

## THE “ORIGINAL INTENT” OF U.S. INTERNATIONAL TAXATION

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INTRODUCTION

The Sixteenth Amendment took effect on February 25, 1913, permitting Congress to tax income "from whatever source derived,"<sup>1</sup> and on October 3rd of that year, Congress approved a tax on the net income of individuals and corporations.<sup>2</sup> The United States regime for taxing international income took shape soon thereafter, during the decade 1919-1928. In the Revenue Act of 1918, the United States enacted, for the first time anywhere in the world, a credit against U.S. income for taxes paid by a U.S. citizen or resident to any foreign government on income earned outside the United States.<sup>3</sup> The Revenue Act of 1921, the first major tax enactment following World War I, introduced a limitation on this foreign tax credit (FTC) to ensure that a taxpayer's total foreign tax credits could not exceed the amount of the U.S. tax liability on the taxpayer's foreign source income.<sup>4</sup> While details of the

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1. U.S. CONST. amend. XVI.

2. See Revenue Act of 1913, ch. 16, 38 Stat. 114.

3. See Revenue Act of 1918, ch. 18. §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080-82 (1919) (§ 222(a)(1) provided a foreign tax credit for individuals, § 238(a) provided a similar credit for domestic corporations, and § 240(c) described creditable taxes). The British had previously allowed foreign tax credits for taxes paid within the British Commonwealth. See Thomas S. Adams, *Interstate and International Double Taxation*, in LECTURES ON TAXATION 101, 102 (Roswell Magill ed., 1932) [hereinafter Adams, *Double Taxation*]. The Revenue Act of 1918 also adopted the so-called indirect foreign tax credit, which allows U.S. companies a tax credit for foreign taxes paid by their controlled foreign subsidiaries. See *infra* note 100 and accompanying text.

4. For example, this allowed an American company, subject to a U.S. corporate tax rate of 35%, with \$1,000 of foreign source income, a \$350 maximum foreign tax credit against its U.S. tax liability. See Revenue Act of 1921, ch. 136, §§ 222(a)(5), 238(a), 42

foreign tax credit have changed and the methodology for determining the foreign tax credit limitation has varied from time to time, these two provisions still constitute the linchpin of U.S. law taxing income earned abroad by U.S. citizens and residents.

A few years later, in 1928, the League of Nations issued draft model bilateral income tax treaties for the reciprocal relief of double taxation of international income.<sup>5</sup> Today, the League of Nations model still serves as the basis for the model income tax treaties of the Organization for Economic Cooperation and Development (OECD), the United Nations, and the United States.<sup>6</sup> Although treaty articles have become more complex, commentaries more detailed, and some apparent loopholes have been closed, almost all the major industrial nations—the members of the OECD—have bilateral tax treaties with one another based on the 1928 League of Nations model.<sup>7</sup> Indeed, the fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world.<sup>8</sup>

Despite massive changes in the world economy in the last seventy years, the international tax regime formulated in the 1920s has survived remarkably intact. To be sure, the complexities of current U.S. tax law governing international transactions would

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Stat. 227, 249, 258. This limitation was intended to ensure that U.S. companies and individuals could not use foreign taxes to reduce or eliminate U.S. taxes on U.S. source income. See discussion *infra* Section III.B.

5. *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562 M.178 1928 II (1928) [hereinafter 1928 Report].

6. Some early nineteenth century double taxation treaties are on record, such as a Dutch measure dating from 1819 exempting foreign ships from the Dutch business-license tax on condition of reciprocity. See Mitchell B. Carroll, *Double Taxation Relief, Discussion of Conventions Drafted at the International Conference of Experts, 1927 and Other Measures* 1 (Dep't of Commerce Trade Information Bulletin No. 523), 1927. But the modern treaty era began with the Prussian-Austrian double taxation treaty of 1899. This treaty's brief regional importance was primarily because it served as a model for several postwar treaties entered into in the early 1920s by central European successor states to the Austro-Hungarian Empire. Like many other early treaties, the Austro-Prussian treaty only applied to nationals of the two countries. In general terms, it followed a domicile-based principle of direct taxation. See *id.* at 2.

7. See generally Adam Vital, *The Strange Career of the Model Double Taxation Treaty: A Brief Historical Outline* (1995) (unpublished manuscript on file with authors).

8. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996).

shock a tax practitioner of the 1920s, and the international network of bilateral income tax treaties could not have been imagined by the handful of men who fashioned the League of Nations' model treaty of 1928. Nor could policymakers of the 1920s have foreseen the integration of the world economy or the dramatic expansion of international capital flows we take for granted today. But, despite such developments, the basic structure of both the 1928 model treaties and the United States' international tax law of the 1920s governs the income tax consequences of international transactions today.

This remarkably stable regime now threatens to come unglued, however. Calls for major restructuring of the United States regime for taxing international income are commonplace. Some claim that the recent emergence of regional trading blocs, such as through the North American Free Trade Agreement (NAFTA), and the economic and political integration of the European Community demand major revision of the taxation of international income.<sup>9</sup>

Others believe that the international tax system has been rendered archaic by the international expansion of capital flows, especially of portfolio investments, the emergence and widespread use of new financial instruments, particularly financial derivatives, and the expansion of international activities by large multinational businesses.<sup>10</sup> These developments have enhanced fears of a multinational "race to the bottom" in the taxation of capital income.<sup>11</sup> Some analysts now call for an exemption from U.S. tax of foreign source income either on the grounds of simplification or to improve the international competitiveness of U.S. multinationals.<sup>12</sup> Such an exemption is used by many European nations.<sup>13</sup> Exempt-

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9. See, e.g., *Colloquium on NAFTA and Taxation*, 49 TAX L. REV. 525, 525-820 (1994) (discussing whether the adoption of NAFTA necessitates a change in tax laws).

10. Between 1970 and 1990, the percentage of United States receipts of foreign income derived from portfolio investment grew from 25% to more than half. See Aviyonah, *supra* note 8, at 1315.

11. A particularly outspoken official on the subject of "racing to the bottom" is European Community Tax Commissioner Christiane Scrivener. See, e.g., *EC Tax Commissioner Outlines Priority Issues*, BNA DAILY TAX REP., Mar. 7, 1990, at G-8. For a critique of the "race to the bottom" scenario, see Alvin K. Klevorick, *The Race to the Bottom in a Federal System: Lessons from the World of Trade Policy*, 14 YALE L. & POL'Y REV. 177 (1996).

12. See, e.g., GARY F. HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (1992).

13. See HUGH AULT ET AL., COMPARATIVE INCOME TAXATION: A STRUCTURAL

ing foreign source income was the proposal advanced in 1996, for example, by the Kemp Commission on Tax Reform, a commission appointed by then Senate Majority Leader Bob Dole and Speaker of the House Newt Gingrich, and headed by former Congressman and Vice Presidential candidate Jack Kemp.<sup>14</sup>

Probably the greatest impetus for major change in the taxation of international business income is that the "classical" system of taxing corporations no longer exists in many industrial nations. The United States retains a classical corporate tax, under which business income earned by a corporation is taxed twice: first when it is earned by the corporation, and again when it is distributed to shareholders as dividends. Many of our trading partners, however, have moved in recent years to eliminate or substantially reduce this double taxation.<sup>15</sup> The international tax regime, however, is predicated on the existence of a double corporate tax. It generally allocates the corporate level tax to the country where the businesses' income is earned and the personal tax on dividends to the country where the recipients reside.<sup>16</sup> A country's unilateral decision to eliminate either the corporate or individual level of tax upsets this equilibrium and demands fundamental reconsideration of the international consensus about how this income should be taxed. Today, some countries, such as the United States and the Netherlands, retain a classical corporate tax while others, such as England, France, Germany and Australia, do not.<sup>17</sup> In such circumstances, adjusting the international tax regime in a manner acceptable to all parties is made even more difficult.<sup>18</sup>

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ANALYSIS 380-85, 402-25 (1997) (discussing use of a foreign source income exemption in the United Kingdom, Canada, Germany, the Netherlands, Australia, and France).

14. See NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, UNLEASHING AMERICA'S POTENTIAL: A PRO-GROWTH, PRO-FAMILY TAX SYSTEM FOR THE TWENTY-FIRST CENTURY, reprinted in 70 TAX NOTES 413 (1996) [hereinafter KEMP COMMISSION REPORT].

15. For a discussion of the experience of Australia, Canada, France, Germany, New Zealand, and the United Kingdom with tax system integration, see U.S. TREASURY DEP'T, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 159-84 app. (1992).

16. See Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice*, 47 TAX L. REV. 565, 565-66 (1992).

17. See U.S. TREASURY DEP'T, *supra* note 15, at 159-84.

18. See Avi-Yonah, *supra* note 8, at 1356-59. See generally COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE ON INDEPENDENT EXPERTS ON COMPANY TAXATION (1992) [hereinafter RUDING COMMITTEE REPORT].

All of these developments motivate calls for a fundamental reexamination of U.S. taxation of international income; as a result, proposals for change have flooded the literature.<sup>19</sup> Some call for taxation of international income only by the source country (the country where the income is earned);<sup>20</sup> others call for taxation only by the residence country (the country where the investor resides).<sup>21</sup> Many call for retaining the present structure—here we call it the 1920s compromise—but with substantial revisions.<sup>22</sup>

In moving forward, we need to be clear about what is baby and what is bathwater. It would be foolish to deny the successes of the existing regime. The system for taxing international income put in place seven decades ago has witnessed, indeed facilitated, a massive expansion in international capital flows. The current clamor for change therefore makes this a propitious moment to look back to see what the originators of this remarkably stable and successful system of international taxation had in mind. Surprisingly, this has never been done before.<sup>23</sup>

19. See, e.g., Avi-Yonah, *supra* note 8, at 1352–53 (proposing taxation of individuals by country of residence and taxation of corporations on a source of income basis); RUDING COMMITTEE REPORT, *supra* note 18; Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 63–86 (1993) (discussing alternative approaches for enhancing the stability of international income taxation); Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 TAX L. REV. 691, 702–38 (1994) (suggesting a treaty-based formulary system to resolve many of the potential tax-induced distortions to free trade caused by NAFTA).

20. See, e.g., KEMP COMMISSION REPORT, *supra* note 14, at 449 (reprinting the Kemp Commission's recommendation that Congress consider a "territorial tax system").

21. See, e.g., Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 12 (Assaf Razin & Joel Slemrod eds., 1990); Green, *supra* note 19, at 86 (urging the United States to move from source-based income taxation to a residence-based system).

22. See, e.g., Avi-Yonah, *supra* note 8, at 1303–05 (calling for a "new consensus . . . to remedy the [1920s compromise's] major weaknesses and ensure its continued viability"); McDaniel, *supra* note 19, at 693–94; Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1757–59 (1995) (arguing that Congress' response to the "source" versus "residence" debate has been "an unprincipled grab for undeserved tax revenue" rather than "considered reevaluation of . . . previously accepted but obviously shaky policy").

23. Earlier efforts to set forth the history of international tax policy include Alan G. Choate et al., *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 TEMP. L.Q. 441 (1971), and William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909–1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379 (1989). Such scholarship, however, has typically devoted little attention to the formative period of 1918–1928, and has rarely scratched below the

We endeavor here to set the historical record straight by setting forth the “original intent” of the U.S. system of taxing international income. This project serves several purposes. It has become commonplace to attribute—we claim to misattribute—the key role in fashioning the modern international tax regime to a 1923 report prepared for the League of Nations by four economists under the leadership of the Columbia University economist Edwin R.A. Seligman.<sup>24</sup> This reading of history overstates the role played by the 1923 Report and, in doing so, it misleads modern policy analysts about the relative historical importance of the tax claims of countries of residence at the expense of countries of source. Our analysis brings to light the central role played in the original formulation of U.S. international tax policy by Thomas Sewall Adams, an economics professor at the University of Wisconsin and Yale University and, crucially, the key Treasury tax advisor during this period. If there was a founder of the U.S. system of international taxation, it was T.S. Adams.

The international tax rules put into place by Congress, largely at Adams’ behest—particularly the foreign tax credit—were not, as some modern analysts seem to think, enacted to advance the goal of worldwide economic efficiency by making Americans indifferent about investing domestically or abroad, although they certainly narrowed the pre-existing differences in making such investment choices.<sup>25</sup> Today’s common attribution to the U.S. international tax regime, by both economists and lawyers, of a deliberate policy of “worldwide efficiency” or “capital export neutrality”—a policy of taxing U.S. residents identically whether they invest here or in a foreign country<sup>26</sup>—overlooks the original primacy given by T.S. Adams and the U.S. international tax regime to source-based taxa-

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surface of standard legislative history. In contrast, this article draws extensively on published and unpublished writings of key actors (especially Thomas Sewall Adams), minutes of League of Nations meetings, and other archival material. To our knowledge, these materials have not previously been used to relate the early history of U.S. international tax policy.

24. See, e.g., Avi-Yonah, *supra* note 8, at 1305–06 (claiming that the 1923 Report underlies modern discussions of jurisdiction to tax); Ault, *supra* note 16, at 567–68.

25. See STAFF OF JOINT COMMITTEE ON TAXATION, 102D CONG., 1ST SESS., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 5 (Comm. Print 1991).

26. See *id.* at 248; Robert Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. \_\_\_\_ (1997) (forthcoming).

tion. Modern policy advocates, of course, may reject the primacy of taxation by countries of source, but they cannot properly claim that such a rejection is simply a continuation of the original U.S. tax policy toward international income.

T.S. Adams' purposes, reasoning, and deep understanding of how international income should—he would say “must”—be taxed not only reveal the original intent of U.S. international taxation but also provide important counterpoints to the consensus views of modern economists about international tax policy today. We make no claim here, however, that the original intent of international taxation should necessarily constrain today's policies. We have no desire to become the Bob Bork and Ed Meese of international taxation.<sup>27</sup> Nevertheless, taking a careful look at Adams' attitude in fashioning U.S. international tax policy at the beginning of the twentieth century provides useful lessons for reevaluating this nation's international tax policy at the century's end, notwithstanding the nature and scope of the changes in the world economy that have taken place in the intervening years. Ignoring the wise and practical views of Adams, the person most responsible for putting this remarkably successful and durable system into place, could well be folly. He has much to teach us about making international tax policy today.

#### I. WHO WAS T.S. ADAMS, ANYWAY?

Thomas Sewall Adams was born in Baltimore, Maryland on December 29, 1873. After obtaining his Ph.D. in economics from Johns Hopkins in 1899, Adams collaborated with his professor, Richard T. Ely, and two others in producing the most widely-used pre-World War I economics textbook, *Outlines of Economics* (published in 1908).<sup>28</sup> He also was the co-author with Helen L.

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27. Whatever one thinks about the demands of a written constitution, the views of yesteryear do not and should not limit the discretion of today's tax policymakers. The nation's tax laws can be changed whenever the President and the Congress agree; changes in tax treaty policies demand only that the President and the Senate concur. Like Bork, however, we do brush aside many of the difficulties of ascertaining “original intent,” by looking to T.S. Adams for illumination of the “principles” or “core values” he sought to implement. See Robert H. Bork, *The Constitution, Original Intent, and Economic Rights*, 23 SAN DIEGO L. REV. 823, 826 (1986). We accept Boris Bittker's characterization of this as something of a “fuzzy target.” See Boris I. Bittker, *Interpreting the Constitution: Is the Intent of the Framers Controlling? If Not, What Is?*, 19 HARV. J.L. & PUB. POL'Y 9, 36 (1995).

28. See 4 JOSEPH DORFMAN, *THE ECONOMIC MIND IN AMERICAN CIVILIZATION* 211



Sumner of the successful treatise *Labor Problems* (1905), but Adams was far better known for his role in shaping tax policy, particularly during the early days of the income tax, than for his scholarly publications.<sup>29</sup>

While he was a professor of economics at the University of Wisconsin from 1901–1915, Adams helped formulate and write the Wisconsin Income Tax Law, the first successful progressive income tax in the United States. The Wisconsin income tax became a model both for other states' income tax statutes and the 1913 federal income tax law. Adams served as a Wisconsin Tax Commissioner from 1911–1915.<sup>30</sup> In 1916, after a brief interlude at Cornell, Adams became a professor of economics at Yale, concentrating principally on public finance and advanced economic theory. In collaboration with Edwin R.A. Seligman, Adams drafted New York's first income tax statute that year.<sup>31</sup> From 1917 until his death in 1933, Adams combined his teaching at Yale with advice to the federal and state governments and to private organizations.

From 1917, when he was appointed tax advisor to the Treasury Department by President Wilson, until 1923, he served as the Treasury's principal advisor on issues of tax policy and administration. During much of the period we are concerned with here,

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(1959). For a discussion of Ely's role in the early development of "law and economics" theory, see Herbert Hovenkamp, *The First Great Law and Economics Movement*, 42 STAN. L. REV. 993, 1021–25 (1990).

29. Much of the material in this section is taken from DORFMAN, *supra* note 28, at 214–221; T.S. ADAMS, 1873–1933 (A.E. Holcomb ed., 1933); W. Elliott Brownlee, *Social Investigation and Political Learning in the Financing of World War I*, in THE STATE AND SOCIAL INVESTIGATION IN BRITAIN AND THE UNITED STATES 323 (Michael J. Lacey & Mary O. Furner eds., 1993).

30. For a discussion of the shortcomings of the pre-Wisconsin income taxes and an overview of the spread of state income taxation after Wisconsin's successful experiment, see ALZADA COMSTOCK, STATE TAXATION OF PERSONAL INCOME 16–18 (1921). Comstock observes, "It would hardly be an exaggeration to say that the success of state income taxes in the last few years of their history has been due largely to the adaptation and use of the plan of centralized and specialized administration which was first used by Wisconsin in 1911." *Id.* at 56. In addition to the innovations of its administrative machinery, the Wisconsin tax was also particularly influential in its taxation of business income. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 629 (5th ed. 1988) (labeling the Wisconsin tax "the father of twentieth-century corporate income taxation"). Adams describes and defends the Wisconsin income tax in T.S. Adams, *The Significance of the Wisconsin Income Tax*, 28 POL. SCI. Q. 569 (1913) [hereinafter Adams, *Wisconsin Income Tax*].

