from factor inputs including capital, tangible assets and intangible assets. Income is also derived from the labor, environment, infrastructure and public benefits of the country in which the various activities are carried out. Which country can be said to be the source of the income based on the economic affinity of the income to the local? Which country has the meritorious case to tax? . . . [T]he country that is the source of the assets that provides the income-producing value should get the exclusive right to tax.<sup>87</sup>

The benefit derived by a host from the importation of capital in all of its forms amply justifies exempting the normal return on this capital, even if it were practical to tax. Capital transfers, even if temporary, cause a redistribution of wealth from developed countries' workers to emerging countries' workers.<sup>88</sup>

Concomitantly, the host has provided the other factors of production: labor, environment, infrastructure, public goods and services, and, in many cases, local markets for the consumption of the MNE's products. These values to the enterprise produce income, which is economically related to the host. It follows that this income does not have its economic origin in the home country so that the host should have the exclusive rights of source taxation.

Where one exempts the normal return on capital provided by the MNE, what one has left can be described as economic rents. Economic rents of MNEs in the context of international operations are of two kinds: locational rents and mobile rents.<sup>89</sup> Locational

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UNITED STATES TAXATION AND DEVELOPING COUNTRIES 223, 241 (Robert Hellawell ed., 1980) (providing numerical support for the idea that American multinational companies vary their direct foreign investment depending on the U.S. treatment of foreign-source corporate income), Peggy Musgrave, *Commentary, id.*, 264 (supporting Kopits' conclusion that local borrowing accounts for almost 80% of the financing of MNEs' FDI in developing countries).

<sup>87</sup> Barker, *supra* note 3, at 202.

<sup>88</sup> See SCHMIDT, *supra* note 11, at 26.

<sup>89</sup> See Harry Grubert, *Tax Credits, Source Rules, Trade and Electronic Commerce:*

rents include net income arising from the factors of production belonging to a host country. Mobile rents, on the other hand, are those derived from mobile factors of production that can be exploited in many different locations because the market for consumption is worldwide. These mobile factors of production that are imported by MNEs include money capital, tangible property, and many intangible values including skilled labor.

The taxation of the normal return on monied capital used by a foreign business enterprise by hosts is less significant due to the prevalence of self-help borrowing practices utilized by MNEs. There is, however—at least as a starting point before emerging economies grant tax holidays, incentives and preferences—the substantial potential for the taxation of the normal return from tangible and intangible assets.

The appropriate source taxation of the income from intellectual property, like patents, is one of the most controversial issues between developed and emerging economies.<sup>90</sup> The position of the developing world was articulated in the Manila Declaration, which adopted the position that royalties should be treated as distributions of profits where the parties were related, and thus would not be deductible and would be subject to withholding.<sup>91</sup> The standard argument for a host's right to tax the royalty income from patents is that the host is providing the environment and protection for its utilization.<sup>92</sup> Where goods or services are produced in the host for export for worldwide consumption, however, the host's protection loses all practical importance. Emerging economies here face the realities of tax competition: nations will compete for this business—for the increased employment, increased taxes, increased local consumption and consumption taxes, and the externalities created by imported technology and highly skilled labor.<sup>93</sup> Nations will tend to bid

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*Behavior Margins and the Design of International Tax Systems* 13–14 (CESifo Working Paper, Paper No. 1366, 2004), available at <http://ssrn.com/abstract=645983> (distinguishing between locational rents and mobile rents' origins).

<sup>90</sup> See RAO, *supra* note 38, at 116–21 (describing the U.N. Group discussions as an example of the intellectual property taxation debate among nations).

<sup>91</sup> Patrick, *supra* note 26, at 318–19.

<sup>92</sup> See A.L.I., *supra* note 78, at 80 (arguing for sourcing the royalty income in the country of use, since it is the host country's legal system that provides the monopoly right that gives the patent its value).

