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

CHARLES E. McLURE, JR.\*

## I. INTRODUCTION

Most countries of Latin America attempt to tax only income deemed to have its source within their boundaries; they do not attempt to tax income of their residents (or citizens) deemed to originate in the rest of the world. These countries employ a territorial or source-based system of taxation, and do not try to implement worldwide or residence-based taxation.<sup>1</sup> To the extent that residents of nations relying on source-based taxation invest their capital abroad, they can avoid taxation at home. Moreover, when Latin American nations attempt to implement worldwide taxation, they meet with little administrative success. Taxpayers in most Latin American countries that do employ the worldwide principle are generally able to evade tax on foreign-source income by commit-

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1. For a list of Latin American countries which rely on source-based and residence-based taxation, see Appendix. Ten of the 17 countries that tax the income of individuals employ the territorial principle; only seven attempt to tax the worldwide income of individuals, and Uruguay has no individual income tax. In corporate taxation, reliance on the territorial principle is even more dominant, with 13 of the 18 that tax corporate income employing the territorial principle. In this paper no distinction is made between residence and citizenship as the basis for worldwide taxation of individuals. Although important, the distinction is secondary for the purpose at hand. Similarly, little attention will be paid to the important question of how source-based taxation of business income is implemented (e.g., via separate accounting based on arm's length prices or via formula apportionment) or to the difficulties inherent in implementation. While these issues are crucial in the taxation of income from a trade or business, they are not of great import in the taxation of income from passive investments.

ting fraud, with relative impunity.

The direct result of the failure or inability of such countries to tax foreign-source income is loss of tax revenues. These countries also suffer a loss of capital otherwise available for productive investment at home and, implicitly, a further diminution of their tax base.<sup>2</sup>

This article examines the inducements to capital flight<sup>3</sup> produced by the interplay among the tax laws of the United States and those of the countries of Latin America. Generally, United States domestic tax policies exacerbate the problem of capital flight from Latin America. Opportunities to channel investments through tax haven countries<sup>4</sup> with which the United States has tax treaties<sup>5</sup> complicates this interplay, although the United States has moved in recent years to reduce the opportunities to use "treaty shopping" to reduce taxes.

The primary issue for examination is tax treatment of income earned by foreigners on passive investments<sup>6</sup> in the United States, as non-business income<sup>7</sup> appears to be the form in which income is most likely to be earned by Latin Americans wishing to invest in the United States without leaving their home countries.

The United States does not tax most capital gains<sup>8</sup> realized<sup>9</sup>

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2. See INTER-AMERICAN DEVELOPMENT BANK, ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA 408 (1986).

3. The term "capital flight" is used in this article as a short-hand reference to describe the investment abroad of capital owned by Latin Americans. While it is assumed that such capital may be highly mobile, there is no suggestion that such funds are necessarily "hot" or "flight capital" leaving because of political instability or economic uncertainty.

4. A tax haven may be described broadly as a place where foreigners may receive income or own assets without paying high rates of tax upon them. A tax haven may be established inadvertently by adherence to a strict territoriality principle of income taxation, de Jantscher, *Tax Havens Explained*, 13 FIN. & DEV. 31 (1976).

5. For a list of countries, some of which may operate as tax havens, with which the U.S. has tax treaties, see the table following 26 U.S.C.A. § 861 (West 1982). See also CUMULATIVE INDEX TO INTERNATIONAL TAX TREATIES OF ALL NATIONS 73-77 (W. Diamond & D. Diamond eds. 1988). C.f. Shoup, *Effects of U.S. Tax Laws on the Tax Systems of Developing Countries*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 181, 184-203 (R. Hellawell ed. 1980) (discussing characteristics of tax haven jurisdictions).

6. I.R.C. § 469(c) (Passive activity losses and credits limited — Passive activity defined).

7. "To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." *Higgins v. Comm'r*, 312 U.S. 212, 217 (1940). See generally Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423 (1963).

8. Capital gains are gains from the sale or exchange of a capital asset. I.R.C. § 1222. Generally, all assets are capital assets except those specifically excluded in I.R.C. § 1221.

by foreigners,<sup>10</sup> except those from real estate and those effectively connected with a trade or business. Most interest income paid to unrelated foreigners<sup>11</sup> is exempt from U.S. tax, whether paid by financial institutions or by others. Dividends on corporate shares and capital gains on real estate are generally subject to tax; however, in the case of dividends it may be possible to reduce taxes substantially through the use of nominee accounts located in treaty partners of the United States. Thus, the United States acts as an enormous magnet poised to attract capital, especially debt funds, from Latin America.

The article illustrates how problems of capital flight and tax avoidance and evasion created by U.S. tax law are further aggravated by the typical tax treatment of capital income in Latin American countries. The discussion of tax systems employed in Latin America will be brief. It is difficult to go beyond the basic characterization of a system as being based on either source or residence without becoming embroiled in minute details. More important, little would be gained from a detailed examination of the tax laws of Latin American countries. A basic premise of this paper is that every tax system in Latin America is likely to resemble a source-based system, especially in its taxation of passive income, even if the tax law states that worldwide income is to be taxed.

The discussion that follows is not based on a naive view that taxes are the only determinant of international capital flows, or even that taxes are the most important determinant. Political instability and fear of economic crises and currency fluctuations provide much more important reasons for capital flight from developing countries. Similarly, any tax advantages of investment in the United States are likely to be dwarfed by the attraction of political

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Major categories of non-capital assets include property held for resale in the normal course of business, i.e., inventory, trade accounts and notes receivables, depreciable property, and real estate used in a trade or business.

9. I.R.C. § 1001(b) (determination of amount of and recognition of gain and loss).

10. "Foreigner" for purposes of this paper refers to natural and juridical persons who are non-residents of the United States for tax purposes. Resident status is determined according to Treas. Reg. § 1.871-2(b). See *Adams v. Comm'r*, 46 T.C. 252 (1966); *Begassiere v. Comm'r*, 31 T.C. 1031 (1959) *aff'd per curiam*, 272 F.2d 709 (5th Cir. 1959); Herbert G. Whyte, Tax Ct. Mem. Dec (P-H) Para. 86,486 at 2213-14 (1986); *Park v. Comm'r*, 79 T.C. 252, 286-98 (1982) *aff'd without opinion* 755 F.2d 181 (D.C. Cir. 1985).

11. See I.R.C. § 864(c)(1)(B) (effectively connected income); an unrelated foreigner is a nonresident person not engaged in a trade or business and whose income during a taxable year is not treated as effectively connected to a trade or business; see also I.R.C. § 864(c)(1)(A).

stability. The tax treatment of various items of U.S. source income in the United States and elsewhere, however, does exert an influence on investment decisions.

No attempt is made here to quantify the proportion of capital drawn into the United States by tax benefits, relative political stability, or any other attraction; that would be a hopeless task, especially as the difficulty in holding all other influences constant is compounded by the lack of reliable data. Instead, this article focuses on U.S. tax policy and the ways in which it attracts capital. No effort is made to provide a comparison of U.S. tax law with that of other countries. To the extent that foreign investors are treated generously elsewhere, comparably generous U.S. treatment may merely divert investment from these developed countries to the United States, rather than inducing additional capital flows from Latin America. If generous taxation of the income of foreigners continues elsewhere, not much may be gained for Latin American countries from a unilateral tightening of U.S. taxation of such income.

## II. PRINCIPLES OF INTERNATIONAL TAXATION

There are two basic approaches to the taxation of income flowing between countries. Under the source principle, all income originating in a given jurisdiction is taxed, but income originating elsewhere is not. This is also called the territorial approach.<sup>12</sup> The residence principle, or worldwide approach, in contrast, focuses on the residence of the taxpayer, and taxes all income of the resident wherever earned.<sup>13</sup> Many countries, including the United States, employ both approaches. That is, they tax both income originating within their borders as well as all the income of residents, wherever earned.

Advocates of the residence principle cite the following primary advantages. First, residence-based taxation does not discriminate between income flows, which vary depending on country of source. Income is taxed in the same manner, whether earned in the United States or in any foreign country. This feature of residence-based taxation is sometimes called "capital-export neutrality." If employed effectively by all nations, residence-based taxation would

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12. For a discussion of territorial or source-based taxation, see Shoup, *supra* note 5, at 194-95.

13. For a discussion of the worldwide or source-based system of taxation see *id.*

not interfere with the allocation of economic resources among nations; in principle, it would lead to allocation of the world's capital to its most productive use. By comparison, source-based taxation discourages investment in high-tax jurisdictions and encourages investment in low-tax jurisdictions.<sup>14</sup> Capital-exporting countries support residence-based taxation because they want to keep the revenue generated by the foreign investment of their residents.<sup>15</sup>

Advocates of source-based taxation argue, in part, that the source country is entitled to capture for its public coffers part of the income originating within its borders.<sup>16</sup> Moreover, residence-based taxation is inevitably difficult to administer, especially in a developing country.<sup>17</sup> To the extent that residence-based taxation cannot be administered effectively, capital flight is likely from the countries with inadequate administration; thus, the theoretical advantages of capital-export neutrality are not actually achieved.<sup>18</sup>

Double taxation results from the application of both source and residence-based taxation to a particular international flow of income. Countries employing the residence principle commonly defer to the fiscal claims of source countries. In the United States this is achieved unilaterally by allowing credit against U.S. tax liability up to the average rate of taxation paid in the United States

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14. Of course, if source-based taxes exactly reflect benefits of public spending, no distortions will occur. Indeed, if public spending provides substantial benefits for business, the failure to levy taxes that reflect such benefits would cause distortions. This qualification is ignored herein, since (at the margin) the direct link between benefits received and taxes paid by corporations and high-income individuals is generally quite weak.

15. For an interpretation along these lines, see Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1163-66 (1981).

16. For a strong argument based on "entitlement," see Musgrave, *Interjurisdictional Coordination of Taxes on Capital Income*, in TAX COORDINATION IN THE EUROPEAN COMMUNITY at 197-225 (S. Cnossen ed. 1987)[hereinafter *Interjurisdictional Coordination*]; P. MUSGRAVE, COORDINATION OF TAXES ON CAPITAL INCOME IN DEVELOPING COUNTRIES (1987); UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (1980).