31. See DORFMAN, *supra* note 28, at 215.

Adams was Treasury's spokesman before the House Ways and Means Committee and the Senate Finance Committee whenever tax legislation was being formulated. From 1923 until his death in 1933, Adams served as the key spokesman for the United States in the international tax treaty movement. Notwithstanding the dramatic political shift marked by the election of Republican Warren G. Harding to the White House, Harding's incoming Treasury Secretary, Andrew Mellon, retained several high-ranking Treasury officials from the Wilson administration, including Adams—a testament to their reputation for nonpartisan expertise.<sup>32</sup> A contemporary observed that "Professor Thomas S. Adams has been the principal Treasury expert and adviser of Secretaries of the Treasury, Ways and Means Committees, and Finance Committees" under both Democratic and Republican regimes, and that his influence was "remarkable" in light of the "bitter election campaign of 1920."<sup>33</sup> Having previously served three Treasury Secretaries (William G. McAdoo, Carter Glass and David F. Houston) under President Wilson, Adams became one of Andrew Mellon's closest advisers during his early years in office.<sup>34</sup> President Harding apparently cared little, and understood less, about tax issues, gladly leaving these difficult matters to his experts at Treasury.<sup>35</sup> Harding once declared, "I can't make a damn thing out of this tax problem. I listen to one side and they seem right, and then—God!—I talk to the other side and they seem just as right."<sup>36</sup>

Reading the transcripts of executive sessions of the tax-writing committees reveals both the scope of Adams' knowledge and the extent to which Congress relied on him. Adams went through draft legislation subsection by subsection explaining proposed rules and the reasons for them. He advised Congress not only on the substance of the law but also on the best style for drafting the legislation. He often explained to the committees legal issues involving Supreme Court opinions, opinions of the Attorney General, and IRS regulations.<sup>37</sup> It should be noted that, at this time,

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32. See Benjamin G. Rader, *Federal Taxation in the 1920s: A Re-examination*, 33 THE HISTORIAN 415, 421 (1971).

33. Roy G. Blakey, *The Revenue Act of 1921*, 12 AM. ECON. REV. 75, 90 (1922).

34. See *id.*; see also Brownlee, *supra* note 29, at 363.

35. See JEROLD L. WALTMAN, *POLITICAL ORIGINS OF THE U.S. INCOME TAX* 83 (1985).

36. *Id.*

37. See, e.g., *Internal Revenue Hearings Before the Committee on Finance of the Unit-*

Congress had no tax staff of its own. The Joint Committee on Taxation, which has long provided a professional tax staff to the Congress, did not come into existence until 1926. The description of Adams as the “father” of the 1921 Act does not seem overstated.<sup>38</sup> Adams had no rivals for the committees’ attention. During hearings on the 1921 Revenue Act, Senator LaFollette remarked to Adams: “I have the greatest confidence in you and I think you know more of the subject [of taxation] than anybody else in the world.”<sup>39</sup> John Witte, the leading chronicler of the political evolution of the income tax, describes Adams as “the leading tax expert of his time.”<sup>40</sup> The tax historians W. Elliott Brownlee and Sidney Ratner also emphasize Adams’ great influence.<sup>41</sup>

Adams also enjoyed the great respect of his peers in the economics profession. He served as president of the National Tax Association in 1923, and also of the American Economic Association in 1927.<sup>42</sup> He apparently was the only person to hold both positions until that feat was repeated by the Brookings Institute economist Joe Pechman in the 1970s and 1980s.<sup>43</sup>

At his death in 1933, friends, colleagues and numerous present and former government officials paid tribute to Adams.<sup>44</sup> Henry Rainey, Speaker of the House, described him as the “great-

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*ed States Senate on H.R. 8245*, 67th Cong. (1921) (Confidential Print for Use of Members of the Senate), reprinted in 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

38. See Carlton Fox, Memoranda Concerning Whose Ideas Formed the Basis of the 1921 Revenue Revision, reprinted in 95 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

39. *Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245*, 67th Cong. 256 (1921) (statement of Senator LaFollette), reprinted in 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979) [hereinafter *1921 Hearings*.]

40. JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 91 (1985).

41. See SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 14 (1967) (noting that Adams was “[o]ne of the greatest of American tax experts”); see also Brownlee, *supra* note 29, at 350-53 (noting Adams’ “experience in legislative consultation, implementing radical forms of progressive taxation, and conducting economic investigations”).

42. See Fred R. Fairchild, *Adams, Thomas Sewall*, in 11 *DICTIONARY OF AMERICAN BIOGRAPHY* 10 (Harris E. Starr ed., 1944).

43. For an appreciation of Pechman’s achievements, see Stuart E. Eizenstat, *Joe Pechman: A Passion for Fairness*, WASH. POST, Sept. 2, 1989, at A25.

44. See T.S. ADAMS, *supra* note 29.

est expert” on taxes he ever knew, and three former Treasury Secretaries, who had served under four different Presidents, David F. Houston (who served under President Wilson), Andrew W. Mellon (Presidents Harding, Coolidge and Hoover) and Ogden D. Mills (President Hoover), praised his enduring contributions to the field of public finance and to the nation’s tax law.<sup>45</sup> Most revealing, however, were two tributes from fellow public finance scholars at Columbia University, his friend and sometimes rival Edwin Seligman and Robert M. Haig. Professor Seligman wrote:

If there ever was a scholar in politics, Adams is a shining example . . . . He wrote, indeed, only little, but every essay that came from his pen was thought-provoking. His greatest qualities however, were his administrative and executive gifts, and his practical common-sense, which enabled him to thread his way so successfully amid the maze of conflicting opinions and which made him so valued a counselor to statesman . . . . In his influence on the fiscal policy of the United States he will live as a fit successor to David A. Wells, who played a similarly prominent part in the Civil War.<sup>46</sup>

Robert Haig was also effusive, and, along with several others, referred specifically to Adams’ accomplishments in the field of international taxation:

However, closest to his heart during this period has been the daring conception of international harmony and co-operation in taxation, . . . [a] prize . . . to be won only by overcoming almost insuperable obstacles. How substantial has been his progress toward a solution I realized only when I sat with such men as Blau in Bern and Dorn in Berlin, watched their eyes kindle with enthusiasms and admiration for Adams and heard their expression of eagerness to assist in the forwarding of his plans. For, by the force of his knowledge and his personality, he won the complete respect and loyalty of this polyglot committee of the League of Nations. Let us hope that its work will be crowned with complete success. He would desire no nobler monument.<sup>47</sup>

While “complete success” in the field of taxation is difficult to know, much less achieve, Adams did succeed in putting in place the fundamental structure of both the U.S. tax law governing

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45. *See id.* at 13-14.

46. *Id.* at 6-7.

47. *Id.* at 7-9.

international taxation and the original model for bilateral tax treaties, the two building blocks which have governed U.S. taxation ever since.

The early formation of American public policies in many instances has depended on the special talents and roles played by a few leading individuals. In each such case, these leaders were masters of both design and implementation. With the exception of the Constitution's founders, about whom probably too much has been said, little is known of such men and the critical roles they played in shaping American public policy. T.S. Adams was such a person, a "prophet" in the field of taxation.<sup>48</sup>

Adams' influence is well-illustrated by an anecdote from the 1922 annual conference of the National Tax Association. The following was to be printed on the official program's schedule of speeches: "How federal taxes are made, by Thomas S. Adams, Yale University." However, a preliminary program read: "How Taxes Are Made by Dr. T.S. Adams of Yale University." Noting Adams' power and influence in Washington, the speaker introducing Adams' talk joked, "I don't know which subject is to be discussed this afternoon."<sup>49</sup>

## II. THE ESSENTIAL DILEMMA OF INTERNATIONAL TAXATION

Despite the seismic changes in the world economy that have occurred in the last seven decades, the fundamental dilemma of international taxation that confronted Thomas Sewall Adams, his Treasury colleagues, and the Congress in the infancy of the income tax remains essentially unchanged. When income is earned in one country by a citizen or resident of another country, both the country where income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income. The basic task of international tax rules is to resolve the competing claims of residence and source nations in order to avoid the double taxation that results when both fully exercise their taxing power. Capital-exporting and capital-importing nations have conflicting financial

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48. For examples of other leaders in the history of government regulation in America, see generally THOMAS K. MCCRAW, *PROPHETS OF REGULATION* (1984). We borrow McCraw's label "prophet" here also to express the "unusual combination . . . of both theorizing about regulation and actually doing it." *Id.* at vii-viii.

49. *Ninth Session*, 15 NAT'L TAX ASS'N PROC. 329, 330-31 (1922).

interests: capital importers have the most to gain from taxation at source, capital exporters from taxation of residents. Absent agreement, residence countries remain unable to limit the unilateral actions of source nations.

It is nevertheless surprising that the solutions to these problems first accepted by this nation in the 1920s—largely at the behest of Adams—have remained so stable. Not only have the scale and scope of international transactions changed dramatically, but the Treasury's views about the relative priorities properly accorded the claims of residence and source countries have also shifted substantially since Adams' time. In its 1977 *Blueprints for Basic Tax Reform*, the Treasury made clear its preference for residence-based taxation.

There are two basic prototype approaches to the taxation of international flows of income. The first is the *residence* principle, under which all income, wherever earned, would be defined and taxed according to the laws of the taxpayer's own country of residence. The second prototype is the *source* principle, which would require the taxpayer to pay tax according to the laws of the country or countries in which his income is earned, regardless of his residence. . . .

A number of considerations point to the residence principle as the more desirable principle to establish. First, the concept of income as consumption plus change in net worth implies that distinctions based on the geographical origins of receipts are inappropriate. Income, by this definition, is an attribute of individuals, not of places. Second, if owners of factor services are much less mobile internationally than the factor services they supply, variations among countries in taxes imposed by residence will have smaller allocation effects than tax variations among places of factor employment. Third, the income redistribution objective manifested by the use of progressive income taxes implies that a country should impose taxes on the entire income of residents. The usual concept of income distribution cannot be defined on the basis of income source.

For these reasons, the model plan recommends that the United States seek, as a long-run objective, a world wide system of residence principle taxation.<sup>50</sup>

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50. DAVID F. BRADFORD, U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 89-90 (2d ed. 1984); see also THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 383 (May 1985) ("The long standing position of the United States that, as the country of residence, it has the right

In 1996, the Treasury reiterated its preference for residence-based taxation:

The United States, as do most countries, asserts jurisdiction to tax based on principles of both source and residence. If double taxation is to be avoided, however, one principle must yield to the other. Therefore, through tax treaties, countries tend to restrict their source-based taxing rights with respect to foreign taxpayers in order to exercise more fully their residence based taxing rights. . . .

In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographic location. Therefore source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere. An individual is almost always a resident of somewhere and, at least under U.S. law, all corporations must be established under the laws of a given jurisdiction.<sup>51</sup>

In both of these statements, the Treasury echoes views of Edwin Seligman, as expressed in the 1923 Economists' Report to the League of Nations, which plainly viewed source-based taxation as illegitimate because it is not based on the taxpayer's full ability to pay, or "faculty." The 1923 Report rejected the notion of an exchange where the government offers services for payments of taxes, stating that "the entire exchange theory has been supplanted in modern times by the faculty theory or theory of ability to pay."<sup>52</sup> Seligman's Report ascribed source-based taxation to "administrative cowardice or frailty"<sup>53</sup> and argued that "as semi-developed countries become more industrialized . . . the principle of personal faculty at the place of residence will become more widely understood and appreciated."<sup>54</sup>

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to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions.").

51. U.S. Treasury Dep't, *Selected Tax Policy Implications of Global Electronic Commerce*, reprinted in BNA DAILY TAX REPORT, Nov. 22, 1996, at L-8.

52. *Report on Double Taxation Submitted to the Financial Committee by Professors Bivens, Einavai, Seligman, and Sir Josiah Stamp*, at 18, League of Nations Doc. E.F.S.73 F.19 (1923) [hereinafter 1923 Report].

53. *Id.* at 40.

54. *Id.* at 51.

However, neither Seligman's views nor those of the present-day Treasury Department were shared by Adams and the Treasury Department of the 1920s. Adams did not believe in the superiority of residence and, although he rejected theoretical dogmatism on both sides of the issue,<sup>55</sup> he was clear about the primacy of the claim of the country where the income was earned—the source country—over the country whose residents supplied the investment capital—the residence country. Adams endorsed source-based taxation “[a]s a matter of both principle and administrative convenience.”<sup>56</sup> Adams wrote, “The income tax is really a dual thing: first, upon individuals levied in rough accordance with their ability to pay; and second, upon income where it is earned.”<sup>57</sup> Indeed, Adams insisted that “[t]he strongest reason for the retention and perfection of business taxation is found in experience and fiscal history.”<sup>58</sup> From “political and moral standpoints,” he offered this “plain” justification for business taxes:

A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment. . . . Business is responsible for much of the work which occupies the courts, the police, the fire department, the army and the navy. New business creates new tasks, entails further public expense. . . . The relationship between private business and the cost of government is a loose one . . . . The connection, however, is real. . . . [B]usiness ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.<sup>59</sup>

Indeed, Adams regarded the “state and community . . . as silent partners in every business enterprise.” The state, he argued, was entitled to a “prior claim . . . upon profits which public expenditures or the business environment maintained by the state have in

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55. See, e.g., Adams, *Double Taxation*, *supra* note 3, at 125 (“I see little hope or validity, in this tangled maze, in sweeping economic or juristic theories about the proper or natural jurisdiction [pertaining to certain taxes.]”); see also *infra* Section V.A.

56. International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 3 (Nov. 24, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923–1924 folder) [hereinafter *American Suggestions*].

57. Letter from T.S. Adams to Edward E. Rhodes, Vice President, Mutual Benefit Life Insurance Company, 1 (Jan. 5, 1923) (available in T.S. Adams Papers, Yale University, Box 28, Jan.-June 1923 folder).

58. Thomas S. Adams, *The Taxation of Business*, 11 NAT'L TAX ASS'N PROC. 185, 186 (1917) [hereinafter Adams, *Taxation of Business*].

59. *Id.* at 187.



part produced.”<sup>60</sup> He was clear that the U.S. should not and would not forego taxation of business income earned in the United States regardless of the residence of the business owners.<sup>61</sup> “Business competes with business, not owners with owners.”<sup>62</sup> He added:

Income must to some extent be taxed where it is earned, at rates and by methods determined by the conditions under which it is earned—not by the conditions under which it is spent. . . . [C]orporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.<sup>63</sup>

Edwin Seligman was never convinced. In sharp contrast, Seligman argued that the income tax was only about ability-to-pay and the progressivity principle. He insisted: “[N]othing is more firmly established than the substitution of the ability theory for the old benefit theory in taxation. To do as Professor Adams now attempts, and to blur these sharp distinctions, is to reopen the Pandora’s box of confusion.”<sup>64</sup>

Ultimately, in addition to his view that source-based taxation was justified by the benefits that the country of source provided to private enterprise, Adams’ respect for the power of economic self-interest and his insistence on solutions which were practical and could be stable over the long-term help explain his preference for taxation by countries of source over taxation by countries of residence. Adams declared: “Every state insists upon taxing the non-resident alien who derives income from source within that country, and rightly so, at least inevitably so.”<sup>65</sup> Adams viewed source-

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60. T.S. Adams, *Federal Taxes Upon Income and Excess Profits*, 3 AM. ECON. REV. 19, 20 (1918).

61. See Thomas S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 Q.J. ECON. 527, 542 (1921) [hereinafter Adams, *Fundamental Problems*] (“If the members of a partnership engaged in business in Detroit all live in Canada, and the partnership competes with business concerns the owners of which live in Detroit, our people will not consent to exempt the Canadians while the owners who live in the United States are taxed on their entire income or expenditures . . .”).

62. *Id.*

63. *Id.* at 542–43.

64. Edwin R.A. Seligman, *Untitled Response to Speech by T.S. Adams, Taxes Upon Income and Excess Profits—Discussion*, 8 AM. ECON. REV. 42, 43 (Supp. 1918).

65. Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 NAT’L TAX ASS’N PROC. 193, 197 (1929) [hereinafter Adams, *Aspects of Double Taxation*].

based taxation as just and inevitable—most nations exercised jurisdiction over source and there was little value in trying to talk them out of it. He further argued, “In the long run the business unit or source will yield more revenue to the public treasury than the individual; and the place where the income is earned will derive larger revenues than the jurisdiction of the person.”<sup>66</sup> Adams was committed to taxing business income, and viewed source-based taxes as more effective at doing so than residence-based taxes.<sup>67</sup> He viewed nations that insisted on residence-based taxation as imposing an affirmative disadvantage on themselves, hobbling the competitiveness of their businesses abroad.<sup>68</sup> Finally, while governments had a profound responsibility to relieve residents of the injustice of double taxation, the more attenuated relationship between governments and nonresidents did not dictate such accommodation.<sup>69</sup> Thus, in Adams’ mind, the case for source over residence was even stronger in cases of double taxation than it was in the abstract.

Adams’ preference for source had a defensive, as well as an affirmative, aspect; he insisted that the right of the United States to tax its own domestic-source income must not be sacrificed. As we shall see, this caused him to ask for a limitation on the foreign tax credit in 1921 so that U.S. residents and citizens could not use the credit to offset U.S. taxes on domestic income.<sup>70</sup> Adams was not willing to imperil his own nation’s ability to collect taxes on income produced within its borders.

Although Adams insisted that residence defer to source in cases of double taxation, he never rejected residence-based taxation altogether. Adams viewed residence as an important backstop to source-based taxation, which is why he generally favored credits for foreign-source taxes paid abroad, rather than exemptions for foreign-source income.<sup>71</sup> Residence only deferred to source if

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66. Adams, *Double Taxation*, *supra* note 3, at 120.

