U.S. INTERNATIONAL TAXATION IN COMPARISON WITH OTHER REGULATORY REGIMES

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This article proposes that U.S. international tax policy analysis must take into account nontax regulation, which is generally disregarded in international tax policy analysis. Structural features of nontax regulatory regimes will be shown to have significant implications for fundamental normative claims of the international tax policy literature.

The article begins with the insight that taxation and regulation are in some sense substitutes. In light of the substitutability of taxation and regulation, the article asks why U.S. international taxation diverges from U.S. international regulation, specifically why the United States imposes tax on worldwide income while nontax regulations typically have limited extra-territorial effect. The article proposes that the policies underlying U.S. international income taxation provide a useful framework with which to analyze U.S. international regulatory regimes. Using such a framework, the article finds that the divergence between taxation and regulation in the international context can be explained by differences in the distribution of the benefits of taxation and regulation.

The article then demonstrates, by analyzing U.S. international regulatory regimes within the framework of international tax policy, how nontax regulatory regimes have significant implications for international tax policy. Given the substitutability of, and the divergence between, taxation and nontax regulatory regimes, the normative justification for imposing tax on worldwide income is weakened when the neutrality norms (such as capital export neutrality and capital import neutrality) that are commonly used to evaluate international taxation are used to evaluate regulation. Although worldwide taxation appears advisable when regulatory costs are not considered (because worldwide taxation supports capital export neutrality

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when nontax factors are omitted from the analysis), a territorial system of taxation may instead be supported depending on the relative rates of regulatory costs. Furthermore, a new justification for the limitations on the foreign tax credit, that an unlimited foreign tax credit may incentivize the export of capital rather than support capital export neutrality (which an unlimited foreign tax credit is claimed to do), becomes apparent when regulation is taken into account. The analytical results are consistent with the general theory of the second best of welfare economics.

TABLE OF CONTENTS

I. INTRODUCTION

Taxation is a form of regulation, and regulation is a form of taxation. Regulation, broadly defined as public law, is a form of taxation in that it imposes costs on certain parties and redistributes benefits to other parties,[1] just as taxation and government spending do together.[2] Labor regulations impose costs directly on employers, while benefiting employees. Environmental regulations impose costs on certain industries, while benefiting the general population. Securities regulations impose costs on issuers of securities, while benefiting purchasers of those securities. Regulation is a form of in-kind taxation — it requires parties to perform some specific action, or to act or not act in some specific way, thereby imposing costs that are typically justified based on the benefits to others in society and to the regulated entity itself.[3] In turn, taxation is a specific form of regulation,

[1] I do not mean to suggest that regulation is solely about costs and benefits. Many regulations have broader substantive purposes and concerns that may not be given due consideration if the regulation is analyzed solely in a cost-benefit framework. Nonetheless, all regulations do have costs and benefits, which can be compared to the costs and benefits of taxation. In analyzing costs and benefits, this article focuses on the effects, rather than the intents, of regulation and taxation. As this article will demonstrate, the government-imposed costs of regulation have significant implications for international tax policy.

[2] Taxation redistributes benefits through the government's ability to spend. The costs and benefits may be direct or indirect, and may range between direct and indirect. For example, as is well known, the direct cost of taxation is borne by the entity that pays the cost, but the actual cost may be passed down to suppliers or employees, depending on factors such as elasticity of supply and demand. The same may be said of regulation — the direct cost of regulation is borne by the entity that is directly regulated, but the actual cost may be passed on to other interest holders. The entity that pays the cost may itself derive a benefit from the law; thus, the relevant quantity for analysis will be the net cost to the entity. For simplicity of analysis, the taxpayers will be treated as perceiving the actual costs and benefits correctly. The effect of the salience of taxes and regulation, *see, e.g.*, David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011); Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. 253 (2011), is an issue I hope to consider in further research. For further discussion of salience in the context of business taxation, see *infra* note 81.

[3] Nontax regulation might thus be more accurately compared to taxation tied together with spending (that is, taxation as a gross cost tied together with its benefits), rather than just to taxation by itself. The benefits of a regulation are closely tied to the costs of the regulation, as the specific costs of a regulation will determine the specific benefits of the regulation. For example, a labor regulation will impose costs on employers, and the benefits are closely related to these costs, as the regulation benefits employees. In contrast, taxation can occur without spending and, as members of Congress know too well these days, spending can occur without taxation; taxation is thus separable from spending. The relative divisibility of taxation from

in that it is public law requiring performance of certain actions, namely the payment of calculable amounts of money.[4]

To put the point differently, taxation and regulation are substitutes in that a goal or effect that could be accomplished through regulation might also be accomplished through taxing and spending. For example, in the case of health care law, in order to ensure access to health care, the government could restrict insurance companies from denying coverage. Alternatively, the government could tax more and provide access to health care itself. There of course may be different behavioral consequences and other effects, as well as different legal bases and purposive justifications,[5] entailed in each approach and that may depend on the substantive context; thus, regulation and taxation are not necessarily perfect substitutes. The partial substitutability of taxation and regulation was noted in the Supreme Court's

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spending compared to the connection between the costs of regulation and its benefits, and consequently the relative flexibility of taxation and spending, may be one reason why tax systems are said to be more effective in redistribution than legal rules are. For works discussing the choice between taxation and regulation, though those works have not made this specific point about divisibility, see generally *infra* note 7. The first half of this article focuses on the net costs of regulation to a business entity and how they are related to taxation; therefore, given the divisibility of taxation and spending, it is appropriate here to focus on taxation rather than to necessarily bundle taxation with spending in the analysis. Furthermore, for a discussion of why the gross costs of taxation may be considered the net costs of taxation to a particular taxpayer, so that nontax regulation can be appropriately compared to taxation for certain purposes without considering the spending side of the equation, see *infra* note 90. The analysis in Part V of this article will, however, take into account the benefits of government spending.

[4] The Supreme Court recently held that federal tax regulations would be held to the same standard of deference as any other federal regulation; this holding supports the view that taxation is a form of regulation. *See* Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713 (2011) ("[W]e are not inclined to carve out an approach to administrative review good for tax law only."). While a major function of taxation is to raise revenue for the government, taxation may also have regulatory or behavioral purposes, as in the case of a Pigouvian tax. Even the international tax system may be said to have a behavioral purpose if it is intended to influence the cross-border movement of capital in particular ways; such intent is evident in policymakers' support of capital export neutrality over capital import neutrality. In the event that a specific tax is not specifically intended to affect behavior but is solely intended to raise revenue, the tax is still like regulation in that the costs are justified based on the benefits to society, namely through government spending.

[5] For example, federal regulation and federal income taxation differ in their constitutional bases. Federal regulation is typically justified on Commerce Clause grounds, whereas a federal law that can be construed as an income tax can be justified on grounds of the 16th Amendment, as the Court's recent health care decision made clear. *See* Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012). As that decision noted in dicta, the Commerce Clause rationale tends to impose a tighter limit on federal regulatory power than an income tax rationale does, except that a regulation must actually fall within the scope of an income tax in order for that rationale to apply.

recent health care law decision.[6] The insight that regulation and taxation are in some sense substitutes has also been noted in the domestic tax policy literature.[7]

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[6] *Id.* at 2579, 2596 ("Put simply, Congress may tax and spend. This grant gives the Federal Government considerable influence even in areas where it cannot directly regulate. The Federal Government may enact a tax on an activity that it cannot authorize, forbid, or otherwise control. . . . '[E]very tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed.'" (quoting Sonzinsky v. United States, 300 U.S. 506, 513 (1937))).

[7] *See, e.g.*, Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994); Chris William Sanchirico, *Taxes versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000); Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989); Reuven S. Avi-Yonah, *Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes* (Univ. of Mich. Law Sch., Pub. Law & Legal Theory Research Paper Series, Working Paper No. 281, 2012); David A. Weisbach, *Taxes and Torts in the Redistribution of Income* (Univ. of Chi. Law Sch., John M. Olin Program in Law & Econ., Working Paper No. 148, 2002). These articles take differing views on whether, when there is a choice between taxation and regulation for a certain purpose, taxation or regulation or some combination is preferable. *See also* Anne L. Alstott, *Tax Policy and Feminism: Competing Goals and Institutional Choices*, 96 COLUM. L. REV. 2001 (1996) (comparing tax policy with other regulatory policies in the context of achieving feminist goals); Clark C. Havighurst & Barak D. Richman, *Distributive Injustice(s) in American Health Care*, 69 LAW & CONTEMP. PROBS. 7, 28 (2006) (comparing health care costs to a head tax and contending that such an implied tax system is regressive); Richard A. Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGMT. SCI. 22 (1971) (considering regulation as a form of taxation in the context of regulated industries); Lawrence Zelenak, *Of Head Taxes, Income Taxes, and Distributive Justice in American Health Care*, 69 LAW & CONTEMP. PROBS. 103 (2006) (responding to Havighurst & Richman's claim that health care costs are regressive). The interaction between taxation and regulation has been discussed somewhat in the international context, though in rather specific contexts, and the substitutability of taxation and regulation does not seem to be a theme in these works. The interaction between tax policy and a subset of regulation, trade policy, has been noted in the international context. *See, e.g.*, Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 TAX L. REV. 275 (2004) (analyzing World Trade Organization decisions from the perspective of tax law); Paul R. McDaniel, *Trade and Taxation*, 26 BROOK. J. INT'L L. 1621 (2001) (noting the intersection of tax and trade policies); Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131 (2001) (examining prohibited and permitted income tax discrimination against international commerce). One article has explored how tax policy analysis might inform international environmental regulation. Yoram Margalioth, *Tax Policy Analysis of Climate Change*, 64 TAX L. REV. 63 (2010). One article briefly considered nontax factors in the context of international tax policy analysis regarding capital ownership neutrality. Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53, 72–73 (2006) (noting two market distortions that may affect ownership of assets: segmented markets and factors affecting firm leverage such as the risk of bankruptcy). Scholars have also discussed implicit taxation in the context of international tax policy, although as used in the

The substitutability of taxation for regulation, and of regulation for taxation, suggest that policies that guide regulation should also guide taxation, and that the policies that underlie taxation might guide regulation. To the extent that taxation and regulation are substitutes, any divergence in policy should be justified.

An interesting divergence of policies underlying taxation and regulation occurs in the international context.[8] The United States taxes the worldwide income of its citizens,[9] but in general, the United States does not regulate the activities of its citizens abroad.[10] This article will attempt to explain this

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literature the term "implicit taxation" does not appear to refer to regulation. *See* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 119 (2011) ("Explicit taxes yield genuine transfers to governments. By contrast, implicit taxes can be viewed as a form of government subsidy, when measured from a hypothetical baseline (in the domestic context, for example, a baseline in which investors are fully taxed on municipal bond income)."). Kleinbard cites various discussions of implicit taxation, *id.* at 119–20, nn.76–77, which suggest that implicit taxation means something closely related to explicit taxation and does not refer to regulation. *See* David A. Weisbach, *Implications of Implicit Taxes*, 52 SMU L. REV. 373, 373 (1999) ("An implicit tax is simply the effect of taxes on the price of an asset."); *see also* Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 SMU L. REV. 339 (1999) (usage consistent with Weisbach's definition); Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263, 300–01 (1994) (consistent with Weisbach's definition: "The equilibrium depression in pre-tax returns is often summarized by saying that the market has functioned to levy an 'implicit' tax . . . .") (emphasis omitted).

