NBER WORKING PAPER SERIES

U.S. TAX LAWS AND CAPITAL FLIGHT FROM LATIN AMERICA

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Working Paper No. 2687

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
August 1988

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NBER Working Paper #2687
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ABSTRACT

The interplay between the tax laws of the United States and those of the countries of Latin America creates inducements for capital flight. Most Latin American countries tax only income originating within their boundaries. If other countries tax income of foreigners originating within their boundaries as heavily, there is no tax advantage to capital flight. Latin American countries thus depend on other countries for the prevention of tax-induced capital flight and the loss of public revenues, investment funds, and equity it implies.

Income from a U.S. trade or business conducted by foreigners, including capital gains, is subject to U.S. tax. Capital gains on real estate and dividends are generally taxed, but it may be possible to reduce those taxes substantially. The United States does not tax most other capital gains realized by foreigners. Most interest income paid to foreigners is also exempt from U.S. tax. Thus U.S. tax laws help attract capital from Latin America.

A solution to this problem does not seem likely. The United States seems unlikely to reverse its policies. Little is to be gained from adoption of a residence-based approach by Latin American countries. A more radical approach that might be more effective would be a switch to consumption-based direct taxation in which interest income is neither taxed nor allowed as a deduction. This would reduce the attraction of favorable U.S. tax treatment by making equally attractive treatment available at home, but raises troublesome issues of equity, the treatment of foreign investment, and transition.

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U.S. Tax Laws and Capital Flight from Latin America

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I. Introduction

Most countries of Latin America attempt to tax only income deemed to have its source within their boundaries; they do not attempt to tax income of their residents (or citizens) deemed to originate in the rest of the world. That is, they employ a territorial (or source-based) system of taxation, and do not attempt to implement worldwide (or residence-based) taxation.[1] To the extent that residents of nations relying on source-based taxation invest their capital in other countries, they can avoid taxation in their home country. Even when Latin American nations attempt to implement worldwide taxation, success in this endeavor is likely to be difficult for administrative reasons. Taxpayers in most Latin American countries that employ the residence principle who are willing to commit fraud are generally able to evade tax on foreign-source income with relative impunity.

The direct result of the failure or inability of such countries to tax foreign-source income is loss of tax revenues potentially available on such income. A more serious threat is the loss of capital that could productively be invested at home and the further diminution of the tax base and the loss of equity it implies. Of course, to the extent that other countries tax all income deemed to originate within their boundaries at rates at or above those levied in Latin American countries, there is no tax advantage to capital flight, regardless of the tax treatment (residence or source) in the home country.[2] In a sense then, the countries of Latin America that do not tax (or cannot effectively tax) income earned abroad are dependent to some degree on other countries for the prevention of tax-induced capital flight and the loss of public revenues, investment funds, and equity it implies.[3]

Income from a U.S. trade or business conducted by foreigners is subject to tax in the U.S. on the same basis as a business conducted by residents of the U.S. But this is probably much less relevant for the present discussion of capital flight induced by favorable U.S. taxation than the tax treatment of income earned on passive investments.

The United States does not tax most capital gains realized by foreigners, except those on real estate and those effectively connected with a trade or business. Most interest income paid to unrelated foreigners is exempt from U.S. tax, whether paid by financial institutions or by others. Dividends on corporate shares and capital gains on real estate are generally subject to tax, but in the case of dividends it may be possible to reduce taxes substantially through the use of nominee accounts in treaty partners of the U.S. Thus the United States acts as an enormous magnet poised to attract capital from Latin America, especially debt funds.

This paper examines the inducements to capital flight produced by the interplay between the tax laws of the United States and those of the countries of Latin America. Complicating this interaction is the possibility of channeling investments through tax haven countries with which the United States has tax treaties. Fortunately for the countries of Latin America, there are relatively few such countries. While the United States has moved in recent years to reduce the opportunities to use "treaty shopping" to reduce taxes, it has followed domestic tax policies that aggravate the problem of capital flight from Latin America.

Section II describes the general principles that govern the taxation of income from capital moving across national boundaries, including relevant provisions of major model treaties for the prevention of double taxation. This description is provided to set the stage for the discussion of the rest of the paper. It includes a limited discussion of the background and apparent rationale for the existing tax treatment of such income in order to serve as background for the discussion in the final section of potential remedies to the problem of capital flight from Latin America induced by generous treatment of certain forms of income earned in the United States by foreigners.

Section III focuses briefly on the tax systems of Latin American countries. The purpose is to indicate how problems of capital flight and tax avoidance and evasion created by the U.S. tax law are aggravated by the tax treatment of capital income typically found in these countries. Besides noting that most countries of Latin America do not attempt to tax foreign-source income, it indicates why it is difficult for the few that attempt to impose tax on a worldwide basis to do so effectively.

This description of tax systems employed in Latin America is quite brief for several reasons. Most obviously, it is difficult to go beyond the basic characterization of a system as being based on either source or residence, without becoming embroiled in minute details. More important, little would be gained from a detailed examination of the tax laws of Latin American countries. A basic premise of this paper is that every tax system in Latin America is in effect likely to resemble a source-based system, especially in its taxation of passive income, even if the tax law states that worldwide income is to be taxed.

Section IV describes how the United States taxes five kinds of income received by foreigners: income from the conduct of a trade or business, interest on bank deposits, interest earned on portfolio investments in debt, income (including capital gains) from other portfolio investment, and capital gains from investment in real estate. Attention focuses on the last four items of non-business income, as they appear to be the forms in which income is most likely to be earned by Latin Americans wishing to invest in the United States without leaving their home countries.

Section V discusses potential solutions to the problem of capital flight induced by attractive U.S. tax treatment of income earned by foreigners. Approaches considered include both changes in the tax system of the United States and changes in the tax systems of Latin American countries. Many of the current provisions of U.S. law can be traced to the perceived need to respond to competitive pressures from foreign countries and to abuses of international tax treaties with the United States; as a result, resolution of the problem based on changes in U.S. law might require cooperation by other developed countries, including treaty partners of the United States, and various tax haven countries. That this is true indicates clearly that there is not much room for optimism that a solution to the problem addressed here based on U.S. action will quickly be found and adopted.

From what has been said above, it is clear that most Latin American countries would gain little benefit from adoption of a residence-based approach. A more effective approach, but one that is much more radical, would be a switch to a consumption-based system of direct taxation in which interest income is neither taxed nor allowed as a deduction. This would reduce the attraction of favorable U.S. tax treatment by making equally attractive treatment available at home. It does, however, raise troublesome issues of equity, the treatment of foreign investment, and transition.