67. Adams argued:

[T]axes upon business have great fiscal virtue . . . . They are relatively inexpensive to collect and comparatively productive in yield. A given rate of taxation laid upon the business unit will usually yield a very much larger revenue than the same rate of taxation laid upon the individual owners of the business.

Adams, *Taxation of Business*, *supra* note 58, at 187.

68. See, e.g., *infra* notes 115–23 and accompanying text.

69. See, e.g., *infra* notes 111–13 and accompanying text.

70. See *infra* Section III.B.

71. Adams not only introduced the foreign tax credit into the U.S. law; he also

source *in fact* exercised its jurisdiction.<sup>72</sup> In Adams' view, the need for residence-based taxation as a backstop lay in his concern over tax avoidance,<sup>73</sup> which he found to be a problem of equal weight to double taxation.<sup>74</sup>

Adams also saw value in residence-based taxation as a means to protect progressive income tax rates, but he clearly felt that some of his peers, including Seligman, exaggerated the importance of graduated rates. Adams characterized "the will to tax progressively" as "a sound enough objective within a limited field, but a sorry substitute for the complex aims and objectives of tax systems considered as systems."<sup>75</sup> Ultimately Adams concluded that "the attempt to make the income tax do the work of social reform is apt to spoil the income tax. . . . It is at best a substitute for taxes which exercise a positively deleterious effect upon the distribution of wealth."<sup>76</sup> Nevertheless, Adams did not regard doing business

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attempted to impose it on international law in his work with the International Chamber of Commerce and the League of Nations. See *infra* notes 193, 254 and accompanying text. The FTC structure was also implicit in the Anglo-American Draft I-b of 1928. See *infra* notes 259-61 and accompanying text.

72.

[T]he jurisdiction of domicile should usually grant an exemption only through the tax credit, by which the taxpayer is exempted at domicile only when he has proved payment of the tax in some other jurisdiction. . . . [T]he state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax.

Adams, *Double Taxation*, *supra* note 3, at 112-13.

73. See T.S. Adams, A Suggested Amendment to Sir Percy Thompson's Proposal Regarding a Deduction or Credit (undated) (unpublished memorandum, available in T.S. Adams Papers, Yale University, Box 17, folder containing undated League of Nations materials) [hereinafter Adams, Suggested Amendment] ("To prevent tax evasion, the relief in question can best be granted through a deduction or credit. . . . If the taxpayer evaded taxation abroad he would be caught at home.").

74. See Adams, *Double Taxation*, *supra* note 3, at 125-26 ("It is the opinion of many persons familiar with the subject, and my own, that in international and interstate trade there is probably as much evasion as double or multiple taxation.").

75. *Id.* at 126-27. For a more complete statement of Adams' views about progressive income taxation, see T.S. Adams, *Effect of Income and Inheritance Taxes on the Distribution of Wealth*, 5 AM. ECON. REV. 234, 234-35 (1915) [hereinafter Adams, *Distribution of Wealth*]. Adams conceded that the income tax should not be levied on the poor, but argued that its burdens should be widely borne by all those capable of supporting themselves financially. He felt that a more narrow tax base would promote class conflict, public extravagance, and needless administrative complexity. He further argued that "the upper limit of enforceable rates is about 10 per cent." *Id.* at 235. Adams seems to have underestimated the enforceability of higher rates, although his calls for low rates and widening the tax base foreshadowed subsequent income tax debates.

76. *Id.*

abroad as an appropriate avenue to escape progressive rates on individual residents.<sup>77</sup> Adams knew well that progressive taxation of individuals was not possible under an exclusively source-based system, since it would require source nations to obtain a great deal of personal information about residents of other countries.<sup>78</sup> Adams thus felt that progressive taxation was best handled by the nation of residence through a credit for foreign-source taxes paid abroad.<sup>79</sup>

Notwithstanding Adams' view that residence-based taxation had a valid role to play as a backstop, it is quite clear that Adams accorded a primary importance to source-based taxation. Adams' contemporaries recognized that the foreign tax credit, Adams' primary innovation, was a rejection of the primacy of residence-based taxation.<sup>80</sup> During the War, the United States had shifted

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77. See Committee on Double Taxation of the International Chamber of Commerce, Report Submitted by the American Section 2 (June 27, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921-1923 folder) [hereinafter American Section Report] ("The American Committee [on Double Taxation] sees no sound reason why a progressive income tax should be reduced merely because [income] is earned or derived from more than one country.").

78. Adams discussed some of the administrative challenges in an argument against providing personal exemptions to foreigners taxed in the United States:

We have to follow it into the foreign country. Maybe the foreign country has no income tax, although it has some tax which is somewhat similar. We have no test of the veracity of the foreign citizen. We can not tell whether he has 10 children or 4 children, or whether he is unmarried or living with his wife. It also means, if you want to administer it with any care and accuracy, that we have to convert the foreign income into dollars in this country.

1921 Hearings, *supra* note 39, at 63.

79. Adams' preference for making residence the custodian of progressivity may have been reflected in his tentative attraction to the normal/super distinction proposed by the International Chamber, though Adams ultimately rejected this model as incompatible with the U.S. tax system. See *infra* note 187. As an alternative, Adams urged the International Chamber to advocate the adoption of American-style FTCs, which, Adams noted, would also protect the progressive rate structures of residence nations. See American Section Report, *supra* note 77, at 1-2.

80. See, e.g., Mitchell B. Carroll, *Proposed and Applied Methods of Preventing Double Taxation*, in DEPARTMENT OF COM. SPECIAL CIRCULAR NO. 122, at 29 (available in T.S. Adams Papers, Yale University, Box 13) (observing that under American law "the principle of origin [source] prevails"). Adams' pro-source position is also manifest in the allocation rules of the 1921 Act, which were aggressive in taxing U.S.-source income. Note, for instance, the contrasting treatments of dividends and interest in the 1921 Act and the 1923 League Report: Adams allocates dividends and interest to the payor's nation (source), while Seligman allocates to the payee (residence). See *infra* note 149 and text accompanying note 221. The "foreign trader" provision of the 1921 Act—which would have shifted a large class of U.S. taxpayers to a purely source-based taxation—further underscores Adams' preference for source. See *infra* Section III.C.

from a debtor to a creditor nation but, as a result of Adams' leadership, the United States did not argue—as did Great Britain, for example—that the country of residence should have the first claim to tax the income. Edwin Seligman described the American approach as the “extreme converse” of purely residence-based taxation.<sup>81</sup> Thus, modern claims that the U.S. international tax regime gives primacy to residence-based taxation should be understood as a repudiation—not a continuation—of its original intent.<sup>82</sup>

### III. THE “ORIGINAL INTENT” OF U.S. TAX LAW GOVERNING INTERNATIONAL TRANSACTIONS

In the early days of income taxation, during the period 1913–1918, before Thomas Sewall Adams made his appearance on the federal scene, U.S. tax law allowed only a deduction from income of taxes paid to a foreign government.<sup>83</sup> The direct offset of U.S. taxes by foreign taxes paid—the foreign tax credit—did not appear until the Revenue Act of 1918.<sup>84</sup> Although there was no talk about such a notion then, economists today view a system of taxing worldwide income with only a deduction for foreign taxes as furthering what they label “national neutrality.”<sup>85</sup> Although this is a form of neutrality in that all net receipts received by persons in the United States are taxed the same regardless of whether they have also been taxed by another nation, this label is somewhat misleading. What “national neutrality” means in this context is that U.S. tax policy should favor U.S. investments over

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81. See EDWIN R.A. SELIGMAN, *DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION* 133–34 n.10 (1928).

82. See, e.g., STAFF OF JOINT COMMITTEE ON TAXATION, *supra* note 25, at 88; H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359, 372 (1981); *supra* text accompanying notes 50–51.

83. See Choate et al., *supra* note 23, at 460 n.96.

84. Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919).

85. See Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581, 583 (1990). The reasoning behind the international tax aspects of the 1913 Act is difficult to discern from the historical sources. Some scholars have concluded that “it is quite likely that Congress gave little or no thought to the effect of the Revenue Act of 1913 on the foreign income of U.S. persons or the U.S. income of foreign persons.” Choate et al., *supra* note 23, at 481. The decision in 1913 to tax the worldwide income of taxpayers may have simply followed the earlier decision to tax worldwide income in the 1909 federal excise tax on corporate income. See Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 11, 112–17.

equally productive foreign investments.<sup>86</sup> National neutrality regards the domestic investment as better because the U.S. Treasury gets the revenue. In such a regime, the United States will capture the benefit of the entire pre-tax return on the domestic investment, either in taxes or in private after-tax returns to U.S. residents. According to this view, U.S. tax policy should encourage U.S. individuals and companies to prefer U.S. investments whenever the U.S. pre-tax rate of return exceeds the return on a foreign investment net of the foreign country's taxes.<sup>87</sup> Thus, such a policy treats foreign taxes as costs of investing U.S. capital abroad and allows foreign taxes to be deducted in computing taxable income, the same treatment as for other costs of earning income.

This normative perspective contrasts sharply with a policy directed toward achieving "worldwide efficiency," which would be neutral about a U.S. resident's choice between a domestic and foreign investment producing the same pre-tax rates of return. A policy of neutrality toward such an investment choice (also known as "capital export neutrality") is indifferent not only about where such investments are made but also about which country collects the tax revenues from the income of the investment. Many economists and other tax policy analysts criticize a policy of national neutrality, claiming that the nation's tax policy goal should instead be worldwide economic efficiency. But it is hard to convince a U.S. President or members of Congress to put aside "narrow" national interests to fashion U.S. tax policy in a manner that is indifferent to whether taxes flow into U.S. coffers or the treasury of some foreign nation. This is particularly true when the foreign nation whose treasury will be enhanced is selected as a private investment decision of U.S. investors, rather than as a reflection of the foreign policy goals of the United States. To take but one instance among many, Kansas' Senator Curtis objected in hearings on the 1921 Act to a relief provision for Americans doing business

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86. See, e.g., Frisch, *supra* note 85, at 583 (describing and criticizing the "national neutrality" viewpoint).

87. For example, if taxpayer A, a resident of country X, has revenue of 100 from sources in X, and costs of 80, its tax in X might be  $.3 \times 20$ , or 6. If taxpayer B, also a resident of X, has revenue of 100 from sources in country Y, costs of 80, and must pay a tax in country Y of 4, then its tax in country X would be  $(100-84) \times .3$ , or 4.80. In this way, A and B have both been taxed in country X at a rate of 30% on their net earnings, but A enjoys a higher after tax return (\$14) on the domestic investment than B (\$11.20) on the foreign investment.

abroad, stating, "Our people get the worst of it, and they ought to, if they go to another country to invest. Let them invest in their own country."<sup>88</sup>

More persuasive in the policymaking arena has been the claim that "national neutrality"—allowing only a deduction for foreign income taxes—is doomed to fail on its own terms.<sup>89</sup> Here the argument shifts from the contention that worldwide economic efficiency is a more worthwhile goal than national well-being to an assertion that, when one takes the likely responses of foreign governments into account, a U.S. tax policy that prefers U.S. investments, at least in the long term, will fail; a self-centered international "beggar-thy-neighbor" contest will lower not only worldwide economic output but also the national output of the United States itself. This claim echoes the argument for favoring free trade over high tariffs on imports, that a policy that seems to further the national self-interest in the short-term will be self-defeating in the long run. This shifts the political debate from normative disputes over goals to empirical claims about consequences and to contentions that the interests of the United States will be best furthered by an international tax regime designed to promote worldwide economic efficiency.<sup>90</sup> Indeed, this constitutes much of the modern debate and, not surprisingly, claims about consequences are often expressed in multiple empirical models of daunting complexity.<sup>91</sup>

A. *The Revenue Act of 1918—Enacting the Foreign Tax Credit*

Just as the enactment of a deduction for foreign taxes occurred in 1913 without any talk of "national neutrality," the move away from this deduction to a foreign tax credit in the 1918 Act took place without any political decision to shift U.S. tax policy to favor "worldwide efficiency" or "capital export neutrality." The Sixteenth Amendment permitting a federal income tax had recently been sold to the American people on fairness grounds, and, in

88. 1921 *Hearings*, *supra* note 39, at 64.

89. See STAFF OF JOINT COMMITTEE ON TAXATION, *supra* note 25, at 239–40.

90. See Frisch, *supra* note 85, at 583–84. See generally JOEL SLEMROD, FREE TRADE TAXATION AND PROTECTIONIST TAXATION 1–28 (NBER Working Paper No. 4902, 1994) (comparing international tax policy to international trade policy).

91. For examples, see the papers collected in THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS (Martin Feldstein et al. eds., 1995).

1918, arguments grounded in tax equity remained far more persuasive politically than notions of promoting more economically efficient investments. T.S. Adams was then just beginning to create the institutional capacity within the Treasury and Internal Revenue Service to analyze the social and economic consequences of fiscal and monetary policies.<sup>92</sup> A politically persuasive case for free trade policies loomed only in a distant future. Throughout the early part of this century, America's trade policy viewed imports unfavorably, and Congress was soon to raise its already substantial protective tariffs.<sup>93</sup>

Then, as now, international tax policy was "something of a stepchild" in the tax legislative process.<sup>94</sup> The big issue before the Congress was finding the means to finance the war, in particular the question whether to impose a war profits or excess profits tax.<sup>95</sup> Indeed, Adams initially joined the Treasury Department to assist with the massive tax increases that would be necessary to fund the United States war effort.<sup>96</sup>

This tax-raising occasion was an odd time for Adams to succeed in making the foreign tax credit (FTC) his first enduring contribution to international tax policy. But, because the United States insisted on taxing the worldwide income of its citizens, the

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92. See Brownlee, *supra* note 29, at 363.

93. See RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 124, 130 (1954). Herbert Hoover, Commerce Secretary under Presidents Harding and Coolidge, "assigned no small credit [to the tariff] for American prosperity." JOSEPH BRANDES, *HERBERT HOOVER AND ECONOMIC DIPLOMACY* 30 (1962). Treasury Secretary Andrew Mellon, the other premier architect of U.S. economic policy during the 1920s, also favored protective tariffs. See PHILIP H. LOVE, *ANDREW W. MELLON* 252-53 (1929).

American trade and fiscal policy during the period covered by this Article had a clear mercantilist cast. President Harding declared, "[W]e must protect American business at home and we must aid and protect it abroad." BRANDES, *supra*, at 15 (quoting Warren G. Harding, *Less Government in Business and More Business in Government*, in *THE WORLD'S WORK* 25-27 (1920)). After sweeping into power in the 1920 elections, Republicans promptly raised tariffs (even before enacting tax cuts), reflecting a prevalent belief, in the words of one contemporary critic, "that the tariff is the panacea for economic ills." Blakey, *supra* note 33, at 76. This mentality culminated in the famous Smoot-Hawley tariff of 1931, which enacted the highest tariffs in American history. This pro-tariff policy ultimately proved incompatible with U.S. insistence on repayment of war debts and resulted in financial collapse in Europe and exacerbation of the depression in the United States. See PAUL, *supra*, at 148.

94. The phrase appears in Ault & Bradford, *supra* note 21, at 11.

95. See WITTE, *supra* note 40, at 83-86.

96. See Fairchild, *supra* note 42, at 10. For a discussion of U.S. taxation during World War I, see W. ELLIOTT BROWNLEE, *FEDERAL TAXATION IN AMERICA* 48-66 (1996).



pre-1918 arrangement permitted a form of double taxation, with foreign-source income being fully subject to taxation both at home and abroad. In 1913, when the American income tax was first implemented, tax rates were low and this double taxation may have been a comparatively minor nuisance. In 1918, however, with the world at war and tax rates inflating rapidly around the globe, international double taxation was becoming a far more serious burden on Americans doing business or investing abroad.<sup>97</sup> The top marginal rates on individuals in the United States reached 77 percent, and although the basic corporate rate was only 10 percent, an excess profits tax at rates from 8 to 60 percent also applied to many large companies.<sup>98</sup> In such circumstances, additional layers of taxation from other nations were potentially confiscatory. Relief became a matter of some urgency.

In this context, Adams presented an extraordinary proposal: the foreign tax credit, which he described as “[o]ne of the most striking departures” in the 1918 Act.<sup>99</sup> Under the FTC, Americans could claim a *credit* against their American taxes for taxes paid to other countries; taxes paid abroad would reduce American tax revenue dollar for dollar.<sup>100</sup> The FTC represented what was an extraordinarily generous measure for its time: the United States was assuming sole responsibility for the costs of reducing the double taxation of its residents and citizens. As Edwin Seligman re-

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97. See *Proposed Revenue Act of 1918: Hearings Before the Comm. on Ways and Means*, 65th Cong., 3d Sess. 648, 649-650 (1918) (statement of Phanor J. Eder, Secretary, Mercantile Bank of the Americas); see also Clyde J. Crobaugh, *International Comity in Taxation*, 31 J. POL. ECON. 262, 262 (1923) (observing that problem of international double taxation had recently “assumed great importance” due to wartime tax increases and growing magnitude of international business transactions).

98. See WITTE, *supra* note 40, at 84-85.

99. Thomas Sewall Adams, *The New Revenue Act*, 108 THE NATION 316, 316 (1919).

100. The FTC was available unconditionally to U.S. citizens, but only available to resident aliens who were citizens of nations granting similar benefits to Americans residing abroad. Compare Revenue Act of 1918, ch. 18, § 222(a)(1), 40 Stat. 1057, 1073 (1919) (credit for citizens) with Revenue Act of 1918, ch. 18, § 222(a)(3), 40 Stat. 1057, 1073 (1919) (credit for resident aliens). The FTC was not available at all to non-resident aliens.