<sup>93</sup> Indeed, it has been suggested that increasing jobs may be more important to developing economies than revenue to their Treasuries. Peggy B. Musgrave,

down the tax on these mobile factors to zero. Moreover, this is a rational strategy as long as the value of the benefits to the host noted above (like increased employment) exceeds the costs to the society, including the cost of providing public goods and services at little or no income tax cost to the MNE.<sup>94</sup> The best strategy, however, is not a forgone conclusion.<sup>95</sup>

Even where assets are used by the MNE for production for domestic consumption, the case for taxing the return on intangibles is weak. Intangibles result from expenditures of capital that were made in other countries that should receive, like monied capital, a normal return free of host tax. Moreover, the nation under whose tax laws the intangible was developed typically gives tax incentives like expensing for the cost of research and development that make the home nation the true joint venturer in the profit making use of those assets, not the host.<sup>96</sup> Only successful intangibles are exported to hosts (thus the country of development

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*Interjurisdictional Equity in Company Taxation, Principles and Applications to the European Union*, in TAXING CAPITAL INCOME IN THE EUROPEAN UNION, (Sijbren Cnossen. ed., 2000).

<sup>94</sup> See Barker, *supra* note 3, at 184–88 (discussing factors to be considered in making this decision in the context of application of intergovernmental versus individual equity for different theories of taxation).

<sup>95</sup> Emerging economies need to weigh many economic factors in assessing the desirability of attracting business activity. For example, the economic impact of the importation of the various forms of capital is different when viewed from the perspective of current account balances. Where monied capital is imported and converted into local currency, this creates a positive balance in the host's current accounts which can be spent on capital exports or on the import of goods and services. Capital spent on labor and purchasing goods and services in the local economy is a stimulus to economic development.

Imports of tangible and intangible assets are rarely sold for local currency and thus have no effect on the monetary supply. Foreign sales of locally-produced products, though booked for accounting purposes to the MNE, unless converted to local currency, will have no effect on the money supply and will not be included as an export in current accounts. Where the profit from domestic sales is repatriated by the MNE, this will be included as a capital export in current accounts, thus requiring additional capital imports or goods and services exports to balance the account. See generally Barker, *supra* note 3, at 175 (describing how economic principles require an equilibrium of the import and export of goods and services).

<sup>96</sup> The fact that the MNE received a tax benefit in the home country for both successful and unsuccessful intangibles is sometimes given as a reason for hosts to tax. See Barker, *supra* note 3, at 202 (declaring the principle that income has a locatable source as one that is taken for granted but the definition of the income's source is not as well-defined). While it may not be unfair to the MNE to tax it, it would be unfair to the home state.

bears the tax loss from unsuccessful expenditures), and the host does not contribute to their creation, just their utilization in host consumption.<sup>97</sup> After a fair return on the MNE's investment, the income related to domestic consumption will be a locational economic rent. Finally, the value of some intangibles, like trademarks, may be the product of activities and expenditures carried out in the host jurisdiction, which does enhance its value. This is not imported value, so the income generated does belong to the host as locational economic rents.

This approach is consistent with the just allocation of the income tax base among nations. The origin of the income is the country that produced the value that gave rise to the income.<sup>98</sup> In the case of income from capital, that income is only the normal return from the capital. In some cases, this income will belong to the host where its economy produced the capital. This happens where monied capital is obtained from residents of the host. Tangible and intangible assets are normally imported by MNEs. Thus, the normal return on these assets represents value created in another country and does not have its economic origin in the host.

### 5.3. Source Rules and Economic Efficiency

Emerging economies must also examine proposed tax rules under properly understood notions of economic efficiency. There are two different theories of economic efficiency in the allocation of capital: Capital Export Neutrality ("CEN") and Capital Import Neutrality ("CIN").<sup>99</sup> Though these do not specifically address business income, a consideration of their approaches can help illuminate the efficient conditions for business income.<sup>100</sup> Both theories of economic efficiency assume general taxation of capital income and source countries' legitimate power to tax the income from capital provided by nonresidents. Both theories recognize that it is the home countries' response that will determine whether

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<sup>97</sup> See Barker, *supra* note 3, at 207-08 (emphasizing the disproportionate benefit reaped by the host country and the potential magnitude of the loss that the home country can incur).