17. If implemented in a non-discriminatory manner, source-based taxation yields "capital-import neutrality," since all taxpayers operating in a given country pay the taxes of that country, rather than the potentially different taxes of their home countries. Though this notion of a "level playing field" in the capital-importing country has intuitive appeal, it has no resource allocation advantages. P. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 119-21 (1969). Source-based taxation, if universally applied, would result in tax-inducements for investment in low tax countries, rather than having no effect on investment decisions.

18. "Though administratively difficult to achieve, a key requirement of the latter aspect (avoidance of capital flight) is to apply global income taxes, corporate and individual." P. MUSGRAVE, *supra* note 16. An important point of this article is that this (implementation of worldwide taxation) is a hopeless goal.

for income taxes paid to foreign governments.<sup>19</sup> As long as the foreign tax rate does not exceed the domestic tax rate, capital-export neutrality is achieved. As an alternative, a taxpayer can opt to take a deduction for foreign taxes, rather than a credit.<sup>20</sup> United States tax treaties also regulate the tax treatment of income flowing between treaty partners.<sup>21</sup>

Nations face conflicting objectives in deciding whether to utilize source or residence-based taxation, as well as whether to give precedence in international tax conventions to the tax system of the source or residence nation. For example, a capital-importing nation might like to enact heavy source-based taxes in order to capture tax revenue for its treasury. On the other hand, it may fear the adverse effects source-based taxation that is not offset by foreign tax credits in capital-exporting countries would have on foreign investment in the country. Indeed, a decision may be made by the source country to forego tax revenues in order to attract capital. This is especially likely where potential foreign investors reside in countries that do not or cannot tax foreign-source income. Capital-exporting<sup>22</sup> countries can be expected to prefer residence-based taxation. This pattern is exemplified in the tax laws of the United States, and sometimes to a lesser degree in those of other developed countries. Although the United States unilaterally extends priority in taxation to the source country through its foreign tax credit,<sup>23</sup> it also attempts to protect its revenue position as a capital exporter by pressing for provisions in its foreign tax treaties that reduce source-country taxation of interest, dividends, and various

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19. In the case of income earned abroad by foreign subsidiaries of U.S. multinational corporations, tax is levied (and credit is allowed for foreign taxes) only when income is repatriated. See I.R.C. § 881 (tax on income of foreign corporations not connected with United States business). Sections 951-961, dealing with controlled foreign corporations, would not apply in this case. As long as U.S. taxes are deferred in this way, taxation is based on source, rather than on residence, and capital-export neutrality does not prevail. For a discussion of capital-export neutrality, see *supra* text accompanying note 13.

20. Allowing a deduction for foreign taxes, rather than a credit, leads to the maximization of national welfare in the capital-exporting country, since the net-of-tax return in the source country will be equal to the gross-of-tax return in the home country. See Hufbauer, *A Guide to Law and Policy*, in G. HUFBAUER, W. SCHMIDT, N. TURE, O. BROWNLEE & D. SMITH, *U.S. TAXATION OF AMERICAN BUSINESS ABROAD* at 1, 1-6 (1975).

21. Treaties traditionally have distinguished between primary income on real investments and secondary income on financial assets; the former are taxed at source while the latter are taxed at residence. See generally P. MUSGRAVE, *supra* note 16.

22. U.S. assets abroad in 1985 amounted to \$949.4 billion, up from \$719.8 billion in 1981. U.S. BUREAU OF THE CENSUS, *STATISTICAL ABSTRACT OF THE UNITED STATES: 1988* 758 (108th ed.).

23. Foreign tax credit is dealt with by I.R.C. §§ 27, 901-908.

other forms of payments to its residents. Capital-importing countries favor relatively high source-based taxes on repatriated income for which capital-exporting countries provide foreign tax credits. In the event that the tax rates applied to these forms of income by the source country fall short of rates in countries of residence which allow foreign tax credits, source countries can raise revenues without fear of adverse economic consequences.<sup>24</sup>

The conflict among these objectives is illustrated by comparing the relevant provisions of the United Nations Model Double Taxation Convention Between Developed and Developing Countries<sup>25</sup> with the Organisation for Economic Cooperation and Development Draft Double Taxation Convention on Income and on Capital.<sup>26</sup> The OECD convention primarily concerns fiscal relations between developed countries. Because capital flows among developed countries can be expected to be roughly in balance over the long run, the distinction between capital-importing and capital-exporting countries may have little significance. Thus, the OECD draft treaty, reflecting the preference of these countries for the residence principle, calls for limiting withholding taxes on interest to ten percent of the gross amount of interest.

By comparison, the U.N. Model Convention involves both developing countries (generally capital importers) and developed ones (generally capital exporters).<sup>27</sup> It leaves the tax rate on interest unstated, subject to bilateral negotiations between the contracting parties.<sup>28</sup> This difference reflects the conflict between the "strong feeling on the part of members from developing countries that those countries should have the exclusive, or at least the primary, right to tax interest"<sup>29</sup> and the view of the representatives of

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24. If the source country's tax rate is lower than that of the taxpayer's resident country, the taxpayer can apply a dollar-for-dollar credit against his tax liability in the residence jurisdiction. The taxpayer will not have a greater total tax burden as a result of being an investor in the source country, and thus no objection to being subject to source country taxation. Thus, a capital-importing country (source country) can raise revenues without controversy or fear of repelling foreign investment by taxing source income up to the rate provided for by the residence country's foreign tax credit.

25. United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. No. ST/ESA/102; U.N. Sales No. E.80.XVI.3. (1980) [hereinafter U.N. Model Convention].

26. Organisation for Economic Cooperation and Development Draft Double Taxation Convention on Income and on Capital, July 30, 1963, OECD Fiscal Committee, 1963 Draft Convention.

27. Presently, no countries have adopted the U.N. Model Convention.

28. U.N. Model Convention, *supra* note 25, at art. 11, para. 2.

29. *Id.* at 123 (commentary accompanying U.N. Model Convention).



developed countries that the home country of investors should have the primary or even exclusive right to tax such income.<sup>30</sup> A similar ambiguity and latitude for negotiations characterizes the U.N. guidelines on withholding rates on dividends, in contrast to the definite limits stated in the OECD model convention.

Foreign tax treaties of the United States commonly give the country of residence an increased secondary claim in the taxation of certain types of income (e.g., interest, dividends, and capital gains) by providing reduced taxation by the source country. While such treaties provide for the capture of tax revenues on income from U.S. capital invested abroad and encourage capital flows between treaty partners and the United States, they are subject to abuse. The most common forms of abuse are described in section IV herein. Moreover, for certain types of income earned in the United States by foreigners, the United States does not attempt to impose source-based taxation as a matter of domestic tax policy.<sup>31</sup>

### III. LATIN AMERICAN PRACTICE

Most Latin American countries attempt to tax income from business and capital earned within their borders by both residents and non-residents.<sup>32</sup> Tax rates applied to individual income range from 30 percent in Bolivia, Colombia, and Paraguay, to 55 percent and above in Chile, the Dominican Republic (70%), El Salvador (60%), Mexico (60.5%), Nicaragua (55%), and Panama (56%). Corporate rates are generally similar, but commonly somewhat lower.<sup>33</sup> Unless income earned abroad by residents is also taxed, either by the home country or by the country in which capital is invested, there are tax-induced incentives for capital flight.

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30. *Id.* at 121-37 (commentary discussing interest), 109-21 (commentary discussing dividends).

31. The United States sacrifices the opportunity to tax income derived from foreign capital invested in the United States, conceivably, to obtain long-term benefits of increased capital investment.

32. Since the primary focus of this paper is on the U.S. tax treatment of income earned by residents of Latin American countries, no attempt is made to survey the tax treatment of income from business and capital in Latin America in detail. Also beyond the scope of this paper are the "quasi-taxes" (ceilings on interest rates and rent controls) and "quasi-subsidies" (protective tariffs and import quotas) that either reduce or increase the attraction of investment in Latin America. See also McLure, *Fiscal Policy and Equity in Developing Countries*, in *POLICY REFORM AND EQUITY*, at 13-42 (E. Berg ed. 1988).

33. Venezuela is an exception to this rule with a corporate tax rate of 50% and an individual tax rate of 45%. See further Appendix.

The countries of Latin America have traditionally been strong proponents of the source principle of taxation.<sup>34</sup> This is reflected in the pattern of jurisdictional standards.<sup>35</sup> Only five of eighteen reporting countries attempt to tax the worldwide income of corporations, and only seven do so for individuals. Although several of the more developed Latin American countries, such as Brazil (for individuals only), Chile, Colombia, and Mexico, do attempt to tax on a worldwide basis, several others, such as Argentina and Venezuela do not. In addition, several of the countries attempting worldwide taxation are relatively undeveloped, such as El Salvador (for individuals only), Honduras, and Peru. With few exceptions,<sup>36</sup> the countries that follow the worldwide approach allow foreign tax credit for taxes paid to source countries. With the exception of Argentina and Brazil, Latin American countries are partners to few tax treaties.<sup>37</sup> No Latin American country has a ratified, effective foreign tax treaty with the United States.

The figures in the Appendix almost certainly overstate effective reliance on residence-based taxation. Major domestic Latin American corporations operating abroad, whether through subsidiaries or branches, can be expected to report income to their home countries, though perhaps not with complete accuracy.<sup>38</sup> The accu-

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34. For a strong statement along these lines, see Atchabahian, *The Andean Subregion and its Approach to Avoidance or Alleviation of International Double Taxation*, in A. ATCHABAHIAN, R. VALDÉS COSTA, E. RICHARD, F. GENDRE, J. HAUSMAN & P. SIBILLE, *FISCAL HARMONIZATION IN THE ANDEAN COUNTRIES* at 7, 28-31 (1975). According to Decision 40 under the Treaty of Cartagena establishing the Andean Group, interest and dividends should be taxed only on the basis of source. See also Agreement on Andean Subregional Integration, May 26, 1969, 8 I.L.M. 910 (1969) [hereinafter *Cartagena Agreement*].

35. See Appendix.

36. Brazil, for example, allows credit only as permitted by treaty.

37. This does not include the tax provisions of the Andean Pact among Bolivia, Colombia, Ecuador, Peru and Venezuela. *Cartagena Agreement*, *supra* note 34.

38. The combination of source-based taxation in the Latin American country and the exemption of interest income paid to foreigners in the United States provides an open door to a particularly egregious form of tax avoidance. Suppose that a Latin American businessman owns a company operating in his country of residence. If he makes an equity investment in his business, the resulting income is ordinarily subject to tax at least once (if invested in a partnership, a proprietorship, or a corporation in a country with generous provisions for the integration of the corporation and individual income taxes); if the investment is made in a corporation in a country that allows no integration, the income may be subject to double taxation, once at the corporate level and again when distributed to the businessman-shareholder.