[8] To be clear, this article focuses on regulation imposed by the United States, with an emphasis on regulations affecting international business decisions, at the level of the investing entity rather than at the level of the nation. Regulation imposed by international legal authorities such as the World Trade Organization or the Kyoto Protocol can be subsumed within the discussion; however, the nation rather than the business investing entity is often the directly affected party under these regimes, and at that point the nation can decide how to distribute the costs of complying with the international rule. Such international laws will thus affect international business decisions indirectly. In any event, if these supranational regimes effectively impose a territorial-based cost, then their effect on business decisions will be more similar to that of typical regulatory regimes than to a worldwide tax system. For example, international environmental regulation may impose greater restrictions on business activity located in certain developed countries as opposed to certain developing countries. See *infra* note 89 for a discussion of the relevance of territorial-based costs to the analysis in Part V of this article.

[9] The United States tax system, however, allows for deferral of taxation of income earned abroad for certain types of income — the income is not taxed until the income is repatriated back to the United States. In this article, "citizen" and "resident" are used interchangeably where the context is appropriate. That the United States taxes the worldwide income of its citizens and domestic corporations is what is meant by a worldwide system of taxation. In contrast, a territorial system of income taxation only taxes income earned or sourced within a particular territory.

[10] An exception is the Foreign Corrupt Practices Act (FCPA) of 1977, as amended, 15

divergence, and will suggest that the policies implicitly guiding regulation should also guide income taxation in certain circumstances.[11] Part II briefly discusses the legal basis of U.S. regulatory regimes in foreign countries. Part III discusses the policies underlying international income taxation. Part IV analyzes nontax regulation from the perspective of the norms underlying international tax policy. Part V places tax policy in the greater context of general regulation and illustrates various ways in which regulatory costs have important implications for international tax policy. Part VI concludes.

II. THE LEGAL BASIS OF U.S. REGULATORY REGIMES IN FOREIGN COUNTRIES

The United States generally does not have jurisdictional power to directly impose regulatory regimes in other countries. The sovereignty of foreign states usually prevents such regulation, and a system of comity inhibits the ability of the United States to regulate activity abroad in cases in

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U.S.C. §§ 78dd–1 to 78dd–3 (2006), which prohibits the bribery of foreign officials. See *infra* note 12 for further discussion. There are other exceptions that are important to the people they affect but are less relevant to contemporary business taxation, which is the focus of this article, as business taxation is the concern of capital export neutrality, a major justification for worldwide taxation in the tax policy literature. These include the military draft when it was in effect, as U.S. men living abroad would have been subject to the draft's requirements. They also include sexual abuse laws, which, like the FCPA, have a major foundation in morality. *See* 18 U.S.C. § 2423(b)–(c), (f) (2006) ("(b) Travel With Intent To Engage in Illicit Sexual Conduct. . . . [A] United States citizen or an alien admitted for permanent residence in the United States who travels in foreign commerce, for the purpose of engaging in any illicit sexual conduct with another person shall be fined under this title or imprisoned not more than 30 years, or both. (c) Engaging in Illicit Sexual Conduct in Foreign Places. Any United States citizen or alien admitted for permanent residence who travels in foreign commerce . . . and engages in any illicit sexual conduct with another person shall be fined under this title or imprisoned not more than 30 years, or both. . . . (f) . . . 'illicit sexual conduct' means (1) a sexual act . . . with a person under 18 years of age that would be in violation of chapter 109A if the sexual act occurred in the special maritime and territorial jurisdiction of the United States; or (2) any commercial sex act . . . with a person under 18 years of age.").

[11] A similar divergence was noted and discussed by James Hines in the context of sales and excise taxes; while income earned abroad may be taxed by the United States, sales and excise taxes do not apply abroad. James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269 (2009). According to Hines, there does not seem to be a good reason for the divergence. *Id.* Clearly, however, different forms of taxation are substitutes for each other. Part IV of this article can be seen as building upon Hines' analysis, extending his logic to consider not only taxation of various kinds but regulation generally. As will be demonstrated in Part IV, there may be a good reason for the divergence between income taxes and regulation, due to the differences between taxes and regulation. Part V of this article will then show how the costs of nonincome tax law (which Part V categorizes as a regulatory cost because of the territorial application of such law, *see infra* note 89) alter the calculus of key claims in international tax policy.

which the United States might have an interest. Laws regulating actions in foreign countries could be imposed and enforced in the United States if a sufficient U.S. nexus exists. For example, the United States could encourage or discourage certain actions committed abroad by persons within its jurisdiction through regulation in the form of tax incentives or through laws such as the Foreign Corrupt Practices Act (FCPA).[12] Where conduct causes certain effects within the United States or on U.S. commerce, U.S. law may also have some extraterritorial effect, as in the case of antitrust laws,[13] food and drug regulation,[14] and national security laws.[15]

Such rules having extraterritorial effect are the exception rather than the norm, and there is a general presumption against extraterritorial effect in U.S. regulation. For instance, the United States does not generally impose minimum wage requirements on employers operating in foreign countries, nor does the United States generally prosecute U.S. citizens for crimes committed in non-U.S. jurisdictions.[16] Employers are able to avoid minimum wage laws and regulations under the Employee Retirement Income Security Act by moving operations abroad and employing local workers.[17] The

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[12] The FCPA makes it "unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business. Specifically, the anti-bribery provisions of the FCPA prohibit the willful use of the mails or any means of instrumentality of interstate commerce corruptly in furtherance of any offer, payment, promise to pay, or authorization of the payment of money or anything of value to any person, while knowing that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to a foreign official to influence the foreign official in his or her official capacity, induce the foreign official to do or omit to do an act in violation of his or her lawful duty, or to secure any improper advantage in order to assist in obtaining or retaining business for or with, or directing business to, any person." *Foreign Corrupt Practices Act*, U.S. DEP'T OF JUSTICE, http://www.justice.gov/criminal/fraud/fcpa (last visited July 1, 2013).

[13] *See* Mark S. Popofsky, *Extraterritoriality in U.S. Jurisprudence*, *in* 3 ISSUES IN COMPETITION LAW AND POLICY 2417, 2418 (ABA Section of Antitrust Law, 2008). The Sherman Act applies to "trade or commerce among the several States, or with foreign nations." 15 U.S.C. § 1 (2006).

[14] The Food and Drug Administration imposes requirements on imported food and drugs. *See* 21 U.S.C. § 384(a) (2006). *See generally FDA Globalization*, U.S. FOOD & DRUG ADMIN., http://www.fda.gov/InternationalPrograms/FDABeyondOurBordersForeignOffices/default.htm (last visited July 1, 2013) (noting U.S. regulatory presence in foreign countries).

[15] *See, e.g.*, Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT ACT) of 2001, Pub. L. No. 107-56, § 317, 115 Stat. 272 (2001) (granting long-arm jurisdiction over foreign money launderers). Much national security policy, though not always in the form of regulation, occurs extraterritorially, as in the wars in Iraq and Afghanistan.

[16] *But see supra* note 10 for counterexamples.

[17] *See, e.g.*, Paul M. Secunda, *"The Longest Journey, With a First Step": Bringing Coherence to Sovereignty and Jurisdictional Issues in Global Employee Benefits Law*, 19

individual mandate of the Affordable Care Act is not applicable to U.S. citizens who live abroad for a minimum period of time.[18] U.S. intellectual property laws do not automatically apply to protect intellectual property abroad.[19] As has been noted elsewhere in the tax policy literature, no country attempts to tax sales or value-added on a residence basis.[20] Furthermore, U.S. banks and other corporations can profit from more lax financial and securities laws in other countries, even though the U.S. government may tax the income earned from activities overseas. In a landmark securities law case, the Supreme Court recently reiterated that "[i]t is a "longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.'"[21] Following the presumption against extraterritoriality, the Court limited the extraterritorial applicability of the anti-fraud provisions, or section 10(b), of the Securities and Exchange Act.[22]

The United States does tax the income of its citizens, even if the income is earned in a foreign jurisdiction. The right of a nation to tax the worldwide income of its residents is "recognized in international law."[23] As Peggy

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DUKE J. COMP. & INT'L L. 107, 108 (2008). Certain employment laws can, however, be applied extraterritorially in cases in which a U.S. national would be the direct beneficiary. *See id.* at 115.

[18] *See* I.R.C. § 5000A(f)(4).

[19] *See Office of Policy and International Affairs — Protecting Intellectual Property Rights (IPR) Overseas*, U.S. PAT. & TRADEMARK OFF., http://www.uspto.gov/ip/iprtoolkits.jsp (last visited July 1, 2013) ("[T]he rights granted by a U.S. patent extend only throughout the territory of the United States and have no effect in a foreign country . . . . Patents and trademarks are territorial and must be filed in each country where protection is sought. A U.S. patent or trademark does not afford protection in another country. . . . However, the Patent Cooperation Treaty (PCT) streamlines the process of filing patents in multiple countries. . . . The Madrid Protocol also makes it easier to file for trademark registration in multiple countries. . . . [T]he United States does not have . . . copyright relationships with every country.").

[20] Hines, *supra* note 11, at 291. Within this article, any reference to taxation refers to income taxation unless another form of taxation is indicated.

[21] Morrison v. Nat'l Australia Bank Ltd., 130 S. Ct. 2869, 2877 (2010) (quoting EEOC v. Arabian American Oil Co., 499 U.S. 244, 248 (1991)).

[22] The Court held that section 10(b) of the Securities Exchange Act of 1934 "reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security within the United States." *Id.* at 2888.

[23] Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335, 1336–37 (2001), *reprinted in* MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 7–8 (2003) (introducing the justifications for worldwide taxation); *see also* Cook v. Tait, 265 U.S. 47, 56 (1924) (U.S. taxation of a U.S. citizen's worldwide income did not violate either the U.S. Constitution or international law).

Musgrave has explained, "[r]esidents are held to owe tax allegiance in return for the rights and privileges which they receive as residents, giving rise to what is commonly referred to as the 'residence principle.'"[24] Further, a home country's right to tax foreign source income is necessary to achieve "equitable tax treatment of resident taxpayers by making all income, wherever earned, subject to tax, consistent with [income tax principles]."[25] Tax sovereignty also functions to provide an "instrument for affecting the outflow of capital in line with national policy objectives."[26] Control over taxation may also be justified as a "payment for productivity-enhancing benefits provided by the country of residence to its own factors of production prior to transfer abroad."[27]

III. POLICIES OF INTERNATIONAL INCOME TAXATION

One problem arises in the tax context: if income is earned in one country (the so-called source country) by a resident or citizen of another country (the residence country), the income could be taxed twice, once by the residence country and again by the source country. A central issue of international taxation policy therefore concerns how to minimize the problem of double taxation that arises when the residence country taxes income that is also being taxed by the source country.

As Michael Graetz has pointed out, the normative discussions of international income taxation often assume that the proper goal of U.S. international tax policy is to advance worldwide economic efficiency.[28] Achieving such efficiency is typically said to involve two kinds of neutralities: capital export neutrality (CEN) and capital import neutrality (CIN).[29]

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[24] Musgrave, *supra* note 23, at 1336; *see also* RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL 7–8 (9th ed. 2008) ("Basing tax jurisdiction on nationality can be justified by the benefits available to nationals. For example, in a very real sense U.S. citizens have an insurance policy; they can return to the United States whenever they want, and they have the protection of the U.S. government wherever they are abroad. Tax payments contribute to the availability of that 'insurance.' U.S. corporations, regardless of their physical presence in the United States, enjoy the benefits of U.S. laws that define corporate relationships. However, the United States is somewhat unusual in relying on citizenship or mere place of incorporation as a basis for jurisdiction.").