It may be appropriate to state clearly, before proceeding, that the discussion that follows is not based on a naive view that taxes are the only determinant of international capital flows, or even the most important determinant. Clearly much more important than taxes as reasons for capital flight from developing countries are such concerns as political instability and fears of economic crises and currency fluctuations. Similarly, any tax advantages of investment in the United States are likely to be dwarfed, inter alia, by the attraction of political stability. Yet, all things equal, the tax treatment of various items of U.S. source income in the United States and elsewhere almost certainly does exert an influence on investment decisions at the margin. The purpose of this paper is to describe some of the most important of the features of U.S. tax law that may have this effect, especially those that result from liberal U.S. tax treatment of income earned in the United States by foreigners.

No attempt is made to quantify either the attraction offered by these tax benefits, relative to other forms of attraction (e.g., differences in political stability) or the amount of capital that may be drawn into the United States by them. Attempting to answer either of these questions would be a hopeless task; the difficulty in the second case of holding all other influences constant is compounded by the lack of reliable data.

Finally, attention focuses on U.S. tax policy as an attraction to capital; no effort is made to provide either a detailed description of the tax laws of Latin American countries or a comparison of U.S. law with tax provisions found in the laws of other countries, especially those of Japan and the developed countries of Europe. Of course, to the extent that foreign investors are treated generously in other countries, comparably generous U.S. treatment may, at least in part, merely divert investment from them, rather than inducing additional capital flows from Latin America. If generous taxation of the income of foreigners continues elsewhere, the tax-induced attraction of funds from Latin American countries may not be reduced much by a unilateral tightening of U.S. taxation of such income.

II. Principles of International Taxation

There are two basic approaches to the taxation of income flowing between countries. Under the source principle all income originating in a given jurisdiction is taxed, but that originating elsewhere is not. This is sometimes also called a territorial approach. The residence or worldwide approach, by comparison, taxes all the income of residents of the taxing jurisdiction, wherever earned.[3] Many countries, including the United States, employ both approaches. That is, they tax both income originating within their borders and all the income of residents, wherever earned.

Advocates of the residence principle cite the following primary advantages. First, residence-based taxation does not discriminate between income flows, depending on their country of source; that is, income is taxed the same, whether earned in the United States or in a foreign country (and regardless which foreign country). This feature of residence-based taxation is sometimes called "capital-export neutrality." If employed effectively by all nations, residence-based taxation would not interfere with the allocation of economic resources among nations; in principle, it would lead to the allocation of the world's capital to the most productive uses. By comparison, source-based taxation (if not matched by benefits of public spending) discourages investment in high-tax jurisdictions and encourages investment in law-tax jurisdictions.[4]

Second, implementation of the ability-to-pay principle of taxation requires that residents of a country pay tax on their entire income under the personalized system prevailing there, rather than having it taxed at the rates applied in the countries where it is earned. This objective is also achieved by residence-based taxation. Finally, capital-exporting countries support residence-based taxation because they want the revenue at stake.[5]

Advocates of source-based taxation argue, in part, that the source country is entitled to capture for its public coffers part of the income originating within its borders.[6] Moreover, they argue, residence-based taxation is inevitably difficult to administer, especially in a developing country.[7] These difficulties are examined further in the next section. To the extent that worldwide taxation cannot be administered effectively, capital flight (from the countries with inadequate administration) is encouraged and the theoretical advantages of capital-export neutrality are not actually achieved.[8]

Double taxation would result from the application of both source and residence-based taxation to a particular international flow of income.

Countries employing the residence principle commonly defer to the fiscal claims of source countries. In the United States this is achieved unilaterally by allowing credit against domestic tax liability for income taxes paid to foreign governments, up to the average rate of taxation paid in the United States.[9] As long as the foreign tax rate does not exceed the domestic tax rate, capital-export neutrality is achieved. As an alternative, a taxpayer can, at its option, take a deduction for foreign taxes, rather than a credit.[10] U.S. tax treaties also regulate the tax treatment of income flowing between treaty partners. The problem, then is to establish norms for taxation by countries of source.[11]

In deciding both whether to utilize source or residence-based taxation and whether the tax system of the source or residence nation should be given precedence in international tax conventions, nations face conflicting objectives. For example, a capital-importing nation might like to enact heavy source-based taxes, in order to capture tax revenue for its treasury. On the other hand, it may fear the adverse effects source-based taxation that is not offset by foreign tax credits in capital-exporting countries would have on foreign investment in the country. Indeed, a decision may be made by the source country to forgo tax revenues in order to attract capital. This is especially likely where potential foreign investors reside in countries that do not or cannot tax foreign-source income.

For revenue reasons, a capital-exporting country can be expected to prefer residence-based taxation. This pattern is exemplified in the tax laws of the United States and, sometimes to a lesser degree, in those of many other developed countries. Long (but no longer) the premier example of a capital-exporting nation, the United States employs residence-based taxation. Whereas it unilaterally extends priority in taxation to the source country through its foreign tax credit, it attempts to protect its position as a capital exporter by pressing for provisions in its foreign tax treaties that reduce source-country taxation of interest, dividends, and various other forms of payments to its residents. Capital-importing countries can be expected to favor an international system in which source-based taxes on these types of income are higher than proposed by capital-exporting countries and in which the latter countries provide foreign tax credits for source-based taxes. Such a situation allows them to raise revenue from foreign multinational corporations with little fear of adverse economic consequences, as long as the tax rates applied to these forms of income by the source country do not exceed those in home countries allowing foreign tax credits.

These contrary pressures of conflicting objectives can be seen by comparing the United Nations (U.N.) Model Double Taxation Convention between Developed and Developing Countries with the Draft Double Taxation Convention on Income and on Capital published by the Organisation for Economic Cooperation and Development (OECD). The latter draft convention is relevant primarily for fiscal relations between developed countries. Since capital flows among such countries can be expected to be roughly in balance (at least multilaterally over the long run), the distinction between capital-importing and capital-exporting countries may be have little significance. Thus the OECD draft treaty, reflecting the preference of these countries for the residence principle, calls for limiting withholding taxes on interest to 10 percent of the gross amount of interest.

By comparison, the U.N. model convention involves both developing countries that are generally capital importers and developed ones that export capital. It leaves the limitation on the tax rate on interest unstated, to be the subject of bilateral negotiations between the contracting parties. This difference reflects the conflict between "the strong view on the part of members from developing countries that those countries should have the exclusive, or at least the primary right to tax interest" and the view of the representatives of developed countries that the home country of investors should have the primary or even exclusive right to tax such income.[12] Analogous ambiguity and latitude for negotiations characterizes the U.N. guidelines on withholding rates on dividends, in contrast to the definite limits stated in the OECD model convention.