A potentially more attractive arrangement from the standpoint of minimizing taxes would be to make a loan to the business. Depending on whether the corporation or the individual was subject to the higher marginal tax rate, the net result might be either a net increase or decrease in aggregate taxation of the corporation and its owner. In any event, the

racy of reporting is likely to depend on the existence and effectiveness of exchange controls, on the availability of (and limitations on) the foreign tax credit in the home country as an inducement to honest reporting, on the extent of exchange of information between fiscal authorities of the source country and the home country, and on the feasibility of structuring parent-subsidiary relations<sup>39</sup> in such a way as to circumvent such exchanges of information and other administrative controls of the home country. Because income from the conduct of a trade or business in the United States is subject to taxation, even if earned by a foreign person, it is not the primary vehicle of tax-induced capital flight to the United States from Latin America.<sup>40</sup>

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situation would be preferable to an equity investment in a country that provides no relief from double taxation of dividends, unless the interest payments were construed to be dividends and therefore subject to the tax treatment described above.

Preferable to either of these two investment strategies would be an arrangement under which the Latin American businessman would make a deposit in a U.S. bank with the understanding that the funds would be lent again to his firm operating in his home country. Under U.S. law no tax would be paid on interest paid on the deposit; by comparison, a deduction generally would be allowed by the home country for interest paid to the U.S. bank. There might be a withholding tax on such interest, but ordinarily at a rate below that at which the deduction is taken. Under source-based taxation no tax would be due the home country on the interest earned on the U.S. bank account. (Even under a residence-based system it would be difficult to tax such income.) Of course, there would be some spread between the interest rate charged by the bank on the loan and that paid on the deposit. But even this is likely to be small, especially since the amount deposited could be held as collateral for the loan. In any event, the spread is likely to be substantially less than the tax saving resulting from the interest deduction. If so, this "tax arbitrage" operation results in a net tax saving.

An even simpler approach is possible in countries that allow deduction for interest paid on bearer debt, with no withholding on interest paid domestically. The company borrows from its owner, issuing bearer debt. Interest payments are deductible to the business, but not taxable to the owner. Of course, this outrageous form of abuse could be substantially curtailed by the elimination of bearer debt, particularly if accompanied by substantial withholding taxes on interest payments.

To the extent that interest rates in the Latin American country include an inflation premium that is allowed as a deduction, this result is magnified. If the inflation rate is low or if a deduction is allowed only for the real component of interest expense (nominal rate less the inflation premium), the incentives to structure financing in this manner are diminished; but even in the event of low inflation or a real interest rate provision, this approach is preferable to either direct equity investment or the form of simple debt investment considered above.

39. For a discussion of transfer pricing, see Wheeler, *An Academic Looks at Transfer Pricing in a Global Economy*, 40 TAX NOTES 87 (1988). See also Hendrix, *A Review of Argentine and Ecuadorian Tax Law Regarding Transfer Pricing and Recommendations for Improving Ecuador's Approach*, 20 U. MIAMI INTER-AM. L. REV. 283 (1989).

40. In 1981, revenues from taxation of income effectively connected with a trade or business of a foreign person yielded only \$260 million; the yield was \$268 million in 1982. By comparison, withholding taxes on income of foreign persons not effectively connected with a

Tax-induced capital flight involves investment in assets and instruments, the gain or income on which foreigners are not taxed by the United States. Interest-bearing securities, bank accounts, corporate shares, and real estate in the United States typify these investments. The United States does not tax most interest paid to unrelated foreigners;<sup>41</sup> and capital gains realized by foreigners on assets other than real estate are exempt from U.S. tax.<sup>42</sup> It also may be possible to reduce substantially U.S. taxes on corporate dividends (and with greater risk and less flexibility than those on capital gains on real estate). The next section contains a discussion of provisions of U.S. law dealing with these types of income.

Can a Latin American country that attempts to impose taxation on a worldwide basis do so effectively with regard to these types of passive investment income? A negative answer is virtually inevitable. Ordinarily, passive income earned abroad, i.e., in the United States, on which neither foreign nor domestic tax was paid will not be repatriated through legal channels. Moreover, since no country in Latin America which employs the worldwide approach has a double taxation treaty with the United States, the exchange of tax information with the United States is nonexistent.<sup>43</sup> In the case of bank interest, even the exchange of information does not help. Because financial institutions are not required to report interest payments to foreign investors to the U.S. Internal Revenue Service, an exchange of information agreement would serve little purpose; under U.S. law there would be no information to exchange.<sup>44</sup>

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trade or business were almost \$830 million in 1981. Much of the latter revenue was collected from reduced rates on payments to treaty countries, and other similar income was completely untaxed. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 695 (1987).

41. For a definition of unrelated foreigner, see *supra* note 11.

42. I.R.C. § 871(a)(2) deals with taxation of nonresident alien individuals.

43. Even if there were such a treaty, it would be simple and relatively safe to give the bank or other payor of interest a false address of convenience, for example, in another Latin American country that employs the territorial system or in a tax haven country with which the U.S. has a tax treaty.

44. Given the difficulties the United States has in preventing its own citizens from evading taxes on U.S. source interest and dividend income, there is little reason to believe that any Latin American country can effectively apply a worldwide system of taxation to non-business income earned in the United States by its residents, either with or without cooperation from the United States. There is little such cooperation now, under current U.S. law and in the absence of treaties.

## IV. U.S. LAW: PRINCIPLES AND FACTS

The United States has a tradition of strongly advocating residence-based taxation. While it applies source-based taxation to income originating within the country, it also taxes the foreign income of U.S. persons.<sup>45</sup> But much income from capital originating in the United States is legally exempt from tax if earned by foreigners,<sup>46</sup> and much is taxed at low rates, channelled through treaty partners of the United States.

A. *Income from a Trade or Business*

Income received by foreigners from the conduct of a trade or business in the United States has long been subject to U.S. taxation. The Foreign Investors Tax Act of 1966 (FITA)<sup>47</sup> made two important changes that restrict the scope of taxation in this area. These changes operate to encourage capital flight from other countries to the United States. Today, investment income<sup>48</sup> received by foreigners also engaged in business in the United States is included in taxable income from the conduct of a trade or business only if "effectively connected"<sup>49</sup> with such a trade or business.<sup>50</sup> Prior law,

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45. This includes, for example, income earned in a trade or business, interest paid to affiliates, and capital gains on real estate. Determination of sources of income is governed by I.R.C. §§ 861-865.

46. Nowhere is the policy explicitly stated that only U.S. source income of foreign persons, as opposed to their total worldwide income, is subject to tax. For a discussion of the history of U.S. law regarding taxation of income earned by foreign persons, see Choate, Hurok & Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers — History, Analysis and Prospects*, 44 TEMP. L.Q. 441 (1971).

47. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1541 (codified as amended in scattered sections of 26 U.S.C.).

48. "Fixed or determinable annual or periodic" (FDAP) income refers to amounts received by nonresident alien individuals as interest, dividends, rents, salaries, wages, certain gains, and sale or exchange of original issue discount obligations under I.R.C. § 871(a)(1) and § 881(a). This income is considered FDAP only to the extent that it is not effectively connected with the conduct of a trade or business in the United States. See Treas. Regs. §§ 1.871-7(b), 1.1441-2(a).

49. I.R.C. § 864(c)(4) defines "effectively connected income." See Treas. Regs. §§ 1.864-3, 1.864-5, 1.864-7. For an excellent discussion of the subject, see Dale, *supra* note 40.

50. For a technical discussion of the Act, see S. ROBERTS & W. WARREN, *FOREIGN INVESTORS TAX ACT: SUPPLEMENT TO U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NON-RESIDENT ALIENS* (1967). The exclusion of most such income from tax when received by foreigners is consistent with the policy and history of FITA, suggesting that its goal was to free investment income from U.S. tax. See generally Dale, *supra* note 40. For a more detailed discussion of prior law and the reasons for the adoption of FITA, see Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1969 and Related Developments*, 22 TAX L. REV. 279 (1967).

relying on the "force of attraction"<sup>51</sup> doctrine, automatically included investment income earned by a foreign corporation or individual in the taxable income of that trade or business.

This distinction in categorization is important. Before the enactment of FITA, investment income was taxed at a fixed rate, commonly thirty percent of the gross amount, unless reduced by treaty. By comparison, income deemed to be derived from pursuit of a trade or business, including that drawn by the force of attraction, was subject to progressive rates as high as seventy percent, albeit on net income (after deductions).<sup>52</sup>

FITA also clarified that the holding of securities for investment purposes did not constitute a trade or business, even if a United States resident agent was granted authority to use discretion in managing a portfolio. Together, these provisions substantially reduced the likelihood that investment income would be subject to taxation as income from a trade or business.<sup>53</sup> The effect of

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To determine whether such items of income are effectively connected, two tests, the "asset test" and the "business activities test" are applied. See I.R.C. § 864(c)(2). The tests are discussed further in Dale, *supra* note 40.

51. The "force of attraction" system has been described as a net which captured all U.S.-source income regardless of its relationship to the U.S. business being conducted by the foreign person. For a discussion of the doctrine, its effects and the reasons Congress abandoned it, see Dale, *supra* note 40, at 690-93.

52. Foreign taxpayers have been allowed to elect to treat certain income from U.S. real estate as effectively connected income, in order to avoid having the gross amount of rental income received by the foreign person taxed at a flat rate of (usually) 30 percent.

Despite its apparent attraction, this election would often have undesirable tax consequences. Since it cannot be revoked without the approval of the IRS, it applies to gains on sale of real estate; in contrast, it was often possible to avoid tax on such gains if no election were made. Because the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) makes virtually all income from sales of U.S. real estate by foreign persons result in effectively connected income, this election has become more attractive.