[25] Musgrave, *supra* note 23, at 1336.

[26] *Id.*

[27] *Id.*

[28] Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 270–71 (2001).

[29] *Id.* In the rest of this part, I borrow from authorities in the international tax policy literature, particularly Graetz, *supra* note 28, to provide an overview of capital export

Capital export neutrality, for a tax system, means that the tax system is neutral about a resident's choice between domestic and foreign investment providing the same pre-tax return.[30] As Graetz notes, capital export neutrality "requires that a resident of a given nation pays the same marginal rate of income taxation regardless of the nation in which she invests."[31] Capital export neutrality is "neutral about where such investments are made" and about which country "collects the tax revenue when capital originating in one country produces income in another."[32] CEN as a practical matter implies taxation by the country of residence and crediting of foreign taxes paid to the source country, and is a major driving policy of U.S. international tax policy.[33]

Capital import neutrality for a tax system "requires that all investments in a given country . . . [be subject to] the same marginal rate of income taxation" regardless of where the investor has residence.[34] "CIN thus subjects all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner."[35] CIN implies taxation only by the source country and exemption from tax on foreign source income by the country of residence.[36]

CEN and CIN are inherently incompatible in a world in which countries choose different tax rates and tax bases.[37] In order for both CEN and CIN to hold, tax systems must be identical across the world: that is, tax rates, tax bases, and choices between source- and residence-based taxation must be the same. Such equality is unlikely since different jurisdictions will want to tax

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neutrality (CEN) and capital import neutrality (CIN). Much of the description of CEN and CIN for a tax system is now standard in the tax policy literature. Other normative criteria for international tax policy, such as capital ownership neutrality or national neutrality, as discussed by Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003) and others, are not the focus here, as the main point of the article can be adequately stated by using the CEN/CIN rubric, and CEN has had a large following in the tax policy literature. For a discussion on CEN's large following in the tax policy literature, see *infra* note 39 and accompanying text. *But see infra* note 68 for a brief discussion of national neutrality. For a discussion of capital ownership neutrality, see *infra* text accompanying note 116.

[30] Graetz, *supra* note 28. The relevant investment is direct investment rather than portfolio investment. *See* Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 539 (2003).

[31] Graetz, *supra* note 28, at 270.

[32] *Id.*

[33] *Id.* at 271.

[34] *Id.* at 270.

[35] *Id.* at 270–71.

[36] *Id.*

[37] *See id.* at 272.

income differently in order to support a different level of spending or to attract more business to their jurisdiction.[38] For example, if tax rates were different between countries *A* and *B*, and taxation in both countries were source-based (thereby fulfilling CIN), an investment in country *A* by a resident of country *B* would be taxed at a different rate than would an investment in country *B* by the resident of country *B*, thereby violating CEN. If CEN held and countries *A* and *B* taxed income at different rates, then income from an investment in country *A* by a resident of country *B* would be taxed at a different rate than domestic investments with the same pre-tax margins in country *A*, thereby violating CIN.

CEN continues to enjoy support in academic, government, and practitioner publications.[39] "This is because distortions in the location of investments are thought to be more costly than distortions in the allocation of savings."[40] "Typically, economists regard CEN as essential for worldwide economic efficiency, because the location of investments would be unaffected by capital income taxes."[41] In contrast, "[i]f CIN holds, "all savers, regardless of their residence, receive the same after-tax returns."[42] "Many economists regard the choice between CEN and CIN as essentially

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[38] *Id.*

[39] *Id.* at 336 n.30 (citing various reports from governmental authorities, including the Joint Committee on Taxation and the Treasury Department); *see also* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1083 n.49 (Dec. 7, 2009) (noting that capital export neutrality is preferable to capital import neutrality or capital ownership neutrality); Kleinbard, *supra* note 7, at 170 (noting that capital export neutrality "may not be everything, but at least is something."); Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 TAX NOTES 1021, 1041 (Sept. 5, 2011) (supporting capital export neutrality). Note, however, that worldwide economic efficiency and capital export neutrality are after-the-fact explanations for worldwide taxation that are today held to justify worldwide taxation. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997). The system of worldwide taxation was put into place in the 1920s, and it was not until the 1960s that capital export neutrality was coined by economist Peggy Musgrave. To be sure, capital export neutrality is not as popular as it once was. *See* Daniel N. Shaviro, *Rethinking Foreign Tax Creditability*, 63 NAT'L TAX J. 709, 718–19 (2010) (noting that though recently challenged, capital export neutrality as a normative basis for the foreign tax credit still has numerous adherents; also noting that capital export neutrality has recently lost some support).

[40] Graetz, *supra* note 28, at 272.

[41] *Id.* at 270. For example, suppose that a U.S. company faces the choice between building a factory in Japan or building one in the United States and that the tax rates in Japan and the United States are 30% and 40%, respectively. Investment in Japan would be favored if the United States did not impose a 40% tax on the U.S. company's worldwide income (with appropriate crediting for foreign taxes paid) to equalize the tax cost as between the two choices.

[42] *Id.* at 271.

empirical, turning on the relative elasticities of savings and investment. Since investment is thought to be more responsive to changes in levels of taxation," CEN predominates.[43]

CEN is implemented in the United States through residence-based taxation on all types of income, which is not a norm for much of the developed world.[44] As is well known, however, the U.S. system departs from capital export neutrality in numerous respects.[45] The U.S. system follows CEN only when the U.S. tax rate exceeds the foreign tax rate.[46] As Hugh Ault and David Bradford have noted, "[w]hen the foreign rate of tax exceeds the U.S. rate," capital export neutrality "would require the United States to credit the taxes against the U.S. taxes paid on U.S.-source income" and to refund any excess.[47] If the excess is not refunded, then investment is discouraged in countries that impose a higher rate of tax than the United States does.[48] Due to the revenue cost of such a policy and the incentive for foreign countries to respond strategically, "the credit has historically been limited to the U.S. taxes attributable to foreign-source income . . . ."[49]

It is well known that the present form of the foreign credit limitation leads to second-best issues.[50] As Ault and Bradford have noted:

> [A]veraging of foreign taxes is allowed for active business income. This means that a U.S. company that is currently paying high foreign taxes with respect to one active business investment is encouraged at the margin to undertake a new business investment in a low-tax foreign country rather than in the United States. The excess credits on the high-tax investment can in effect shelter all (or at least some) of the U.S. tax burden on the low-tax investment.[51]

"Similar issues arise with respect to the taxation of income earned

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[43] *Id.* at 272.

[44] *Id.* at 329; *see also* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 467 (3d ed. 2010).

[45] *See* Hugh J. Ault & David F. Bradford, *Taxing International Income*: *An Analysis of the U.S. System and its Economic Premises*, *in* TAXATION IN THE GLOBAL ECONOMY 11, 40–41 (Assaf Razin & Joel Slemrod eds., 1990), *as reprinted in* MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 28–29 (2003).

[46] *Id.*

[47] *Id.*; *see also* Shaviro, *supra* note 39, at 718 (noting CEN's prescription of worldwide taxation with unlimited foreign tax credits).

[48] *But see infra* text accompanying note 98 for reasons why this conclusion may not hold once regulation is taken into account.

[49] Ault & Bradford, *supra* note 45, at 40.

[50] *Id.*

[51] *Id.* at 41.

through U.S.-controlled foreign subsidiaries."[52] A policy of CEN would tax the subsidiary income to the U.S. shareholder on an accrual basis.[53] In contrast, a policy of capital import neutrality would require the exemption of foreign income from U.S. taxation.[54] Congress has historically accepted "business arguments that current U.S. taxation adversely affects the competitive position of U.S. companies in foreign markets."[55] It has thus "allowed the deferral of U.S. tax on subsidiary income until repatriation, but only as long as that income fell into certain categories."[56] On repatriation, capital export neutrality considerations reappear, and "the income is then taxed, with the allowance of the 'deemed' foreign tax credit for the foreign taxes paid by the subsidiary."[57] This mixture of capital import and capital export neutrality considerations "has led to the complex dividing lines required by subpart F to sort income into deferral and accrual categories . . . ."[58]

In summary, U.S. international taxation is effectively a compromise between CEN and CIN, though CEN is the dominant policy.[59] Thus, the United States tends to tax its residents and citizens (corporate and individual) on their worldwide incomes. Many other countries, adhering more to CIN than to CEN, do not tax their citizens on all their worldwide incomes.

IV. USING THE TERMINOLOGY OF TAX POLICY TO ANALYZE U.S. REGULATORY REGIMES IN THE INTERNATIONAL CONTEXT

To the extent that regulation and taxation are substitutes, regulation can be analyzed under the CEN/CIN framework.[60] This exercise will in turn give perspective to the CEN/CIN analysis in the context of taxation. Capital export neutrality, applied to regulation generally, would require enforcement of regulations to be based on the residence of the actor, rather than where the action takes place; if regulation imposed net costs on domestic economic activity but not foreign economic activity of residents of a country, then there

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[52] *Id.*

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *See* Graetz, *supra* note 28, at 274.

[60] More generally, to the extent that regulation and taxation are substitutes, the analytical tools of tax policy can be used to study regulation, and the analytical tools of regulatory policy can be used to study taxation, in all cases with appropriate adjustments to account for relevant differences between regulation and taxation in the given context.

would be an incentive to move the activity abroad.[61] Yet most U.S. regulations follow CIN: the United States tends not to regulate the actions of its citizens when they are abroad. Likewise, while the tax systems of other developed countries follow CIN, they also follow CIN in applying their regulations to their citizens abroad: they tend not to regulate the activities of their citizens abroad.

The divergence between the U.S. system of international taxation and other U.S. regulatory regimes, and between the U.S. system of international taxation and regulation generally (including the tax and regulatory systems of other countries), requires explanation. What are the rationales for having U.S. international taxation follow CEN, while having U.S. regulation abroad implicitly follow CIN? The following paragraphs will examine various possible explanations.

A common rationale for capital export neutrality in international taxation is to promote efficiency. As stated earlier, economists typically regard CEN as essential for worldwide economic efficiency, since capital income taxes under CEN would not affect the location of investments.[62] Since investment is thought to be more responsive to changes in levels of taxation than other factors of production are, a policy of CEN predominates. The level of regulation in a jurisdiction, however, may affect investment decisions just as much as taxation does; yet a system of CEN does not predominate in the general regulatory arena. The economic efficiency argument thus does not explain or justify why CEN is generally not followed in the regulatory sphere.

Legal constraints affect the extent to which the United States can regulate its citizens abroad, as discussed earlier.[63] Nonetheless, CEN could still be imposed through a system of penalties directed towards the U.S.-residing assets of U.S. citizens affected by the law; the FCPA and the Internal Revenue Code itself are examples. Thus, legal constraints do not satisfactorily explain why there is no CEN-type system for general regulation.

One possible explanation may rely on the differential in the problem of double regulation. Because regulatory CEN could be imposed through a system of penalties directed towards the U.S.-residing assets of U.S. citizens,

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[61] That the regulation is imposed on the basis of the residence of the actor is not always sufficient for capital export neutrality. Implicit in the claim that capital export neutrality can obtain in the realm of regulation when considering net regulatory costs is an assumption that benefits to the relevant entity will not be different between countries when regulation is imposed on the basis of the residence of the actor. What happens when benefits do vary, thus affecting net costs, can be considered in further research, though the fact that benefits can vary makes capital export neutrality in the realm of regulations harder to achieve.