The 1918 Act also originated the so-called “indirect” or “deemed paid” foreign tax credit, which allows domestic corporations credits for foreign taxes paid by foreign subsidiaries when dividends are distributed to the parent. See Revenue Act of 1918, § 240(c). Subsidiaries incorporated in foreign countries are not considered U.S. residents and therefore are not subject to U.S. taxes on their income earned abroad. The dividends paid to a U.S. parent, however, are income to the parent and the indirect FTC was considered necessary to relieve double taxation on that income.

marked, "[T]he United States is making a present of the revenue to other countries."<sup>101</sup> In so doing, the U.S. unilaterally renounced a potentially important bargaining chip in convincing other nations to forego taxing their residents on U.S. source income. Adams expected his proposal to be turned down because the press of wartime financing made tax relief generally inappropriate in 1918:

In the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities . . . by including in the federal income tax the so-called credit for foreign taxes paid . . . I had no notion . . . that it would ever receive serious consideration.<sup>102</sup>

Such generosity was virtually unprecedented. Great Britain, for example, limited its relief from double taxation, also a foreign tax credit, to taxation within the British Empire and, in legislation in 1920, the British further limited its FTC to a maximum of one-half of the British taxes on the foreign income.<sup>103</sup> Yet Adams

101. See SELIGMAN, *supra* note 81, at 135.

102. Adams, *Aspects of Double Taxation*, *supra* note 65, at 198.

103. See Adams, *Double Taxation*, *supra* note 3, at 102. For a discussion of other similarly limited unilateral relief measures that were in existence prior to the U.S. FTC, see JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCALITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 10-14 (1932) (describing legislation intended to alleviate some burdens of double taxation in the Netherlands (providing that foreign ships would be exempt from licensing taxes only if their countries granted a reciprocal exemption to Dutch ships), Belgium (taxing all income of Belgians, but providing for a lower tax rate on foreign income than on domestic income), Norway (providing foreigners exemption from taxation in Norway if their countries provided a reciprocal exemption for Norwegians), and Switzerland (noting that the Center of Thuryan exempts residents' foreign income from local taxation if it has already been taxed abroad)). A few nations also protected residents from double taxation by taxing only domestic-source income. See T.C. Jen, Double Taxation 4 (1924) (describing income taxes of Australia, New South Wales, and South Africa) (unpublished manuscript, available in T.S. Adams Papers, Yale University, Box 29, May-Aug. 1924 folder).

Among the American states, New York was shortly to implement a new income tax that provided a credit to residents for taxes paid to another state, but only if the other state also had an income tax and provided a similar exemption for New Yorkers. See Edwin R.A. Seligman, *The New York Income Tax*, 34 POL. SCI. Q. 521, 534 n.1 (Supp. Aug. 1918 - July 1919).

Interestingly, given Adams' association with the state, Wisconsin also provided a tax credit to prevent double taxation, though double taxation of a different kind: Wisconsin permitted taxpayers to offset their personal property taxes against income taxes. See W. ELLIOTT BROWNLEE, PROGRESSIVISM AND ECONOMIC GROWTH: THE WISCONSIN INCOME

pursued his scheme because he felt that "it touched the equitable chord or sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."<sup>104</sup>

To Adams' surprise, the FTC provoked little opposition (or indeed notice) and became law in 1919.<sup>105</sup> Adams attributed the success of his proposal to the fact that legislators are particularly sensitive to the charge of double taxation.<sup>106</sup> Adams later observed, "In my experience with legislative bodies I have found that you can accomplish more for equity and justice in taxation in the name of eliminating or preventing double taxation, than with any other slogan or appeal."<sup>107</sup>

At bottom, Adams objected to double taxation because it offended his sense of fairness.<sup>108</sup> From 1918 until his death in

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TAX, 1911-1929, at 62 (1974).

104. Adams, *Aspects of Double Taxation*, *supra* note 65, at 198.

105. *See id.* The FTC was part of the Revenue Act of 1918, misleadingly named because the law was enacted in 1919. Originally drafted in a special session of Congress during the summer of 1918, the Act was passed by the House in late September; however, the Senate could not complete its deliberations until after the Armistice on November 11. Peace necessitated a certain amount of redrafting, which prevented final Senate action until February, 1919. *See* WITTE, *supra* note 40, at 85.

106. *See* Adams, *Aspects of Double Taxation*, *supra* note 65, at 197. During the limited discussion of the measure, Congressmen focused on the great burden of double taxation, but also depicted the FTC "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation." Roswell Magill & William C. Schaab, *American Taxation of Income Earned Abroad*, 13 TAX L. REV. 115, 118 (1958).

107. Adams, *Aspects of Double Taxation*, *supra* note 65, at 197. Before turning his attention to the international arena, Adams concerned himself with the problem of double taxation within the United States. In his first published article on taxation, a monograph on the Maryland tax system, Adams identified the double taxation of debt as the "worst defect" of the state's property tax and argued that reform was necessary in order to "satisfy our innate ideas of justice." Thomas Sewall Adams, *Taxation in Maryland*, 18 JOHNS HOPKINS U. STUD. HIST. & POL. SCI. 13, 44-45 (1900) [hereinafter Adams, *Taxation in Maryland*].

108. To be precise, the problem at issue was not double taxation *per se*; Adams did not devote much attention, for instance, to the double taxation inherent in the classical model of corporate taxation or to the double taxation represented by the joint application of federal and state income taxes. Rather, Adams was vexed by the concurrent taxation of the same income by different nations. Seligman had long ago distinguished between just and unjust double taxation: double taxation "is not always wrong; it is unjust only when one taxpayer is assessed twice while another in substantially the same class is assessed but once." EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 98 (1900). Adams' focus on *international* double taxation grew out of a similar sense that what is wrong in double taxation is *discrimination*: the person who chooses to live in one country and earn money in another is singled out for a double dose of taxes.

1933, Adams maintained a nearly continuous involvement in one project or another to alleviate international double taxation.<sup>109</sup> Even legislators, whose wisdom Adams sometimes doubted, responded to what Adams perceived as the manifest injustice of double taxation:

There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.<sup>110</sup>

Adams framed the problem of double taxation not as an issue of economic efficiency, but as a matter of invidious discrimination. Adams identified the ultimate culprit causing this discrimination as the nation of residence: "More double taxation of the unjust variety is inflicted upon the taxpayer by his own government than by foreign governments."<sup>111</sup> He elaborated:

Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, at least inevitably so. Now, then, in due course of time, citizens of the home state inevitably invest abroad and derive income from foreign sources. The average state refuses to acknowledge in this situation the right of its own citizen to a proper exemption on income derived from foreign sources. It . . . refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad.<sup>112</sup>

Given the predictability and the justness of taxation abroad, in Adams' view, the nation of residence wronged its taxpayers by levying an additional tax upon foreign-source income, thereby discriminating unfairly against residents who happened to earn their income abroad.<sup>113</sup>

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109. After completion of the 1928 model treaties, Adams joined the newly-formed permanent Fiscal Committee of the League of Nations. In this capacity, he focused on the problem of apportionment of international business income, but died before this project produced any concrete results. For a discussion of the history of the apportionment project, see Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 2 INT'L LAW 692, 702-07 (1968).

110. Adams, *Aspects of Double Taxation*, *supra* note 65, at 197.

111. *Id.*

112. *Id.* at 197-98.

113. Some would argue that a government is justified in discriminating against those who do business abroad—in particular, that there may be something unpatriotic in send-

Though Adams felt, as a matter of principle, that nations should work to alleviate the double taxation of their residents, and, during the limited discussion of the measure, members of Congress focused on the great burden of double taxation and the urgency of relieving it given wartime tax rates, other factors also played a role. In particular, there was a growing recognition of a need to encourage private investments by Americans in Europe. Adams also believed that the United States would reap practical benefits from providing relief to its own taxpayers; he was convinced that a discriminatory tax system that imposed unconscionably high rates on some taxpayers would ultimately prove to be unenforceable.<sup>114</sup>

Moreover, Adams generally shared the sentiments about business of the Administrations for which he worked;<sup>115</sup> he believed American prosperity depended in large measure on the competitiveness of American business abroad.<sup>116</sup> Certain members of Congress also depicted the FTC “as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation.”<sup>117</sup> Trade abroad was considered crucial to the nation’s economic well-being and was thought to require appropriate support from the government.<sup>118</sup> Relief

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ing one’s capital abroad. During hearings on the 1921 Act, for instance, as we have pointed out, Senator Curtis voiced this objection. *See supra* text accompanying note 88. But this was plainly not Adams’ position. Nor was it the prevailing view of the post-war American government. *See infra* note 118.

114. *See Adams, Distribution of Wealth*, *supra* note 75, at 235 (“To enforce a progressive income tax the cooperation of the taxpayer must be secured. But to secure his cooperation the rates must be fair and reasonable.”); *see also infra* note 310 and accompanying text.

115. *See BRANDES, supra* note 93, at 12 (“Throughout Hoover’s term as Secretary [1921–1928] the Department of Commerce spared no effort in acting on the policy that exports were a key to business stability and thus to American prosperity.”).

116. *See infra* text accompanying notes 118–23.

117. Magill & Schaab, *supra* note 106, at 118.

118. In the 1920s, the locus of this support was Herbert Hoover’s Department of Commerce. For a description of the Department’s aggressive efforts to assist American business abroad, *see BRANDES, supra* note 93, at 10–15. In this vein, the Department took an active interest in the international tax issues on which Adams worked, maintaining a vigilant eye on both the FTC, *see infra* note 148 and accompanying text, and the work of the League of Nations. With respect to the League, for instance, the Department of Commerce played a role in the decision to send Adams to London and Geneva as the U.S. representative on the Committee of Experts, *see Adams Choice Here for Parley Abroad to Ease Trade Tax*, N.Y. J. COM., Dec. 28, 1926 (reproduced from National Archives), and dispatched its own foreign tax officer to act as Adams’ assistant at the meetings. *See HERNDON, supra* note 103, at 65. All of this suggests the importance

from double taxation constituted just such appropriate support.<sup>119</sup> And there is some evidence that Adams had this policy in mind in his international tax efforts. His close associate, Mitchell Carroll, characterized Adams' FTC in this way:

The American credit system is ideal for a wealthy nation that desires to encourage the expansion of its foreign trade, and is willing to afford relief from double taxation to its own citizens or residents . . . . The United States says, in effect, to its citizens—go abroad and trade. If you have to pay tax on your earnings in foreign countries, show me your tax bill and I will give you relief . . . .<sup>120</sup>

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of export-promotion to Adams' work on international tax.

While the Department of Commerce's preference was perhaps for exporting *goods*, and not capital, the international balance of payments was such that export of goods after World War I depended upon the export of capital, *see infra* notes 124–28 and accompanying text, and, in any case, the United States was perceived to have a surplus of financial capital, *see* BRANDES, *supra* note 93, at 160, 163. Moreover, Europe's high tariff barriers made the export of finished goods rather difficult; American firms thus found it increasingly profitable to invest in manufacturing subsidiaries abroad, the sales of which were free from tariffs, rather than selling wholly American-made goods. *See* FRANK A. SOUTHARD, JR., *AMERICAN INDUSTRY IN EUROPE* 115–19 (1931). In sum, there was little sense in systematically treating the export of capital less favorably than the export of goods, and, in fact, the Department of Commerce generally encouraged investment abroad. *See* BRANDES, *supra* note 93, at 163. However, the United States government did sometimes act to discourage American firms from building manufacturing facilities abroad, fearing U.S. job losses. *See* MIRA WILKINS, *THE MATURING OF MULTINATIONAL ENTERPRISE: AMERICAN BUSINESS ABROAD 1914 TO 1970*, at 95, 162 (1974). Moreover, the government also encouraged American bankers to require that loans abroad be used to purchase American-made goods when available. *See* BRANDES, *supra* note 93, at 157, 160.

While the American government leaned overall towards encouragement of the export of capital, the import of capital seems to have been somewhat less of a priority, understandably so, given the dearth of capital in post-war Europe. Indeed, much of the meager post-war investment by European firms in the United States was funded with U.S. capital. *See* SOUTHARD, *supra*, at 200.

119. Such relief was also consistent with the Department of Commerce's desire to maintain comparatively low taxes for U.S. businesses selling U.S. products abroad in order to offset relatively high domestic labor costs, thus reducing the incentive for firms to move operations (and jobs) overseas. *See* BRANDES, *supra* note 93, at 168 (discussing the Department of Commerce's advice to firms considering moving overseas to take advantage of lower labor costs).

120. Mitchell B. Carroll, *The Double Taxation Conference* 28–29 (Sept. 3, 1927) (unpublished manuscript, available in T.S. Adams Papers, Yale University, Box 16, Sept. 1927 folder). Congress also tended to view the FTC as an export-enhancing device, an attribute of the FTC that was discussed when it was originally adopted in 1918, *see* Magill & Schaab, *supra* note 106, at 188, and that helped preserve the FTC against an assault by the House Ways and Means Committee in 1933, *see id.* at 120.

Adams himself made clear that some of the reforms he presented in the 1921 Act had the competitiveness of American businesses in mind.<sup>121</sup> And he carried similar concerns with him into his tax treaty work:

[Legislation authorizing U.S. negotiation of tax treaties] will enable the businessmen of this country to compete on somewhat fairer terms with the business men [sic] of those foreign countries which have the benefit of conventions or treaties of this kind protecting them from the burdens of international double taxation.<sup>122</sup>

Perhaps such concerns over international competitiveness explain Adams' statement during the League of Nations' international tax treaty process that "[e]ach State should be eager, for selfish and economic reasons, to relieve its own nationals and residents from that measure of double taxation which is due to its own legislation."<sup>123</sup> For Adams, political principle and national self-interest coalesced around the issue of international double taxation. Particularly in light of the global increase in tax rates due to World War I, he found it imperative to relieve such taxation, first by adopting the bold measure of the FTC.

By the end of 1918, the United States had another reason to favor relief for Americans investing abroad: A variety of American economic and diplomatic interests required that a substantial quantity of American capital be channeled to rebuild post-war Europe. The United States was owed eleven billion dollars by allied governments for wartime loans;<sup>124</sup> somehow Europe would need access to American dollars to pay off this debt.<sup>125</sup> Europe would

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121. See *infra* note 156 and accompanying text.

122. Adams, *Aspects of Double Taxation*, *supra* note 65, at 194. Adams' associate, John Herndon, further observed that such concern over American businesses being left out of favorable foreign tax treaties was one of the major reasons the United States decided to participate in the model treaty effort in the first place. See HERNDON, *supra* note 103, at 64-65.

123. T.S. Adams, *Draft Convention Proposed by Professor Adams*, League of Nations Doc. D.T.120, at 2 (1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder) [hereinafter Adams, *Draft Convention*].

124. See BRANDES, *supra* note 93, at 171.

125. For a general discussion of the history of the war debts in the 1920s, see *id.* at 170-80. American allies objected vociferously to U.S. insistence on full repayment, tagging the United States with the label "Uncle Shylock." *Id.* at 170. After the war, the United States gave a brief respite to its allies, but ultimately applied economic sanctions in order to force its debtors to enter into repayment agreements, which most did between 1923

also need American dollars to purchase American exports—a central goal of American economic policy.<sup>126</sup> Given the U.S. antipathy to imports and its high tariffs, it was difficult for Europeans to sell goods to the United States. Moreover, the wartime devastation of Europe's human, physical, and financial capital made serious competition in American markets unlikely. If dollars could not be raised through sales, another possibility was loan forgiveness or other public financing of European recovery by the American government. However, domestic politics in the United States were very different after World War I than after World War II. Americans wanted smaller government, lower taxes, and fewer international entanglements. Americans would not tolerate loan forgiveness, much less a Marshall Plan, to aid Europe at a time when the United States government was itself sagging beneath what it considered an enormous wartime debt.<sup>127</sup> In sum, if Eu-

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and 1926. *See id.* at 173–79.

Ultimately, the debt issue was about more than just inter-allied relations: U.S. insistence on debt repayment forced the Allies to press Germany for war reparations, which amounted to \$33 billion. *See id.* at 180. The American government perceived that the rebuilding of Germany was vital to the future prospects for peace in Europe, *see id.* at 182, and, in 1924, in order to relieve the financial pressures imposed by reparations, advanced a substantial loan to Germany and encouraged private American investment in the German recovery, *see id.* at 183.

126. American interest in exporting to Europe did not abate even during wartime. For instance, in April of 1918, Congress passed the Webb-Pomerene bill, which permitted U.S. businesses to join together for exporting purposes notwithstanding antitrust laws. The purpose of this bill was to give American exporters greater leverage in negotiating with cartels of European buyers. *See WILKINS, supra* note 118, at 49–50.

Historically, Europe was the greatest market for American exports, taking 64% of total U.S. exports in 1914. *See* SIDNEY RATNER ET AL., *THE EVOLUTION OF THE AMERICAN ECONOMY* 386–87 (1979). Prior to World War I, the United States had been a net exporter of goods and services for four decades, but a net importer of capital. *See id.* at 385. Although the book value of U.S. investments abroad increased from \$94 billion to \$478 billion between 1897 and 1914, *see WILKINS, supra* note 118, at 17–18, it took World War I to transform the United States into a net exporter of capital, *see id.* at 30. Exports of capital would need to remain high to fund the continued purchase of American goods in Europe, on which the American economy had increasingly come to rely. The total value of American exports had more than doubled between 1914 and 1916 alone. *See* Harry N. Scheiber, *World War I as Entrepreneurial Opportunity: Willard Straight and the American International Corporation*, 84 *POL. SCI. Q.* 486, 497 (1969).

During the postwar era, it was a commonplace observation that American capital would need to be sent abroad in order to maintain and expand the sale of American goods in other countries: "The American banker and American salesman must go abroad." *Id.* at 509 (quoting Henry A. Wise Wood, *Planning the Future America*, 72 *ANNALS AM. ACAD. POL. & SOC. SCI.* 22 (1917)). Indeed, even during wartime, the authorization of loans to European nations was largely motivated by the desire to support American exports. *See* Scheiber, *supra*, at 494.