53. FITA tightened tax provisions for business income, as well as loosened them for investment income. It did this by including certain types of foreign-source income within the "effectively connected" net. This provision was justified in part to prevent "the use of the United States as a tax haven." The following is an example of the type of abuse addressed by this provision. A foreign corporation operating through a sales office in the United States would have only foreign-source income, provided title to goods passed outside the country. Rather than modifying the defective source rules (a change made in the 1986 Tax Reform Act), FITA attacked this abuse by considering income of the type described to be effectively connected with the U.S. trade or business. See also R. DALE, *THE REGULATION OF INTERNATIONAL BANKING* 716 (1986). According to Dale,

ECI (effectively connected income) rules are a substitute for the prior indiscriminate but jurisdictionally-limited monopoly magnet. Instead they create a more subtle but more powerful bipolar magnet, which repels from the net progressive rate regime some types of previously-attracted U.S.-source income, but attracts to it certain foreign-source income which was previously beyond its force field.

these provisions has assumed even greater significance with the increased use of treaty shopping and the repeal of the thirty percent withholding tax on portfolio interest.<sup>64</sup>

FITA was passed in response to concern about the balance of payments problems experienced by the United States in the early 1960s.<sup>65</sup> Its purpose — to attract foreign capital into the United States — was made explicit in the report of a task force appointed by President Kennedy in 1963.<sup>66</sup> The task force report stated that: "[r]evision of U.S. taxation for foreign investors is one of the most immediate and productive ways to increase the flow of foreign capital to this country." With this purpose in mind, it recommended "that a nonresident alien individual engaged in trade or business within the United States be taxed at regular rates only on income connected with such trade or business."<sup>67</sup>

### B. Bank Interest

Interest on bank accounts paid to foreigners has long been exempt from U.S. taxation.<sup>68</sup> This exemption is a response to competitive pressures from abroad; it is argued that without such an exemption, U.S. banks would be unable to compete for funds in international capital markets.<sup>69</sup>

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*Id.* at 692.

The Tax Reform Act of 1986 closed several loopholes that could formerly be used to avoid paying U.S. income tax on the disposition of business assets. Under prior law it was possible either to sell business assets under the installment method, receiving the proceeds after termination of engagement in a U.S. trade or business, or to cease operating in one year and sell the assets in the next, when the taxpayer would no longer be engaged in a U.S. trade or business. The 1986 Act eliminates these techniques. Moreover, under prior law a foreign shareholder could liquidate a U.S. corporation (other than a real property holding corporation) without paying U.S. tax, since capital gains realized by foreign persons are exempt from U.S. tax. Under the new law a provision of general applicability (repeal of the General Utilities Doctrine) subjects all gains on corporate assets realized through liquidation to corporate tax.

54. See I.R.C. § 1441 (withholding tax on nonresident aliens); I.R.C. § 1442 (withholding tax on foreign corporations). See also Granwell, *Repeal of the 30 Percent Withholding Tax on Interest Paid to Foreigners*, TAX MGMT. INT'L J. 306, 387 (1984).

55. For a discussion of the legislative history of the repeal of 30% withholding tax on portfolio interest, see Granwell, *supra* note 54, at 387 n.14 (1984).

56. The Fowler Task Force Report, H.R. REP. No. 13103, 89th Cong., 2d Sess. (1967) was transmitted to President Johnson in April 1964.

57. See Dale, *supra* note 40, at 691.

58. I.R.C. § 861(a)(1), in conjunction with § 861(c), treats interest on deposits in the U.S. held by nonresident aliens as if it were of a foreign source if it is not effectively connected with a U.S. business.

59. Until 1976, this feature of the United States Internal Revenue Code had been ex-

United States financial institutions which pay interest to foreign recipients are not obligated to report such payments to the U.S. Internal Revenue Service. Some U.S. residents probably use this exemption, as well as that for interest on debt securities and the reduced rates provided by treaties, to avoid U.S. taxes. It is important to note the administrative difficulties the United States has encountered because they indicate the obstacles likely to be encountered by Latin American countries which seek to tax these types of U.S.-source income.

### C. Portfolio Interest

Until 1984, interest on portfolio income<sup>60</sup> from debt securities issued in the United States was subject to a thirty percent withholding tax, or a lower rate if provided by treaty. Commonly, a U.S. corporation avoided this tax by using a finance subsidiary<sup>61</sup> incorporated in the Netherlands Antilles.<sup>62</sup>

The following is a simple example of this type of abuse of the treaty process. The finance subsidiary of a U.S. corporation chartered in the Netherlands Antilles would float a public issue in the Euro-dollar bond market<sup>63</sup> and loan the proceeds to its U.S.

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tended repeatedly for three- or four-year periods on a "temporary" basis. In the Tax Reform Act of 1976, the tax-free treatment of interest received by foreigners from financial institutions was made permanent. See Karzon, *International Tax Evasion: Spawned in the United States and Nurtured by Secrecy Haven*, 16 VAND. J. TRANSNAT'L L. 757, 764 (1983). The rationale offered for the permanent status of the exemption was that "[t]oo many Americans are unemployed due to a lack of capital growth through sufficient investments. The Senate Finance Committee bill [for a permanent exemption] will motivate greater capital flow to this country and will subsequently benefit all Americans." *Id.* at 765. The House Ways and Means Committee voted to eliminate the 30% withholding tax on portfolio income paid to foreigners, but not until 1984 was portfolio interest paid to foreigners actually exempted from tax.

60. Portfolio interest, for purposes of the exemption, is defined in I.R.C. §§ 871(h)(2), (3). I.R.C. § 871(h)(4) excludes from the definition of portfolio interest any interest paid by a corporation or partnership to a person who owns 10% or more of the voting shares of the corporation or of the capital or profits interest in the partnership.

61. A "finance subsidiary" is a wholly-owned corporation, organized for the purpose of soliciting funds which are lent out to further the business of the parent corporation. The parent corporation is usually not liable for the obligations of the subsidiary. The two organizations may have different bond or credit ratings on their respective debt.

62. The Netherlands Antilles is an autonomous member of the Netherlands Kingdom since the enactment of the Charter for the Kingdom of the Netherlands in 1954. A. GASTMANN, *THE POLITICS OF SURINAME AND THE NETHERLANDS ANTILLES* 1 (1968). See generally Tax Mgmt. (BNA) No. 263, *Business Operations in the Netherlands Antilles* (1988).

63. The Euro-currency market is the international market for the borrowing and lending of foreign currencies, of which the U.S. dollar is the most important. Euro-bonds are



parent. The parent would obtain a deduction for interest<sup>64</sup> paid to the finance subsidiary, but the interest payments made by the U.S. parent to its finance subsidiary would be exempt<sup>65</sup> from U.S. withholding taxation under the terms of the treaty between the Netherlands and the United States, as extended to the Netherlands Antilles. The finance subsidiary would be subject to tax on interest income in the Netherlands Antilles only to the extent of the spread between the interest paid and interest received, which commonly is approximately one percentage point. Interest payments made by the finance subsidiary to bond holders would be exempt from taxation in both the United States and the Netherlands Antilles. Moreover, subject to certain limitations, the income tax paid to the Netherlands Antilles could be used to offset, dollar for dollar, the U.S. parent's U.S. income tax liability via the foreign tax credit.<sup>66</sup>

The Tax Reform Act of 1984 repealed<sup>67</sup> the thirty percent tax on interest paid to foreigners for portfolio obligations issued after the repeal's July 18, 1984 enactment.<sup>68</sup> Repeal of that withholding

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dollar denominated debt instruments available on the Euro-currency market. For a discussion of the Euro-currency market, see generally R. JOHNSTON, *THE ECONOMICS OF THE EURO-MARKET: HISTORY, THEORY AND POLICY* (1982) and D. KANE, *THE EURODOLLAR MARKET AND THE YEARS OF CRISIS* (1983).

64. I.R.C. § 163.

65. Interest paid to a Netherlands Antilles corporation is exempt from United States withholding if certain formal status requirements are met and if the requirements of the treaty withholding regulations are met. 26 C.F.R. 505, 302-05. See Rev. Proc. 79-40, 1979-2 C.B. 504.

66. For a description of the typical structure of a U.S. parent-Netherlands Antilles subsidiary transaction, see Granwell, *supra* note 54, at 306-07.

67. For an explanation of the repeal of the 30% withholding tax on portfolio interest paid to foreign persons, see *Tax Reform Act of 1984*, 72 Stand. Fed. Tax Rep. (CCH) 387, 387-98 (1985) (report prepared by the Staff of the Joint Committee on Taxation; includes reproduction of the text of the General Explanation of the Revenue Provisions of the Tax Reform Act of 1984) [hereinafter General Explanation 1984].

68. Several justifications can be given for the repeal of 30% withholding tax on portfolio interest. The repeal increased tax equity and the efficiency of international transactions by extending to all borrowers and lenders the tax treatment that had previously been available only to those able (perhaps because of size) to take advantage of the type of "treaty shopping" manipulation described above. It was deemed inadvisable simply to attempt to close the treaty shopping loophole, because to do so would place U.S. borrowers at a disadvantage in Eurodollar markets, as lenders commonly insisted upon a return high enough to compensate for the U.S. withholding tax.

There was also some concern that sudden abrogation of the treaty with the Netherlands Antilles would cause severe economic dislocation in that country. See Granwell, *supra* note 54, at 309-10. For evidence that the pre-1975 Canadian withholding tax on portfolio interest paid to foreigners increased interest costs of Canadian corporations, see generally Brean, *International Portfolio Capital: The Wedge of the Withholding Tax*, 37 NAT'L TAX J. 239

tax increased the attractiveness of U.S. investments for those taxpayers from countries with mobile capital.<sup>69</sup>

The repeal of the thirty percent withholding tax makes this problem largely academic, except with respect to interest on existing debt. While repeal of the Netherlands Antilles treaty will eliminate the most egregious opportunity for treaty shopping, it will not totally eliminate the problem posed by third-country use of treaties, especially for non-interest payments.

#### *D. Other Portfolio Income*

Capital gains on assets other than real estate realized by foreign persons generally are exempt from U.S. tax. Such gains are subject to taxation only if they are effectively connected with a U.S. trade or business,<sup>70</sup> or, when realized by an individual, if the owner was in the United States for more than 182 days during the year of disposition.<sup>71</sup>

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(1984). Because of its greater size one might expect effects in the United States to be somewhat less pronounced, but still important.

69. The following is a particularly biting before-the-fact assessment of this strategy:

[I]t belittles the United States to prey on other residence countries. Unilateral exemption without insistence on the recipient's identifying himself carries funds from those violating currency controls . . . , criminals, and garden variety tax evaders. . . . The idea of the United States — the ultimate residence country, the repository of tax morality and information reporting, the critic of tax havens — obtaining lower interest costs for its residents in this fashion does not comport with any overall United States idea of how the international tax system should operate. In any event, there is little advantage to be gained by doing so. A 1978 submission to the Treasury asserted that the Eurodollar interest saving then amounted to less than one-fourth of 1%: a tax system's integrity should bring more than that.