Foreign tax treaties of the United States commonly give the country of residence an increased secondary claim in the taxation of certain types of income (e.g., interest, dividends, and capital gains) by providing reduced taxation by the source country. Besides capturing tax revenues on income from U.S. capital invested abroad for the U.S. Treasury and encouraging capital flows between treaty partners and the United States, such treaties are subject to abuse; the most common forms of abuse are described in section IV. Moreover, for certain types of income earned in the U.S. by foreigners the United States does not attempt to impose source-based taxation as a matter of domestic tax policy.

III. Latin American Practice

Most countries of Latin America attempt to tax most income from business and capital earned within their borders by both residents and non-residents.[13] The top tax rates applied to individual income range from 30 percent in Bolivia, Colombia, and Paraguay, to 55 percent or above in Chile, the Dominican Republic, El Salvador, Mexico, Nicaragua, and Panama. Corporate rates are generally similar, but commonly somewhat lower. (See Table 1.) Of course, the actual burden on domestic source income depends on the details of the tax law of various countries. But one thing is certain. Unless income earned abroad by residents is also taxed, either by the home country or by the country in which capital is invested, there are tax-induced incentives for capital flight.

The countries of Latin America have traditionally been strong proponents of the source principle of taxation.[14] This is reflected in the pattern of jurisdictional standards reported in Table 1. Of the 18 countries covered, only five attempt to tax the worldwide income of corporations and only seven do so for individuals. Although several of the more advanced countries of Latin America do attempt to tax on a worldwide basis (e.g., Brazil, but only for individuals, Chile, Colombia, and Mexico), several others do not (e.g. Argentina and Venezuela), and several of the countries attempting worldwide taxation are not highly advanced (e.g., El Salvador, but only for individuals, Honduras, and Peru). With few exceptions (Honduras and Brazil, which allows credit only as permitted by treaty) the countries that follow the worldwide approach allow foreign tax credit for taxes paid to source countries. With the exception of Argentina (eight treaties) and Brazil (fifteen), Latin American countries are partners to few tax treaties other than the Andean Pact between Bolivia, Colombia, Ecuador, Peru and Venezuela. No Latin American country has a foreign tax treaty with the United States.

Even the figures in Table 1 almost certainly greatly overstate effective reliance on residence-based taxation. Major domestic Latin American corporations operating abroad, whether through subsidiaries or branches, can be expected to report income to their home countries, though perhaps not with total accuracy.[15] The accuracy of reporting is likely to depend, *inter alia*, on the existence and effectiveness of exchange controls, on the availability of (and limitations on) the foreign tax credit in the home country, on the extent of exchange of information between fiscal authorities of the source country and the home country, and on the feasibility of structuring intercorporate relations in such a way as to circumvent such exchanges of information and other administrative controls of the home country. But this does not seem to be of primary importance for the purpose at hand, both because (as is documented further below) income from the conduct of a trade or business in the U.S. is subject to tax, even if it is earned by a foreign person, and because this type of foreign investment (investment in a trade or business) by Latin Americans does not seem to be the essential problem of tax-induced capital flight.[16]

The real potential for tax-induced capital flight would appear to involve investment in interest-bearing securities and bank accounts, corporate shares, and real estate in the United States. The U.S. does not tax most interest paid to unrelated foreigners, and capital gains on assets other than real estate realized by foreigners are exempt from U.S. tax. It may also be possible to reduce substantially U.S. taxes on corporate dividends (and with greater risk and less flexibility those on capital gains on real estate). Provisions of U.S. law dealing with these types of income are discussed in the next section. The question to be addressed briefly in the remainder of this section is whether a Latin American country that attempts to impose taxation on a worldwide basis can effectively do so on these types of income from passive investment.

It appears that a negative answer is virtually inevitable. Exceptions would be likely to occur only in the simplest cases. For example, someone might repatriate funds through legal channels to a country with strong exchange controls and not be able to prove that the funds do not constitute income. In fact, one would not ordinarily expect that passive income earned abroad on which neither foreign nor domestic tax had been paid would be repatriated through legal channels. Moreover, since no country in Latin America, including those employing the worldwide approach, has a double taxation treaty with the United States, the exchange of tax information with the United States is nonexistent. Even if there were such a treaty, it would be simple and relatively safe to give the bank or other payor of interest a false address of convenience, for example, in another Latin American country that employs the territorial system or in a tax haven country that has a treaty with the U.S. In the case of bank interest, even this is not necessary. Since financial institutions are not required to report payments of interest to foreign investors to the U.S. Internal Revenue Service, an exchange of information agreement would serve little purpose; under U.S. law there would be no information to exchange.

Given the difficulties the United States has in preventing its own citizens from evading taxes on domestic-source interest and dividend income (through means to be described in section V), there is little reason to believe that any Latin American country can effectively apply a worldwide system of taxation to non-business income earned in the United

States by its residents, either with or without cooperation from the United States. Of course, under current U.S. law and in the absence of treaties there is little such cooperation.

IV. U.S. Law: Principles and Facts

The United States has traditionally been a strong advocate of the principle of residence-based taxation. Even so, it is also commonly said to apply source-based taxation to income originating within the country, as well as to the foreign income of U.S. persons. In fact, aside from income earned in a trade or business, interest paid to affiliates, and capital gains on real estate, much income from capital originating in the United States is legally exempt from tax if earned by foreigners.[17] More can be taxed at low rates if channelled through treaty partners of the United States.

A. Income from a Trade or Business

Income received by foreigners from the conduct of a trade or business in the United States has long been subject to U.S. taxation. The Foreign Investors Tax Act (FITA) of 1966 made two important changes that restrict the scope of taxation in this area in ways that encourage capital flight from other countries to the United States to avoid taxes. First, it provided that investment income (commonly termed "fixed or determinable annual or periodical," or FDAP income) received by foreigners also engaged in business in the United States would be included in the taxable income from the conduct of a trade or business only if "effectively connected" with such a trade or business.[18] (The most important items of FDAP are interest, dividends, rents and royalties. Gains on the sale of capital assets may also be characterized as effectively connected.) By comparison, the "force of attraction" doctrine of prior law had provided that investment income earned by a foreign corporation or individual engaged in a trade or business would automatically be included in the taxable income of that trade or business.