[62] *See supra* text accompanying note 41.

[63] *See supra* Part II.

it is possible to have a problem of double regulation in the international context, just as there is a problem of double taxation. Yet the double regulation problem may be less acute than the double taxation problem, depending on the regulation. Two regulatory requirements (one domestic and one foreign) regarding a specific action will often overlap, such that fulfillment of one requirement goes a long way towards fulfilling the other. For example, in the case of minimum wage laws, if the United States imposes a minimum of 100 on a U.S. company and the foreign country imposes a minimum of 110, then fulfilling the U.S. requirement goes a long way in fulfilling the foreign requirement. In contrast, in the case of taxation, and granted some regulations, fulfillment of one requirement will not fulfill the other unless there is a mechanism to reduce the double burden, as in the case of the foreign tax credit system.[64] The fact that the double regulation problem is often inherently less burdensome than the double taxation problem should actually increase the likelihood of seeing worldwide regulation compared to the likelihood of seeing worldwide taxation; yet we do have worldwide taxation but not worldwide regulation. The differential in the problem of double regulation thus does not provide a satisfying explanation for why we see CEN being followed in tax policy but not in other regimes.

Another explanation for why CEN is not imposed in general regulatory regimes is that the benefits are not shared with the government or the wider public governed by the law to the extent that the benefits would be in a taxation system. General (nontax) regulations typically benefit people and locations surrounding the regulated actor. In the case of minimum wage laws, the intended and direct beneficiaries are the workers and employees, who are typically also part of the polity that imposed the tax. In the context of environmental laws, the intended and direct beneficiaries are typically the localities surrounding a polluting factory, and both the localities and the polluting factory are within the same polity. If applied in a foreign country, however, such regulations would directly benefit only people not governed by the regulation. Minimum wage laws and environmental protections affecting an American corporation operating in a foreign country would directly benefit the local population of the foreign country who themselves

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[64] An example of a regulation imposing a nonoverlapping requirement is if the domestic country imposes a minimum wage, while the foreign country does not impose a minimum wage but requires payment of employees' health insurance; there is then an extra burden for the company to operate in the foreign country. Frequently, however, labor regulations will have significant overlap.

In the event that the foreign and domestic regulations are mutually exclusive, for example if a domestic law requires a certain action that the foreign law prohibits, and there is no mechanism to mitigate the conflict of laws, the company may be able to follow one law and pay the penalty for not following the other.

are not governed by the regulation.[65] Thus, the burdens of the regulation, if CEN were to be upheld in the international regulatory context, would fall on the U.S. resident (and, in the case of a corporation, its interest holders, many of whom are presumably U.S. residents),[66] while the direct benefits would inure to foreigners.[67] This provides a practical reason why CEN in international regulatory systems would not or should not be upheld: the government tasked with upholding the regulation would not directly benefit from enforcing the regulation abroad.[68]

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[65] There may be an indirect benefit to American workers in that the incentive to ship jobs overseas is much less if the U.S. regulations are imposed in the foreign country. Capital export neutrality is thus job export neutrality. Yet the fact remains that there is a direct benefit to the foreign country; for example, in the case of minimum wages, there is a transfer of wealth to the local workers of the foreign country. The costs of these direct benefits may outweigh the indirect benefits to the American people.

[66] *See, e.g.*, Graetz & Grinberg, *supra* note 30, at 551 (discussing the "home bias" in ownership of corporate debt and equity); Hines, *supra* note 11, at 294 (similar).

[67] That the effect and benefits of regulation tend to be distributed territorially relates to the point made in note 3 that the benefits of regulation are not as divisible from the costs of the regulation, though spending and taxation are divisible from each other — the U.S. regulation enforced abroad will often lead to benefits abroad, whereas U.S. taxation abroad can lead to benefits domestically in the form of increased revenue to the fisc.

[68] U.S. regulations applied in the international context thus generally follow a policy of advancing the interests of the American people, a goal that Michael Graetz and others have recommended for U.S. international tax policy. *See* Graetz, *supra* note 28, at 280–82; John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593 (June 29, 2009). In the context of regulations, this will be similar to so-called national neutrality, which is supposed to maximize national welfare though it may result in an inefficient choice of investment location from a worldwide efficiency perspective. The analogous formulation of national neutrality (following Peggy Musgrave's formulation of national neutrality in the realm of taxation, which is based on the intuition that the country of the investor's residence will obtain the maximum benefit by equating pre-tax returns on domestic investments and after-tax returns on foreign investments, *see* PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS 134 (1969)) will rest on equating pre-regulatory, pre-tax returns on domestic investments with post-regulatory, post-tax returns on foreign investments. In essence, when regulation is taken into account, the pre-tax, pre-regulatory foreign return must be that much greater so that the post-tax, post-regulatory foreign return will be worth the residence country forgoing the investment. Although this is slightly different than Musgrave's formulation, the practical implication is similar: foreign regulatory costs should be deducted, just as national neutrality says that foreign tax costs should be deducted. National neutrality, however, does not necessarily require that regulation be imposed on a worldwide basis as it would require of taxation; this follows because the benefits of domestic regulation imposed on a worldwide basis may not inure to the country of residence as taxation would. As noted in note 65, the government could indirectly benefit from enforcing general regulations abroad under a CEN rationale. By equalizing investment costs, the government does not encourage investment in foreign countries by home country investors, and this is part of the rationale for following CEN in taxation. A well-known problem with this line of reasoning, however, is

In contrast to regulations generally, the U.S. government and the U.S. populace could be said to benefit from a policy of taxation on a worldwide basis since the U.S. Treasury is made richer by being able to tax the overseas activities of its citizens.[69] In other words, in contrast to enforcement of regulations abroad (in which case the benefits often inure to foreigners), enforcement of a residence-based international tax regime directly benefits the U.S. Treasury.[70] As noted earlier, however, the common justification for following CEN in international tax policy is worldwide economic efficiency, not revenue effects.[71] Yet since the economic efficiency argument concerning allocation of investment applies as much to the costs of regulation as it does to taxation, the distribution of benefits (such as the revenue effects in the case of taxation) appears to be a more plausible explanation, if not a justification, for why CEN is tenable in international tax policy without being followed in most other regulatory regimes.

The costs of following or not following CEN are harder to quantify in the regulatory system. In the taxation system, tangible quantities such as revenue into the treasury can be counted; in the regulatory system, behavioral effects may be more complex, with intangible factors such as psychic costs and benefits and the moral concerns of a certain law. In the case of the FCPA, a major benefit is the reinforcement of moral norms, which was the original

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that upholding CEN would actually encourage companies to reincorporate abroad; in the tax context, Congress attempted to curb the practice of reincorporating abroad to avoid taxes, by enacting section 7874 of the Internal Revenue Code. Moreover, upholding CEN encourages U.S. companies to organize their companies abroad in the first place so as not to be subject to U.S. laws. This logic applies to regulation as well as to taxation, and undercuts some of the rationale for following CEN.

[69] This assumes that the U.S. Treasury is not a net loser through indirect effects of worldwide taxation, such as taxable activity shifting to foreign jurisdictions. Three reasons can be given to discount the magnitude of negative effects. First, although worldwide taxation may encourage a company never to be resident in the United States in the first place, once a company has U.S. residency, worldwide taxation tends to reduce the tax incentive to move activity abroad. Second, although averaging of foreign income taxes for purposes of the foreign tax credit may encourage investment in a low-tax foreign country rather than in the United States, that argument requires the company to pay a higher rate of foreign taxes than U.S. taxes; currently, however, U.S. statutory corporate tax rates are generally higher than those of other countries. Third, the extent to which worldwide taxation actually causes such negative effects is less verifiable than the legal fact that worldwide taxation causes more money to be owed to the Treasury; indirect effects are harder to prove than direct effects.

[70] Note that these statements apply to sales, excise, value-added, and property taxes just as well as they do to income taxation. Thus, source-based versions of these taxes are less necessary than they are in the case of regulations; the home country may actually benefit directly from residence-based versions of these taxes, unlike in the case of most residence-based regulations.

[71] *See supra* text accompanying note 41.

primary rationale according to the 1977 House Report;[72] the FCPA effectively increases the competitiveness of foreign companies who are allowed to bribe foreign officials when American companies are not allowed to, so the law did not appear to directly benefit the U.S. economically.[73] Yet despite difficulties in quantification of costs and benefits, Congress enacted the FCPA in a manner that follows CEN, indicating a net positive value. Difficulty in quantifying costs and benefits is thus not necessarily a barrier to enacting a CEN regulatory regime.

Following CEN may not have been foremost on the minds of Congress when it enacted the FCPA.[74] Nonetheless, following CEN is implicit in the enactment of the FCPA. Whether this was a consideration in enacting the FCPA or other regulatory regimes that follow CEN is something that can be considered in a separate study.[75]

V. PLACING TAXATION IN THE CONTEXT OF OTHER REGULATIONS

Income taxation and the FCPA are exceptions to the rule that CIN is implicitly followed in U.S. regulatory regimes when applied to its citizens abroad. In the case of the FCPA, there were clear reasons overriding CEN and CIN — a desire to stamp out corruption by American-based companies and to support moral norms. It seems likely, however, that considerations of CEN and CIN were implicit early on, since it would be clear that this legislation could harm American companies vis-à-vis foreign companies, who were not subject to the burdens of the FCPA.

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[72] H.R. REP. NO. 95-640, at 4–5 (1977).

[73] There admittedly may be indirect benefits, such as the behavioral consequence that not engaging in bribery abroad may make bribery less habitual and therefore less likely to occur in the U.S. context. Moreover, fighting bribery has the indirect effect of promoting democratic values abroad; President Bill Clinton's statement accompanying the signing of the International Anti-Bribery and Fair Competition Act of 1998, implementing the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, which obligated the U.S.'s major trading partners to implement something akin to the FCPA, noted that "bribery is inconsistent with democratic values, such as good governance and the rule of law." Presidential Statement on Signing the International Anti-Bribery and Fair Competition Act of 1998. 34 WEEKLY COMP. PRES. DOC. 2290 (Nov. 10, 1998).

[74] Following CEN was also apparently not a concern when the current structure of U.S. international taxation was first put into place, yet it has become a primary justification for worldwide taxation. *See* Graetz & O'Hear, *supra* note 39.

[75] A brief review of the legislative history suggests that efficiency concerns of some sort may have been a factor. H.R. REP. NO. 95-640, at 4–5 (1977) (payment of bribes "short-circuits the marketplace by directing business to those companies too inefficient to compete in terms of price, quality or service, or too lazy to engage in honest salesmanship, or too intent upon unloading marginal products. In short, it rewards corruption instead of efficiency and puts pressure on ethical enterprises to lower their standards or risk losing business.").

There may be good reasons for a regulatory regime to implicitly follow CEN, and good reasons for a regulatory regime to implicitly follow CIN. The reasons given in the taxation context emphasize economic efficiency, as noted earlier.[76] As with regulation generally, however, there are larger policy values that should be followed.

Michael Graetz has criticized the international tax policy literature for its focus on economic efficiency.[77] "The focus in the international income tax literature on economic efficiency to the exclusion of all other values is antithetical to the analysis of tax policy generally . . . ."[78] As Graetz noted, "[t]ax policy decisions, including decisions regarding a country's tax treatment of international income, should be, and inevitably are, decided based on a nation's capacity, culture, economics, politics, and history."[79] Graetz argued that other taxation principles should guide international taxation:

> When assessing our domestic income tax policy or arguing for any substantial change in that policy, the debate generally is guided by a coherent, if controversial, set of multiple principles. There is great dispute over the meaning of these norms and about the priority to be accorded to each, but since Adam Smith, it has been commonplace to say that a tax system should be fair, economically efficient, and reasonably easy to administer and comply with.[80]

I agree with Graetz that there are more principles that should guide international tax policy than economic efficiency.[81] I noted earlier the

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[76] *See supra* text accompanying note 41.