<sup>98</sup> See generally *id.* at 202-12 (discussing whether the host or home country is entitled to the income).

<sup>99</sup> There is actually a third, National Neutrality ("NN"), that will not be discussed herein. For a description of National Neutrality, see *id.* at 190 (identifying National Neutrality as a doctrine that allows both the home and host country to tax capital).

<sup>100</sup> For a full discussion of these concepts' use and misuse, see *id.* at 188-95.

capital is efficiently allocated worldwide; they differ as to what that response should be. CIN provides that "capital should be taxed at the same rate as that imposed on domestic capital in the capital-importing nation."<sup>101</sup> CIN's model of efficiency is that capital should not be taxed in the home state; hence, the home should provide an exemption for foreign source income. CEN provides that "capital should be taxed at the same rate whether utilized in the home country or in the host country."<sup>102</sup> CEN favors worldwide resident taxation with a full tax credit for taxes paid to the host. Emerging economies are strong advocates of CIN because source taxation levels income by subsidizing capital importing nations. CIN provides emerging nations a potentially cheap source of capital.<sup>103</sup>

Economists generally favor CEN because a nation that taxed only domestic income from capital would experience a large capital drain.<sup>104</sup> Not surprisingly, developed countries in general have followed the logic of CEN and have taxed residents on their foreign source income from capital. Where effective, a CEN system increases the cost of capital to emerging economies, but, because its model of efficiency is pre-tax, it permits the host to tax it. These regimes, however, are ineffective in many cases. On the one hand, home countries have found that it is difficult to exercise effective jurisdiction over the foreign source capital income of its residents due to tax avoidance and evasion and because capital income is often mixed with business income which is deferred or exempt.<sup>105</sup> The effect of not effectively taxing residents' foreign source capital income is to destroy the effectiveness of CEN and to create the premise underlying CIN. On the other hand, by providing tax incentives with or without exemption or tax sparing, the efficiency of CIN is undermined where tax breaks are discriminatory and create unfair competition for those who are without them. CIN's premise is that capital will flow to the country where it garners the highest return—that is, the country where it will be put to its most productive use. CIN, however, is post-tax. The highest return is

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<sup>101</sup> *Id.* at 189.

<sup>102</sup> *Id.*

<sup>103</sup> See Schmidt, *supra* note 11, at 34.

<sup>104</sup> See Barker, *supra* note 3, at 190-91 (arguing that CEN is a superior doctrine because it encourages an efficient allocation of world investment).

<sup>105</sup> See *id.* at 165-69 (tracking the historical shift in countries' tax bases from capital and business income to labor and consumption).

either tax-free, or any tax must be added on to the rate. Thus, source countries are more and more unlikely to tax nonresidents' capital income for very good reasons. Taxation either will stymie the import of capital or will be ineffective because it will be passed onto the borrower and the host economy. These practicalities help illustrate a basic truth in terms of two theories of justice in taxation: benefit and ability to pay. Hosts cannot tax the normal return from capital because it benefits little from the host's environment.<sup>106</sup> Hosts, in addition, cannot tax the normal income from capital according to the principle of ability to pay because ability to pay is an attribute of residence and source countries lack both sufficient justification and the practical power to tax.

CIN, therefore, is non-neutral because the tax will be added onto the cost of borrowing and will increase the debtor's costs. CIN is inefficient because tax affects the locational decision and the only way to create conditions of efficiency is for no country to tax or for all countries to tax at the same rate. The failure of CIN is in its paradigm, which assumes that the relevant competitive environment or level playing field within which a nonresident competes is a single country.

The notion of fair competition within a country ignores the reality of open capital markets, freer trade, and freer factor mobility. This not only affects FPI, but FDI as well. MNEs have choices. Their playing field can be several countries or a region in a zone of free trade. More and more, the choices for production of goods and the provision of services are becoming worldwide. In the case of financial services, for example, it is already there. Thus, CIN's conditions of efficiency promote tax competition, inexorably driving the rate for source taxation of a normal return from capital to zero.<sup>107</sup>

The concept of CIN and a single nation level playing field can

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<sup>106</sup> See *id.* at 195-97 (describing CIN as justifying source-based taxation, given the minimal benefit the host country provides the taxpayer).