This distinction is important, because investment income (FDAP) was subject to tax at a fixed rate, commonly 30 percent unless reduced by treaty, on the gross amount. By comparison, income deemed to be derived from pursuit of a trade or business (including that drawn by the force of attraction) was subject to progressive rates reaching as high as 70 percent, though only on net income after deductions.[19]

The second important change made by the FITA was to clarify that holding securities for investment purposes did not constitute a trade or business, even if an agent resident in the United States was granted authority to use discretion in managing a portfolio. Together these two provisions reduced substantially the likelihood that investment income would be subject to tax as income from a trade or business.[20] Initially they implied primarily that such investment income would be subject to the 30 percent withholding rate (or lower rate, as provided by treaty); with the increased use of treaty shopping and the eventual repeal of 30 percent withholding on portfolio interest these provisions have assumed even greater importance; see parts C and D of this section.

The FITA was passed in response to concern about the balance of payments problems the United States was experiencing in the early 1960s. That the purpose was to attract foreign capital into the United States was made quite explicit in the report of a task force appointed by

President Kennedy in 1963 that transmitted its report to President Johnson in April 1964. The task force report stated, "revision of U.S. taxation of foreign investors is one of the most immediate and productive ways to increase the flow of foreign capital to this country." With this purpose in mind, it recommended, "that a nonresident alien individual engaged in trade or business within the United States be taxed at regular rates only on income connected with such trade or business."[21]

B. Bank Interest

Interest on bank accounts has long been exempt from U.S. taxation when paid to foreigners. This exemption (which was implemented by the construction of attributing such income to foreign sources prior to rationalization via an explicit exemption in the 1986 Tax Reform Act) is justified as responding to competitive pressures from abroad; it is argued that without such an exemption U.S. banks would be unable to compete for funds in international capital markets.[22]

U.S. financial institutions paying interest to a foreign recipient are under no obligation to report the payments to the U.S. Internal Revenue Service. As indicated more fully in part F of this Section, some U.S. residents probably use this exemption, as well as that for interest on debt securities and the reduced rates provided by treaties, to avoid U.S. taxes. This is relevant because it indicates just how difficult it would be for Latin American countries employing the worldwide approach to tax U.S. source income of these types.

C. Portfolio Interest

Until 1984 interest on portfolio investment in debt securities issued in the U.S. was subject to 30 percent withholding (or lower rates, as provided by treaty). It was, however, a relatively common (though far from simple) matter for a U.S. corporation to avoid paying this tax by using a finance subsidiary incorporated in the Netherlands Antilles, with which the U.S. had a quite favorable treaty.

The following is a simple example of this abuse of the treaty process. The finance subsidiary of a U.S. corporation chartered in the Netherlands Antilles (N.A.) would float a public issue in the Eurodollar bond market and loan the proceeds to its U.S. parent. The parent would obtain a deduction for interest paid to the finance subsidiary, but the interest payments made by the U.S. parent to its finance subsidiary would be exempt from U.S. withholding taxation under the terms of the treaty between the Netherlands and the United States, as extended to the Netherlands Antilles. The finance subsidiary would be subject to tax on interest income in the Netherlands Antilles only to the extent of the spread between the interest paid and interest received, commonly approximately one percentage point. Interest payments made by the finance subsidiary to bond holders would be exempt from taxation in both the United States and the Netherlands Antilles. Moreover, subject to certain limitations, the income tax paid to the Netherlands Antilles could be used to offset dollar for dollar the U.S. parent's U.S. income tax liability via the foreign tax credit.[23]

The Tax Reform of 1984 repealed the 30 percent tax on interest paid to foreigners for portfolio obligations issued after July 18, 1984, the date of enactment. Several justifications can be given for the repeal of 30 percent withholding on portfolio interest. First, repeal increased tax equity and the efficiency of international transactions by extending to all borrowers and lenders the tax treatment that had previously been available only to those able (perhaps because of size) to take advantage of the type of "treaty shopping" manipulation described above.[24] It was deemed inadvisable simply to attempt to close the treaty shopping loophole, since to do so would place U.S. borrowers at a disadvantage in Eurodollar markets, since lenders commonly insisted upon a return high enough to compensate for the U.S. withholding tax.[25] Of course, repeal of 30 percent withholding increased the attraction of U.S. investments for those from all countries with mobile capital.[26] As a result it facilitated financing the large deficits in the U.S. balance of payments. Second, it would enable the U.S. government to reduce interest outlays necessary to finance the large and rapidly growing debt of the federal government.

Following years of debate and negotiations the U.S. government announced on June 30, 1987 the termination of its tax treaty with the Netherlands Antilles, effective January 1, 1988. Because of the outcry from world financial markets, the termination was eventually rescinded for interest payments, leaving them eligible for benefits of the treaty.[27] The repeal of 30 percent withholding makes this largely academic, except for interest on existing debt. While repeal of the Netherlands Antilles treaty will eliminate the most egregious opportunity for treaty shopping, it will not totally eliminate the problem posed by third-country use of treaties especially for non-interest payments. (For more on this, see the next part of this section and, in a different context, section V below.)

D. Other Portfolio Income

Capital gains on assets other than real estate (to be considered immediately below) realized by foreign persons are generally exempt from U.S. tax. Such gains are subject to tax only if they are "effectively connected" with a U.S. trade or business (see part A of this section), or, in the case of an individual, if the owner was present in the U.S. for more than 182 days during the year of disposition.

Dividends, royalties, and other forms of portfolio income paid to foreigners and not yet discussed are subject to 30 percent withholding, except as reduced by treaties.[28] As with interest income under pre-1984 law, there are opportunities for residents of nations having no treaty with the United States (as well as U.S. citizens) to channel funds through treaty countries in order to benefit from the reduced withholding rates provided by treaty.

Abuse of the treaty mechanism is relatively straightforward. Under U.S. law the recipient of U.S.-source dividends need only provide an address in a treaty country to the payor of dividends in order to benefit from the reduced rate of withholding provided by treaty. Unless the withholding agent has knowledge that the recipient of dividends is not actually a resident of the treaty country, it is allowed under U.S. law to apply the reduced withholding rates specified in the treaty with the relevant country. Though slightly different, the withholding requirements for non-dividend income are equally lax; it is a simple matter to obtain reduced withholding rates by certifying residence in a treaty country. Since U.S. regulations do not require that payors of portfolio income determine the identity and residence of the beneficial owners of nominee accounts, such accounts held in treaty countries can be used to evade U.S. withholding tax on such income.[29]

E. Capital Gains on Real Property

Before passage of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor could easily invest in real property in the United States and incur no U.S. tax liability on gains realized on disposition of the property. A simple way to achieve this result would be to hold the real property through a U.S. or foreign corporation and then sell the corporation's stock.[30]

FIRPTA changes this situation dramatically. Under FIRPTA tax is imposed on gains realized after June 18, 1980 by a foreign person upon the disposition of a "United States real property interest" (USRPI). This effect is achieved through the formal mechanism of deeming all gains and losses from dispositions of USRPIs as effectively connected with a U.S. trade or business.[31] (FIRPTA does not, however, change the basic rule that mere ownership of U.S. real property does not cause a foreign person to be deemed to be engaged in U.S. trade or business, in the absence of active management or the exercise of an option to be treated in this way.) In so doing it over-rides foreign tax treaties that allowed the taxpayer the option of choosing annually whether gains and losses would be deemed to be from a trade or business.[32]

In addition to direct fee-simple ownership of property, such arrangements as leaseholds and options to acquire property interests are included in the scope of the definition of a USRPI. Moreover, an interest in a U.S. corporation (other than simply as a creditor), half of whose assets are U.S. property (a United States real property holding corporation or USRPHC) is also a USRPI.[33] For purpose of FIRPTA real property is defined broadly, and includes interests in cooperative apartments, residential dwellings, plants and factories, rental property and hotels, and interests in mineral, timber, and oil and gas properties.