[77] Graetz, *supra* note 28, at 276–97.

[78] *Id.* at 294.

[79] *Id.* at 279.

[80] *Id.* at 294.

[81] Nonetheless, I do think that when considering business taxation as opposed to individual taxation, economic efficiency should become relatively more important than fairness. Graetz might agree, noting that "vertical equity, distinguishing among individuals based upon ability to pay, does not demand distinctions among corporations similar to those among individuals. The income of a single corporation may be owned by or attributable to individuals with markedly different levels of income and different abilities to pay taxes." Graetz, *supra* note 28, at 302; *cf.* Jeffrey L. Kwall, *The Repeal of Graduated Corporate Tax Rates*, 131 TAX NOTES 1395 (June 27, 2011) (questioning the need for graduated corporate income tax rates similar to graduated individual income tax rates, thus downplaying the importance of ability to pay in business taxation); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 550 (2003) (setting out theoretical foundations for a law of mercantile contracts that would be different from general contract law). Business taxation may also be different from individual taxation in the way salience (which refers to the visibility or prominence of a law, *see* Schenk, *supra* note 2, at 275–76)

importance of the distribution of benefits to an explanation (if not a justification) of why CEN is tenable in international tax regimes but is not followed in most other regulatory regimes.[82] The point I want to add here is that the economic efficiency argument, which is the primary rationale by which the international tax policy community supports following CEN, is too myopic in considering only taxation in its analysis — the effect of following CEN in the taxation context may be dwarfed or negated by the cost or benefits to the American people or the U.S. Treasury of CEN not being followed in other areas of regulation.[83] In short, economic reality in a larger context should be a consideration in international tax policy. International income taxation is just one part of regulatory regimes, which affects the costs and benefits of doing business, the general welfare of the people, and the revenues that the government earns.[84] As noted in an Office of Tax Policy study, the Institute for Management Development studied 290 separate factors in order to rank the competitive position of forty-seven countries for its 2000 global survey; of these 290 factors, only fourteen related to tax.[85] Following CEN in the realm of taxation but not following CEN in other regulatory realms may mean that any economic efficiency gains from following the policy of CEN in taxation would be minor, nil, or even contrary to capital export

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affects taxpayer behavior. Businesses are more likely to engage in meticulous tax planning; therefore, the effects of salience may be less prominent in business taxation than in individual taxation.

[82] *See supra* Part IV.

[83] Note that this is different from, but consistent with, Graetz's point that "the proper function of economic efficiency in this context is to ask — from the national perspective — what international income tax rules will enhance Americans' standard of living, now and in future generations, for example, by promoting economic growth in the United States." Graetz, *supra* note 28, at 282. Graetz proposed from a normative perspective that international income tax policy analysis should focus on the national interest rather than on worldwide efficiency; here, I show from a descriptive perspective how the arguments of supporters of a focus on worldwide efficiency may be diluted once regulation is taken into account.

[84] The point was noted in an Office of Tax Policy study on subpart F. In asking whether subpart F affected competitiveness, the study noted that multinational competitiveness "is an amalgam of many factors, only a few of which related to tax" and that "[i]t is questionable whether any single feature of a tax system is likely to have a significant effect on multinational competitiveness." OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 56 (2000). The study found that the available data did not provide a reliable basis for evaluating whether subpart F has had a significant effect on multinational competitiveness. *Id.* at 61.

[85] *Id.* at 56. As noted *infra* in the text accompanying note 119, the thesis in this article does not merely say that nontax factors affect the investment decision, which has already been noted in the literature; the thesis instead focuses on how nontax factors affect claims concerning capital export neutrality.

neutrality in the aggregate.[86] A few examples will illustrate.[87]

A. Examples of Taking Regulation into Account in Analyzing the Effect of Worldwide Taxation on Achieving Capital Export Neutrality

1. Worldwide Taxation Does Not Necessarily Have the Purported Effect when Regulation is Taken into Account

In the first example, suppose that a U.S. company faces the choice between building a factory in Japan or building one in the United States.[88] Further suppose that Japan imposes an income tax at a rate of 30% on a territorial basis and regulatory costs[89] at a rate of 10% on a territorial basis,

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[86] To be sure, the tax policy literature mentions, if only briefly, the point that regulatory costs can undermine neutrality with respect to taxation. *See, e.g.*, Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 65 (1993) ("even if effective tax rates were successfully harmonized, the goal of investment neutrality would be undermined by competition on the expenditure side of the budget or in the regulatory sphere."). The analysis in this part of the article develops that point, shows the extent to which it is true or untrue in different circumstances (and importantly, economic efficiency, which is the ultimate goal of capital export neutrality, is not always undermined by nontax factors, as this article shows), demonstrates how taxation and regulation interrelate in affecting investment neutralities, and relates the argument to a general theory of welfare economics.

[87] The examples are formalized in Part V.B and are summarized in tables in Part V.C.

[88] This is an extension of the example in note 41, in which taxation but not regulation is considered. That example shows how following CEN in taxation leads to an economically efficient investment decision, if one only considers tax costs. The addition of CIN-based regulation to this analysis alters the conclusion, as the examples in the text demonstrate. The examples in the text reduce to the example in note 41 if post-regulatory, pre-tax surplus is the same in the United States and in Japan. The base example of proponents of capital export neutrality can thus be seen as implicitly assuming that regulatory costs across the two choice countries are the same or are otherwise ignorable. These new examples show the importance of considering regulation and other territorial-based costs in international tax policy — by varying that implicit assumption, the result that worldwide taxation supports capital export neutrality simply does not hold. For a mathematical formalization of this statement, see *infra* note 103 and accompanying text. Of course, this model of analysis, common in the international tax policy literature, simplifies the real world of international taxation. Additional complications, such as two levels of taxation, tax deferral, multiple foreign jurisdictions, market competition, the responses of foreign countries, and the possibility of income shifting, are issues that I would like to consider in further research. Nonconstant rates of taxation and regulation can also be considered.

[89] Or noncreditable taxes (e.g., value-added taxes) or even nontax and nonregulatory costs, or some combination. The important trait of these costs is that they are incurred on a territorial basis; we might term them territorial-based costs. Note that this means that the analysis in the examples in the text will be applicable to a case in which we include in the deductible cost basic economic factors that may be due more to nature than to regulation, such

and that the United States imposes a tax rate of 40% on a worldwide basis and regulatory costs at a rate of 20% on a territorial basis. Assume that all these numbers are net costs; that is, any benefit from the regulation or taxation is incorporated in the underlying surplus, so that effectively any benefit to the business entity is subtracted from the gross cost to that business entity.[90] Further assume that all the surplus is taxable. If the company would have pre-tax and pre-regulation surplus of 100 in either Japan or the United

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as geography or climate, as long as the costs are incurred on a territorial basis; we can call them natural costs, a subset of territorial-based costs. For example, suppose a company has the choice between locating a factory in the United States or in Iceland. Investing in Iceland will cause the company to incur the cost of shipping the goods that are produced there; these geographically imposed costs will alter the investment decision calculations in the same way that regulation does because they are all incurred on a territorial basis. Yet as regulation is within the control of governments in the same way that taxation is and can be substituted for taxation, whereas natural costs tend to be fixed or beyond a government's control, it is appropriate to focus on regulatory costs as a particular concern for tax policy. Natural costs are necessary costs and may therefore be considered as taken into account in determining the surplus from activity, whereas the regulatory and tax costs may be considered relatively optional costs (aside from the amount necessary to maintain a government and order in society) whose imposition can be varied by government fiat. Another way to distinguish regulatory costs from natural costs is to see that incurring a natural cost will not directly benefit society, while incurring a regulatory cost should generally benefit the class of persons that the regulation is intended to benefit. Additionally, because the relevant distinction is whether the cost is imposed on a territorial basis or a residence basis, regulatory costs imposed on the basis of residence can be counted for certain of our purposes as if it were taxation on a residence basis.

[90] One could question this assumption on the basis that all taxation and regulation should have a net benefit to society, since otherwise there would be an incentive to eliminate the tax or the regulation. Although this may be true in the aggregate (and even so, there may be various political frictions that would hinder repeal of a tax or regulation that has a net cost), in the case that taxation or regulation redistributes away from the relevant taxpayer or regulated entity, there should be a net cost to that entity. Note that it is unnecessary to this analysis that the net cost be positive or that the gross cost be greater than the benefit to the entity; if the net cost were negative, the so-called net cost becomes an incentive.

That the net cost is the relevant quantity is not always an explicit assumption of the traditional tax policy analysis, which may be seen as viewing the benefits of the government getting additional tax revenue from a particular entity (and thus spending additional amounts) as too diffuse to be relevant to the analysis. Although taxation may be said to be the cost for public goods such as a national defense and an organized and properly functioning government, because they are public or nonexcludable goods, the cost to any particular entity is generally divisible from the benefits of taxation, and the benefit will be provided whether or not a particular entity is obligated to pay a particular cost. Thus, the taxpayer may not feel that additional taxation will be of measureable benefit to her and the gross cost of any additional taxation is effectively what matters to the taxpayer. Since regulatory costs are less divisible from regulatory benefits, and the benefits of a regulation may outweigh the costs (for example, where regulation might solve a prisoner's dilemma situation), it is important to consider net costs when considering regulation.

States,[91] even though CEN applies in the realm of taxation to equalize tax costs as between investment in each jurisdiction, the investment in Japan is relatively more attractive because of lower regulatory costs. The arithmetic is as follows: if the investment is in Japan, the post-regulation, pre-tax return is 90 (or 100 minus 10 of regulatory costs), and the Japanese government takes 27 in income tax (or 30% of 90), while the U.S. government takes 9 (40% of 90 less 27), for a net amount of 54 for the company. If the investment is in the United States, the post-regulation, pre-tax return is 80, and the U.S. government takes 32 in income tax (or 40% of 80), for a net amount of 48 for the company. Despite CEN in the realm of taxation, investment is more attractive in Japan, and following CEN in taxation would effectively have had no influence in the final investment decision. This result generally holds, as in this example, whenever regulatory costs are lower in the foreign country and the residence-based tax system in the home country equalizes income tax costs as between investment in the two countries.[92]

2. Worldwide Taxation Can Lead to a Capital Export Disincentive

In the second example, suppose again that a U.S. company faces the choice between building a factory in Japan or building one in the United States. Further suppose that Japan taxes income at a 25% rate on a territorial basis and imposes regulatory costs at a 20% rate on a territorial basis, and that the United States imposes an income tax of 40% on a worldwide basis but no regulatory costs. In this example, the government extraction from the investment by a domestic company is the same in both Japan and the United States, as 20% plus 25% of the post-regulation revenue in Japan (80%) is 40%, the U.S. tax rate.[93] If the company would have pre-tax and pre-regulation income of 100 in either country, the investor should be neutral as

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[91] The assumption that the surplus (the aggregate gains from activity) would be the same whether in Japan or in the United States could, of course, be altered, and the pre-tax and pre-regulatory proceeds would likely differ in the real world, given differentials in various costs. Costs may be classified as regulatory costs rather than pre-regulatory costs to the extent that they are caused by regulation.