<sup>107</sup> There are some risks to exemption for non-residents' capital income. Nontaxation of nonresident capital income can also be potentially harmful to the host. The domestic economy of the host is exposed to a risk that untaxed foreign capital will be lent at a rate below the pretax return on taxed domestic capital. The cure, of course, is full taxation by the home country, but this is not within the control of the host. The host may conclude that the trade-offs are acceptable because cheaper capital benefits domestic borrowers and economic productivity in general. Should hosts wish to prevent this from happening, the solution is to tax nonresident capital income, which will increase the cost to its borrowers and/or decrease the supply.



be a useful paradigm for the taxation of locational economic rents, however. Though MNEs' playing fields are truly global and the competition is for world markets, each chooses a location to earn rents. These rents are the product of non-mobile factors of production and an MNE's ability to maximize the return on capital in that location.

From the perspective of developing economies whose objectives are the dual goals of encouraging foreign investment and taxing that investment, taxing economic rents is economically neutral because "[b]y definition, taxes on rents secure revenues for public purposes without disturbing private economic decisions."<sup>108</sup> A tax on rents should be a successful tax because by their nature MNEs should have some firm specific assets that make it possible for them to exploit the values found in developing economies in a more efficient way than domestic companies that would otherwise have a natural advantage.<sup>109</sup> An additional consideration is that a tax on economic rents represents a sharing of the risk between the MNE and the host government since only successful enterprises are taxed, and the host shares the risk by receiving no tax on the margin on new investment. Therefore, not only does the tax on economic rents encourage new investment in a non-distorting manner, but it is ideal from the point of view of developing economies trying to increase the welfare of their citizens by taxes whose burden falls on nonresident firms.<sup>110</sup>

This does not mean that competition among nations disappears. However, due to the natural differences in the endowments of emerging economies, tax differentials on economic rents, which will be spent on public inputs that directly enhance the business environment and public welfare measures that indirectly enhance the business environment, will lose much of their importance. Ultimately, just knowing what tax base clearly

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<sup>108</sup> Slemrod, *supra* note 74, at 4.

<sup>109</sup> See Richard Bird, *The Interjurisdictional Allocation of Income*, 3 AUSTRALIAN TAX F. 333-54 (1986) (emphasizing that that the firm's assets themselves produce economic rents); see also Peter B. Sorensen, *Changing Views of the Corporate Income Tax*, 48 NAT'L TAX J. 279, 290 (1995) (arguing that sometimes the "local factors" of a country enable multinational companies to earn higher than normal rents on investments). My point develops their analysis by suggesting that these advantages make it possible to more efficiently exploit the location, thus earning additional rents.

<sup>110</sup> See Slemrod, *supra* note 74, at 6-7 (discussing tax on foreign-owned rents).

belongs to the source country will encourage emerging economies to exercise their tax jurisdiction.

Knowledge of the economic origin of income not only provides the clearest indication of which nation has a right and interest in taxation, but it also can indicate the weakness of a nation's claim to taxation where the territorial basis lacks an economic justification. The simple truth for emerging economies is that even where income can be sourced within their jurisdictions under traditional approaches to source jurisdiction, a so-called tax incentive that would relinquish their tax over income that does not have a sufficient economic connection with the host, instead of being a sacrifice, is instead in the direction of just tax policy. It is not presently, however, a rational policy. The tax incentives, tax holidays and tax preferences commonly adopted by emerging economies today are inefficient in accomplishing their goals, and are discriminatory and cause harm to the resident taxpayers thus putting pressure on hosts to grant similar tax benefits to residents. To the contrary, the incentive system proposed herein is not like the generality of the incentives offered which are targeted, discriminatory tax breaks for a few, but instead are general exemptions from taxation that would be neutral as to investment and business activities and are the most economically efficient under current conditions. The common advice of the developed world to the emerging world is to refrain from discriminatory tax incentives, and to entice MNEs instead with low rates of tax applied to both nonresidents and residents alike.<sup>111</sup> The more optimal strategy suggested herein that accomplishes a similar neutrality is to reconstitute the tax base by eliminating targeted preferences and redefining business income. This reduces the tax base with regard to income from capital, but increases the tax base with regard to non-capital business income. This strategy recognizes an appropriate tax base for emerging economies with a realistic power to impose a significant burden.