The passage of FIRPTA seems to have been motivated both by concern that foreign investors were bidding up the price of American farm land and by the view that it was unfair that foreigners could profit from investment in U.S. real estate without paying any U.S. tax, while Americans could not.[34]

As originally passed, FIRPTA imposed extensive reporting requirements on U.S. nonpublic corporations, partnerships, trusts, and estates which had a foreign investor whose pro-rata share of the entity's USRPI exceeded $50,000 and on any foreign person not engaged in a trade or business in the United States owning a USRPI exceeding that figure in value and not otherwise required to file an information return.[35] Alternatively, a security deposit for the payment of federal income taxes could be furnished in lieu of filing certain of the information reports described above.

These requirements for information reporting were extremely complex and ambiguous, as well as intrusive. They were strongly resisted. It was generally felt that many foreign persons and U.S. entities through which foreign persons hold USRPIs would be unwilling or unable to comply with the reporting and/or security requirements of the law. As a result the tax reform act passed in 1984 substituted a system of withholding for the system based on reporting and security deposits.[36] In general the transferee of a USRPI is required to withhold 10 percent of the amount realized from the disposition of a USRPI. Under certain circumstances the withholding requirements are placed on corporations, partnerships, and trusts. In addition a foreign corporation that distributes a USRPI to its shareholders (whether foreign or domestic) in a transaction in which gain is taxable under FIRPTA must withhold 34 percent of such gain. These obligations can be avoided if the transferor of the USRPI certifies that the transferor is not a foreign person and provides the U.S. taxpayer identification number of the transferor.[37]

There has been some concern that FIRPTA might be having less impact than originally envisaged, in part because it has been interpreted quite narrowly and the repeal of 30 percent withholding has been given an overly broad interpretation. Regulations indicate that the 1984 tax act repealed withholding on interest payments on certain private placements, as well as for portfolio investments in publicly traded securities. It has been unclear whether under FIRPTA it would be possible to structure an interest in real estate as a creditor having strong elements of equity participation in such a way that it would not constitute a USRPI. If so, investments with the economic features of an equity investment but the legal features of debt could be used to circumvent the purpose of FIRPTA. If a foreign creditor were given fixed interest bonds with additional payments contingent on appreciation of property, a USRPI would almost certainly be found to exist. Actual transactions would generally be much more complicated than this, so that the economic nature of the matter would be less transparent. The tax treatment of debt with contingent interest/equity kickers based on net operating profits, appreciation of property, or gain on the sale of property is somewhat less certain. The U.S. Treasury Department has, however, warned taxpayers that it will interpret debt with "equity kickers" as USRPIs subject to FIRPTA

Another potential gap in FIRPTA results from the fact that it may be possible to structure ownership arrangements in such a way as to avoid a taxable disposition under U.S. tax law. For example, a USRPI might be held by a foreign corporation; the ownership of the foreign entity could change without triggering U.S. taxation under FIRPTA. Even though a foreign corporation can be characterized as an RPHC, disposition of its stock by a foreign person is not subject to U.S. tax under FIRPTA. Of course, this is likely to be a quite clumsy investment vehicle, particularly since the buyer assumes the corporation's "tax history" in such a case. It can be assumed, moreover, that the purchaser of stock in such a corporation would reduce the price paid for such stock to reflect the tax that must be paid upon liquidation; since the buyer (through the corporation) retains the seller's basis in the real property, tax can be deferred indefinitely, but it cannot be avoided completely. On balance, the most appropriate conclusion is probably that the taxation of capital gains on U.S. real estate realized by foreigners has been tightened substantially, though some gains may escape tax or may be deferred for long periods.

F. Summary Assessment

Recent years have seen a pattern in the evolution of the U.S. taxation of income from capital earned by foreigners. First, income from the conduct of a trade or business in the United States remains fully taxable. There seems to be no inclination to lighten the tax burden of foreigners doing business in the United States; indeed, it was increased in relative terms by the Tax Reform Act of 1986, especially by the provisions pertaining to the branch profit tax. Moreover, gains from the sale of U.S. real estate are now subject to income tax, and withholding is applied to the gross proceeds from such sales in many cases. This change was made explicitly to forestall foreign investment in U.S. real estate and to equalize tax treatment of American and foreign investors in real estate.

By comparison, portfolio interest has joined interest paid by financial institutions in being exempt from withholding tax. To a large extent this simply ratified the status quo, since many large corporations had come to use financing subsidiaries chartered in the Netherlands Antilles to circumvent the previously existing withholding requirements. It is noteworthy, however, that this problem was attacked by exempting portfolio interest, rather than by simply abrogating the Netherlands Antilles treaty, because of the express desire to avoid putting American borrowers at a disadvantage relative to their foreign competitors, who are said to have ready access to financial markets abroad without the requirement to pay withholding taxes.

Other forms of portfolio income received by foreigners remain subject to withholding tax, but these taxes can be reduced substantially by channeling investments through countries with which the United States has tax treaties. Residents of non-treaty countries, as well as U.S. residents, can use these techniques to avoid U.S. withholding taxes on payments to residents of non-treaty nations. It is thus not surprising that in 1978 almost ninety percent of investment income sent from the United States to foreign countries flowed to countries having tax treaties with the United States. Even more telling is the fact that approximately one-half of dividends and one-third of non-bank interest paid to foreign addressees (at that time still subject to withholding tax) went to only three countries, Switzerland, the Netherlands, and the Netherlands Antilles, nations that are notorious for their use by those interested in "treaty shopping."[38]

V. Potential Solutions

Faced with the situation just described, Latin American countries that are concerned about the possibility that generous tax treatment in the United States may induce capital flight have three basic options. This section examines these options. It concludes that none of the three approaches is likely to be effective in eliminating tax-induced incentives for capital flight

First, they can attempt to adapt to the international tax environment in order to minimize the damage to their economies. This would imply adoption of the worldwide principle and negotiation of foreign tax treaties with the United States; presumably such treaties must contain exchange of information agreements if they are to be effective. This approach is unlikely to be effective.