Kingson, *supra* note 15, at 1286-87. As argued below, this policy also allows the United States to prey on countries with source-based tax systems.

The U.S. government announced on June 29, 1987 the termination of its tax treaty with the Netherlands Antilles, effective January 1, 1988. The termination announcement was motivated by "wrangling over certain aspects of the exchange of information clause, . . . ." *United Nations and Netherlands (On Behalf of Netherlands Antilles)*, in 21 INTERNATIONAL TAX TREATIES OF ALL NATIONS at 361 (W. Diamond & D. Diamond series B eds. 1988) (introductory note preceding Treaty). However, outcry from world financial markets persuaded the U.S. to retain the exemption for bonds, but to revoke the rest of the treaty. Fears that termination of the treaty might apply to interest on bonds issued before the 1984 repeal of 30% withholding caused a furor in Eurodollar markets, because it would trigger provisions under which high yield bonds could be called to take advantage of lower interest rates. *Id.*

70. See I.R.C. § 882(a) (tax on income of foreign corporations connected with United States business).

71. See I.R.C. § 871(a)(2) (capital gains of aliens present in the United States 183 days

Dividends, royalties, and other forms of portfolio income paid to foreigners are subject to a thirty percent withholding tax, except as reduced by treaties.<sup>72</sup> As with interest income under pre-1984 law, residents of nations without a treaty with the United States (as well as U.S. citizens) can channel funds through treaty countries in order to benefit from the reduced withholding rates.

Abuse of the treaty mechanism is accomplished in a relatively straightforward manner. The recipient of U.S.-source dividends provides an address in a treaty country to the payor of dividends. Unless the withholding agent knows that the dividends recipient is not a resident of the treaty country, it may reduce withholding rates to those specified by treaty. Though slightly different, the withholding requirements for non-dividend income are equally lax; it is a simple matter to obtain reduced withholding rates by certifying residence in a treaty country. Since U.S. regulations do not require that payors of portfolio income determine the identity and residence of the beneficial owners of nominee accounts, such accounts held in treaty countries can be used to evade U.S. withholding tax on such income.<sup>73</sup>

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or more).

72. In principle, the United States disallows treaty rates if the treaty partner imposes discriminatorily low rates on income from foreign sources. But this measure is largely ineffective if the treaty partner has a low rate that is generally applicable or if it allows bloated deductions that reduce the tax base to such an extent that application of a high rate results in a low effective rate of tax. Little was gained when, in 1963, the United States decided to disallow benefits of the Netherlands Antilles treaty for investment companies opting to be taxed at one-tenth the normal Netherlands Antilles tax rate (three percent instead of 30 percent). It was a simple matter to replicate the effects of a three percent tax rate and 100% equity financing of such companies with a debt-equity ratio of nine-to-one and a 30% tax rate. Although Netherlands Antilles law did not allow a deduction for interest paid to foreign shareholders, it was a simple matter to turn non-deductible interest into deductible interest by using a back-to-back transaction in which shareholders deposit funds in an interest-bearing account with an independent bank, which then re-lends the funds to the investment company. It is worth noting that this 1963 modification of the United States-Netherlands Antilles treaty was "prompted in part by complaints from Latin American and other countries that the United States was using the convention to attract the investment of flight capital. . . ." Kingson, *supra* note 14, at 1279.

73. It is instructive to quote at length from a 1980 article that uses the following example of the use of treaty shopping by a resident of Venezuela, which, at the time, employed the territorial system of taxation:

Assume that Juan Sanchez, a resident of Venezuela, buys a portfolio of \$1 million worth of U.S. shares. Venezuela, like some two-thirds of all Latin American countries, taxes its residents only on a territorial basis. It imposes no tax on foreign-source income. Thus, Sanchez pays no Venezuelan taxes on his dividends or capital gains from U.S. shares. Venezuela gives Sanchez no foreign tax credit or other relief for taxes he pays abroad so he is anxious to pay the least possible amount of total taxes to other countries.

### *E. Capital Gains on Real Property*

Before passage of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA),<sup>74</sup> a foreign investor could easily invest in real property in the United States and incur no U.S. tax liability on gains realized on disposition of the property.<sup>75</sup> A simple way to achieve this result would be to hold the real property through a U.S. or foreign corporation and then sell the corporation's stock.<sup>76</sup>

FIRPTA changes this situation dramatically. FIRPTA imposed a tax on gains realized after June 18, 1980 by a foreign person from the disposition of a "United States real property interest" (USRPI). All gains and losses from dispositions of USRPIs were reclassified<sup>77</sup> as being effectively connected with a U.S. trade

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If he invests in the United States directly — using no intervening investment company — he would pay 30 percent U.S. withholding tax on the dividends. His capital gains would be tax-free under domestic U.S. tax law. Suppose, however, that he interposed an intervening Netherlands Antilles investment company. Under the treaty, it would pay 15 percent U.S. withholding tax instead of the statutory 30 percent rate. . . . [h]e is subject to 15 percent Antilles tax on the dividend, but it has remained comparatively easy to reduce the combined effective rate to between 20 and 25 percent, since the Antilles tax is imposed on net rather than gross income. . . .

The Sanchez fact pattern is clearly an example of treaty shopping. Sanchez is a resident of Venezuela which has no income tax treaty with the United States; he is not a resident of the Netherlands Antilles. Nevertheless, he has established his investment company in the Antilles for the purpose of using — or abusing — the income tax treaty between the Antilles and the United States. Langer, *Tax Treaties Creating Tax Haven Situations*, 11 *Tax Notes* 667, 667-69 (1980).

In theory, foreign countries with which the United States has treaties could require that nominees subject to their jurisdiction withhold U.S. taxes in the case of accounts held for non-residents, as required, for example, by the United States treaty with Switzerland. In fact, it is reported that only Belgium and Switzerland are effective in doing so, and they are said to consider it to be "a costly accommodation to the United States." See Karzon, *supra* note 59, at 771-73.

74. Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2682-2690 (codified at I.R.C. §§ 861, 871, 882, 897, 6039C, 6652).

75. For a discussion of FIRPTA's legislative background, see Feder & Parker, *The Foreign Investment in Real Property Tax Act of 1980*, 34 *Tax Law* 545, 547-48 (1981).

76. The new owner of the corporation ordinarily could liquidate the corporation without tax liability. Alternatively, the corporation could sell the property and then be liquidated. No tax would be due on the gain realized by the corporation if a plan of liquidation were adopted before the sale and implemented within one year. The gain realized by the shareholders upon liquidation generally would be subject to tax only under the conditions stated in the text accompanying this note. Tax on capital gains on real estate can still be avoided (or at least postponed) if the real estate is owned by a foreign corporation whose ownership changes. For an excellent analysis of FIRPTA, upon which much of this discussion is based, see *id.* The present discussion provides only a broad outline of FIRPTA, a law which is "complex and replete with ambiguities." *Id.* at 546.

77. FIRPTA does not change, however, the basic rule that mere ownership of U.S. real

or business.<sup>78</sup> Thus, FIRPTA supplants foreign tax treaties that allow the taxpayer the annual election of whether gains and losses are to be deemed to be from a trade or business<sup>79</sup> or are to be presumed to be derived from passive investments.

United States real property interests include fee simple ownership of property, leaseholds, and options to acquire property interests.<sup>80</sup> A foreign person's interest in a U.S. corporation, half of whose assets are U.S. property, (i.e., a U.S. real property holding corporation, or USRPHC) is also a USRPI.<sup>81</sup> Real property is defined broadly under FIRPTA, and includes interests in cooperative apartments, residential dwellings, plants and factories, rental property and hotels, and interests in mineral, timber, and oil and gas properties.<sup>82</sup>

The passage of FIRPTA was motivated by concern that foreign investors responding to tax incentives unavailable to U.S. tax citizens were bidding up the price of American farm land.<sup>83</sup> As originally passed, FIRPTA imposed extensive reporting require-

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property does not cause a foreign person to be engaged in U.S. trade or business, in the absence of active management or the exercise of an option to be treated as engaged in a trade or business.

78. Because the income taxed under FIRPTA is deemed to be from U.S. sources, it cannot be offset by taxes paid to foreign countries through foreign tax credits.

79. Foreign investors had the option of electing to have real estate activities taxed as a trade or business to avoid tax on gross income (at a rate of 30%, unless reduced by treaty). This election had the disadvantage that capital gains on disposition of real estate would be subject to tax. Most pre-1980 U.S. foreign tax treaties modify this election to make it available on a year-by-year basis. Thus, residents of countries with which the U.S. has such treaties could make a selective election, choosing trade or business status for operating income and yet pay no tax on capital gains. These treaties were subject to abuse by non-residents of treaty nations. See Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1109-10 (1983).

80. I.R.C. § 897(c)(6)(A).

81. I.R.C. § 897(c)(2). There are two important exceptions to this rule. The first is for stock regularly traded on an established securities market in which the investor holds five percent or less of the corporation's stock. I.R.C. § 897(c)(3). The second exception applies if the corporation was not a USRPHC during the time the foreign investor held its stock. I.R.C. § 897(c)(1)(A)(ii)(I). For purposes of applying these tests, FIRPTA provides "an impressive battery of 'look-through' provisions. . . . The statute's point seems clear: formalities of title holding are irrelevant, whether they involve foreign or domestic corporations, partnerships, or other conduits. A company's status as a 'United States real property holding corporation' is a function of its substantive asset ownership and nothing else." Kaplan, *supra* note 79, at 1106-07.

82. See I.R.C. § 897(c)(1)(A)(i) (United States real property interests); I.R.C. § 897(c)(6)(B) (real property includes associated personal property). See also Treas. Reg. § 1.897-1.