[92] For a formalization of this statement, see *infra* Part V.B.2. In the case that regulatory costs are higher in the United States, but the foreign country's income tax rate is higher than the U.S. income tax rate, the investment decision will depend on the relative magnitudes of differences in the regulatory costs and income tax rates.

[93] Recall that we are focusing on net costs to the company rather than overall societal benefits. It is not germane to the current analysis that choosing one of taxation and regulation over the other may lead to different behavioral effects and different levels of societal benefits because of various inefficiencies associated with the particular choice, though this possibility is something I would like to consider in further research. Such effects can be incorporated into the surplus; regulatory and tax costs will thus be a measure of the actual transfer of gains.

between investing in the United States and Japan, in a world of territorial taxation. Because of the U.S. policy of taxing worldwide income, however, a U.S. company has an incentive to invest in the U.S. rather than in the foreign country. Investment in Japan would bring the company a net amount of 48 (or 60% of 80, 100 less regulatory costs of 20), while investment in the United States would leave the company with 60 (100 less income tax of 40). As investment in the United States is now preferred, the efficient allocation decision is not obtained even though the United States follows the prescription of CEN in international income taxation.[94] The example demonstrates that when regulatory costs are greater in the foreign country than in the United States, the residence-based tax system may actually make investment by the U.S. company in the United States preferable, and more so than in the case of territorial taxation.[95] An explanation for this result is that the worldwide tax system equalizes tax costs as between investment in the United States and the foreign country; yet the traditional rationale for following worldwide taxation does not account for the possibility that the reason that the foreign tax rate may be lower is a correspondingly higher rate of regulatory costs, so that this equalization may not be necessary or desirable from an economic efficiency perspective. This result, especially the incentive to invest in the United States, gives further support to the claim that the practical reason why CEN is tenable in the realm of taxation may not be economic efficiency, but rather the real or perceived monetary benefits to the Treasury.[96]

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[94] Consider the case in which the Japanese investment should be favored, in a world of territorial taxation, by being marginally more productive than the U.S. investment. For example, suppose the surplus of Japanese investment is 101 compared to the surplus of 100 for the United States. Under these numbers and the other facts of the example, the investment by the U.S. company in the United States would still be preferred in a world in which the United States taxes worldwide income, even though the Japanese investment should be preferable on a worldwide efficiency basis.

[95] The statement will be true even if the foreign country's income tax rate is lower than the U.S. income tax rate, as in that case, the U.S. system of worldwide taxation negates the effect of the lower foreign tax rate for U.S. companies.

[96] The results noted in the text can be seen as instances of the general theory of the second best. The general theory of the second best, as expounded by R.G. Lipsey and Kelvin Lancaster, states that if a constraint prevents the attainment of optimality on one dimension, conditions of optimality on other dimensions may thereby be altered. In other words, if an optimality condition on one dimension cannot be fulfilled, then in many situations an optimum situation can be achieved only by departing from optimality conditions on other dimensions. The optimum situation finally attained may be termed a second best optimum because it is achieved subject to a constraint. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11, 12 (1956). Since regulation generally will not always be imposed on a worldwide basis, imposing tax on a worldwide basis will generally not lead to the optimum that would be predicted if tax were the only consideration or if all regulation

3. Reconsidering the Foreign Tax Credit Limitation

Note that when the tax rate is higher in Japan than in the United States, we may need to consider the effect of the limitations on the foreign tax credit. In the case of a limited foreign tax credit and a higher foreign tax rate, the numbers do not vary between the case of worldwide taxation and territorial taxation — when the foreign tax rate is greater, the foreign tax rate in the territorial taxation case is the same as the effective foreign tax rate in the worldwide taxation case, and the domestic tax rate in the territorial taxation case is the same as the effective domestic tax rate in the worldwide taxation case.[97] Thus, this is not a particularly interesting situation for our current purposes.

In the case of *full crediting* of the foreign tax and a higher foreign tax rate, however, the numbers may vary between the territorial and worldwide taxation cases because in the case of worldwide taxation (but not in the case of territorial taxation) the foreign tax will be credited so that the effective tax rate for investment in the foreign country is equal to the tax rate for domestic investment. While revenue concerns[98] and strategic considerations[99] are common justifications for the United States not providing a full credit, an additional justification — that a full credit can result in a greater capital export incentive than would be obtained without full crediting — can be seen when taking regulation into account. Consider a third example, which is the reverse of the second example: Suppose that the United States taxes income at a 25% rate and imposes regulatory costs at a 20% rate, and that Japan imposes an income tax of 40% but no regulatory costs. If the United States provided a full foreign tax credit, the effective rate of government-imposed costs for investment by a U.S. company in Japan would be 25%, compared to a rate of 40% for the comparable investment in the United States. As this example demonstrates, contrary to the dictates of the capital export neutrality school of thought (which claims that full crediting is necessary to achieve capital export neutrality), full crediting may actually create a capital export incentive when the costs of regulation are taken into account. Full crediting would not account for the possibility that the foreign tax rate is higher due to a correspondingly lower regulatory rate in the foreign country. Moreover, full crediting may not be necessary because the effective rates of government-imposed costs in different countries may be closer to one another once a broader concept of government-imposed costs is taken into consideration.

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were also imposed on a worldwide basis.

[97] For charts to aid in this analysis, see Table 2 in Part V.C.1 and Table 4 in Part V.C.2.

[98] *See supra* text accompanying note 49.

[99] Foreign countries would have the incentive to increase their tax rates if the United States would credit them fully.

B. A Formal Model

Formalizing the examples may help to clarify the conclusions.

1. Assumptions and the Traditional Analysis

Suppose, as in the examples, that a U.S. company faces the choice between building a factory in Japan and building one in the United States. The United States is thus the capital-exporting nation and Japan is the capital-importing nation. Suppose that the Japanese income tax rate is t_J, while the U.S. income tax rate is t_U. For simplicity, suppose that $t_U > t_J$, unless otherwise specified.[100] Suppose the Japanese regulatory rate (the costs imposed by the government and other local actors on a territorial basis per unit of surplus)[101] is r_J and that the U.S. regulatory rate is r_U. Assume that all costs reflect net costs and that the entire surplus is taxable.[102] Assume full deductibility of regulatory costs and that the rates of regulation and taxation can range from 0% to 100%, including 0% and excluding 100%.

In the traditional analysis, in which regulatory costs are not considered, a territorial system of taxation leaves the investor with $(1 – t_J)$ of the pre-tax surplus if she invests in Japan and with $(1 – t_U)$ of the pre-tax surplus if she invests in the United States. This is said to violate capital export neutrality, and the fix is supposedly to tax income on a worldwide basis, so that effectively the rate of return to the investor whether she invests in Japan or the United States is $(1 – t_U)$, with the governments of Japan and the United States splitting t_U through operation of the foreign tax credit if the investment is in Japan.

2. Adding Regulation to the Traditional Analysis (Formalizing Examples 1 and 2)

Now suppose that regulatory costs are taken into consideration. In a territorial tax system, if the investor builds the factory in Japan, the rate of return is $(1 – r_J)*(1 – t_J)$, while building the factory in the United States will yield a rate of return of $(1 – r_U)*(1 – t_U)$. In a worldwide tax system, the rate of return for building the factory in Japan becomes $(1 – r_J)*(1 – t_U)$, while the rate of return for building the factory in the United States remains

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[100] As discussed in Part V.A.3, the case in which the foreign tax rate exceeds the U.S. tax rate is generally not very interesting to the analysis with the current limitations on the foreign tax credit. For further discussion of the foreign tax credit limitation, see *infra* Part V.B.3.

[101] *See supra* note 89.

[102] The assumption that the entire surplus is taxable can be modified in an extension of the analysis beyond the scope of this article.

$(1 - r_U)*(1 - t_U)$.

These figures show that worldwide taxation of income achieves capital export neutrality in the general sense only if the rate of regulatory costs is the same in Japan as in the United States; that is, that $r_J = r_U$. To see this, note that for capital export neutrality to hold, the rate of return for building the factory in Japan has to be equal to that for building the factory in the United States. Thus, we need $(1 - r_J)*(1 - t_U) = (1 - r_U)*(1 - t_U)$. Algebra shows that this implies $r_J = r_U$.[103] The result that worldwide taxation supports capital export neutrality is thus dependent on regulatory costs being equal across countries or otherwise ignorable. As this is generally not a realistic assumption, the analysis shows the fragility of the claim that worldwide taxation supports capital export neutrality.[104]

When regulatory costs are greater in the United States than in Japan, or $r_J < r_U$, worldwide taxation effectively does nothing to equalize investment incentives. This is because $r_J < r_U$ implies $(1 - r_J)*(1 - t_U) > (1 - r_U)*(1 - t_U)$, so the return from building the factory in Japan is always greater than the return from building in the United States when regulatory costs are greater in the United States.[105]

When regulatory costs are greater in Japan than in the United States, or $r_J > r_U$, worldwide taxation increases the incentive to invest in the United States compared to the incentive to invest in the United States under territorial taxation. The intuition behind this result is that worldwide taxation increases the cost of investing in Japan compared to the case of territorial taxation, while the return on investing in the United States remains the same whether under worldwide taxation or territorial taxation.[106] As the second

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[103] $(1 - r_J)*(1 - t_U) = (1 - r_U)*(1 - t_U)$ implies $(1 - r_J) = (1 - r_U)$, which implies $r_J = r_U$.

[104] Nonetheless, minimal departures from perfect equality may not change incentives significantly and may thus be considered de minimis.

[105] The differential in incentive may be less with worldwide taxation than with territorial taxation, however, since $(1 - r_J)*(1 - t_J) > (1 - r_J)*(1 - t_U) > (1 - r_U)*(1 - t_U)$ under our assumptions. In other words, when regulatory costs are greater in the United States, the return to the investor of investing in Japan under a territorial tax system is greater than the return to the investor of investing in Japan under a worldwide tax system, which is greater than the return to the investor of investing in the United States under either a territorial or worldwide tax system.

[106] To see this more formally, first notice that $(1 - r_J)*(1 - t_U) < (1 - r_J)*(1 - t_J)$ when $t_U > t_J$, as we have assumed; in other words, the return from investing in Japan under a worldwide tax system is less than the return from investing in Japan under a territorial tax system when the tax rate is higher in the United States. Second, recall that the return from investing in the United States is the same under territorial taxation and worldwide taxation, specifically $(1 - r_U)*(1 - t_U)$. Third, notice that $(1 - r_U)*(1 - t_U) > (1 - r_J)*(1 - t_U)$ when $r_J > r_U$; in other words, when regulatory costs are higher in Japan, the return from investing in the United States is greater than the return from investing in Japan under a worldwide tax system. Fourth, returning

example above suggests, it is possible that worldwide taxation lowers the return from investing in Japan so that, even though investing in Japan might be preferable to investing in the United States on the basis of underlying surplus, worldwide taxation actually makes the investment in the United States more attractive, leading to an inefficient investment decision in a situation in which territorial taxation would not lead to the inefficient investment decision. That is, it is possible that $S_J*(1 - r_J)*(1 - t_J) \geq S_U*(1 - r_U)*(1 - t_U)$, which is the comparison in the case of territorial taxation, but that $S_J*(1 - r_J)*(1 - t_U) < S_U*(1 - r_U)*(1 - t_U)$,[107] which is the comparison in the case of worldwide taxation. In such a scenario, the efficient investment decision is not necessarily obtained, because the worldwide tax system can skew investment toward the United States even when investment in Japan would have provided a larger surplus.