127. *See* Paul P. Abrahams, *American Bankers and the Economic Tactics of Peace:*



rope was going to get the dollars necessary for the repayment of its debts, the purchase of American exports, and the economic stability necessary for peace, the source would have to be private investment.<sup>128</sup>

Accordingly, the United States undertook a number of initiatives in 1918 and 1919 to encourage investment abroad.<sup>129</sup> Perhaps the most noteworthy initiative, in addition to the foreign tax credit, was the Edge Act, passed by Congress in late 1919, which promoted the development of federally-chartered banking enterprises designed to channel private domestic capital to European reconstruction.<sup>130</sup>

Ultimately the foreign tax credit was only a small part of a large, complex, and ultimately controversial bill. In addition to sharp increases in corporate and individual income taxes (though not sharp enough for some progressives), the 1918 Act introduced a brand new war profits tax to limit war profiteering, a provision that provoked much attention and debate, and which clearly overshadowed the FTC in importance.<sup>131</sup> Although the 1918 Act constituted the largest single tax increase of the war years, because it was not actually enacted until after the Armistice, this legislation

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1919, 56 J. AM. HIST. 572, 573, 583 (1969).

128. Observing these imperatives, incoming Commerce Secretary Herbert Hoover urged greater investment in Europe in a speech to the American Bankers' Association, arguing that such investments would raise "the capacity of foreign people to purchase American goods and to repay obligations to the United States." BRANDES, *supra* note 93, at 152 (quoting Herbert Hoover, speech to the American Banker's Association (Dec. 10, 1920)). Hoover set out important qualifications and also insisted that loans be extended through *private* channels and that they be carefully tailored to achieve productive purposes. *See id.*

Connecting these imperatives with international tax policy, George May, an American businessman who worked with Adams in the International Chamber of Commerce's double taxation initiative, argued that the United States was compelled to relieve double taxation because "[o]ur own country could hardly maintain its policies of restriction of imports through high tariffs, exportation of surplus food products, collection of foreign government debts and the building up of a merchant marine, without making foreign investments to balance the international account." George O. May, *Double Taxation*, 5 FOREIGN AFFAIRS 69, 69 (1926).

129. *See* Abrahams, *supra* note 127, at 576-78.

130. For a full description and history of the Edge Act, see *id.* at 577-83. Abrahams argues that the Edge Act was a response to the tension between U.S. trade and fiscal policies after World War I: "As the Americans saw it, the problem was to keep responsibility for the war-debt payments in Europe and at the same time give the Europeans enough financial breathing space to reconstruct their economy, restore the trade network, and earn enough dollars to pay their debts and buy American exports." *Id.* at 575

131. *See* WITTE, *supra* note 40, at 85.

also incorporated a number of long-term tax relief provisions, such as automatic phased-in reductions in corporate and individual tax rates beginning with the 1919 tax year.<sup>132</sup> Thus, the FTC, while an anomalous tax relief provision pre-Armistice, was rather more consistent with the overall spirit of the 1918 Act by the time it became law.

B. *The 1921 Act—Limiting the FTC and Enacting Specific Source Rules*

With the FTC, Congress put into place the centerpiece of an American international tax scheme that persists to this day: the United States taxes non-residents on U.S.-source income,<sup>133</sup> and residents and citizens on world-wide income, but allows the latter to offset their U.S. tax liability with a credit for income taxes paid abroad to alleviate double taxation. Though the Revenue Act of 1921 retained this basic structure, Adams returned to Capitol Hill once again as spokesman for the Treasury Department to urge a number of significant refinements to the mechanism.

The most important of these reforms was a limitation on the FTC. As originally devised, the FTC could be used to offset up to the full amount of any U.S. “income, war profits and excess-profits taxes” owed by an American taxpayer.<sup>134</sup> Thus, an American with substantial investments abroad, particularly if made in a high-tax nation (or nations), might eliminate his entire tax bill to the United States. Such an unlimited feature of a foreign tax credit in fact furthers the principle of capital export neutrality because, under such a regime, decisions about where to make investments turn only on comparing pre-tax rates of return even when the

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132. *See id.* at 85–86.

133. Foreign businesses doing business in the United States were taxed on their net income from U.S. sources. *See, e.g.*, Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 1, 112–17 (taxing income of foreign corporations from “business transacted and capital invested within the United States”); *see also* Revenue Act of 1918, ch. 18, § 213(c), 40 Stat. 1057, 1065–66 (1919) (providing for taxes on profits from the manufacture and disposition of goods within the United States by nonresident alien individuals).

In order to facilitate collection of taxes from nonresident aliens, the 1918 Act required American payors of fixed or determinable annual or periodic income to withhold a percentage of the income. *See* Revenue Act of 1918, § 221. Such withholding taxes have become another fixture of U.S. international tax policy, although today, unlike under the 1918 and 1921 Acts, these “withholding taxes” are in fact final taxes, not subject to offsetting deductions and credits.

134. Revenue Act of 1918, ch. 18, § 222(a)(1), 40 Stat. 1057, 1073 (1919).

foreign tax rate is higher than the domestic tax rate. But neither Adams nor Congress was thinking about achieving such neutrality during this period, and both regarded the limitless FTC in 1921 as creating the potential for “abuse.”<sup>135</sup> With the high U.S. tax rates obtaining in 1918 and 1919, the ability of the FTC to erase U.S. tax liability was not readily apparent. By 1921, however, U.S. rates had fallen considerably and were in the process of being reduced further.<sup>136</sup> Meanwhile, European nations maintained their higher rates. For instance, in 1921 the “normal tax” (i.e., the base rate applied to the lowest income categories) was 10 percent in the United States, but 30 percent in Great Britain.<sup>137</sup> Under such circumstances, an American investing in Great Britain might easily wipe out his entire U.S. tax liability even though the lion’s share of his income was from U.S. sources.

Adams justified a limitation on the FTC to the Senate Finance Committee as follows:

[The unlimited FTC] is subject to this . . . rather grave abuse: If the foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which fairly belong to this country. . . . [W]e know of instances where big corporations whose income was derived largely from this country have had their tax wiped out, so far as this country is concerned, because the English tax rates are three times as high as ours.<sup>138</sup>

Specifically, Adams requested and Congress enacted what we now call an “overall limitation”: the amount of FTC available to any given taxpayer was limited to a proportion of the taxpayer’s overall U.S. tax liability equal to the proportion of the taxpayer’s global income derived from foreign sources. For instance, an American obtaining 10 percent of his income from foreign sources could use the FTC to offset a maximum of 10% of his total U.S. tax liability on his worldwide income; the taxpayer would thus have to bear an increased tax burden for investing in foreign countries with higher average taxes than the United States. To the Senate Finance Committee, the case for such a limitation was so strong that there was no need even to discuss the proposal.<sup>139</sup>

135. See *infra* note 138 and accompanying text.

136. See WITTE, *supra* note 40, at 88 (observing that maximum rates on individuals fell from wartime high of 77% to 24% by the end of the 1920s).

137. See *1921 Hearings*, *supra* note 39, at 74.

138. *Id.* at 73–74.

139. See *id.* at 74. The final version of the FTC limitation appears in the Revenue

The repeal of the U.S. excess profits tax in 1921 made such a limit even more compelling. Contemporary critics derided the limitless FTC as an instance of unjustified "prodigality" on the part of the American government.<sup>140</sup>

The fundamental purpose of the 1921 foreign tax credit limitation was to protect the ability of the U.S. to collect tax on U.S. source income, but the limitation on the foreign tax credit also has had a number of effects on the investment decisions of U.S. residents. Generally, under such a limitation, if a foreign country's tax rate is higher than the U.S. rate, a U.S. investor will prefer a domestic investment to a foreign investment with an identical pre-tax rate of return. For an investor who has already made some foreign investments, however, the limitation's averaging of foreign taxes of high-tax and low-tax countries might create advantages for investments in low-tax countries (to average against the high-tax foreign country's taxes as a way of offsetting U.S. tax) or indifference about investments in high tax countries (because, due to investments in low tax countries, the limitation may not be reached). The limitation enacted in 1921 clearly eliminated the pure neutrality as between foreign and domestic investments with the same pre-tax rates of returns that had existed under the unlimited earlier version of the FTC.<sup>141</sup>

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Act of 1921, ch. 136, § 222(a)(5), 42 Stat. 227, 249.

140. See May, *supra* note 128, at 75.

141. The 1921 Act marked the beginning of tax legislation limiting foreign tax credits. For example, in 1932 Congress, as part of a general revenue increase, revised the limitation so that taxpayers were required to use the lesser of an overall or per-country limitation. See Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 169, 211. In 1954, the overall limitation was repealed, leaving only a per-country limitation. See Internal Revenue Code Act of 1954, ch. 736, § 904, 68A Stat. 3, 287-88 (codified at I.R.C. § 904 (1958)). In 1960, taxpayers were given the option of using an overall or per country limitation. See Act of Sept. 14, 1960, Pub. L. No. 86-780, § 1(a), 74 Stat. 1010, 1010 (codified at I.R.C. § 904(b) (1964)) (amended 1976). In 1976, the per-country limitation was repealed, and the law had come full circle to the position of the 1921 Act. See Tax Reform Act of 1976, Pub. L. No. 94-455, sec. 1031, § 904, 90 Stat. 1610, 1620-24 (codified as amended at I.R.C. § 904 (1994)). In 1986, a system that categorizes various income into so-called baskets assumed primacy. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1201, § 904(d), 100 Stat. 2085, 2520-28 (codified as amended at I.R.C. § 904 (1994)). Other "refinements" have also occurred; principally in an effort to ensure that the credit limitation operates to protect U.S. taxation of U.S. source income, as the 1921 Act had originally intended. See, e.g., Treas. Reg. § 1.861-8 (as amended in 1995) (prescribing rules for the allocation and apportionment of a taxpayer's deductions in an effort to provide guidance as to the determination of the taxpayer's taxable income from specific sources and activities).

In addition to capping the FTC, Adams sought also to establish clear source rules in the 1921 Act. The distinction between domestic and foreign-source income had become a central organizing feature of the American international tax system. It required determining the “U.S. source” income on which foreigners could be taxed and the “foreign source” income on which Americans could claim the FTC. The 1918 Act, however, had failed to specify any rules for determining which income was foreign and which was domestic source. In the absence of any statutory direction, the Attorney General had established source rules through written opinions.<sup>142</sup>

The Justice Department’s judgment, however, differed from that of Adams and the Treasury Department on at least two significant issues. First, the Attorney General decided that business income followed sales, regardless of where a product was manufactured or through whose hands it traveled to its final selling point. According to the Attorney General, who was guided more by common law traditions than tax policy considerations, only the nation in which the sale was concluded could levy a tax on income arising from the sale.<sup>143</sup> Adams objected that such a rule denied the United States authority to tax much income that was, in essence, produced domestically, and that such a rule was open to taxpayer manipulation:

An English corporation which owns timberland in Arkansas cuts the trees, roughly fashioning the timber, and cutting them into rough implement form here, completing the final process of manufacture in Scotland and selling from London, would be held to derive no part of the profit here. The present law is to this effect—that a Canadian corporation, for instance, can set up a factory here, go through all of the business transactions except final sale, and the income will follow the place of sale.

The danger of all that is that it is possible within limits to consummate sales wherever you wish. You can conclude the sale wherever you want to, abroad or here, frequently at your option.<sup>144</sup>

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142. See *1921 Hearings*, *supra* note 39, at 6, 67.

143. See *id.* The Attorney General’s opinion is reported at 32 Op. Att’y Gen. 336 (1920).

144. *1921 Hearings*, *supra* note 39, at 6.

In response to Adams' argument, Congress transferred discretion over the allocation of business income to the Commissioner of Internal Revenue. The Commissioner was to promulgate regulations apportioning such income between foreign and domestic sources in a manner more accurately reflecting their relative contributions than the simple sales rule.<sup>145</sup>

The second major departure from Department of Justice policy sought by Adams concerned the source rule for interest income. The Attorney General, again guided by common law, allocated interest to the residence of the creditor. In contrast, Adams sought allocation to the residence of the debtor.<sup>146</sup> Adams derived this rule from the practices of the American states with their income taxes.<sup>147</sup> The rule Adams preferred not only would strengthen source-based taxation, but also would reassure American lenders in Europe that the European taxes on their interest income would be credited against their U.S. tax liability. Adams reported to the Congress the "very active interest" of the Departments of State and Commerce in the provision, suggesting that the channeling of private capital to Europe was at least one motivation for the reform.<sup>148</sup> The interest source rule advanced by Adams was accepted by Congress.<sup>149</sup>

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145. See Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 243-45. More specifically, Congress empowered the Commissioner to develop "processes or formulas of general apportionment" with respect to income derived from sources "partly within and partly without the United States," a category of income expressly including income arising from the manufacture of goods in one country and the sale in another. *Id.* This preference for formula apportionment may reflect a longstanding interest of Adams. Indeed, this method of apportionment had been pioneered by Adams' Wisconsin income tax, and would become the norm in state taxation. See HELLERSTEIN & HELLERSTEIN, *supra* note 30, at 628-31. Nonetheless, § 217(e) offered a different mechanism for the allocation of income arising from the purchase of goods in one country and the resale in another; in such cases, the "source" of the income would be "the country in which [the goods were] sold." Revenue Act of 1921 § 217(e). In interpreting this ambiguous standard, courts ultimately looked to commercial law principles relating to passage of title. See Choate et al., *supra* note 23, at 450.

This issue remains both important and difficult today. See, e.g., TREASURY SALES SOURCE REPORT TO CONGRESS (1992). The Clinton Administration proposed in its budget for fiscal year 1998 a revision to the sales source rules that would allocate income from products manufactured in the U.S. and sold abroad based on "actual economic activity." The President's Budget for Fiscal Year 1998, submitted to Congress Feb. 6, 1997, *Analytical Perspectives*, at 52.

146. See 1921 Hearings, *supra* note 39, at 66-67.

147. See *id.*

148. *Id.* at 68.

149. See Revenue Act of 1921, ch. 136, § 217(a), 42 Stat. 227, 243-44. As with inter-

Though the interest and business income rules represented the most significant departures from existing practices (as established by the Attorney General), Adams offered Congress a full range of source rules, governing income from real property, intellectual property, personal services, and dividends. Adams assured Congress that these rules were derived from existing domestic and international practices, and reassured the Senate Finance Committee that the source rules were the most thoroughly researched provision of the 1921 Act.<sup>150</sup> As a result, Congress enacted an extensive set of detailed source rules in the 1921 Act, specifically covering interest, dividends, rents and royalties from real, personal and intangible property, personal services, gains from the sale of real and personal property and the manufacture and sale of personal property.<sup>151</sup> Adams' views concerning the need for explicit and clear source rules and about the proper rules, as reflected by the 1921 Act, would also play a significant part in his subsequent efforts to shape the source rules of a model international income tax treaty.<sup>152</sup>

*C. The Foreign Traders and Possessions Corporations Provisions of the 1921 Act—Exempting Foreign Source Income*

The FTC mechanism, enacted in the 1918 Act and refined in the 1921 legislation, effectively gave priority to source-based taxation, while retaining residence-based taxation as a backstop.<sup>153</sup> The residence-based safeguard was generally relevant only to taxpayers who had income from foreign tax havens or who otherwise managed to dodge foreign taxes on their foreign-source income. This safeguard worked reasonably well for non-business income, but by 1921, certain problems had emerged in the treatment of

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est, the 1921 Act sourced dividends based on the residence of the payor. Rental and royalty income from tangible property was sourced to where the property was situated, while income from intellectual property was sourced to where used. *See id.* These source rules have largely remained intact to the present day. *See* I.R.C. §§ 861(a)(4), 862(a)(4) (1994).

150. *See 1921 Hearings, supra* note 39, at 67.

151. *See* Revenue Act of 1921, § 217, 42 Stat. 243–45.

152. *See infra* notes 251–55 and accompanying text.

153. Unlike most countries, the U.S. taxes U.S. residents and non-resident citizens alike, so the FTC was also a backstop for citizenship-based taxation. To avoid cumbersome repetition of the phrase “residents and citizens,” however, we have lumped together the United States’ citizenship-based and residence-based tax jurisdiction under the term “residence-based.”

business income.<sup>154</sup> Businesses that derived much income from jurisdictions with low income taxes had a tax incentive to trade in their American charters, reincorporate in a foreign jurisdiction, and thereby avoid American taxes.<sup>155</sup>

Even in the early days of income taxation, experience was proving that the corporate form could and would be easily manipulated in order to escape residence-based taxation. In the 1920s, such manipulation not only circumvented the residence backstop, but also was considered a threat to American prestige and economic power; many successful American businesses abroad might ultimately be transformed into foreign enterprises. Moreover, those American businesses that remained incorporated in the United States claimed they were being handicapped in competition with foreign firms from countries that exempted all foreign source income from any domestic taxation.<sup>156</sup>

Adams also was concerned with the potential for related corporations to manipulate intercompany prices to reduce their combined tax burdens. Adams described such concerns during the hearings on the 1921 Act in urging a provision to give the Bureau of Internal Revenue the authority to consolidate the returns of affiliated corporations for the purpose of properly apportioning profits. This was the precursor to the still-controversial modern "Arm's Length Standard," under which transactions between related entities can be adjusted by the IRS if it finds that the taxpayer's accounting does not produce transfer prices that are in accord with the prices that would have been selected by parties dealing at arm's length.<sup>157</sup> Adams said:

At the present time it is possible—and I am afraid the device is being used increasingly—to incorporate a subsidiary and throw

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154. The residence backstop, for instance, discouraged Americans from investing in tax-exempt bonds issued by foreign governments—a tax dodge that was a particular bogey man for Adams and the Treasury Department in the 1920s. See *infra* note 307.

