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# COMMENTARIES

## EQUITY CONSIDERATIONS IN INTERNATIONAL TAXATION

*Nancy H. Kaufman*\*

A few of my students describe me as an “equity freak.” Like most descriptions of its kind, aside from the advantage of brevity, it has a grain of truth. When I read much of the international tax literature today, it seems to me that issues of fairness, which are inherently about values, play second fiddle to some other considerations. Dr. Musgrave and I both find issues of fairness, including inter-nation equity, to be important aspects of tax policy. Elsewhere I have responded to much of the equity discussion in Dr. Musgrave’s paper.<sup>1</sup> Please allow me to take a few minutes of your time to summarize that response for you in the process of expanding it a bit.

It might be useful to start from the position with which a lot of commentators would agree: For equity reasons, an income tax should apply to a taxpayer’s entire income, wherever earned or derived.<sup>2</sup> I agree with this. I don’t agree that a taxpayer’s entire income necessarily needs to be taxed by a single country—the residence country. Explicit in Dr. Musgrave’s work is the position that the integrity of a residence country’s income tax requires that country to tax its residents’ worldwide incomes. A couple of different approaches have been taken to explain this popular view. One is a traditional combination of tax theory and international law, while

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1. Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW AND POL’Y INT’L BUS. 145 (1998).

2. See *id.* at note 149.

the other deals with the tax base itself.

Dr. Musgrave uses the more traditional formulation. A residence country is entitled to tax the worldwide incomes of its taxpayers. This entitlement derives from the nature of the income tax as a "personal" tax. The income tax seeks to tax the taxpayer's entire welfare as measured today by the income tax base.<sup>3</sup> The income tax base is conceived of as an attribute of the taxpayer.<sup>4</sup> In customary international law, a country has prescriptive jurisdiction over the persons of its nationals, wherever they may be.<sup>5</sup> Therefore, the residence country is entitled to tax the worldwide incomes of its residents. Moreover, as Dr. Musgrave notes, taxes imposed at the source generally have been classified as *in rem* taxes, not *personal* taxes. Hence, the only sovereign in a position to impose a *personal* income tax on the taxpayer's entire welfare as measured by the income tax base is the residence country. Equity then demands that it do so.

Coming at this from a different perspective, other commentators, pointing to the Schanz-Haig-Simons formulation of income,<sup>6</sup> have noted that the income tax is a tax on consumption and savings. Consumption and savings are attributes of persons not places. Consumption and savings, they say, are not susceptible to source. Accordingly, the income tax base is not susceptible to source.<sup>7</sup>

Of course both approaches, and equity considerations generally, concern individuals, not corporations. We are told sometimes that corporations act as surrogates or proxies for individuals in this regard. Although I have never been entirely certain about this, I am not prepared to take issue with the point here.

The more traditional approach to tax equity, largely adopted by Dr. Musgrave and many others, has a certain beauty in

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3. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 223 (5th ed. 1989).

4. *See Id.* at 215.

5. *See, e.g.*, RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 402(2) (1986).

6. *See* Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 1-2* (Robert Murray Haig ed., 1921); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

7. 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, 31 (A. Razin & J. Slemrod eds., 1990).

its form. But it lacks substance. However broad the income tax base may be, it is not a realistic measure of a person or that person's well-being. It doesn't even measure consumption and savings. The comprehensive income tax base is the sum of what can be measured—the results of transactions.<sup>8</sup> Hence, I wonder if the classification of the income tax as a personal tax really should have any significance under international law. Additionally, the rise of positivism in international law and its professed elimination of value judgments make strange companions for the income tax, a tax at least initially developed and adopted based on considerations of equity.<sup>9</sup> Before we buy into international law as the foundation of income tax equity, we ought to examine carefully the value judgments it expresses.

The notion that the comprehensive income tax base is not susceptible to source also is not entirely correct, and Dr. Musgrave does not suggest that it is. For the record, Simons' definition of income is an accounting equation. On one side of the equation are the sources of new wealth: that is, income. On the other side of the equation are the uses of new wealth: that is, consumption and savings. People acquire their wealth on the income side of the equation and consume or save their wealth on the other side. New wealth does, in fact, derive from specific geographic sources.<sup>10</sup> When Shanz and Haig and Simons sat in their offices separated by miles and years and contemplated the meaning of "income," I don't think any of them gave much thought to the problems of taxing income internationally. What we know as the comprehensive income tax base addresses equity between individuals, not the distribution of the competence to tax internationally. Dr. Musgrave suggests that "[C]ommon source rules employing consistent methods of unitary combination and uniform formulary apportionment should be developed by international agreement."<sup>11</sup> To a very large extent, I agree that work should proceed in this direction.

However, as noted, I do not agree that equity *requires* the

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8. See Kaufman, *supra* note 1, at notes 140-46 and accompanying text.