Second, they can attempt to change the external environment by persuading the United States and other developed countries to alter their tax treatment of income earned by foreigners. In essence this means convincing the U.S. and other developed countries to reverse their long-standing preference for residence-based taxation — or at least actually to apply source-based taxation to income originating within their jurisdictions in order to avoid attracting funds from Latin America. The outlook for this strategy is also not bright.

A third and far more extreme option would be to adopt a fundamentally different system of direct taxation that exempts capital income from domestic investment. Such an approach would place domestic-source income from business and capital on even terms with income from foreign investment. While this approach would produce a more nearly level playing field, it has certain obvious problems.

A. Switch to Residence Principle

At a superficial level it might appear that the problem addressed in this paper could be eliminated if Latin American countries now using the territorial principle would adopt worldwide taxation of the income of residents. In fact, such an attempted solution would probably be largely ineffectual, for reasons suggested in section III. By itself, simply requiring that residents pay tax on worldwide income would have little effect, except on those who comply with tax laws as a matter of moral principle. It is true that failing to pay tax involves fraud and the psychological cost of fearing the consequences of detection. Even more rigorous tax administration is unlikely to have a major effort in inducing compliance with the tax law, since the receipt of foreign-source income is extremely difficult to detect. In the absence of exchange of information agreements between the United States and Latin American countries, there would be little possibility that tax could be collected on capital income earned in the United States by residents of those countries.

Even if exchange of information agreements would be completely effective, but could be obtained only as part of a comprehensive tax treaty with the United States, it is not obvious that pursuing such agreements would be in the interest of most Latin American countries. It can be expected that the United States would require low withholding rates on interest and dividends as part of any such treaty. The revenue loss that would result from accession to such U.S. demands might be too great a price to pay. This issue, while important, cannot be pursued here.

In fact, exchange of information agreements would stop only the simplest forms of abuse, those in which the Latin American investor accurately reports his or her name and address to the U.S. payor of interest, dividends, etc. A relatively simple way to circumvent the fiscal authorities would be to provide false information to the payor. For example, a resident of Colombia might give a Venezuelan address, if the U.S. had an exchange of information agreement with Colombia, but not with Venezuela.

To prevent this form of abuse it would be necessary for the United States and the home country of the investor to detect the use of addresses of convenience in countries imposing no tax on such income. In order to understand the difficulty of relying on exchange of information agreements to assist Latin American countries in the implementation of worldwide taxation of the income of their residents, it is instructive to contemplate the opportunities for tax evasion on U.S.-source income that are open even to residents of the United States created by the combination of liberal U.S. treatment of income ostensibly paid to foreigners and lax administrative procedures.[39]

Even before passage of the 1984 legislation that eliminated withholding on portfolio interest paid to foreigners, the following assessment was made of the ease with which U.S. residents could evade tax on interest received from domestic financial institutions:

> Evidence is mounting that some United States residents are posing as foreign persons, establishing interest-bearing savings and checking accounts at United States banks and savings and loan institutions, directing that the interest income be sent to them at an address of convenience in a foreign country, and omitting that interest as income on

> their United States tax returns. The failure of a United States resident to report this interest. . .constitutes willful tax evasion. (Karzon, 1983, pp. 764-65)

Nor is the cause of this growing source of evasion difficult to identify. Karzon (1983) writes:

> The scheme appears to succeed only because many barriers impede tax officials from detecting the transaction. At the United States end of the transaction the financial institution paying the bank interest is not required to withhold tax or report the transaction... [A] survey of the practices of representative banking institutions has indicated that many payors rely solely upon the foreign address submitted by the depositor and have little or no internal safeguards to verify a depositor's true residency. (Karzon, 1983, p. 765,766)

One can only assume that similar abuses will result from the exemption of portfolio interest paid to foreigners, despite the safeguards contained in the 1984 law.[40]

The implications for Latin American countries wishing to tax the worldwide income of their residents is obvious: If the government of the United States takes so little pains to prevent this type of evasion by its own residents, there is little reason to expect it to provide much U.S. assistance in helping Latin American countries prevent evasion of worldwide taxes on their residents. It is unrealistic to expect the United States, through its fiscal authorities, to do for other countries what it cannot — or will not — do for itself.

Aggravating the problem just described is the increased secrecy being provided by certain countries as part of an attempt to attract intermediation of international capital movements.[41] Such secrecy laws "conceal the transaction and the identity of the taxpayer, and block United States authorities from gaining the information necessary to trace and prove the fraud." (Karzon, 1983, p. 779)[42] Needless to say, problems of this type would be compounded if Latin American countries attempting to implement worldwide taxation tried to penetrate the shield of secrecy or asked the United States to assist them in doing so.[43]

Before the 1984 law exempting portfolio interest was passed, both Americans and foreigners could resort to the use of nominee accounts in countries having favorable tax treaties with the United States to evade completely or partially withholding taxes on portfolio income, including interest and dividends. While this technique is no longer necessary in the case of portfolio interest, its use remains a possibility (for both Americans and those from other countries) in the case of other forms of portfolio income. Again, it does not appear that cooperation between the United States and a Latin American country, without the help of the U.S. treaty partner, is likely to reduce this problem significantly. But relying on U.S. treaty partners is truly likely to be an exercise in futility.[44] While the United States has an interest in persuading it treaty partners not to allow U.S. residents to use this device to evade U.S. taxes, neither it nor the treaty partners has much interest in preventing its use by residents of third countries. It seems quite unlikely that the United States will expend much more of its scarce political capital in convincing its treaty partners to cooperate with Latin American countries to protect their fiscal resources.[45]

There is also an interesting question of whether a switch to residence-based taxation would constitute sound public policy. To see this, suppose that a Latin American country were to attempt, even if unsuccessfully, to implement taxation on a worldwide basis. Any taxpayer repatriating funds from abroad would immediately face several questions: whether the repatriation represented a return flow of capital or taxable income; whether tax had been paid on income earned abroad in previous years; if such funds were subsequently invested abroad, would they be presumed to earn income subject to tax? All things considered, a risk-averse taxpayer might be well-advised not to make the repatriation or to hide it.