155. Businesses in high-income-tax jurisdictions had less of a temptation to reincorporate abroad because their foreign taxes could more fully offset American taxes through the FTC. Thus, the foreign-source income of such businesses was more-or-less effectively exempt from American taxes. By contrast, American businesses in a nation such as China, which did not have an income tax, were fully liable to the United States for their foreign-source income. Given that nations without an income tax might still levy a range of sales taxes, property taxes, and registration fees, American businesses in such nations might still regard themselves as facing substantial taxation.

156. See *1921 Hearings*, *supra* note 39, at 7.

157. See I.R.C. § 482 (1986).



the profits one way or the other. If that subsidiary is a foreign corporation you can throw the profits to it: in other words, by selling products to it at artificially high prices.<sup>158</sup>

Adams responded to both of these concerns by proposing to lift the residence backstop of the foreign tax credit from a particular class of taxpayers, which he dubbed “foreign traders” and “foreign trade corporations.”<sup>159</sup> These taxpayers would be “taxed substantially as foreign corporations and foreign nonresidents”—in other words, taxed only on their U.S.-source income.<sup>160</sup> In order to qualify for this exemption of foreign source income, a taxpayer would need to show that its income was derived primarily from the active conduct of business abroad: at least 80 percent of the taxpayer’s income over the past three years had to come from foreign sources, and at least 50 percent from the active conduct of business.<sup>161</sup>

Recognizing a distinction between active business income and passive income, which permeates international taxation today, Adams expressly excluded passive investment abroad from the foreign trader provision.<sup>162</sup> The restrictions requiring active business income were “put in there to prevent, for instance, persons living over here investing in French or Danish or Swiss bonds and getting a large percentage of income from that and claiming exemption. . . . The thing would be open to abuse if some such condition[s] were not imposed.”<sup>163</sup> Adams intended to lift the residence backstop only in those cases in which he thought it was unhelpful because easily evaded and perhaps detrimental to U.S. economic interests.<sup>164</sup>

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158. *1921 Hearings*, *supra* note 39, at 80.

159. *Id.* at 6.

160. *Id.*

161. *See id.* at 7.

162. Further legislation dealing with this problem was adopted in 1937 and the Code today contains a complex array of provisions addressing the treatment of such passive income. *See, e.g.*, I.R.C. §§ 871(a)(1), 881(a), 904(d)(2)(a) (1994). For further discussion of the treatment of passive income in international tax, see, e.g., Avi-Yonah, *supra* note 8, at 1305–10.

163. *1921 Hearings*, *supra* note 39, at 7.

164. In part, Adams probably felt comfortable making the foreign trader proposal because of the other reforms contained in the 1921 Act. The trader provision created a risk that American firms with trader subsidiaries would juggle their accounting so as to shift as much income as possible to the subsidiaries, which were free from U.S. residence-based taxes. However, the Internal Revenue Bureau’s new authority to look

The House and the Senate Finance Committee agreed to Adams' proposal.<sup>165</sup> The Senate Report argued:

Under existing law an American citizen or domestic corporation is taxed upon his or its entire income, even though all of it is derived from business transacted without the United States. This results in double taxation, places American business concerns at a serious disadvantage in the competitive struggle for foreign trade, encourages American corporations doing business in foreign countries to surrender their American charters and incorporate under the laws of foreign countries, results in serious administrative difficulties with respect to the collection of taxes due from individuals resident in foreign countries, and encourages American citizens to expatriate themselves. In order to remedy this situation foreign traders and foreign trade corporations . . . will be taxed under this act substantially as nonresidents . . . .<sup>166</sup>

On the Senate floor, however, the Progressive Senator LaFollette led a successful attack on the provision, arguing that it represented an inequitable tax break for the wealthy and would encourage the flight of capital and jobs abroad.<sup>167</sup> As the debate progressed, two facts emerged: 1) few nations at that time exempted the foreign-source income of residents, suggesting that Americans were in fact not routinely handicapped by U.S. residence-based taxation in competition with companies from abroad;<sup>168</sup> and 2) as a practical matter, the problems associated with the residence backstop then were of great economic import only in the

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through corporate accounting practices to the substance of transactions (the proto-Arm's Length Standard authority) provided hope that such tax avoidance could be effectively countered. The language of the proposed Arm's Length standard provision expressly covered foreign trade corporations. *See id.* at 80; *see also supra* note 157 and accompanying text.

165. *See* Magill & Schaab, *supra* note 106, at 123.

166. S. REP. NO. 67-275, at 9 (1921), *reprinted in* 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

167. *See* Magill & Schaab, *supra* note 106, at 123. Joining Senator LaFollette, Senator Simmons argued that the provision "came from sources 'profoundly interested in advancing the interests of consolidated, coordinated, combined, and predatory wealth.'" Roy G. Blakey, *The Revenue Act of 1921*, 12 AM. ECON. REV. 75, 96 (1922) (quoting 61 CONG. REC. 8994 (1921)).

168. U.S. residence-based taxation disadvantaged a U.S. corporation in competition with a company resident in a low-tax jurisdiction for business in that jurisdiction, but it did not disadvantage a U.S. company in competition with companies from a third country that itself did not exempt foreign source income.

Philippines.<sup>169</sup> In the end, Congress adopted a compromise measure: the “foreign trader” provision was transformed into a special exemption for businesses operating in U.S. possessions. Only taxpayers who obtained at least 80 percent of their income from U.S. possessions (including the Philippines), and at least 50 percent from the active conduct of business, were eligible for an exemption of income.<sup>170</sup>

Economists today regard a system that exempts foreign source income from tax in the residence country as furthering “capital import neutrality.”<sup>171</sup> The typical example to make this point is an investment by a U.S. company in a low-tax jurisdiction. A

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169. See Magill & Schaab, *supra* note 106, at 124.

170. See Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 271. Notwithstanding Senator LaFollette’s belief that rejection of the “foreign trader” proposal would help keep American capital at home, Congress seems to have been well aware that the LaFollette Amendment would simply encourage American firms to incorporate subsidiaries abroad—capital would continue to flow overseas, but through a corporate form shielding the returns from current U.S. residence-based taxation. Accordingly, the Conference Committee introduced a number of measures into the 1921 Act that provided competitive advantages to American firms with foreign subsidiaries. For example, Congress made clear that interest and dividend income paid by corporations that derived 80% of their gross income from foreign sources would be treated as foreign-source income. See Revenue Act of 1921 § 217(a)(1)-(2). We have not been able to ascertain what role, if any, Adams played in the development of these provisions. Note that they respond to one of the concerns the “foreign trader” provision was intended to address (competitiveness of American firms abroad), while acquiescing to the incorporation of American business enterprises abroad. Though the “foreign trader” provision was not originally intended to promote trade and investment in any particular region, its transformation into the Possessions Corporation provision pointed to a later theme in U.S. international tax policy: the provision of tax benefits to encourage economic development in favored regions. Thus, in 1939 Congress implemented a new law quite similar in structure to the Possessions Corporation provision, but designed to benefit Western Hemisphere Trade Corporations. See Terence M. Flynn, *Western Hemisphere Trade Corporations: Quo Vadis?*, 12 TAX L. REV. 413, 414 (1957). In 1922, Congress passed the China Trade Act (CTA), which provided relief to China Trade Corporations, albeit through a complicated structure dissimilar to that governing Possessions Corporations. See *id.* Notwithstanding the dissimilar relief mechanism, the CTA grew in part out of concerns similar to those motivating the “foreign trader” proposal: In China, as in the Philippines, the FTC was inadequate to place American firms on an equal tax footing with important foreign competitors. See generally Jennifer Hunt, *China Trade Act (1922)* (unpublished manuscript, on file with authors). Indeed, the House Ways and Means Committee held hearings on the China problem prior to its hearings on the 1921 Act. Adams did not testify on the subject in 1920 or later, and appears never to have articulated a position on the CTA, or, more generally, on such regionally-focused tax relief measures.

171. See Frisch, *supra* note 85, at 584; see also Avi-Yonah, *supra* note 8, at 1312 n.42; Ault & Bradford, *supra* note 21, at 39 (pointing out that capital import neutrality “obtains when there is no tax-based difference in circumstances at firms operating within a given country associated with the nationality of the firm’s owners”).

foreign tax credit system is designed to tax the U.S. resident on its foreign source income at a rate equal to the excess of the U.S. rate over the foreign rate. This is all the relief necessary to eliminate double taxation (and, it is said today, to make the U.S. investor indifferent about investing here or abroad). This, however, could create a disadvantage for U.S. multinationals in competition with investors who reside in countries that exempt foreign-source income of their residents. These investors will only owe the low-rate tax imposed by the source country. France, Germany, the Netherlands and Canada are among the countries who are regarded as having such exemption or "territorial" systems.<sup>172</sup> This concern with international competitiveness motivated the 1921 "foreign trader" proposal, as today it spurs calls for moving to an exemption for foreign source income.<sup>173</sup> Policymakers' attitudes toward these arguments often depend on whether they are focusing on a choice by a U.S. resident to invest here or abroad, in which case they worry about favoring foreign investment, or, on the other hand, are focusing on whether an investment abroad will be made by a U.S. or foreign firm, in which case they worry about the international competitiveness of the U.S. firm.

But the distinction between exemption and foreign tax credit systems tends to be overdrawn. First, many countries that have an exemption system exempt foreign source income only if taxed "comparably" abroad.<sup>174</sup> In addition, many countries—with France being a notable exception—have a so-called exemption with progression, and take the exempt income into account in determining the applicable tax in a progressive rate structure.<sup>175</sup>

Moreover, the U.S. system has important elements of a regime designed to promote capital import neutrality. The averaging across countries inherent in an "overall" limitation on the foreign tax credit often makes it advantageous for a company that already has investments in a jurisdiction with tax rates higher than the U.S. to invest in foreign jurisdiction with a lower tax rate. In addition, if an investment abroad is made by a foreign subsidiary of a U.S. parent, no U.S. tax is imposed until the earnings of the sub-

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172. See AULT ET AL., *supra* note 13, at 402-08.

173. See HUFBAUER, *supra* note 12, at 57-60 (discussing the implications of a policy of capital import neutrality on international competitiveness).

174. See Ault & Bradford, *supra* note 21, at 24-28.

175. See *id.*

sidiary are repatriated as dividends to the parent. When that happens, the U.S. allows a credit for the taxes paid to the foreign government.<sup>176</sup> If the tax rate of the foreign country is low or the deferral of U.S. tax is sufficiently lengthy, the present value of the U.S. tax can be very close to zero—an exemption. In addition, by timing the payment of dividends from foreign subsidiaries, U.S. parents can minimize the impact of the FTC limitation.<sup>177</sup> Thus, a recent survey of countries' different systems concluded: "While the exemption technique is often contrasted with the credit approach, in actual operation the two methods of relieving double taxation often yield quite similar results."<sup>178</sup>

Adams' attempt to effect a significant departure from a credit system in favor of an exemption system had only limited success. His 1921 foreign trader proposal does, however, offer further evidence of the primacy Adams accorded source-based taxation of business income. Indeed, Adams felt that jurisdiction over business taxation was by nature source-based, while jurisdiction over personal income could be residence-based: "The personal income tax is laid upon the individual in his capacity of consumer, and is paid where he resides; whereas the business income tax is paid by men in their productive or commercial capacity at the place where the income is earned."<sup>179</sup> After 1921, Adams remained committed to the foreign tax credit mechanism as a residence backstop, particularly for capturing tax from U.S. residents on foreign-source income not taxed abroad. Adams apparently never revived his "foreign trader" proposal. Indeed, the 1921 Act was Adams' last as chief spokesperson for the Treasury Department and with passage of the 1921 Act, Adams' work on international taxation shifted from domestic legislation to international agreements.<sup>180</sup>

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176. See I.R.C. § 902 (1994). This is the modern version of § 240(c) of the Revenue Act of 1918.

177. See, e.g., JAMES R. HINES, JR., TAX POLICY AND THE ACTIVITIES OF MULTINATIONAL CORPORATIONS 31 (NBER Working Paper No. 5589, 1996) (stating that firms have incentives "to reduce their tax liabilities through selective repatriations").

178. AULT ET AL., *supra* note 13, at 381.

179. Adams, *Taxation of Business*, *supra* note 58, at 193.

180. See Fairchild, *supra* note 42, at 10.

## IV. THE LEAGUE OF NATIONS MODEL INCOME TAX TREATY

A. *The Beginning of the Tax Treaty Process: The International Chamber of Commerce*

Many present-day scholars have noticed that the modern OECD model tax treaty is a direct descendant of the League of Nations model treaty developed in the mid-1920s, and some have recognized roots of the League effort in earlier work by the International Chamber of Commerce.<sup>181</sup> Newly organized in 1920, the International Chamber—an umbrella organization with ties to national chambers of commerce in many nations, including the United States—placed double taxation on the international diplomatic agenda and formulated an influential early approach to the problem. T.S. Adams, a member of the International Chamber's Double Taxation Committee, played an important role in the Chamber's effort. This prologue to the League's 1928 model treaty advanced resolution of many issues the League would grapple with and also sheds light on the priorities and assumptions subsequently carried by Adams to his position as U.S. representative to the League.<sup>182</sup>

The International Chamber adopted a resolution at its organizational meeting in Paris in 1920, calling for “prompt agreement between the Governments of the Allied countries in order to prevent individuals or companies from being compelled to pay a tax on the same income in more than one country.”<sup>183</sup> Given the

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181. See Ault, *supra* note 16, at 567–68 (stating the “ultimate result” of the League of Nations work on bilateral tax treaties was the OECD Model Treaty); see also Rosenbloom & Langbein, *supra* note 82, at 365–66 (observing that the League's choice of “classification and assignment” as the basic structure for bilateral tax agreements is used today in “virtually all tax treaties”). Although the role of the International Chamber has been neglected somewhat in recent scholarship, older accounts of the history of the tax treaty movement usually begin with the Chamber. See, e.g., HERNDON, *supra* note 103, at 19–40; Carroll, *supra* note 109, at 696 (noting the International Chamber's appeal to the League of Nations at the close of World War I to prevent double taxation).

182. The Chamber materials may be particularly instructive about Adams' approach to international treaty-making, because he was involved with the Chamber's effort almost from its outset. On the other hand, by the time Adams joined the League's double taxation project, the League had already produced a draft treaty and was invested in a particular approach to the double taxation problem. Thus, Adams' role within the League was somewhat more limited than his role in the Chamber's effort.

183. HERNDON, *supra* note 103, at 20 (quoting *Organizational Meeting of the International Chamber of Commerce* Res. 11 (June 28, 1919) INT'L CHAMBER OF COMMERCE). Several American delegates were apparently quite active in fashioning this resolution. See Memorandum No. 2: A Statement Upon the Attention That Has Been Given to the

key American presence, the 1920 resolution, to no one's surprise, envisioned an American-style solution to the double tax problem: taxation by both residence and source with residence deferring to source, while retaining a "right to claim the difference between the [source country] tax paid and the home tax."<sup>184</sup>

A year later, the International Chamber took up more detailed resolutions concerning double taxation.<sup>185</sup> Contrary to the American position, these resolutions distinguished the progressive and non-progressive elements of an income tax (or "super" and "normal" taxes), suggesting that the former should be levied based solely on citizenship, while the latter should be levied based on the place where income was "earned and collected."<sup>186</sup> Nations levying normal taxes were to exempt foreign-source income, or at least provide a credit for normal taxes paid abroad. Under this approach, taxing jurisdiction would turn on the nature of the tax in question—as we will see, an idea that reappears in the League effort.<sup>187</sup>

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Subject of Double Taxation in International Chamber Circles to Date 5 (undated and unsigned, but probably prepared for Adams in 1922 by John O'Connor, an official of the U.S. Chamber of Commerce and secretary of the double taxation committee) (available in T.S. Adams Papers, Yale University, Box 12, 1921-23 folder) [hereinafter 1922 Chamber Memo].

184. HERNDON, *supra* note 103, at 20 (quoting Resolution Number 11).

185. These resolutions were drafted by a committee comprised of representatives from the national chambers of commerce of Belgium, France, Great Britain, Italy, the Netherlands, and the United States. *See id.* at 21.

Between the 1920 and 1921 International Chamber meetings, the 1920 International Financial Conference in Brussels had taken up the call for international action to prevent double taxation. The Financial Conference was particularly concerned with the effect of double taxation on the ability of investors to make foreign investments, and specifically requested the League of Nations to take up the issue. *See id.* at 41-42.

186. *Id.* at 21-22. The distinction between progressive and non-progressive elements of an income tax may be less clear today than in 1921. The early American income taxes included both a "normal" tax, a flat tax applicable to all taxpayers, and a graduated surtax on high incomes. *See* WITTE, *supra* note 40, at 76-86. Under the 1921 resolutions, then, the United States would only levy its surtaxes on citizens—irrespective of residence or source of income—and its normal tax on domestic-source income. Schedular taxes, levies of varying rates—commonly used by European nations—on specific sources of income, were treated as "normal" taxes under this scheme.

187. In preparation for the 1921 meeting, the U.S. Chamber of Commerce consulted with Adams about the resolutions. Adams found the normal/super tax distinction to be "equitable and fundamentally in accord with sound theory," but suggested a number of modifications: 1) "where collected" should not be the basis for allocating income because it is easily manipulable; 2) source rules must be carefully worked out prior to submitting a plan to national legislatures; 3) because the surtaxes were so much heavier and more important in America than the normal taxes, it was inappropriate not to take source into

The 1921 resolutions also required nondiscrimination among residents, citizens, and foreigners. This nondiscrimination requirement has become a fundamental principle of tax treaties.<sup>188</sup> It is essentially a requirement that a country where income is sourced must not tax such income in a manner that discriminates against foreigners.<sup>189</sup>

After the International Chamber adopted the 1921 resolutions, the scheme was referred to the national chambers of commerce for suggestions for implementation. The U.S. Chamber asked Adams to head a special subcommittee on the subject.<sup>190</sup> Adams urged the International Chamber to endorse unilateral domestic legislation along the lines of the American FTC, to canvass the double taxation committees of the various national chambers of commerce for concrete examples of international double taxation, and to develop proposals for specific source rules to overcome the problems.<sup>191</sup> In 1922, Adams convened a meeting of the U.S. Committee to discuss specific reform proposals.<sup>192</sup> The Americans

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account in figuring the surtaxes, particularly with respect to American corporations doing most of their business abroad; and 4) super taxes should be levied not just on citizens, but also on resident aliens. See 1922 Chamber Memo, *supra* note 183, at 9-10. Adams' first three suggestions seem to flow out of problems with the U.S. domestic legislation, which Adams was also working on in 1921. Note that, as usual, Adams assumes source should be the ultimate basis of jurisdiction for the most important taxes.