83. For a discussion of the concerns that motivated passage of FIRPTA, see Kaplan, *supra*, note 79, at 1092-95.

ments<sup>84</sup> on U.S. nonpublic corporations, partnerships, trusts, and estates which had a foreign investor whose pro-rata<sup>85</sup> share of the entity's USRPI exceeded \$50,000.<sup>86</sup> In addition, reporting requirements applied to any foreign person not engaged in a trade or business in the United States which owned a USRPI of more than \$50,000 in value and was not otherwise required to file an information return. Alternatively, a security deposit for the payment of federal income taxes could be furnished in lieu of filing certain of the information reports.<sup>87</sup> The extremely complex, ambiguous, and intrusive reporting requirements were strongly resisted. Many foreign persons and U.S. entities through which foreign persons hold USRPIs, were unwilling or unable to comply with the reporting or security requirements. In response, the Tax Reform Act of 1984 substituted a system of withholding<sup>88</sup> for the reporting requirements and security deposits. In general, the transferee of a USRPI is required to withhold ten percent of the amount realized from the disposition of a USRPI.<sup>89</sup> Under certain circumstances,<sup>90</sup> the withholding requirements are placed on corporations, partnerships, and trusts. In addition, a foreign corporation that distributes a USRPI to its shareholders (whether foreign or domestic) in a transaction in which gain is taxable under FIRPTA must withhold thirty-four percent of such gain.<sup>91</sup> These obligations can be avoided if the transferor of the USRPI certifies that it<sup>92</sup> is not a foreign person and provides a U.S. taxpayer identification number.<sup>93</sup>

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84. See I.R.C. § 6039C (returns with respect to foreign persons holding real property interests).

85. See I.R.C. § 6039C(c)(3)(A).

86. See I.R.C. § 6039C(b)(2).

87. See further Norman, *Tax Aspects of Foreign Investment in US Real Estate*, INT'L BUS. LAW. 213 (May 1985).

88. See General Explanation 1984, *supra* note 67, at 406-15.

89. The transferee owes the transferor of the property the purchase price. If, for example, the withholding rate is ten percent and the transferee owes \$1000 (purchase price), \$900 will be remitted to the transferor and \$100 (ten percent) will be remitted directly to the I.R.S. as "amount withheld." The burden of withholding is placed on the transferee on the presumption that he will honestly report to the I.R.S.; the transferee will not lose money as a result of the withholding.

90. See Treas. Reg. § 1.1445-1 (withholding on dispositions of U.S. real property interests by foreign persons).

91. See I.R.C. § 1445(e)(1) (special rules relating to distributions by corporations, partnerships, trusts, or estates).

92. See I.R.C. § 1445(b)(2) (transferor furnishes non-foreign affidavit).

93. Such a requirement for certification by the transferor places the burden of proof on the transferor and removes the necessity for transferees in ordinary real estate transactions (most of which are between Americans) to know the identity of the ultimate owners of beneficial interests in USRPIs transferred to them. For a negative assessment of the use of both

There has been some concern that FIRPTA might have less impact than expected. Regulations indicate that the 1984 tax act effectively repealed withholding tax on interest payments on certain private placements, as well as on portfolio investments in publicly traded securities. It has been unclear whether under FIRPTA it would be possible to structure a creditor's interest in real estate with a strong element of equity participation in such a way that it would not constitute a USRPI. If this is possible, investments with the economic features of equity participations but the legal features of debt could be used to circumvent the goals of FIRPTA. If a foreign creditor were given fixed interest bonds with additional payments contingent on appreciation of property, a USRPI almost certainly would be found to exist. Actual transactions generally would be much more complicated than this, so that the economic nature of the matter would be less transparent.

The tax treatment of debt with contingent interest<sup>94</sup> "equity kickers"<sup>95</sup> based on net operating profits, appreciation of property, or gain on the sale of property is somewhat less certain. The U.S. Treasury Department has, however, warned taxpayers that it will interpret debt with equity kickers as a USRPI subject to FIRPTA. Another potential gap in the FIRPTA provisions results from the fact that it may be possible to structure ownership arrangements in such a way as to avoid a taxable disposition under U.S. tax law. For example, a USRPI might be held by a foreign corporation whose ownership could change without triggering U.S. taxation under FIRPTA. Even though a foreign corporation can be characterized as a real property holding company, disposition of its stock by a foreign person is not subject to U.S. tax under FIRPTA. Of course, this is likely to be a quite clumsy investment vehicle, particularly since the buyer assumes the corporation's "tax history" in such a case.<sup>96</sup> It can be assumed, moreover, that the purchaser of stock in such a corporation would reduce the price paid for such stock to reflect the tax that must be paid upon liquidation. As the buyer (through the corporation) retains the seller's basis in the real property, tax can be deferred indefinitely, but it cannot be avoided

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information reporting and withholding to implement FIRPTA, see Kaplan, *supra* note 79, at 1114-20.

94. Treas. Reg. § 1.897-1(d)(3)(ii)(B).

95. Treas. Reg. § 1.897-1(d)(2)(i) (direct or indirect share in the appreciation in value).

96. For example, the transferee would assume the transferor's basis, holding period, net operating loss carry forwards, investment credit carry forwards against future tax liability, and all other tax attributes.

completely. On balance, the most appropriate conclusion seems to be that the taxation of capital gains on U.S. real estate realized by foreigners has been tightened substantially, although some gains may escape taxation or tax may be deferred for long periods.

#### *F. Summary Assessment*

U.S. taxation of income earned by foreigners appears to have evolved in recent years. Portfolio interest, like interest paid by financial institutions, now enjoys exemption from withholding tax. To a large extent, this simply codified the practice of many large corporations, namely, establishing Netherlands Antilles financing subsidiaries to circumvent previously existing withholding requirements.<sup>97</sup>

Other forms of portfolio income received by foreigners remain subject to withholding tax, but these taxes can be reduced substantially by channeling investments through countries with which the United States has tax treaties. Residents of non-treaty countries, as well as U.S. residents, can use these techniques to avoid U.S. withholding taxes on payments to residents of non-treaty nations.<sup>98</sup>

### V. POTENTIAL SOLUTIONS

Faced with the situation just described, Latin American countries concerned about the possibility that generous tax treatment in the United States may induce capital flight have three basic options. This section examines these options. It concludes that prospects are not bright under any of the three approaches.

First, the country can attempt to adapt to the international tax environment in order to minimize the damage to its economy. This would imply adoption of the worldwide principle and negotiation of foreign tax treaties with the United States; presumably,

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97. It is worth noting, however, that this problem was attacked by exempting portfolio interest, rather than by simply abrogating the Netherlands Antilles treaty. This was because of the express desire to avoid putting American borrowers at a disadvantage relative to their foreign competitors, who are said to have ready access to financial markets abroad without the requirement to pay withholding taxes.

98. It is not surprising that in 1978 almost 90% of investment income sent from the United States to foreign countries flowed to countries having tax treaties with the United States. Even more telling is the fact that approximately one-half of dividends and one-third of non-bank interest paid to foreign addressees (at that time still subject to withholding tax) went to only three countries (Switzerland, the Netherlands, and the Netherlands Antilles), nations that are notorious for being used by those interested in "treaty shopping."



such treaties must contain exchange of information agreements if they are to be effective. This approach seems to offer little promise.

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

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

#### *A. Switch to Residence Principle*

Perhaps the problem of tax-induced capital flight could be eliminated if Latin American countries relying on a territorial-based tax system instead were to adopt a system based on the worldwide taxation of their residents. However, without exchange of information agreements, merely requiring that residents pay tax on worldwide income would raise little revenue, except from those who comply with tax laws as a matter of moral principle. More rigorous tax administration also is unlikely to have a major effect in inducing compliance with the tax law, because the receipt of foreign-source income is extremely difficult to detect. Little possibility exists that tax could be collected on capital income earned in the United States by residents of Latin American countries.

Exchange of information agreements, although not a panacea, would complement a comprehensive tax treaty with the United States. Pursuit of such agreements, however, may not fulfill the goals of many Latin American countries. The United States can be expected to require low withholding rates on interest and dividends as a condition to any such treaty. The revenue loss that would result from accession to foreseeable U.S. demands might be too costly.

In fact, exchange of information agreements are useful only when the Latin American investor accurately reports his or her name and address to the U.S. payor. False information provided to the payor enables the taxpayer to circumvent monitoring by fiscal authorities. To prevent this form of abuse, it would be necessary for the United States and the home country of the investor to detect the existence of addresses of convenience in countries imposing no tax on such income. In order to understand the difficulty of relying on exchange of information agreements to assist Latin American countries in the implementation of worldwide taxation of the income of their residents, it is instructive to contemplate the opportunities for tax evasion on U.S.-source income that are open even to residents of the United States; these opportunities are created by the combination of liberal U.S. treatment of income ostensibly paid to foreigners and lax administrative procedures.<sup>99</sup>

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

Evidence is mounting that some United States residents are posing as foreign persons, establishing interest-bearing savings and checking accounts at United States banks and savings and loan institutions, directing that the interest income be sent to them at an address of convenience in a foreign country, and omitting that interest as income on their United States tax returns.<sup>100</sup>

The cause of this growing source of evasion is not difficult to identify.

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

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99. For an excellent review of difficulties in this area, see Karzon, *supra* note 59, at 764-66.

100. *Id.* at 764-65.

residency.<sup>101</sup>

One can only assume that similar abuses will result from the exemption of portfolio interest paid to foreigners, despite the safeguards contained in the 1984 law.<sup>102</sup>

The implications for Latin American countries wishing to tax worldwide income of their residents is discouraging. If the United States devotes little effort to prevent this type of evasion by its own residents, there is little reason to expect U.S. assistance to Latin American countries seeking to prevent evasion of worldwide taxes by their residents. United States fiscal authorities are unlikely to do for other countries what they cannot or will not do for the United States.

Aggravating the problem just described is the increased opportunity for secrecy being provided by certain countries as part of an attempt to attract intermediation of international capital movements.<sup>103</sup> "[S]ecrecy laws conceal the transaction and the identity

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101. *Id.* at 765-66.