B. Changing the International Tax Environment

As an alternative to the futile attempt to implement residence-based taxation, the countries of Latin American might try again to convince the United States and other developed countries that they are wrong to favor residence-based taxation and should increase their source-based taxes. At this point it is appropriate to quote at length from a recent paper that blames allegiance to the residence principle for the increase in tax evasion by U.S. citizens using the types of ruses described earlier in this paper:

> Responsibility for the burgeoning tax evasion by United States residents does not lie solely on the doorsteps of the many nations accused of being tax or secrecy havens. <u>The fault also lies in the historical United States insistence on a treaty policy which fosters international tax evasion by favoring residency basis taxation over source basis taxation for portfolio income</u>....The tilt in treaty policy from source-based to residency-based taxation

> of portfolio income has widened the opening for tax evasion. It is most difficult for a residence country, such as the United States, to detect all portfolio income earned abroad by the United States residents and all United States-sourced portfolio income and bank interest received abroad by United States residents masquerading as foreigners with false foreign addresses....The treaty policy orientation toward residency country taxation of portfolio income should be reappraised, and a return to source country taxation should be reconsidered....The merit of source country taxation lies in its simplicity of administration and certainty of tax collection....In view of the sizeable amount of United States-owned, foreign-sourced portfolio income, this shift might enhance rapport with developing countries, long advocates of source taxation. (Karzon, 1983, pp. 827-31; emphasis added)

If the United States would actually implement the source principle that ostensibly underlies its tax treatment of income earned in the United States by foreigners, the problems described in this paper would be much less important. (They would not be eliminated as long as other developed countries continued generous treatment of such income. We return to this point below.) It seems unlikely, however, that there is much reason to expect that this approach will soon be fruitful.

As indicated in section IV, current U. S. practice in this area seems to reflect certain objectives. Income from a U.S. trade or business operated by a foreign person is taxed in full, in order to avoid conferring a competitive advantage on such persons, relative to Americans. Gains on the sale of real estate are now considered to be derived from a trade or business, and thus subject to tax. Again, there was a desire to equalize the tax treatment of U.S. and foreign investors in real estate and reduce what were seen to be inappropriate incentives for foreign investment in U.S. real estate.

By comparison, interest from bank accounts and interest earned on portfolio investments is exempt from U.S. tax, as long as it is not "effectively" connected with a U.S. trade of business. These exemptions—which are totally inconsistent with source-based taxation of income originating in the United States—are provided in part in order to attract foreign capital into the United States and in part to avoid putting American financial institutions and non-financial borrowers at a competitive disadvantage, relative to their counterparts in other developed countries. Contrary to the situation with income from a trade or business and capital gains on real estate, there is no offsetting concern that foreigners have an unfair competitive advantage over Americans because of more favorable tax treatment. Dividends (and other forms of "fixed or determinable or periodical" income) continue to be subject to withholding, but this tax can be reduced by routing investment funds through a treaty partner of the United States.

Given the recent repeal of 30 percent withholding on portfolio interest and the explicit expression of the sentiments described previously as a reason for that legislation, it seems highly unlikely that the United States will soon reverse this policy. Certainly it seems unlikely that the United States will follow such a policy if other developed countries do not follow suit. American opponents of taxation of interest income earned by foreigners would point to the continued availability of debt instruments in Europe on which there is no withholding as justification for continuation of the exemption. Moreover, as long as such instruments continue to be available in other countries, taxation of interest by the United States would not be totally effective in solving the problem of tax-induced capital flight from Latin America, in any event. Of course, powerful political forces oppose changes of this type in Europe.

The strongest impetus for a change of this type in the United States is likely to be convincing evidence that Americans are evading substantial amounts of U.S. income tax by such illegal means as channelling investments through foreign nominee accounts and buying bonds of American issuers that are targeted to foreign lenders. While there is good reason to believe both that abuses of this type existed before repeal of 30 percent withholding on portfolio interest and that they have been aggravated by repeal of 30 percent withholding, there presently does not seem to be much sentiment in Congress to attempt to do anything about the problem. Further impetus could come from the need for deficit reduction. Additional federal revenues could be raised by curtailing the exemption of interest going to foreign addresses.

Even if the United States could be convinced to tax interest income earned by foreigners, the problem examined in this paper probably would not be eliminated, as long as reduced rates are applied to interest earned by residents of countries with which the United States has tax treaties. As indicated earlier, funds of Latin American investors could be channelled through selected "tax haven" treaty countries in order to benefit from such reduced withholding rates. This gimmick would presumably be available on both interest and dividends (and, indeed, on any payment for which reduced withholding taxes are provided by treaty).

It seems quite unlikely that the developed countries of the world, traditionally advocates of residence-based taxation, will reverse the historical trend of using treaties to reduce source-country taxation of these income flows, especially if the primary justification is to assist the developing countries in avoiding capital flight. (Developed countries might be somewhat more sympathetic to an appeal from LDCs based on the need for assistance in implementing their income taxes. Of course, such an appeal has little force as long as the developing countries continue to employ the territorial principle.)

A less ambitious approach would be for developing countries to appeal to the developed countries for assistance in preventing their residents from using treaty shopping to avoid payment of source-based taxes in other developed countries. In this effort they might have as allies those developed nations who believe their own residents are engaging in similar abuses. Of course, this approach will have no effect, except for income subject to withholding. As long as interest remains largely untaxed when paid to foreigners, it is the use of such devices as false addresses of convenience and nominee accounts by residents of countries employing the residence principle that poses the problem. Again, there does not seem to be much reason to believe this approach will be fruitful.

C. A More Radical Approach

The discussion to this point has been conducted in the context of a traditional income tax in which interest is a deductible expense and in which interest income is subject to tax, unless explicitly exempted, as in the case of foreign-source interest income earned by residents of a country with a territorial system. As indicated above, there seems to be little reason to expect that the tax-induced incentives for capital flight from Latin America will be reduced in such an income-based tax system. It is possible, however, that a more extreme reform offers somewhat more hope. The remainder of this section examines this possibility.