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<sup>111</sup> See CORPORATE TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT, *supra* note 1, at 26-27 (discouraging generally the use of special tax incentives and encouraging a reduced statutory corporate income tax rate); see also INTERNATIONAL MONETARY FUND, *supra* note 52, at 10 (describing a reform measure that sets the rate for corporate income tax equal to that of the top marginal personal income tax rate and allows only minimal tax incentives).

#### 5.4. A Consumption Tax Model of Source Taxation for Emerging Economies

Economic rents are the profits left over after the normal return on capital is isolated.<sup>112</sup> An income tax on economic rents is equivalent to a business expenditure or consumption or cash flow tax.<sup>113</sup> The critical components of such under an income tax approach would be an allowance for economic depreciation and an imputed interest deduction for the normal rate of return on all capital. Under a consumption or expenditure tax model instead, the tax base permits deductions for all expenditures for goods and services, both current and capital. This kind of cash flow tax would be a much simpler model than an income tax on economic rents.<sup>114</sup>

A business expenditure tax taxes what is available for consumption over and above capital and its normal return. On account of this, a tax on economic rents ignores the income tax problem of the bias toward present consumption, treating present consumption and greater future consumption as equal where the present discounted value of future consumption is the same as present consumption. It accomplishes this by ignoring interest. This is a significant advantage due to the distortion caused by

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<sup>112</sup> The emphasis herein on exclusive source taxation of economic rents distinguishes this proposal from the international consensus as described by Reuven Avi-Yonah, which proposes the source taxation of active business income and the residence-based taxation of portfolio income. See Avi-Yonah, *supra* note 3, at 1305. That is because when one isolates the economic rent component of income, the result is the allocation to the resident country of the tax on the normal return on all capital, not just the foreign portfolio income component.

<sup>113</sup> See Barker, *supra* note 3, at 212 (explaining that after one removes the normal return of capital from the tax base, the remaining portion is consumption).

<sup>114</sup> Were home countries not to adopt the solution of exempting foreign source economic rents, which is discussed in Section 7, the issue arises as to whether such a tax is an income tax creditable against home country income tax. See, e.g., I.R.C. § 901 (2000) (setting forth various restrictions on the foreign tax credit provided by the United States). Since a tax on economic rents is clearly a tax on an amount that constitutes income, the answer should be a categorical yes. Though authority for this proposition is sparse, the United States does allow a partial credit for the IRAP, the Italian general consumption tax on small and medium-sized businesses. News Release, IRS, IRS News Release IR-INT-98-6 (Mar. 31, 1998). Since the IRAP does not allow a deduction for labor and interest, it reduces the credit by the proportion of the base that represents un-deducted interest and taxes. Under the consumption tax model proposed herein, labor costs are deductible and interest costs can be deducted under the R&F, as opposed to the R system. See *infra* note 115 (discussing the R and R&F systems).

deductions for the inflation component of interest in income tax systems.<sup>115</sup>

In addition, if earnings and profits are defined in terms of economic rents (less taxes), then dividend distributions are distributions of rents, not income from capital. Emerging nations that wish to encourage continued use of these funds in their countries could contemplate a two-tiered system: a tax on the rents at the corporate level, and a second tax imposed upon the distribution of rent to the shareholders.

#### 6. HOME COUNTRY RESPONSE

Traditional doctrine recognizes that home countries, though not the source of the economic activities that gave rise to the income, have an independent basis for taxing the revenue, and that is residence. The demonstration of the economic origin of economic rents in the host necessarily demonstrates that it is not in the home and that the home lacks any economic claim to tax the income in rem. The tax claim of residence, however, is supported by the taxpayer's relation to the country, an in personam principle.