9. See *id.* at notes 147-48 and accompanying text.

10. See *id.* at notes 156-58.

11. Peggy B. Musgrave, *Sovereignty, Entitlement and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335 (2001).

taxation of worldwide income by a single sovereign. Professor Graetz's and Michael O'Hear's portrayal of T.S. Adams indicates that the historical roots of the U.S. international tax system may not have sprung from a perceived necessity for equity reasons to tax a resident's worldwide income.<sup>12</sup> Adams, an influential figure in the development of U.S. international tax law, apparently operated from the beliefs that double taxation is inherently unfair, and source-based taxation should be primary, but that a need existed for residence-based taxation to serve as a backstop in a world relatively devoid of international cooperation in tax matters.<sup>13</sup> Adams' world need not be our world. If we were motivated to engage in meaningful international tax cooperation, it would be possible for each country with which a taxpayer had ties to impose its tax on that portion of the taxpayer's income arising within that country. In that event, the taxpayer's entire comprehensive income tax base would be subject to tax, different parts of it by different countries. A worldwide system of source taxation would thus achieve the income tax goal to which we all seem to subscribe: An income tax should apply to a taxpayer's entire income, wherever earned or derived. Other means might be employed to achieve the same result.<sup>14</sup> Since, in my view, equity does not necessarily require the taxation of the taxpayer's worldwide income by a single sovereign, I don't agree with Dr. Musgrave that personal taxes are inappropriate to a situation in which only part of the taxpayer's global income is to be taxed.

The point here is not to sell you a system of international income taxation based on source. I have not sold that system to myself yet. I would like to convince you that inter-individual equity in income taxation does not require the taxation of worldwide income by a single sovereign. Accepting that premise opens up a range of possibilities for negotiation. There is one more thing. Simply stated: In defining its share of the tax base at the international level, each sovereign should take

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12. See generally Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

13. *Id.* at 1054-59.

14. See, e.g., Klaus Vogel, *World-wide vs. Source Taxation of Income—A Review and Reevaluation of Arguments (Part I)*, 1988 INTERTAX 216, 219 (quoting Georg von Schanz, *Zur Frage der Steuerpflicht* [On the Question of Tax Burden] 9 II FINANZ ARCHIV 1, 4 (1882)).

inter-nation equity into account as an important consideration. I would like to finish with a few comments about this.

Dr. Musgrave distinguished between inter-individual equity and inter-nation equity over thirty-five years ago.<sup>15</sup> Professor Graetz has pointed out that T.S. Adams relied on fairness issues at the international level to support the enactment of the first foreign tax credit limitation in 1921. Adams did not think that an unlimited foreign tax credit should be able to decrease taxes that in fairness belonged to the United States.<sup>16</sup> Adams' pragmatic interest in what Dr. Musgrave later identified as inter-nation equity should put at ease those who still may be uneasy with the idea of tax equity among nations. Just ask any member of Congress: The United States should be able to prevent its tax base from slipping into the clutches of some other sovereign's tax administration. The question is just how far, as a matter of fairness to other nations, the U.S. tax base, or that of any other country, should extend.

So what is it about inter-nation equity that is so difficult to talk about? (And I do think people find fairness difficult to talk about.) In writing about the taxation of aliens in 1952, Albrecht noted that, "the right to tax aliens under international law is not at present in fact based upon ethical principles. Moreover," he said, "no clear and generally accepted standards of fairness can be said to exist, and attempts to formulate them tend to diverge into metaphysical speculation."<sup>17</sup> The temptation is great to leave "metaphysical speculation" to the philosophers while the rest of the academy gets on with the deceptively more precise task of delineating the economic consequences of the system. And as disillusioned as we may or may not become with the results of applied economic theory, few who have devoted years to economic analysis want to re-tool ourselves as philosophers. And even if someone were to do so, where would it get her in this multicultural world in which so little agreement exists about anything to do with values?

Still, when it comes to fairness in international taxation,

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15. PEGGY BREWER RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME—AN ECONOMIC ANALYSIS* 15-24 (1963).

16. See Graetz & O'Hear, *supra* note 12.

17. A.R. Albrecht, *The Taxation of Aliens Under International Law*, 29 BRIT. Y.B. INT'L L. 145, 148 (1952).

or just about anything else, the failure to choose becomes a choice in itself. The present system is not devoid of values just because we choose not to talk about them. When we talk about the entitlement of the residence country to tax the worldwide income of its taxpayers, subject to the right of the source country to tax the income arising within its borders, we describe a system in which residence countries are entitled to a share of what their residents earn in the marketplace except to the extent that a source country comes along and claims it as its own. I have for some time suspected that this system finds its roots in a version of entitlement theory.

Professor Musgrave and I both advocate international cooperation in substantive tax matters. Folks have been talking about this for decades. In the meantime, we've fought two world wars, scared ourselves half to death with a cold war, maintained an at least somewhat viable United Nations for more than fifty years, signed innumerable trade agreements, and have gotten the World Trade Organization underway. What is it that has kept us from achieving greater international cooperation in substantive tax matters? A good bet is that the stumbling blocks have somewhat less to do with economic analysis and more to do with various sovereign actors' perceptions of the fairness of the distribution of the tax base internationally.