An alternative to the traditional income tax that has gained favor among some academic observers provides tax treatment for interest and dividends that is very different from that under the income tax laws of most countries.[46] In particular, no deduction is allowed for interest expense, and interest income is not subject to tax. In addition, dividends are not taxable in the hands of the recipient, and as under the income taxes of most countries, they are not a deductible expense. Thus interest and dividends are placed on equal footing from a tax point of view, thereby eliminating the bias against equity finance found in the tax systems of most countries.[47] Immediate deduction is allowed for all business purchases, including those of capital goods; thus there is no need for either depreciation allowances or special accounting for inventories.[48] The base of such a tax can be shown to be consumption, rather than income.[49]

The extreme simplification of tax law that this alternative would make possible has led some observerss to suggest that it should be given serious consideration by developing countries for that reason alone.[50] But for the present discussion another aspect of this tax is more relevant. This approach essentially combats the problem of capital flight from LDCs created by the tax exemption of certain income in its country of source by also exempting much domestic-source income from business and capital.[51]

1. LDC Policy

Predicting the full implications of adoption of a system such as this for the problem of tax-induced capital flight is quite difficult. If only a single developing country were to adopt the system, interest and dividends earned on domestic investment would be exempt and business income would be subject to a zero marginal effective tax rate; of course under most income tax systems that are administered reasonably well (and have adequate provisions for withholding on interest) this benefit is now generally available only for income on capital invested abroad (under either the territorial system or an ineffectively administered worldwide system). This change would appear to reduce the tax incentives for capital flight. But interest paid by domestic businesses would no longer be a deductible expense. Depending on the relation between the marginal tax rates currently applied to interest income and to the net income of business, the net effect of such a change might be either to increase or reduce the total taxation applied to domestic interest flows. Given commonly observed patterns of asset ownership, marginal tax rates, and evasion of tax on interest income, a small net increase in the taxation of interest paid by business might be expected. By comparison, there would be no offset to the exemption of interest on public debt. Total taxation of domestic-source dividends would clearly drop, except in cases where substantial relief from double taxation of dividends already exists.

But this is only part of the story. The immediate expensing of all business purchases, including capital goods and items added to inventory, would further reduce the taxation of business income from equity investment in most countries. This would be true especially where neither rapid depreciation (or other generous investment allowances) nor inflation adjustment of depreciable basis is allowed. The net effect of these changes would be too country-specific to allow easy generalization. For example, some countries might allow such rapid depreciation that expensing would provide little additional benefit. Similarly, in a country that adjusts interest expense for inflation the total disallowance of deductions for interest expense and the exclusion of interest income from the tax base may be relatively unimportant. But movement from full deduction of nominal interest to no deduction would be dramatic. Though capital flight might be either worsened or reduced as the net effect of a change such as this, a reduction seems most likely for most countries that do not allow either inflation adjustment of depreciable basis or generous capital consumption allowances.

Of course, this is still only part of the story. The taxation of income from foreign capital invested in the country would also be affected by a change as far-reaching as this. As for domestic firms, interest expense would no longer be deductible, but immediate expensing would be allowed. Net effects would again be very country specific (or even industry of firm specific), but it appears that taxation would commonly be reduced. Revenues from foreign investors might, however, be recouped through increased remittance taxes on interest and dividends.

Further complicating matters is uncertainty about how capital exporting countries that provide foreign tax credits for source-country taxes on net income would treat such a tax and any increased remittance taxes that might accompany it. Since no deduction is allowed for interest expense, there is some risk that such a tax would not be allowed as a credit against home-country taxes.[52] Of course, to the extent that the tax-saving benefits of expensing outweigh the tax-increasing costs of the loss of the interest deduction, tax liabilities would fall and there would be less of a problem than loss of the foreign tax credit under an income tax. But the problem would resurface if higher remittance taxes were used to prevent a drop in revenue from income on investments from foreigners.

It is difficult to know how capital-exporting countries would treat this tax.[53] The United States has traditionally been zealous in its denial of foreign tax credits for any taxes other than those on net income, in order to prevent the credit being taken for gross receipts taxes, severance taxes, disguised state royalties, etc., especially those paid on the exploitation of natural resources. This focus on net income is evidenced by the insistence that deductions be allowed for all expenses of earning income.

Of course, the disallowance of interest deductions under the tax being considered here is quite different from the failure to allow deductions for expenses under a gross receipts tax. The interest disallowance is an integral part of a direct tax system based on consumption, rather than income. Moreover, it may typically be offset — or more than offset — by the allowance of expensing of all purchases.[54] This is potentially quite important under U.S. law, which provides that a tax can be creditable even if it does not allow deductions for all expenses, provided a compensatory benefit of at least equal value is allowed. On balance, it appears that there is at least some chance that the tax in question would be creditable, at least in the United States. If it is (is not) creditable, then the withholding tax on foreign remittances would almost certainly (not) be creditable, since its creditability would probably depend on the creditability of the underlying consumption-based tax.

A final word on creditability is appropriate before leaving that issue. The U.S. foreign tax credit is, in rough terms, limited to the average U.S. tax rate on foreign-source income. Moreover, this limit is calculated on an "overall" (worldwide) basis, rather than on a country-by-country basis. Any foreign taxes in excess of the average U.S. rate result in "excess foreign tax credits." Recent changes in U.S. law, including rules for the determination of the source of income, as well as rate reduction, make it more likely than before that American firms will be in an excess foreign tax credit position. To the extent this is true it may make relatively little practical difference whether the tax under consideration in this section is credited. As long a the firm is in an excess credit position in the aggregate, additional taxes on foreign income cannot be credited, even if, in principle, they are creditable.

2. Advanced Country Policy

Widespread adoption of this approach by the developed countries could do much to eliminate the present tax advantages for foreigners to invest in such countries. Under current law interest paid to these investors benefits from the combination of the interest deduction and the exclusion of interest income from withholding tax; in effect the combined (payor cum payee) marginal tax rate applied to such income in the country of source is negative, the net tax benefit being equal in magnitude to the product of the interest flow and the tax rate applied to business income. (For present purposes we can assume that such income is not effectively taxed by the country of residence.) Under the simplified alternative being examined here, the combined marginal tax rate on such income would rise to zero, since the deduction for interest expense would be eliminated. This would essentially eliminate the tax advantages of capital flight examined in this paper, even if LDCs did nothing, at least for debt capital.

Perhaps as important, the possibility of abusing this system through the use of foreign nominee accounts, addresses of convenience, and treaty shopping would be eliminated. Tax would, in effect, be collected through the disallowance of interest deductions, rather than withholding, and withholding taxes could be eliminated.[55]

A switch to a system of this type clearly does not offer a "quick fix." Its adoption would run counter to decades of development of the tax on net income. There are also important concerns about equity and transition that must be addressed satisfactorily. Moreover, under this approach taxation of capital income is, in effect, placed on a source basis, rather than a residence basis. Thus the entire system of international conventions dealing with flows of income between nations would need to be rethought.[56]

In particular, the developed countries that have fought so diligently for residence-based taxation would need to reverse that stance. Given the worldwide proclivity to adopt "beggar - thy neighbor" policies — even by developed countries in their dealings with LDCs, quick action of this type seem unlikely. It is likely to come about only if LDCs bind together in insisting that present international tax conventions do not function satisfactorily and push for reconsideration of existing conventions.[57] Though the road to a new international fiscal order may be a long one, some observers believe it worthwhile to begin the journey.[58]