The international tax model proposed here, however, has blurred the traditional conflict between source- and residence-based taxation by rewriting the rules for sourcing income based on concepts of economic origin. The concept of economic origin represents a holistic approach to sourcing income that weighs the importance of territory and residence, in rem and in personam jurisdiction, to determine the most important economic ties. This is a value-laden approach that assesses right, might, and justice. *Business* income is divided into economic rents which are sourced in the host, hence territorial jurisdiction, and the return from capital which is sourced in the home jurisdiction, hence personal

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<sup>115</sup> See Barker, *supra* note 3, at 213 (arguing that an advantage of the consumption tax is that the inflows and outflows of debt or equity and their returns are treated equally); see also J.E. MEADE, THE STRUCTURE AND REFORM OF DIRECT TAXATION 230-33 (1978) (describing the effects of R-base and R&F base consumption taxes). An R-base consumption tax accomplishes this directly by denying a deduction for interest. Were a deduction for interest necessary to make a consumption tax look more like an income tax for foreign tax credit purposes of home countries, the host could adopt an R&F base tax which changes the treatment of loans, including borrowings, as income and treats principal and interest repayments as deductions. *Id.* at 233. An alternative design based more closely on income tax principles would allow a deduction for interest for the real component of interest to the MNE. The MNE would also be entitled to deduct economic depreciation of assets plus set up a reserve for replacement cost.

jurisdiction. In this model, residence becomes a primary, not a secondary, right to tax. Where the claims of residence are included in the sourcing determination, can residence still be an independent basis for taxation? The premise of worldwide taxation is that a nation has the right to tax the total income of its own people because of the special obligations and duties between them. Principles of equality among a nation's taxpayers suggest that all pay taxes on the basis of their ability to pay.

Inter-nation conflict, however, requires nations to make concessions to the principles of ability to pay. Exemption countries suspend the principle for active business income. Foreign tax credit regimes suspend the principle when they adopt comprehensive deferral and exemption systems for foreign "source" income. The result may be that only the MNE benefits because the host taxes lightly or not at all. In light of the magnitude of the present concessions made, should the principles of ability to pay require the home country to tax the value that the emerging nation has added to the world? If so, is this not poaching on the tax base of the developing world?

Moreover, taxation in accordance with ability to pay is poorly applied to corporate enterprises.<sup>116</sup> A principle reason for the taxation of worldwide income is the importance of progressive tax principles. Progressive principles rarely apply to MNEs.<sup>117</sup> Corporations at best are temporary surrogate taxpayers for their owners. At worst, they are independent persons without boundaries or true national affiliation. The benefit derived by MNEs from countries in which they operate is still the best basis for taxing corporations, and the justice of taxation in accordance with benefit clearly belongs to the host in the case of locational economic rents. Moreover, these rents are derived from value contributed by the host to the taxpayer. The home still benefits, however. These rents eventually make their way home and add to the store of the home country's wealth. They are paid as dividends

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<sup>116</sup> See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 318-23 (2001) (arguing that the ability-to-pay principle should not be applied to foreign-source income of U.S. corporations because of challenges in defining the corporation's residence and the possibility of U.S. residents purchasing portfolio investments in order to take advantage of benefits that were intended for corporations).

<sup>117</sup> For a limited exception for low-income corporations from the principle of flat rate taxation, see I.R.C. § 11 (2000).

and resident shareholders will pay tax on them as dividends or capital gain on the sale of their shares. While the corporate tax base would not be shared with the home with respect to foreign sourced economic rents, this tax base is shared with the home through the taxation of individuals. This should be a fitting compromise in a world with conflicting claims to revenue.

If fairness to developing economies were not sufficient justification, there are other compelling reasons why home countries should be willing to relinquish tax on foreign economic rents. The home has a strong interest in its foreign ventures being competitive; that is why home states often use tax incentives to promote these activities. Relinquishing tax on foreign source economic rents can help home businesses compete with other countries' MNEs which operate on a worldwide playing field dominated by free capital movement and businesses seeking rents where much of business income is exempt from home country tax.<sup>118</sup> This model acknowledges the real world in which we live.