Note that in the case that $r_J < r_U$, which is the assumption two paragraphs above, there is an analogous argument that concludes oppositely to the conclusion of the previous paragraph. When $r_J < r_U$, the worldwide taxation system may actually help to achieve the efficient investment decision, whereas territorial taxation may not; in such a situation, the territorial tax system can skew the investment toward Japan even when investment in the United States would have provided a larger surplus. One way to see this is that when the regulatory costs are less in Japan, the worldwide tax system in the United States makes the return between foreign and domestic investment closer than they would be under a territorial tax system, due to the equalizing of tax costs by the worldwide tax system; the further difference in the case of the territorial tax system may mean that an investment in Japan may be preferred on an after-cost basis even though the surplus may be greater for the investment in the United States, a preference that may be avoided if the United States imposes tax on a worldwide basis.

Whether worldwide taxation or territorial taxation is preferred for a capital exporting nation is thus dependent on the relative rates of regulation of the capital-exporting nation compared to that of the capital-importing

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to the first inequality in this footnote, that inequality means that the preference for domestic investment is greater in the case of worldwide taxation than in the case of territorial taxation under our assumptions. The following algebra will show this result: the inequality $(1 - r_J)*(1 - t_U) < (1 - r_J)*(1 - t_J)$ implies, by subtracting from both sides the return from investing in the United States, $(1 - r_J)*(1 - t_U) - (1 - r_U)*(1 - t_U) < (1 - r_J)*(1 - t_J) - (1 - r_U)*(1 - t_U)$. Now, multiplying both sides by -1 because the left-hand side is known to be negative (given the third point above), and rearranging, we get $(1 - r_U)*(1 - t_U) - (1 - r_J)*(1 - t_U) > (1 - r_U)*(1 - t_U) - (1 - r_J)*(1 - t_J)$, which says that the preference for U.S. investment is greater in the case of worldwide taxation than in the case of territorial taxation.

[107] S_J and S_U are the surplus in Japan and in the United States, respectively, and we are assuming that $S_J > S_U$. Note that under the assumption $r_J > r_U$, $(1 - r_J)*(1 - t_U) < (1 - r_U)*(1 - t_U)$.

nation. If the capital-importing nation has a greater regulatory rate, territorial taxation may be preferred for the capital-exporting nation; if, however, the capital-importing nation has a lower regulatory rate, worldwide taxation may be preferred for the capital-exporting nation on the basis of supporting the efficient investment decision.

3. Reconsidering the Foreign Tax Credit (Formalizing Example 3)

Now let us consider the case of an unlimited foreign tax credit. The possibility of an unlimited foreign tax credit is relevant when the foreign country has a higher tax rate than does the United States. So let us suppose that $t_J > t_U$. A preliminary point is that in order for the unlimited foreign tax credit to support capital export neutrality (as it is said to do), the rates of regulatory costs must be equal as between the two countries. As in the earlier discussion in Part V.B.2, the return from investing in Japan under our current assumptions is $(1 – r_J)*(1 – t_U)$, while the return from investing in the United States is $(1 – r_U)*(1 – t_U)$. Capital export neutrality is satisfied only when these two figures are equal, or $(1 – r_J)*(1 – t_U) = (1 – r_U)*(1 – t_U)$. As before, this equality implies that $r_J = r_U$, which is generally not a realistic assumption.

When $r_J < r_U$ (that is, when regulatory costs are lower in Japan), investment in Japan is always preferred in the case of worldwide taxation with an unlimited foreign tax credit, because $r_J < r_U$ implies $(1 – r_J)*(1 – t_U) > (1 – r_U)*(1 – t_U)$. In the case of territorial taxation or in the case of worldwide taxation in which the foreign tax credit is limited to t_U, however, it is possible that investment in the United States is preferred since it is possible that $(1 – r_J)*(1 – t_J) < (1 – r_U)*(1 – t_U)$, when $t_J > t_U$ (as it is by assumption). Thus, the unlimited foreign tax credit tends to support a capital export incentive when $r_J < r_U$, compared to the world of territorial taxation or worldwide taxation with a foreign tax credit limitation. As in the earlier discussion, it is also possible that worldwide taxation with full crediting can skew the investment towards Japan even in cases in which the U.S. investment would have provided a greater underlying surplus, thus leading to an inefficient decision that may not have been obtained under territorial taxation or worldwide taxation with limited crediting.

When $r_J > r_U$, then investment in the United States should always be preferred for investments having the same underlying surplus in Japan and the United States, since regulatory and tax costs are both higher in Japan. Yet the differential between the return from investing in one country versus the other is less in the case of worldwide taxation with an unlimited foreign tax credit than in the case of territorial taxation or worldwide taxation with a foreign tax credit limitation, due to the tendency of the unlimited foreign tax credit to equalize tax costs. Similarly to the earlier discussion, this tendency

may mean that worldwide taxation with unlimited crediting may help achieve an efficient investment decision in cases in which investing in Japan would have provided a greater underlying surplus, a decision which may not be obtained under territorial taxation or worldwide taxation with limited crediting; this conclusion mirrors the last sentence of the previous paragraph.

As in the discussion about the preferability of worldwide taxation or territorial taxation at the end of Part V.B.2, whether limiting the foreign tax credit helps achieve an efficient investment decision may depend on the relative rates of regulatory costs. If the capital-importing nation has a lower regulatory rate, a limited foreign tax credit may be preferred for the capital-exporting nation (corresponding to the possibility that the lower regulatory rate is due in part to the assumed higher tax rate in the capital-importing nation); if, however, the capital-importing nation has a higher regulatory rate, an unlimited foreign tax credit may be preferred for the capital-exporting nation, on the basis of supporting the efficient investment decision.

C. Summary Tables

The following tables summarize the formal model and the examples.

1. Figures of the Formal Model (Tables 1 and 2)

The following assumptions apply to the figures in Tables 1 and 2, which summarize the formal model:

(1) The investor is a U.S. resident choosing between building a factory in Japan or one in the United States.

(2) The tax rate in Japan is t_J, and the tax rate in the United States is t_U.

(3) The regulatory rate in Japan is r_J, and the regulatory rate in the United States is r_U.

TABLE 1.

Rates of return, assuming either that $t_J < t_U$ or that the United States provides a full credit in the case of worldwide taxation

	Return from investing in Japan	Return from investing in the United States
Traditional analysis (disregarding regulation), territorial taxation	$(1 - t_J)$	$(1 - t_U)$

Traditional analysis (disregarding regulation), worldwide taxation	$(1 - t_U)$	$(1 - t_U)$
With regulation, territorial taxation	$(1 - r_J)*(1 - t_J)$	$(1 - r_U)*(1 - t_U)$
With regulation, worldwide taxation	$(1 - r_J)*(1 - t_U)$	$(1 - r_U)*(1 - t_U)$

TABLE 2.

Rates of return, assuming that $t_J > t_U$ and that the foreign tax credit is limited in the case of worldwide taxation

	Return from investing in Japan	Return from investing in the United States
Traditional analysis (disregarding regulation), territorial taxation	$(1 - t_J)$	$(1 - t_U)$
Traditional analysis (disregarding regulation), worldwide taxation	$(1 - t_J)$	$(1 - t_U)$
With regulation, territorial taxation	$(1 - r_J)*(1 - t_J)$	$(1 - r_U)*(1 - t_U)$
With regulation, worldwide taxation	$(1 - r_J)*(1 - t_J)$	$(1 - r_U)*(1 - t_U)$

2. Summary of Examples (Tables 3 and 4)

In the examples in Tables 3 and 4, the investor is a U.S. resident choosing between building a factory in Japan or one in the United States. In the traditional analysis (disregarding regulation), let the pre-tax surplus be 100, and in the analysis considering regulation, let the pre-tax, pre-regulation surplus be 100, unless otherwise noted.

The imputed numerical difference between the modes of analysis (considering or not considering regulation) is unimportant. The traditional analysis disregards regulation, indicating an implicit assumption that regulation can be disregarded without affecting the analytical results; thus, if regulation were to be included in the analysis under the implicit assumptions of the traditional analysis, it would be a constant factor and would not affect the results. In other words, although positive regulatory costs imply that the pre-tax, *post*-regulation numbers should be lower than pre-tax, *pre*-regulation numbers for the same underlying surplus, that differential does not matter to

our analysis since we can easily change the numbers so that the pre-tax, pre-regulation surplus is higher by the appropriate amount (so that it is, say, 120) when the pre-tax, post-regulation surplus is 100.

Alternatively, in the analysis that includes regulation, we could increase the surplus by some factor (e.g., by a factor of ten, so that the surplus is 1000), and the analytical conclusion will be the same, because the relative magnitude of the differences will be the same. We are interested in the effect that the mode of analysis (considering or not considering regulation) has on differences between territorial and worldwide taxation. Thus, we are interested in (a) the differences between investing in one country and investing in another country within a particular system of taxation (worldwide or territorial) within a particular mode of analysis (considering or not considering regulation), (b) how those differences vary between the two modes of taxation within a mode of analysis, and (c) how that difference between the two modes of taxation changes with the mode of analysis. We are not interested in the specific numerical difference between (x) investing in one country under one taxation system and mode of analysis and (y) investing in another country under either taxation system and the *other* mode of analysis.

TABLE 3 (EXAMPLES 1 AND 2)

	Example 1: Regulation and taxation lower in Japan $t_J = 30\%$, $r_J = 10\%$; $t_U = 40\%$, $r_U = 20\%$		Example 2: Regulation higher but taxation lower in Japan $t_J = 25\%$, $r_J = 20\%$; $t_U = 40\%$, $r_U = 0\%$	
	Return from investing in Japan	Return from investing in the United States	Return from investing in Japan	Return from investing in the United States
Traditional analysis (disregarding regulation), territorial taxation	70	60	75	60
Traditional analysis (disregarding regulation), worldwide taxation	60	60	60	60

With regulation, territorial taxation	63	48	60	60
With regulation, worldwide taxation	54	48	48	60
Analytical conclusions	When regulation is taken into account, worldwide taxation does not fully equalize the returns from investing as it does in the case disregarding regulation.		When regulation is taken into account and regulatory costs are greater in the foreign country, worldwide taxation leads to a capital export disincentive.	
Analytical conclusions if varying the amount of surplus	When considering regulation, returns in Japan and the United States are more similar in the case of worldwide taxation than in the case of territorial taxation, meaning that *if* the surplus for the investment in the United States were higher by a certain amount, territorial taxation may favor the less efficient investment in Japan.		When considering regulation, returns in Japan and the United States may be more similar in the case of territorial taxation than in the case of worldwide taxation, meaning that *if* the surplus for the investment in Japan were higher by a certain amount, worldwide taxation may favor the less efficient investment in the United States.	