188. See OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, art. 24, cl. 5, Sept. 1, 1992, reprinted in 1 Tax Treaties (CCH) ¶ 191 [hereinafter OECD Model Treaty.] For additional examples of nondiscrimination provisions in international tax treaties, see KEES VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW 76-123 (1986) (studying nondiscrimination clauses under United States, Netherlands, and OECD Model Convention tax treaties).

189. See Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 600 (1994).

190. See 1922 Chamber Memo, *supra* note 183, at 12. The members of the U.S. Committee were: Thomas S. Adams; Robert Grant, Jr. (Higginson & Co., London); W.F. Gephart (Vice President, First Nat'l Bank in St. Louis); Jerome D. Greene (Lee, Higginson & Co., New York); and John J. O'Connor (Manager, Finance Dep't, U.S. Chamber of Commerce). See *id.*

191. See Minutes of the Meeting of the Committee on Double Taxation of the International Chamber of Commerce 4 (Mar. 1, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921-1923 folder).

192. The U.S. Committee could not produce a list of concrete examples of double taxation and concluded that American companies, in fact, were subject to double taxation only quite rarely. See American Section of the International Chamber of Commerce Double Taxation Committee, Memorandum to Accompany Minutes of Meeting on Double Taxation (May 23, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921-1923 folder) [hereinafter American Section Memo]. In this regard, members of the Committee noted that the foreign tax credit was a "lifesaver" for American firms. See *id.*



decided not to adhere to the normal/super tax distinction of the 1921 resolutions. Rather, Adams' committee endorsed the following suggestions: 1) an American-style foreign tax credit; 2) income of shipping companies should be sourced to the nation of registry of the ship or to the nation in which "effective control" of the company was exercised; and 3) income from sales of manufactured goods abroad should be apportioned "by some fair and reasonable method" between the nation of manufacture and the nation of sale.<sup>193</sup> This was vintage Adams: the U.S. Committee rejected carving out a particular type of tax (here, the super tax) for exclusive citizenship or residence-based jurisdiction, preferring to rely on a foreign tax credit as a means of collecting residual residence-based taxation. The Committee regarded source-based taxation as primary, and it focused most of its efforts on incremental improvements to source rules.

The International Chamber synthesized the responses of the various national committees, and sent a resulting set of fifteen resolutions back to the national committees for comment.<sup>194</sup> These resolutions, slated for discussion and voting at the International Chamber's 1923 Congress in Rome, were to become the blueprint in many respects for all subsequent model treaty proposals (though the resolutions themselves were not in the form of a model treaty and in fact were not ultimately adopted by the Rome Congress principally due to opposition from the British). In particular, the Rome Resolutions incorporated a classification and as-

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The Committee also noted that other nations routinely failed to enforce certain taxes against foreign companies, and that many taxes that were enforced were easy to evade by use of certain organizational structures. *See id.*

193. The Committee preferred the tax credit over an exemption for reasons of progressivity and for concerns over some income escaping taxation altogether. *See American Section Report, supra* note 77, at 1-3. The shipping tax suggestion represented a very narrow, incremental reform. *See id.* at 2-3. The U.S. Committee conceded that theory did not dictate the registry/effective control rule, but argued that "[i]t is more important to secure the adoption of one uniform rule than to insist that an exactly correct theoretical rule be developed." *Id.* at 3.

194. These resolutions included the foreign tax credit, but not the shipping or sales apportionment suggestions of the U.S. Committee. For a list of the resolutions with a point-by-point summary of the American and British responses, see Committee on Double Taxation of the International Chamber of Commerce, Observations of the American and British National Committees with Regard to Resolutions Presented at the Rome Congress by the International Chamber's Select Committee on Double Taxation (Aug. 29, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923-1924 folder) [hereinafter Observations].

signment system for various categories of income (e.g., income from real estate to the nation where located, income from business divided among source nations according to the relative contributions of each).<sup>195</sup> The Rome Resolutions further foreshadowed the core principles of later model treaties by crystallizing the competing theories of taxation at residence and source (discarding the notion of citizenship), reaffirming the ideal of nondiscrimination between foreigners and residents, and proposing the allocation of business profits between source nations by some objective mechanism.<sup>196</sup> A witness to the later League of Nations meetings on double taxation observed that the Rome Resolutions set forth for the first time "a clear statement of the problem" and that it was with the terminology of the Rome Resolutions "that the battles of the [League] experts were waged in 1927 and 1928."<sup>197</sup> He added that while "no group of experts has accepted all these principles [of the Rome Resolutions] as sound . . . they have been used as the firm basis on which draft conventions have been built or actual treaties adopted."<sup>198</sup>

The 1923 Rome Resolutions by the International Chamber hedged on the allocation rules for interest and dividends, stating that these categories of income could be taxed by the nations of either payor or payee.<sup>199</sup> This, too, was an omen of things to come; a few years later, interest and dividend income would become the most contentious items in negotiations over the League's model treaty.

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195. See HERNDON, *supra* note 103, at 25-26. "Perhaps the most significant aspect of the League's work [on double taxation in the 1920s] was its ultimate choice of 'classification and assignment' as the basic structure for a model bilateral agreement. This structure is used today in virtually all tax treaties." Rosenbloom & Langbein, *supra* note 82, at 366 (footnote omitted). The choice was perhaps "significant," but by no means innovative. The Rome Resolutions and the source rules of the American Revenue Act of 1921 employed classification and assignment before the structure made its first appearance in a League report in 1923. For additional discussion of the 1923 Report, see *infra* notes 215-28 and accompanying text. The International Chamber was in close contact with the League on the double taxation issue throughout the 1920s, and the League was no doubt well aware of the structure of the Rome Resolutions. See HERNDON, *supra* note 103, at 24-25.

196. See HERNDON, *supra* note 103, at 24-25.

197. *Id.* at 28.

198. *Id.* The Rome Resolutions also envisioned a credit mechanism which would allow nations of residence to levy taxes on worldwide income at whatever rate or rates they choose, but only after an offset for taxes paid abroad on foreign-source income. See *id.*

199. See *id.*

Adams and the U.S. Committee generally approved the substance of the Rome Resolutions, but objected somewhat to the form. Specifically, the Americans opposed the systematic, *ex ante* allocation of all types of income to one jurisdiction or another; the Americans preferred more limited reforms tailored to address specific, concrete instances of double taxation.<sup>200</sup> Adams sensed that the Rome Resolutions would generate much controversy over the relative claims of countries of residence and source, and felt that the International Chamber should focus on generating consensus behind allocation rules that everyone could agree on.<sup>201</sup> If forced to take a position on the interest/dividend issue, however, the Americans came down on the side of the claim of the payor's country, i.e., taxation by source rather than residence.<sup>202</sup> Otherwise, the U.S. Committee generally approved the resolutions.<sup>203</sup>

In contrast, the British Committee vociferously opposed these resolutions. Its overriding objection was to the resolutions' emphasis on source-based taxation. The British argued that all taxation should be residence-based, mirroring the British system. The British, for example, opposed the Americans on interest and dividends, calling for taxation exclusively by the recipient nation.<sup>204</sup>

The British also made concrete their preference for residence-based taxation by writing their preference into a 1926 bilateral tax treaty with the new Irish Free State, which exempted nonresidents

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200. See American Suggestions, *supra* note 56, at 1-2.

201.

The American Committee entertains grave doubt whether real progress is likely to be made by an attempt to adopt abstract principles . . . . [T]here are, not one, but many principles or bases of taxation which are theoretically valid. . . . [D]ouble taxation can be . . . reduced to a minimum not by discussions of abstract principles, but by adopting . . . 'a few definite proposals of a comparatively restricted scope . . . .'

*Id.* at 1 (citations omitted).

202. See *id.* at 3. The American Committee arrived at this decision both as a matter of "principle" and "administrative convenience." *Id.*

203. Notwithstanding its general approval of the Rome Resolutions, the American Committee proposed technical modifications of some provisions and, for political reasons, suggested the complete removal of a provision creating an international board of appeal for tax issues. See *id.* at 5 ("The American Committee regretfully expresses its belief that there is no hope that the American federal or state governments would in any way permit their decision of actual tax cases to be affected by an international organization . . . ."). This sentiment has contemporary echoes in current debates over U.S. submission to the jurisdiction of international trade tribunals. See, e.g., David E. Sanger, *U.S. Rejects Role for World Court in Trade Dispute*, N.Y. TIMES, Feb. 21, 1997, at A1.

204. See Observations, *supra* note 194, at 2-3.

from taxation.<sup>205</sup> With the exception of this treaty, consummated with a dependant partner with little room to maneuver, the United Kingdom did not sign any comprehensive tax treaty until its 1945 treaty with the United States. It took that long for Britain to compromise its preference for residence-based taxation. That year Britain also first introduced a foreign tax credit applicable to nations outside the Commonwealth.<sup>206</sup>

In addition to its apparently principled view that taxation should be imposed by the country of residence, residence-based taxation was beneficial to the British fisc as a net exporter of capital. The fact that the United States, also a net capital exporter at that time, took a contrary position may be explained by a variety of factors: Adams' preference for source-based taxation as an appropriate means of implementing the benefit principle of taxation and administrative advantages; Adams' desire to avoid antagonizing debtor nations, who comprised the bulk of International Chamber members and whose support would be necessary to forge a successful international agreement; and the international balance of payments, which was overwhelmingly in the United States' favor and which permitted (perhaps even, in the interests of providing dollars for the purchase of U.S. exports and for the payment of U.S.-held debts, required) generosity in source rules to capital importers. Source-based taxation also represented a less significant departure from prevailing practices under the United States' tax law than in Great Britain—thanks in substantial part to Adams' work.

Thus, the battle lines were drawn, with the capital-exporting British rejecting any semblance of source-based taxation, and the capital-importing debtor nations of continental Europe, principally France and Italy, defending source-based taxation, along with the United States which, however, was expressing skepticism about the general direction of the International Chamber's project and certain specific provisions. Caught in this crossfire, the Resolutions failed to be accepted at the Rome Congress, and were referred back to the International Double Taxation Committee for further development.<sup>207</sup>

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205. See May, *supra* note 128, at 74.

206. See Vital, *supra* note 7, at 6.

207. See HERNDON, *supra* note 103, at 28–29.

In response to the issues raised by the American and British national committees, the International Committee proposed a compromise in November, 1923: the International Chamber would endorse the principle that in the long run all taxation should be residence-based, but, in the short run, nations should work toward developing bilateral treaties implementing the American-style foreign tax credit.<sup>208</sup> However, the U.S. and other national committees (notably the Italians) maintained their opposition to even this formulation of residence-based taxation.<sup>209</sup> The Americans continued their call for a more incremental, less theory-oriented approach to reform. The U.S. Committee argued that no progress would be made so long as the International Committee was in the business of trying to decide between residence and source-based taxation. The Americans asserted that the theoretical claims of both sides were valid and that, in any event, few nations could afford to give up entirely one of the two classes of taxes.

Prior to the 1923 Rome Congress, and arguably until 1925, the International Chamber exercised primary leadership in the movement against international double taxation. As we discuss in detail in the next section, in 1923 a committee of economists appointed by the League of Nations issued a major study of double taxation.<sup>210</sup> This report established a foothold in the international tax field for the League, but the Economists' 1923 Report did not exert a discernible influence on the International Chamber effort. The following two years continued the impasse in the Chamber's work. The body could not reconcile the varying agendas of the British, the Americans, and the continental allies.

During that time, the League of Nations appointed a committee of "technical experts," who were representatives of seven European governments, to study the double taxation problem.<sup>211</sup> In 1925, these experts produced a new report, less theoretical and

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208. See International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 1-2 (Nov. 24, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923-1924 folder).

209. See Annual Report of the American Committee on Double Taxation (c. 1924) (available in T.S. Adams Papers, Yale University, Box 12, 1923-1924 folder). For a discussion of the Italian position, see HERNDON, *supra* note 103, at 33-34.

210. See *infra* note 215.

211. See HERNDON, *supra* note 103, at 57. Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands, and Switzerland were the original countries represented. See *id.* at 58.

more favorable to source-based taxation than the 1923 Report.<sup>212</sup> Given the impasse in its own effort, the Chamber—with Adams' support—endorsed the 1925 Report.<sup>213</sup> After this endorsement, the League assumed a clear leadership position. The Chamber remained active, primarily through its representatives to the League's Committee of Technical Experts, but from then on the resolutions of its annual congresses largely functioned as endorsements of the League's work, rather than exercises of innovation and influence.<sup>214</sup>

### B. *The Torch Passes to the League of Nations*

As we noted, the League of Nations fired its opening salvo on double taxation with the widely noted 1923 Report by the "four economists": Professor Edwin R.A. Seligman of the United States, Sir Josiah Stamp of Great Britain, Professor G.W.J. Bruins of the Netherlands, and Professor Luigi Einaudi of Italy.<sup>215</sup> Seligman,

212. See Report and Resolutions Submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, League of Nations Doc. No. C.115 M.55 1925 II (1925) [hereinafter 1925 Report]. For further discussion of the 1925 Report, see *infra* notes 229–35 and accompanying text.

213. See HERNDON, *supra* note 103, at 36–37 (quoting resolutions of 1925 Brussels Congress of the International Chamber of Commerce). Adams' position on the 1925 Report is discussed *infra* note 236 and accompanying text.

214. For a discussion of the post-1925 work of the International Chamber on double taxation, see HERNDON, *supra* note 103, at 38–40.

215. Seligman and Stamp initiated a correspondence on the project in the fall of 1921, before it was even clear who the other members of committee would be. See Letter from Stamp to Seligman (Oct. 31, 1921) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). The two exchanged five lengthy "notes" which essentially became the first, and less important, half of the 1923 Report, dealing with the "burdens and barriers" caused by double taxation. All of these notes are contained in E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder. In the last of these notes, Seligman proposed the personal/impersonal distinction and the allocational mechanism of economic allegiance which, as we will see, became the foundation for the second part of the 1923 Report, recommending solutions for the problem of double taxation. See E.R.A. Seligman, Note on Sir Josiah Stamp's Note Transmitted on June 1st, 1922, at 6–8 (June 22, 1922) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder).

Professor Bruins did not weigh in with substantive comments until March 8, 1923, and then largely endorsed the approach sketched out by Seligman's note. See G.W.J. Bruins, Some Observations (March 8, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Senator Einaudi appears never to have contributed substantive comments before the 1923 Report was drafted.

The economists met in Geneva in March, 1923, to hash out the details of the Report. Einaudi was unable to attend the meeting. See SELIGMAN, *supra* note 81, at 140. After the meeting, Seligman had exclusive responsibility for editing the manuscript. See

the primary architect of the 1923 Report, was one of the few living Americans who could claim authority equal to Adams' on taxation.<sup>216</sup> Though similarly renowned as a tax authority, Seligman, a professor of political economy at Columbia, possessed a very different intellectual style than Adams. Adams—a man who held both academic and governmental posts throughout his life—was pragmatic, instinctual, sensitive to political and administrative constraints, and usually oriented toward the technical aspects of a problem. In sharp contrast, Seligman—a lifelong academic—was a grand, systematic thinker. Seligman did not ignore political and administrative constraints, but he preferred to focus on the big picture and avoid problems for which theory seemed inadequate.<sup>217</sup>

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Letter from Leon Dufour to E.R.A. Seligman (April 11, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Einaudi was given the opportunity to comment on this draft, but given the pressure of publishing deadlines, was told that his comments could not be incorporated into the text; he simply had the choice of signing on or not signing on to the draft. See Letter from Seligman to Einaudi (April 4, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Einaudi opted to sign on, although he had made virtually no input into the 1923 Report. See Letter from Einaudi to Seligman (April 7, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder).

In sum, the relative contributions of each of “the four economists” to the 1923 Report may be ranked, in descending order of importance: Seligman, Stamp, Bruins, and Einaudi. Significantly, Einaudi, the least important, was the only one of the economists from a net debtor nation (Italy). Seligman later expressed regret about this, fearing that the Report had been somewhat unbalanced in its presentation. See SELIGMAN, *supra* note 81, at 140.

216. For a discussion of Seligman's contributions to tax theory, see HAROLD M. GROVES, *TAX PHILOSOPHERS* 39–47 (1974); Hovenkamp, *supra* note 28, at 1004–09. Seligman (1861–1939) was a “foremost early proponent of the net income tax in the United States.” GROVES, *supra*, at 42. Like Adams, Seligman was an active member of both the National Tax Association and the American Economic Association. His influential text, *Essays in Taxation*, went through ten editions—“setting something of a record” for tax treatises. *Id.* at 40. Moreover, perhaps because this and his other books read so much like legal treatises, see Hovenkamp, *supra* note 28, at 1009, Seligman was said to be “[t]he Progressive Era economist with the greatest explicit influence on judicial policymaking.” *Id.* at 1004.