This proposal is compatible with the Report of the President's Panel on Federal Tax Reform<sup>119</sup> that recommended that the United States adopt a territorial tax system for business income earned by United States residents.<sup>120</sup> The Panel recommended that both active business income earned by foreign affiliates abroad and dividends paid out of active foreign business income would be exempt.<sup>121</sup> The proposal provides that interest and royalties deducted in the host country would not be exempt, nor would income generated by foreign assets like financial income.<sup>122</sup>

Home countries may also consider the aspects of justice toward

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<sup>118</sup> See Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937, 938, 950 n.22, 957 (2004) (concluding that were the United States to exempt foreign source income (other than passive income) of corporations, both world and American welfare would be advanced). The proposal herein provides the methodology for accurately accomplishing this outcome.

<sup>119</sup> PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), available at <http://taxreformpanel.gov/final-report/>.

<sup>120</sup> *Id.* at 62.

<sup>121</sup> *Id.* at 134.

<sup>122</sup> *Id.* Though one cannot be sure from the description of the plan, the Panel's proposal could be implemented by taxing worldwide income with an exclusion for foreign economic rents. The result would be, however, that the entire return on capital would be taxable in the United States, not just the return that was deducted in the host state.

the developing world. Where developed countries wish to foster development in emerging economies, it would greatly benefit these countries to give them control over this tax base. Freedom from the entanglement of foreign tax systems would free them to achieve social and economic policies unfettered by the tax consequences of these policies in the home states of foreign investors. Indeed, MNEs may find that hosts, now assured of the soundness of their tax base, may exercise their rights to tax for the public good providing both infrastructure development of benefit to MNEs and accomplishing redistributive goals.

This is also a pragmatic solution because it substantially benefits home countries. The basic premise of residence-based taxation is that residence defers to source, and home countries are only entitled to the residual tax. Even though few countries tax the investment income of foreign residents, resident countries' tax systems face incredible difficulties in capturing this base. Even where the income is reported, home countries may only get a portion of the tax. The territorial understanding of source has sourced the normal return on capital in all of its forms outside the country of residence, typically in the country of use.<sup>123</sup> Where income is from a foreign source, there is a likelihood that it will be exempt or shielded by foreign tax credits in the resident state even where the host imposes little or no tax. Residence taxation with deferral and foreign tax credits produce little revenue, as has been documented in the case of the United States, where recent findings show that the tax on repatriated earnings of MNEs is approximately 3.3%.<sup>124</sup> Much of this is the result of many taxpayers being in excess credit positions. Indeed, this results in the developing economies subsidizing the developed economies' higher source rates on business income and increases the pressure on them by international business to reduce their effective tax rates by providing tax holidays, incentives, and preferences. The solution proposed herein presents a fair trade; under these

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<sup>123</sup> See Barker, *supra* note 3, at 203 (arguing that the best territorial source of interest income rule is the place of use). In some cases, surrogate principles like the residence of the debtor are assumed to accurately identify the place of use. *Id.* at 204. Many of the sourcing rules in pre-apartheid South Africa were designed to circumvent the limitation of territorial taxation. See Fifth Report, *supra* note 21, paras. 1.3.3. & 2.1. (describing the growth of source provisions in South Africa's tax system). Royalty income, for example, is sourced in the country of the owner's residence.

<sup>124</sup> Altshuler & Grubert, *supra* note 20, at 798.

proposed allocation rules, home nations are allocated the full tax on residents' capital income in exchange for the tax on foreign locational economic rents.