102. In order to prevent U.S. persons from taking advantage of the repeal of the 30% withholding tax, the law provides certain safeguards. First, the exemption is available for registered debt only if the beneficial owner of the obligation is not a U.S. person. A statement to this effect can be provided the U.S. payor of interest by either the beneficial owner or specified types of financial institutions. Bearer debt (obligations that are not registered, and therefore are payable to whoever has possession of the instrument) can be issued without withholding, provided the following requirements intended to target such debt to foreign investors are satisfied: (a) the obligations must be sold under procedures reasonably designed to prevent sales to U.S. persons; (b) interest must be payable only outside the United States; and (c) the obligations must state that U.S. holders are subject to U.S. income tax on interest on such obligations. Granwell, *supra* note 54, at 309, notes that "where the ultimate recipient of the interest is unknown, withholding will be required where the payor does not know the identity of the beneficial owner of the securities." Moreover, he notes that "regulations presently in place . . . require withholding in such circumstances." *Id.*

Under certain circumstances interest paid to foreigners will not be exempt from the 30% tax. Interest is not exempt if paid to someone owning 10% or more of the voting stock of a corporate payor or 10% or more of the capital or profit interest in a partnership payor, or if the interest is paid to a bank under a loan agreement entered into in the ordinary course of its business (except for interest of the U.S. government). Interest income effectively connected with the conduct of a U.S. trade or business also is not exempt from tax. *See id.*

103. The following procedural factors contribute to the use of foreign addresses to evade taxes:

- (1) insufficient mechanisms to verify that a particular recipient is a qualified foreign resident at the claimed address;
- (2) the lack of any official procedure to penetrate a foreign nominee account and determine the identities and addresses of its beneficial owners;
- (3) the grant of authority to nongovernmental bodies — the withholding agents — to determine and dispense massive tax reductions by reducing tax withheld at the source; and
- (4) the conceded inability of the gov-

of the taxpayer, and block United States authorities from gaining the information necessary to trace and prove the fraud.”<sup>104</sup> The same problems that confront the United States would similarly impede Latin American countries attempting to implement a world-wide taxation system.<sup>105</sup>

Before the 1984 law exempting portfolio interest was passed, Americans and foreigners could use nominee accounts in countries with which the United States had a favorable tax treaty to evade withholding taxes on interest and dividends from portfolio income. While the interest exemption renders this machination unnecessary, the practice may persist as a means by which to avoid taxation on other forms of portfolio income. Cooperation between the United States and a Latin American country, without the help of the U.S. treaty partner in which the nominee account is established, is unlikely to reduce this problem significantly. Moreover, reliance on U.S. treaty partners is apt to be futile.<sup>106</sup> While there is

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ernment to oversee the withholding system effectively and in a timely manner. *The foreign component that permits the schemes to flourish unchecked is the alarming phenomenon of increasingly strict secrecy laws in a multiplicity of foreign jurisdictions.*

Karzon, *supra* note 59, at 779 (emphasis supplied).

104. *Id.* For a detailed discussion of how foreign secrecy laws in Switzerland, the Netherlands, the Bahamas, and Panama impede detection of abuse of the foreign address system of determining eligibility for exemption from withholding, see *id.* at 778-801.

In the extreme case, a foreign investor interested in anonymity may use a two-stage structure consisting of an account with a Bahamian bank, which then opens an inter-bank deposit with a bank in Panama. “[S]ecrecy is enforced in both jurisdictions and beneficial ownership is unknown in each jurisdiction.” *Id.* at 800.

105. Professor Karzon postulates that:

[a]s long as one haven is in existence, capital seeking secrecy will migrate to it with the speed of electronic transfer, and the present enforcement dilemma will remain substantially unresolved. The current preoccupation with bank secrecy legislation, moreover, obscures a more fundamental economic fact: almost all countries offer anonymity to those investors who take advantage of the nominee structure to use banks or brokerage houses to hold portfolio investments or who establish unsupervised corporations to issue bearer shares. Each of these legal structures, which are ubiquitous as well as respectable in developed countries, can conceal effectively the identity of an investment's true owner. It is unrealistic to expect and egocentric to believe that the United States could, or should, compel all other countries to alter their internal tax, corporate, banking, and commercial laws, at the expense of their nationalistic self-interests, in order to facilitate United States tax collections.

*Id.* at 827.

It seems even less likely that accommodation would be made to Latin American countries.

106. In a slightly different context, this appraisal was given: “the residence basis taxation policy of the treaty places the United States in the position of relying on our treaty partners to prevent abuse of our tax system — a particularly risky proposition in the case of

a United States interest in persuading its treaty partners to prohibit a U.S. resident's use of a nominee account to evade U.S. taxes, no similar interest is present for the U.S. or a treaty partner to prevent abuses by residents of third countries.<sup>107</sup> It seems unlikely that the United States will expend political capital to convince its treaty partners to protect fiscal resources of Latin American countries.

Latin American tax authorities might ponder the practical wisdom of residence-based taxation. Conceivably, a switch in systems designed to generate revenue could result in a complete and permanent flight from the national economy. If a Latin American country were to implement, albeit unsuccessfully, taxation on a worldwide basis, repatriation of foreign source income might be avoided entirely. Taxpayers repatriating funds from abroad would face several questions: whether the repatriation represented a simple return of capital from abroad or taxable income; whether tax had been paid on income earned abroad in previous years; and, if such foreign source income were subsequently reinvested abroad, whether it would earn taxable income. A risk-averse taxpayer might decide against any repatriation.

### *B. Changing the International Tax Environment*

Rather than implement residence-based taxation, Latin American countries might try again to convince the United States and other developed countries to increase their source-based taxes. Allegiance to the residence principle may be the cause of the increase in tax evasion by U.S. citizens using the types of ruses described above.

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

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treaties with tax havens.' " *Id.* at 829 n.293 (quoting *Hearings on Income Tax Treaties Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 96th Cong., 2d Sess. 28 (1980) (statement of David Brockway)).

107. It is possible, however, that the indirect benefits to the United States resulting in the fiscal solvency of Latin American countries, derived in part through increased collection of tax revenues and decreased capital flight, would sufficiently motivate the United States to prevent such abuses.

*income. . . .*

The tilt in treaty policy from source-based to residency-based taxation of portfolio income has widened the opening for tax evasion. It is most difficult for a residence country, such as the United States, to detect all portfolio income earned abroad by the United States residents and all United States-sourced portfolio income and bank interest received abroad by United States residents masquerading as foreigners with false foreign addresses. . . .

The treaty policy orientation toward residency country taxation of portfolio income should be reappraised, and a return to source country taxation should be reconsidered. . . .

The merit of source country taxation lies in its simplicity of administration and certainty of tax collection. . . .

In view of the sizeable amount of United States-owned, foreign-sourced portfolio income, this shift might enhance rapport with developing countries, long advocates of source taxation.<sup>108</sup>

If the United States actually implemented the source principle that ostensibly underlies its tax treatment of income earned in the United States by foreigners, the problems described in this paper would diminish in significance. However, they would not be eliminated as long as other developed countries continued generous treatment of such income. There is not much reason to be optimistic that this suggested approach will come to fruition.

Current U.S. practice in this area seems to reflect certain objectives. Income from a U.S. trade or business operated by a foreign person is taxed in full, in order to avoid conferring a competitive advantage over U.S. persons. Gains on the sale of real estate are now considered to be derived from a trade or business, and thus are subject to tax. This reflects the desire to equalize the tax treatment of U.S. and foreign investors in real estate, and redo what were seen to be inappropriate incentives for foreign investment in U.S. real estate.

By comparison, interest from bank accounts and interest earned on portfolio investments is exempt from U.S. taxation if it is not "effectively" connected with a U.S. trade or business. These exemptions (which are inconsistent with source-based taxation of income originating in the United States) are provided in part to attract foreign capital to the United States and in part to avoid a

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108. Karzon, *supra* note 59, at 827-31. (emphasis supplied) (footnotes omitted).

competitive disadvantage for American financial institutions in relation to their counterparts in other developed countries. Contrary to the situation regarding income from a trade or business and capital gains on real estate, there is no offsetting concern that foreigners have an unfair competitive advantage over Americans because of more favorable tax treatment. Dividends (and other forms of "fixed or determinable or periodical" income) remain subject to withholding, but this tax can be reduced by routing investment funds through a treaty partner of the United States.

Given the recent repeal of the thirty percent withholding tax on portfolio interest, and the explicit expression of the sentiments described previously as a reason for that legislation, it seems highly unlikely that the United States soon will reverse this policy. It is, moreover, unlikely that the United States will change its policy if other developed countries do not follow suit. American opponents of a scheme which taxes interest income earned by foreigners point to the continued availability of debt instruments in Europe on which there is no withholding tax, as justification for continuation of the exemption. Finally, as long as such instruments remain available in other countries, taxation of interest by the United States will not be totally effective in solving the problem of tax-induced capital flight from Latin America.

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

Even if the United States could be convinced to tax interest income earned by foreigners, the problem examined in this paper probably would not be eliminated, as long as reduced rates are applied to interest earned by residents of countries with which the United States has tax treaties. As indicated earlier, funds of Latin American investors could be channelled through selected "tax ha-

ven" treaty countries in order to benefit from such reduced withholding rates. This gimmick would presumably be available on both interest and dividends (and on any payment for which reduced withholding taxes are provided by treaty). It seems quite unlikely that the developed countries of the world, traditionally advocates of residence-based taxation, will reverse the historical trend of using treaties to reduce source-country taxation of these income flows, especially if the primary justification is to assist the developing countries in avoiding capital flight.<sup>109</sup>

### *C. A More Radical Approach*

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

An alternative to the traditional income tax that has gained favor among some academic observers provides tax treatment for interest and dividends that is very different from that under the income tax laws of most countries.<sup>110</sup> In particular, no deduction is allowed for interest expense, and interest income is not subject to tax. Additionally, dividends are not taxable in the hands of the recipient, and, as in most countries, they are not a deductible expense. Thus, interest and dividends are placed on equal footing from a tax point of view, thereby eliminating the bias against eq-

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109. Developed countries might be somewhat more sympathetic to an appeal from lesser developed countries based on the need for assistance in implementing their income taxes. Of course, such an appeal has little force as long as the developing countries continue to employ the territorial principle.

110. See, e.g., S. BRADFORD, *UNTANGLING THE INCOME TAX* (1986) (an exposition on the proposal that interest be non-deductible and exempt from tax). See also R. HALL & A. RAUSHKA, *THE FLAT TAX* (1985). For thorough examinations of this approach to direct taxation in a developing country context, see generally G. ZODROW & C. McLURE, *IMPLEMENTING DIRECT CONSUMPTION TAXES IN DEVELOPING COUNTRIES* (World Bank Working Paper No. WPS 131, Dec. 1988); C. McLURE, J. MUTTI, V. THURONYI, & G. ZODROW, *THE TAXATION OF INCOME FROM BUSINESS AND CAPITAL IN COLOMBIA* (1989) (forthcoming).



uity finance found in the tax systems of most countries.<sup>111</sup> Immediate deduction is allowed for all business purchases, including those of capital goods; thus, there is no need for either depreciation allowances or special accounting for inventories.<sup>112</sup> Consumption, rather than income, would provide the basis for this tax system.