TABLE 4 (EXAMPLE 3)

	Example 3: Regulation lower but taxation higher in Japan t_J = 40%, r_J = 0%; t_U = 25%, r_U = 20%			
	Example 3.a: Foreign tax credit limited to t_U for worldwide taxation		Example 3.b: Unlimited foreign tax credit for worldwide taxation	
	Return from investing in Japan	Return from investing in the United States	Return from investing in Japan	Return from investing in the United States
Traditional analysis (disregarding regulation), territorial taxation	60	75	60	75
Traditional analysis (disregarding regulation), worldwide taxation	60	75	75	75
With regulation, territorial taxation	60	60	60	60
With regulation, worldwide taxation	60	60	75	60
Analytical conclusions	No difference between territorial taxation and worldwide taxation under either mode of analysis		An unlimited foreign tax credit can incentivize the export of capital, after taking into account regulatory costs	

D. Further Research

Further empirical research beyond the scope of this article would be helpful in assessing the effects of following CEN in tax policy, yet while also following CIN in other realms of regulation.[108] For instance, it would be

[108] Fuller analyses of the interconnection of taxation and regulation and the choice

interesting to see how often, and for which countries, foreign regulatory costs are higher than U.S. regulatory costs, in which case the U.S. system of worldwide taxation would favor investment in the United States by U.S. companies regardless of the relative income tax rates. If foreign regulatory costs are generally greater than domestic regulatory costs, the U.S. system of worldwide taxation may actually be said to enhance the competitiveness of the United States in competing for investments by U.S. companies, since investment in the United States is thereby favored irrespective of relative income tax rates as demonstrated in the second example above. In such a case, the U.S. system of taxing worldwide income may be said to sustain a capital export disincentive rather than to support capital export neutrality.

On the other hand, to the extent that income taxation is not a major determinant of international investment decisions after taking into account other factors, a circumstance that may occur when regulatory costs in the United States are greater than they are abroad, as in the first example above, claims in the tax literature that switching from a worldwide system to a more territorial system would cause dramatic changes in investment decisions may have to be qualified.[109] If, however, regulatory costs in the capital-exporting nation are greater than in the capital-importing nation, then, as noted earlier, worldwide taxation for the capital-exporting nation may still be favored because of its tendency to aid in achieving the efficient investment decision.[110] Nevertheless, when regulatory costs are higher in the capital exporting country, an unlimited foreign tax credit will tend not to support capital export neutrality, contrary to what is often claimed in the literature that does not consider regulatory costs.

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between the two generally would also be helpful. For example, the foreign tax credit, which is necessary only because of worldwide taxation, may create an incentive for foreign countries to choose income taxation rather than regulation to implement a redistribution policy because the foreign income taxes paid would be credited while the regulatory costs would only be deducted, thus making investment for a U.S.-based company more expensive in the case of foreign regulation rather than a foreign income tax. This is exemplified in the second example above. There is a similar incentive for a foreign country to impose a creditable tax rather than an uncreditable tax, as the United States effectively provides a greater subsidy for creditable taxes than for uncreditable taxes.

[109] *See, e.g.*, Kimberly A. Clausing, *A Challenging Time for International Tax Policy*, 136 TAX NOTES 281, 282 (July 16, 2012) (estimating the number of jobs that would move overseas as a result of changing to a territorial tax system). Though quite impressive, the econometric analysis on which Clausing relies would be more persuasive if it accounted for more nontax factors affecting business decisions. As in the first example above, lower taxes could be correlated with lower rates of regulation; if so, what looks to be caused by lower taxes could in reality be due to lower rates of regulation. Omitting the potentially significant variable complicates the validity of causal inference based on observational data, though Clausing's conclusion is not necessarily incorrect.

[110] *See supra* Part V.B.2.

As the analysis in the previous two paragraphs turns on whether foreign regulatory costs are higher or lower than in the capital exporting nation, the empirical question is complicated by the possibility that regulatory costs in some capital-importing nations will be higher than in the capital-exporting nations, but lower in other capital-importing nations. The U.S. system of worldwide taxation supports a capital export disincentive, but only with respect to foreign countries in which regulatory costs are higher than in the United States; the U.S. system of worldwide taxation may aid in achieving the efficient investment decision with respect to countries in which regulatory costs are lower than in the United States. Moreover, regulatory costs and effective tax rates may vary by industry, adding further complications to an empirical analysis.[111] All of these numbers will also likely vary over time, so one policy prescription for a particular period may not be applicable to future periods.[112] Even if it would be feasible to segment the U.S. international tax system so that it follows worldwide taxation in some instances but follows territorial taxation in other instances, depending on differences in regulatory costs, it would create incentives to game the system; this may be an interesting area of further research.

Further theoretical research can be conducted to consider how other forms of neutrality (such as the different forms of capital import neutrality, national neutrality, and capital ownership neutrality) are affected by taking into account regulatory costs. For instance, in the case of capital import neutrality as savings neutrality,[113] regulatory costs will affect the decision to save versus to consume in a similar way that taxation does.[114] National neutrality was briefly considered earlier.[115] In the case of capital ownership

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[111] The possibility that regulatory benefits for regulations that are imposed on the basis of residence may vary from country to country may also be worthy of consideration. *See supra* note 61.

[112] The relevant figures for the businessperson making the investment decision would, of course, be expected values with appropriate discounting. It may be interesting to consider the relative regulatory burdens as a historical matter. It is possible that, earlier in the history of the U.S. tax system, regulatory rates were higher in the United States than in countries that imported American capital. Such a circumstance would provide a rationale for the adoption or continuance of worldwide taxation during that period.

[113] *See* Michael S. Knoll, *Reconsidering International Tax Neutrality*, 64 TAX L. REV. 99, 107–09 (2011).

[114] *Cf.* Hines, *supra* note 11, at 274 (noting this point with respect to CIN but not applying it to CEN or national neutrality (NN): "since many national policies influence the return to savers, CIN is often dismissed as a policy objective compared to CEN and NN.").

There are, of course, differences to how regulatory costs and taxation affect the investment decision, as regulation may be more likely than taxation to result in a change in benefits felt by the investor. For further discussion, see *supra* note 90.

[115] *See supra* note 68.

neutrality, any law that treats nationals of one country differently than nationals of another country may cause a departure from capital ownership neutrality.[116] In the United States, the many examples include the Committee on Foreign Investment in the United States (CFIUS) and laws restricting foreign ownership of U.S. airlines and shipping vessels.[117] Foreign countries have similar provisions, the costs of which can be accounted for in regulatory costs in the analysis in the previous sections. That these regulations exist, some for arguably justifiable reasons such as national security, means that capital ownership neutrality in its general sense may never be fully satisfied when a broader concept of government-imposed costs is taken into account. Even if capital ownership neutrality is followed in the tax system, as occurs when all countries exempt foreign income from taxation, the presence of regulations that prohibit the nationals of particular countries from owning certain assets may cause capital ownership neutrality not to be satisfied in the aggregate. Following the prescription of the general theory of the second best,[118] and similarly to the above analysis about capital export neutrality, analysis of tax systems regarding capital ownership neutrality therefore must consider not only tax but also other regulatory factors that will affect ownership.

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[116] For example, in the case of taxation, if the United States follows worldwide taxation, whereas other countries do not, capital ownership neutrality will not be satisfied. *See* Desai & Hines, *supra* note 29, at 495. A tax system is said to satisfy capital ownership neutrality if it does not distort ownership patterns. *Id.* at 494. As in the case of capital export neutrality, there is an analogous implicit norm that can be applied to analyze nontax regulation.

In his article discussing capital ownership neutrality, Mitchell Kane does speak of nontax factors that may affect bid prices and the ownership of assets. *See* Kane, *supra* note 7, at 77 ("There are myriad distortions, tax and otherwise, beyond those related to taxation of foreign source income that may influence bid prices."). Kane titles one section of his article "Non-Tax Induced Distortions to Ownership," and his examples there relate to segmented markets and leverage in the capital structure. *See id.* at 72–73. Kane's analysis is different from the main analysis proposed in this part of the article, as Kane focuses on capital ownership neutrality rather than capital export neutrality. Kane also focuses on tax-induced distortions rather than nontax factors. *See id.* at 72 ("The focus of this paper is on tax-induced ownership distortions to [foreign direct investment].").

[117] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-608, SOVEREIGN WEALTH FUNDS: LAWS LIMITING FOREIGN INVESTMENT AFFECT CERTAIN U.S. ASSETS AND AGENCIES HAVE VARIOUS ENFORCEMENT PROCESSES (2009). The incentives need not be anti-foreigner. For example, before the enactment of the Foreign Investment in Real Property Tax Act (FIRPTA) in 1980, codified as I.R.C. § 897, U.S. tax law effectively incentivized investment by certain foreigners in U.S. real property compared to the same investment by domestic residents because foreigners could escape U.S. income taxation on capital gains derived from the disposition of U.S. real property interests. *See* Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1098 (1983).

[118] *See supra* note 96.

Irrespective of further theoretical or empirical findings,[119] the point remains that the arguments of pro-CEN commentators emphasizing economic efficiency must be tempered. The claim that worldwide income taxation supports economic efficiency in the allocation of investments is often simply unsupported when other government-imposed costs are taken into account. The call to consider regulatory costs is more than the mere point that nontax considerations will affect the investment decision, which has been noted in the tax literature. The point is that regulatory costs need to be considered alongside tax costs in the calculus of whether and when a particular form of neutrality holds. Currently, international tax policy analysis considers only tax costs without duly considering regulatory costs.

VI. CONCLUSION

Taxation and regulation are in some sense substitutes, yet regulation is generally given minimal or no consideration in the international tax policy literature.[120] The result has been that U.S. taxation policy has developed capital export neutrality, a concept which has implicit analogues in regulation, but for good reason (the distribution of benefits) is generally not followed in other regulatory regimes. Yet, since regulation and taxation can in significant ways replace each other, and moreover, the overall result is what will drive business decisions, tax policy must be studied and considered

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[119] Additional theoretical findings may, of course, be obtained by varying any number of the simplifying assumptions made in the analysis.

[120] *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION 40-99 (Comm. Print 1999) (discussing U.S. international tax policy without considering other U.S. regulatory regimes); GARY CLYDE HUFBAUER, INST. FOR INT'L ECON., U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 49–50 (1992) (briefly mentioning but not discussing nontax regulations, and noting that tax policy analysts have preferred to ignore nontax regulations: "[I]t is worth pointing out that the CEN school assesses tax policy in isolation from a variety of other policies that might distort the location of investment. For example, protective tariffs, buy-national public procurement, and capital grants to firms can all tilt plant location decisions. According to the CEN school, these other policies should be corrected on their own turf; the tax code is not the place to offset the great variety of distortions that governments inflict on the international economy."); Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 58 TAX NOTES 1511 (Mar. 15, 1992), *reprinted in* 135 TAX NOTES 1229 (June 4, 2012); Fleming, Peroni & Shay, *supra* note 39, at 1084; Knoll, *supra* note 113, at 104 (considering post-tax numbers and pre-tax numbers, but not considering pre-tax, pre-regulation numbers); Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203, 207 (2007) (similar, comparing post-tax numbers to pre-tax numbers); Fadi Shaheen, *International Tax Neutrality: Revisited*, 64 TAX L. REV. 131 (2011); *see also* Graetz & O'Hear, *supra* note 39 (reviewing the early history of U.S. international income tax policy and showing no evidence that non-tax regulations were considered in conjunction with tax policy).

in light of other regulatory regimes. This means taking into account the effect of taxation in comparison with other regulatory regimes and the economic consequences that regulation might have for central claims of the tax policy literature.

An analysis that takes regulation into account shows that the costs of nontax regulation have significant implications for international tax policy. This outcome is consistent with the general theory of the second best of welfare economics. Such an analysis weakens the normative case for worldwide taxation on the grounds of economic efficiency, shows how worldwide taxation can incentivize domestic investment, may support a territorial system of taxation when a capital importing nation imposes greater regulatory costs than does the capital exporting nation, supports a worldwide system of taxation for a capital exporting nation with relatively high regulatory costs, and shows how an unlimited foreign tax credit can actually be contrary to capital export neutrality.