Though according the exclusive right to tax the normal return on capital to the country of residence does reflect a growing consensus in theory and practice in the developed world, its implementation has been primarily through treaties for the elimination of double taxation. While this paper has argued that this is good tax policy for emerging economies, emerging economies may hesitate to relinquish this tax base without obtaining concessions. A realistic prospect of implementation may require the adoption of bilateral treaties which will be highly advantageous to both countries and taxpayers alike. More tax treaties with emerging economies would certainly be in the best interest of countries such as the United States, which have had trouble negotiating treaties with emerging economies due to its refusal to grant concessions like tax sparing.<sup>125</sup> Exemption of economic rents might encourage developing economies to enter into treaties with countries like the United States that could provide access to information that would make taxation of foreign derived capital income more effective. Moreover, the solution to give up what it neither has nor really deserves in exchange for a tax base it does deserve and can effectively capture, would clearly be an ideal solution to fostering development in emerging economies and curbing the harmful effects of tax competition both at home and abroad.

## 7. CONCLUSION

Sustained world development will only be achieved by recognizing the facts of government tax competition, among both emerging and developed economies. International tax regimes and tax competition also affect the competition between different nations' transnational enterprises. Progress can be achieved by establishing non-antagonistic, economically effective source and residence country taxation.

Economic evidence strongly supports the conclusion that tax incentives do not lead to the type of long-term foreign business presence in developing economies that promotes significant

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<sup>125</sup> Some countries will not enter treaties without tax sparing. See TAX SPARING, *supra* note 1, at 19-20.



economic improvement. Recent evidence does support the finding, however, that tax sparing does lead to increased foreign direct investment in tax sparing treaty partners. It provides a powerful incentive for MNEs to invest in particular emerging economies because the tax savings end up as larger profits for MNEs. Evidence is lacking, however, regarding whether tax incentives with or without exemption or tax sparing result in significant development in emerging economies. The bulk of the evidence, however, indicates that incentives are harmful because they are inefficient, distorting, and encourage the repatriation of dividends by MNEs. Tax sparing, in fact, exacerbates the problem by encouraging emerging economies to grant even more tax concessions to MNEs.<sup>126</sup> Thus, tax sparing as it presently exists seems no more than state subsidies by developed countries of their own enterprises and a stimulus to harmful tax competition by developing countries.

There is, however, a workable strategy for both developing and developed economies that will encourage foreign direct investment in emerging economies, while at the same time reduce the wasteful consequences of tax competition. Emerging economies should abandon the source taxation of the normal return from capital of foreign persons. This would promote economically efficient tax relief for foreign business.

What is left for source countries is the taxation of economic rents. The importance of increased tax revenues to developing economies indicates that they should tax these rents. The proposal suggests that they could benefit by a two-stage tax, one on corporate rents and a second on a distribution of these rents to shareholders. This would encourage MNEs to retain their profit in the developing economy. They should refrain from taxing any other income of nonresident MNEs unless their intent is to discourage their presence.

This proposal does not eliminate tax competition; it simply restructures it in accordance with sounder principles with less harmful effects. The abandonment of territorial jurisdiction over the normal return from capital, which emerging economies have neither the might nor the right to do, will create neutrality among source countries vis-à-vis capital flows. Due to the natural

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<sup>126</sup> Cf. Hines, *supra* note 62, at 28 (concluding that Japanese firms are taxed at lower rates than American firms in countries with which Japan has tax sparing agreements).

differences in country endowments, tax differences (which, if wisely spent, will increase the attractiveness of emerging economies) will lose much of their importance. Ultimately, emerging economies assured of power over this tax base may decide to use it.

Developed countries should exempt or adopt tax sparing for locational rents. This is not foreign aid, but is instead a recognition that the public purpose that supports worldwide taxation of residents is weak in the case of MNEs and should give way to a more important purpose of recognizing the justice of developing countries' exclusive entitlement to this tax base. Control over this tax base would provide emerging economies choices concerning their own development.

Though this strategy for unilateral action produces immediate and substantial gains for both developed and emerging economies, countries may only be willing to concede their historic tax base through bilateral tax treaties. Tax treaties present a superior method for international tax claim adjustments because they provide a stable and attractive environment for MNEs, they can reduce the pressure of tax competition of emerging economies, they can provide needed tax information to both countries, and they provide substantial non-tax externalities. This would be a win-win result indeed.