The extreme simplicity of this alternative should afford it serious consideration by developing countries. But simplicity is not its only attractive quality. This approach essentially combats the problem of capital flight from LDCs created by the tax exemption of certain income in its country of source by also exempting much domestic-source income from business and capital.<sup>113</sup>

### 1. LDC Policy

Predicting the full implications of adoption of a system such as this for the problem of tax-induced capital flight is quite difficult. If only a single developing country were to adopt the system, interest and dividends earned on domestic investment would be exempt and business income would be subject to a zero marginal effective tax rate; of course, under most income tax systems that are administered reasonably well (and have adequate provisions for withholding on interest) this benefit is now generally available only for income on capital invested abroad (under either the territorial system or an ineffectively administered worldwide system). This change would appear to reduce the tax incentives for capital flight. But interest paid by domestic businesses no longer would be

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111. For a discussion of these biases and alternative ways to integrate the income taxes, see C. McLURE, *MUST CORPORATE INCOME BE TAXED TWICE?* (1979).

112. Indeed, all the complex timing issues that plague the income tax are eliminated. An additional administrative advantage of such a system, not relevant for the present discussion, is that there is no need for inflation adjustment in the measurement of income from business and capital, a complex necessity if real income is to be measured accurately. McLure, *Lessons for LDCs of U.S. Income Tax Reform*, in *TAX REFORM IN DEVELOPING COUNTRIES*, at 1347 (M. Gillis ed. 1989).

113. Interest and dividends received by individuals are explicitly exempt. For businesses, the combination of expensing of purchases and disallowance of interest expense is equivalent in present value terms to exempting the marginal return to capital. This is easily seen in the case of equity finance. Suppose that the tax rate is 40% and the interest rate is 10 percent. Because of expensing, an investment of 100 costs the taxpayers only 60 and costs the government 40. If the asset is fully depreciated in one year and yields a rate of return of 10%, the government takes 44 of the 110 of yield and return of principle, and the taxpayer keeps 66. The 10% after-tax yield of 6 on the private investment of 60 is the same as if there were no income tax or if the income were exempt. A similar demonstration can be provided for debt-financed investment. For further discussion, see G. ZODROW & C. McLURE, *supra* note 110; C. McLURE, J. MUTTI, V. THURONYI, AND G. ZODROW, *supra* note 110.

a deductible expense. Depending on the relation between the marginal tax rates currently applied to interest income and to the net income of business, the net effect of such a change might be either to increase or reduce the total taxation applied to domestic interest flows. Given commonly observed patterns of asset ownership, marginal tax rates, and evasion of tax on interest income, a small net increase in the taxation of interest paid by business might be expected. By comparison, there would be no offset to the exemption of interest on public debt. Total taxation of domestic-source dividends would clearly drop, except in cases where substantial relief from double taxation of dividends already exists.

The immediate expensing of all business purchases, including capital goods and items added to inventory, would further reduce the taxation of business income from equity investment in most countries. This would be true especially where neither rapid depreciation (or other generous investment allowances) nor inflation adjustment of depreciable basis presently is allowed. The net effect of these changes would be too country-specific to allow easy generalization. For example, some countries might allow such rapid depreciation that expensing would provide little additional benefit. Similarly, in a country that adjusts interest expense for inflation, the total disallowance of deductions for interest expense and the exclusion of interest income from the tax base may be relatively unimportant. But movement from full deduction of nominal interest<sup>114</sup> to no deduction would be dramatic. Though capital flight might be either worsened or reduced as the net effect of a change such as this, a reduction seems most likely for most countries that do not allow either inflation adjustment of depreciable basis or generous capital consumption allowances.

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

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114. Nominal interest rate is the rate actually charged to the borrower. The real interest rate is the rate charged, less an inflation premium, which is a factor of the total or nominal rate.

The reaction of capital exporting countries which provide foreign tax credits for source-country taxes on net income adds uncertainty to the prediction. Disallowance of the interest expense raises the risk that taxes paid by U.S. residents would not be credited against U.S. income taxes.<sup>115</sup> Of course, the tax savings of expensing may more than offset the loss of the interest deduction and loss of the foreign tax credit.<sup>116</sup>

Disallowance of interest deductions under the tax system proposed is quite different from the failure to allow deductions for expenses under a gross receipts tax. The interest disallowance is an integral part of a direct tax system based on consumption, rather than income. Moreover, it typically may be offset, or more than offset, by the allowance of expensing of all purchases.<sup>117</sup> This is potentially quite important under U.S. law, which provides that a tax can be creditable even if it does not allow deductions for all expenses, provided a compensatory benefit of at least equal value is allowed. On balance, it appears that there is at least some chance that the tax in question would be creditable, at least in the United States.<sup>118</sup>

The U.S. foreign tax credit is, in rough terms, limited to the average U.S. tax rate on foreign-source income. This limit is calculated on an "overall" (worldwide) basis, rather than on a country-by-country basis. Foreign taxes exceeding the average U.S. rate result in "excess foreign tax credits," which may not be applied against U.S. tax liability. Recent changes in U.S. law, including rules for the determination of the source of income,<sup>119</sup> as well as rate reduction, make it more likely than before that U.S. firms will have excess foreign tax credits. To the extent that this is the case,

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115. Under U.S. law, the test of whether a tax is creditable is whether the tax is imposed on net income. It appears that treatment more generous than is needed to measure economic income is acceptable, but that less generous treatment jeopardizes availability of the credit. The reason is that the United States is unwilling to allow credits for payments to governments other than income taxes, e.g., royalties and gross receipts taxes. For one speculation about the likely U.S. reaction to adoption of a consumption-based direct tax by another country and the significance of that reaction, see C. McLURE, J. MUTTI, V. THURONYI, & G. ZODROW, *supra* note 110, at ch. 9.

116. But the problem would resurface if higher remittance taxes were used to prevent a drop in revenue from income on investments from foreigners.

117. This can be seen from the fact that the marginal effective tax rate is zero. See *supra* note 113.

118. Creditability of the withholding tax on foreign remittances will most likely depend on the creditability of the underlying consumption-based tax.

119. See Treas. Reg. § 1.861-8(f)(1)(i) (overall limitation to the foreign tax credit).

it may make relatively little practical difference whether the tax under consideration herein is credited. As long as the firm is in an excess credit position in the aggregate, additional taxes on foreign income cannot be credited, even if, in principle, they are creditable.

## 2. Advanced Country Policy

Widespread adoption of consumption-based tax by the developed countries could do much to eliminate the present tax advantages motivating foreigners to invest in such countries. Currently, firms paying interest to foreigners enjoy a deduction for interest payments, and the foreign recipient enjoys the exclusion of interest income; the combined marginal tax rate of payor and payee applied to such income in the source country is negative.<sup>120</sup> Without a deduction for interest expense, the combined marginal tax rate on interest remittances would rise to zero. Capital flight promoted by advantageous tax treatment of debt would thereby be eliminated, or at least severely reduced.

Perhaps equally as important, abusive use of foreign nominee accounts, addresses of convenience, and treaty shopping would be eliminated. Tax, in effect, would be "collected" through the disallowance of interest deductions, rather than by withholding, and withholding taxes could be eliminated.<sup>121</sup>

As exciting as a switch to a system of this type may appear, it clearly does not offer a "quick fix." Its adoption would run counter to decades of development of the tax on net income. There are also important concerns about equity and transition that must be addressed satisfactorily. Moreover, under this approach taxation of capital income in effect is placed on a source basis, rather than a residence basis. Thus, the entire system of international conventions dealing with flows of income among nations would need to be rethought.<sup>122</sup>

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120. For present purposes we can assume that such income is not effectively taxed by the country of residence. The net tax benefit is equal in magnitude to the product of the interest flow and the tax rate applied to business income.

121. Reference to collecting taxes may appear inappropriate for a system in which the present value of taxes is zero. But this feature of the consumption-based tax is properly traced to the tax treatment of depreciable (and similar) assets, and not to the treatment of interest. For purpose of the comparison with the income tax, the statement accompanying this note seems appropriate.

122. There may be a reluctance to disallow interest deductions for domestic firms, if

Developed countries that have fought diligently for residence-based taxation would need to reverse their stance. Given the worldwide proclivity to adopt "beggar-thy neighbor" policies, even by developed countries in their dealings with LDCs, the prospects for quick action of this type are dim. Revision is likely only if Latin American countries insist *en masse* that present international tax customs and practices are unsatisfactory. Though the journey to a new international fiscal order may be long, it may be worthwhile to begin.

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such deductions continue to be allowed to foreign firms by their country of residence, because to do so would place domestic firms at a distinct disadvantage in takeover campaigns. Letter from Richard Bird to Charles McLure.

## APPENDIX

Jurisdictional Standards, Tax Rates, and Relief from International Double Taxation, Latin American Countries

Country	Tax Rates		Jurisdictional Standard		Foreign Tax Credit	Treaty Participation
	Corp.	Ind.	Corp.	Ind.		
Argentina	33	45	T	T	*	8
Bolivia	30	30	T	T	*	Andean + 1
Brazil	45	50	T	W	*/by treaty	15
Chile	25?	56	W	W	No	1
Columbia	30	30	W	W	Yes	Andean
Costa Rica	50	50	T	T	No	None
Dominican Rep.	46	70	T	T	*	1
Ecuador	39?	50	T	T	*	Andean + 1
El Salvador	30	60	T	W	*/Yes	None
Guatemala	42	48	T	T	*	None
Honduras	40	40	W	W	No	None
Mexico	42	60.5	W	W	Yes	None
Nicaragua	44/49.5	55	T	T	*	None
Panama	50	56	T	T	*	None
Paraguay	30	30	T	T	*	None
Peru	40	48	W	W	Yes	Andean + 1
Uruguay	30	30	T	No tax	*	None
Venezuela	50	45	T	T	*	Andean

Notes: Jurisdictional Standards: T = Territorial; W = Worldwide

Foreign Tax Credit: \* signifies that neither credit nor deduction is allowed or appropriate, since the country uses the territorial principle; thus "yes" or "no" is relevant only for countries using the worldwide principle.

Treaty participation: numbers indicate how many treaties are in effect. "Andean" indicates that the country has agreed to the provision that income flowing between two signatories will be subject to taxation only in the source country.

Source: Corporate Taxation in Latin America (Amsterdam: International Bureau for Fiscal Documentation, various dates, 1985-86).