217. As an example, Seligman's book on double taxation devotes twenty-six pages to the history of thinking about the subject (beginning in the thirteenth century!) and thirty pages to an abstract taxonomy of taxes, but contains hardly a word about the allocation of business income among source nations. See SELIGMAN, *supra* note 81, at 32–57, 58–87. In contrast, Adams called the apportionment of business income “the most important technical problem in this field,” Adams, *Double Taxation*, *supra* note 3, at 121, and devoted much attention to the issue. In 1929, he obtained a grant from the Rockefeller Foundation to study the subject, a project on which he was still working at the time of his death in 1933. See Carroll, *supra* note 109, at 702.

Three great principles—all characteristically Seligman's—shaped the 1923 Report: 1) The classification and assignment of specific categories of income to source or residence should be determined by an objective test, "economic allegiance," whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income;<sup>218</sup> 2) Existing tax practices across the globe tended to underestimate the contribution of residence and to reflect a misguided belief in the naturalness and rightness of source-based taxation;<sup>219</sup> and 3) Progressive taxes on global income were fundamentally different than other taxes and ought to be the unique province of residence-based taxation.<sup>220</sup>

218. See 1923 Report, *supra* note 52, at 18–25. "The problem consists in ascertaining where the true economic interests of the individual are found. It is only after an analysis of the constituent elements of this economic allegiance that we shall be able to determine where a person ought to be taxed or how the division ought to be made as between the various sovereignties that impose the tax." *Id.* at 20. Seligman developed the concept of economic allegiance in his early, path-breaking text *Essays in Taxation*, in which he optimistically argued that "all modern governments" are shifting to economic allegiance as the basis of tax jurisdiction. See SELIGMAN, *supra* note 108, at 110–11.

219. See 1923 Report, *supra* note 52, at 40. The 1923 Report leveled the following attack on existing practices:

[I]f we recognised *facts* and were not prevented by historical accidents and administrative cowardice or frailty from taxing every man in one sum upon his total resources instead of getting at him piecemeal, the "origin" idea would be far less instinctive. It leads direct to the consequence that countries creditor on balance should bear the main cost of relieving double taxation, and countries debtor on balance should contribute nothing to that cost. Although countries hold so instinctively to this origin principle in theory (and actually apply it when the foreigner has *made* investments already and is helpless), they drop the principle at once as soon as the practical question of new investment arises. Can origin, then, be so sacred a principle?

During the past year or so loans have been sought, for example, in the British money market by numerous foreign borrowers; Australia, New Zealand, France, Brazil have each recently issued their securities yielding fixed rates of return. One and all are distinguished by a common feature, namely, the exemption of the yield from all taxation, present or future, of the borrowing country.

*Id.*

220. See *id.* at 45–46. The 1923 Report represents something of a repudiation of the American foreign tax credit: as a progressive tax on worldwide income, the American income tax, under the reasoning of Seligman and the other League economists, should not have deferred in any sense to foreign source-based levies. Seligman's support for exclusively residence-based taxation in the context of progressive levies on worldwide income, which is comparable to the International Chamber's 1921 treatment of "super taxes," rested on two distinct concerns. First, he wished to distinguish between taxes levied solely on the theory of "ability to pay" from other taxes. Seligman regarded "ability-to-pay" taxes as substantially different in kind and distinctly personal in nature; in these characteristics, Seligman found important implications for jurisdiction: "[I]f the tax is a purely personal one, much may be said for the contention that the country of domicile



The 1923 Report recommended a scheme that rested on a distinction between taxes on global income and all other taxes. The former were to be levied based solely on residence, while the latter were to be divided between residence and source based on the principle of economic allegiance, a principle that turned out to be quite generous to residence. Of most practical importance, the 1923 Report allocated taxes on interest and dividend income to the country of residence (that is, of the recipient).<sup>221</sup> Finally, na-

should have the right to impose the tax. The person is taxable as such where he is; the tax adheres to, or inheres in, the person." SELIGMAN, *supra* note 81, at 110. In contrast, he viewed other taxes as resting, at least in part, on a benefit theory—the taxpayer was being charged for the value of specific services rendered by the government. Jurisdiction for such taxes might more logically rest on the relative contributions of various nations to the production or consumption of the wealth being taxed. *See id.* In contrast, Adams regarded the notions of benefit and ability to pay as not easily separable. *See* text accompanying notes 54–64.

In addition to this argument, Seligman also rested his position on the inability of theory to produce clean allocations of business income. *See* 1923 Report, *supra* note 52, at 45 ("[I]t is almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie."). Seligman's principle of economic allegiance was designed to weigh the competing claims of residence and source, but was of little value when there was more than one claim, as when a product was manufactured in one country and sold in another. In the absence of any clear theoretical solution to the source problem, the 1923 Report considered the possibility of an arbitrary division between treaty partners: for example, when a product is made in one country and sold in the other, each nation is entitled to tax one half of the profits. *See id.* at 51. The 1923 Report held "out no hopes of this proving to be a smooth and practicable arrangement. It can only be approximate and not an instrument of that degree of sensitiveness and accuracy which developed communities expect." *Id.*

Seligman ultimately wished to safeguard the ability of nations to levy progressive taxes on the worldwide income of residents—an understandable goal, and one that was largely shared by Adams with respect to taxation of individuals—but transformed this principle into an absolute preference for residence-based taxation. Alternatively, progressive rates might be protected through an American-style FTC: worldwide income is assessed at progressive rates set by the nation of residence, but source nations pocket a share of the ultimate tax liability. Seligman, however, rejected the FTC as being too much generosity to ask of creditor nations. *See id.* at 41–42. But the approach he endorsed placed an equally great burden on debtor nations. In the end, Seligman simply seems to favor residence-based taxation, though not for the world-wealth maximization reasons often used to justify residence-based taxation today.

221. *See id.* at 39. Thus, interest and dividends going from an entity in one country to an individual in another could not be taxed at all in the source nation. The source nation was not entitled to levy a global income tax on foreigners and could not levy specialized withholding taxes on interest and dividends. The aversion of the 1923 Report to withholding taxes has been an enduring feature of international treaty making. One of the main functions of contemporary tax treaties has been to reduce such taxes. *See* Ault, *supra* note 16, at 568–69. This tendency has been subject to criticism as it builds into the tax treaty network an assumption of classical corporate taxation, i.e., separate taxation of

tions of residence were not expected to provide a credit for taxes paid abroad, even if such taxes were legitimately allocated abroad under the economic allegiance principle.

Modern scholars have characterized the 1923 Report as “the intellectual base from which modern treaties developed.”<sup>222</sup> The importance of the 1923 Report, however, has been overemphasized, although echoes of both its organizational structure and its rejection of source-based taxation of interest and dividends can be discerned in modern tax treaties. The legislation enacted in the United States in 1919 and 1921 and the work of the International Chamber were undoubtedly more important. One of the principal methods considered in the 1923 Report for the international taxation of income—the exemption of nonresidents from source country tax—has been of virtually no import outside of Great Britain.<sup>223</sup>

While the 1923 Report envisioned the development of a model tax treaty, it was not such a model treaty itself. An entirely different body of individuals was left with the task of drafting

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income at the corporate and the shareholder level. *See id.* If dividends were allocated to source, rather than residence, nations would be in a better position to implement integration with respect to foreign shareholders in a way that is consistent with the treatment of domestic shareholders.

Other allocation rules in the 1923 Report were less controversial and generally reflect the substance of the American rules from the 1921 Act, such as the allocation of the income from real estate to the nation where the real estate was located.

222. Ault, *supra* note 16, at 567; *see also* Avi-Yonah, *supra* note 8, at 1305–10.

223. *See* 1923 Report, *supra* note 52, at 47–48. The 1923 Report considered the exemption of nonresidents as having three points in its favor: 1) exemption accorded with the common practice of many nations in issuing tax-exempt securities to foreigners; 2) exemption also accorded with the “true economic interests” of developing countries; and 3) exemption permitted escape from the theoretical difficulties of division and classification. *See id.* at 48. The primary problem the economists saw with the exemption of nonresidents was that it systematically disadvantaged debtor nations. *See id.* The economists did recognize that such an exemption might thus have difficulty gaining widespread acceptance. *See id.* at 50. They saw no solution to this problem, although they did express some optimism:

[A]s semi-developed countries become more industrialised, with the resulting attenuation of the distinctions between debtor and creditor countries, the principle of personal faculty at the place of residence will become more widely understood and appreciated and the disparity between the two principles will become less obvious, so that we may look forward to an ultimate development of national ideas on uniform lines toward [the exemption of nonresidents], if not as a more logical and theoretically defensible economic view of the principles of income taxation, at least as the most practicable solution of the difficulties of double taxation.

*Id.* at 51. In sharp contrast, the exemption of foreign source income was rejected out of hand as being too much to ask of creditor nations. *See id.* at 41–42.

model treaties, and this group decided a number of pivotal issues barely addressed by the Report, such as the apportionment of international business income.<sup>224</sup> Moreover, an analysis of the minutes of subsequent meetings of the treaty drafters (the Committee of Technical Experts) suggests that the opinions of the 1923 Report were rarely discussed or consulted. The term “economic allegiance,” for instance, appears nowhere in the minutes of the 1927 meeting of the model treaty drafters, although controversy over allocation rules dominated that conference. As the discussion below makes clear, the preference for residence of the 1923 Report was hardly shared by the Technical Experts. Ultimately, Seligman himself came to regret that his chief co-contributors in drafting the 1923 Report had also come from creditor nations (Great Britain and the Netherlands), and feared that the Report had reflected the interests and assumptions of creditor nations overmuch.<sup>225</sup> Finally, although the classification and assignment structure of the Report has been termed “[p]erhaps [its] most significant aspect,”<sup>226</sup> this structure in fact merely reflected the structure of the earlier Rome Resolutions of the International Chamber of Commerce.

In sum, to characterize the 1923 Report as the fountainhead of tax treaties is to miss much of the story. The conventional account of the 1920s understates the precedents of the prior U.S. tax legislation, the work of the International Chamber of Commerce, and the subsequent role played by the League’s Committee of Technical Experts. It also overlooks the influence of tax treaties concluded prior to the League’s first model treaty, many of which also antedate the 1923 Report.<sup>227</sup> The first important multilateral tax treaty, signed at Rome in 1921 by Austria, Hungary, Italy, Poland, Yugoslavia, and Romania, as well as several contemporary

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224. The 1923 Report contained a brief “addendum” on apportionment, which failed to make any specific recommendation beyond noting that the experiences of the American states might prove instructive on the problem. *See id.* at 52–53. More generally, contemporaries found the Report to be “exasperatingly dull and difficult.” Letter from Lockhart to A. Holcomb 1 (July 16, 1923) (available in T.S. Adams Papers, Yale University, Box 14) (quoting with approval commentary by the *London Economist* on the 1923 Report). Another reader found the prescriptive section of the Report to be “inconclusive.” *See* Carroll, *supra* note 80, at 23, 25.

225. *See* SELIGMAN, *supra* note 81, at 141.

226. Rosenbloom & Langbein, *supra* note 82, at 366.

227. For an exhaustive description of these treaties, see HERNDON, *supra* note 103, at 10–18, 69–145.

bilateral treaties, employed the same type of classification and assignment scheme offered by the 1923 Report.<sup>228</sup>

Even before completion of the 1923 Report, the Fiscal Committee of the League of Nations had appointed a Committee of Technical Experts, comprised of representatives from seven European nations, to develop more practical suggestions for mitigating international double taxation.<sup>229</sup> In 1925, the Technical Experts presented a preliminary report, which, as noted above, was endorsed by the International Chamber of Commerce.<sup>230</sup> In essence, the 1925 Report was an effort to transform the pro-residence 1923 Report into a more balanced product. The underlying politics were obvious: while the 1923 Report was the product of creditor nations, a majority of the drafters of the 1925 Report came from debtor nations.<sup>231</sup> The compromise reached by these Technical Experts appropriated the 1923 Report's distinction between taxes on global income and other taxes (now denominated "personal" and "impersonal" taxes), but significantly changed the consequences of this distinction.<sup>232</sup> While Seligman and his colleagues had allocated personal taxes to residence and divvied up impersonal taxes between source and residence, the Technical Experts allocated personal taxes to residence and impersonal taxes exclusively to source.<sup>233</sup> This was an attempt to allow both creditor and debtor nations their special jurisdiction.<sup>234</sup> The Technical Experts made no pretension of theoretical coherence: "The division which we have established . . . has been made for purely

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228. See Carroll, *supra* note 80, at 29.

229. See Carroll, *supra* note 109, at 697-98.

230. See *supra* text accompanying note 213.

231. Participants included representatives from Belgium, France, the United Kingdom, Italy, the Netherlands, Switzerland, and Czechoslovakia. See Carroll, *supra* note 109, at 697-98.

232. For a reprint of excerpts of the 1925 Report, see SELIGMAN, *supra* note 81, at 179-82.

233. See *id.* at 60-61.

234. The Technical Experts justified source-based taxation on the grounds that:

New countries which need foreign capital for their general development desire to have a share in the taxes levied on income arising in their territory, and they are unwilling to leave them to the countries, often already very rich, which have provided the capital. Moreover, from a technical point of view, the collection of [source taxes], which does not involve the declaration by the taxpayer of his total income, is, generally speaking, easier and surer than in the case of the [personal taxes].

1925 Report, *supra* note 212, at 15.

practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact.”<sup>235</sup>

Adams, still active as chairman of the American Section of the International Chamber’s Double Taxation Committee, plainly felt that the 1925 Report represented a significant step forward from the 1923 Report. He wrote that the Technical Experts’ 1925 Report

is based upon the frank recognition of the fact that the income-tax serves two purposes; it must satisfy the claims both of the country of origin and the country in which the taxpayer resides; income will inevitably be taxed where it is earned and where the taxpayer resides. This is the first time perhaps that full recognition has been given to the valid claims of the country of origin and the country of residence.<sup>236</sup>

Seligman was less favorably disposed, although he tried to put a positive spin on the 1925 Report, contending that the Economists and the Technical Experts reached “virtually identical” conclusions in that both groups agreed to the “adoption of domicile [residence] as the primary and general criterion applicable to pure income taxes, and its modification by considerations of origin [source] in the case of” impersonal taxes.<sup>237</sup>

The 1925 Report also called for the League of Nations to consult representatives from additional governments and requested authorization to draft a model bilateral agreement.<sup>238</sup> As a result, the Committee of Technical Experts was expanded from seven to thirteen members by the time of its London conference in 1927.<sup>239</sup> The United States, among the nations sending a delegate for the first time in 1927, chose to be represented by T.S. Adams, who would play an important leadership role in the League proceedings of 1927 and 1928.<sup>240</sup>

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235. *Id.*

236. T.S. Adams, Untitled Comment Regarding the 1925 Report of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations 1-2 (July 5, 1925) (unpublished comment, available in T.S. Adams Papers, Yale University, Box 13, 1924-1925 folder).

237. SELIGMAN, *supra* note 81, at 150.

238. *See* HERNDON, *supra* note 103, at 60.

239. The new representatives came from Germany, Poland, Japan, Venezuela, Argentina, and the United States. *See id.* at 61.

240. In 1928, for instance, Adams was among the four most vocal delegates, speaking more than thirty times during the proceedings. *See id.* at 176.

A number of interests motivated the decision of the American government to become involved in the League effort. First, with only two creditor nations—Great Britain and the Netherlands—represented on the Committee, the American government feared that its interests as a creditor might be prejudiced by the ultimate structure of the model treaty. Second, the personal/impersonal distinction, while well suited to the tax systems of various European nations, was ambiguous in the context of the American system. For instance, the French employed a set of schedular taxes on eight categories of income plus a graduated general income tax—the former fit the definition of impersonal taxes and the latter, personal. But the American income tax was a far more unified affair; if the United States levied its entire tax based on residence, without obligation to grant credits for foreign source-based taxes—as apparently envisioned by the 1925 Report—the model treaty would actually contradict the spirit of the established FTC mechanism. Third, certain existing bilateral treaties were more favorable to foreign businesses than was the American FTC. In nations participating in such treaties, American businesses were sometimes disadvantaged. The League model treaty was viewed as a mechanism by which American businesses could obtain access to a more advantageous competitive position.<sup>241</sup> Fourth, the growth of American foreign trade and investment gave the United States an interest in uniform, favorable international tax rules. Fifth, the United States Chamber of Commerce and other authorities wished to see the League push toward a multilateral treaty, rather than a model bilateral treaty.<sup>242</sup> Finally, and perhaps most importantly, tax concessions obtained from trading partners might reduce the revenue cost of the FTC.<sup>243</sup>

The Technical Experts met in 1926, 1927, and 1928 to draft model tax treaties, with the 1928 treaties becoming the definitive League model.<sup>244</sup> Through day after day of long and contentious

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241. See *id.* at 63–64.

242. See *id.*

243. Mitchell Carroll, who assisted Adams at the 1927 and 1928 meetings as chief of the foreign tax section of the United States Chamber of Commerce, recalled four decades later that the American involvement was motivated by a desire to reduce foreign taxes on American business so as to reduce the costs of the FTC. See Carroll, *supra* note 109, at 693–94.

244. The Experts drafted separate treaties covering income taxation, succession duties, administrative cooperation, and judicial cooperation. This Article only deals with the income tax treaty, which was the primary focus of the Committee's work. Between the

negotiations, the Technical Experts generally tried to retain the essential compromise of the 1925 Report: personal taxation by residence and impersonal taxation by source. The most serious intellectual difficulty confronting the Technical Experts was the problem of translating this binary scheme into a workable treaty that could be employed by nations with vastly disparate fiscal systems. As we have said, the compromise worked well enough with a nation like France, which had two important, structurally distinct income taxes, but did not fit well with the American or British models of income taxation.<sup>245</sup> The American income tax, for instance, was comprised of a relatively flat normal tax levied on residents, citizens, and non-resident aliens (though, of course, foreign-source income of the latter group was exempt), a significantly graduated surtax on the same individuals, and a flat normal tax for corporations. Which were the impersonal taxes?<sup>246</sup>

For nations with “unified”<sup>247</sup> tax systems, the personal/impersonal distinction raised a specter of uncertainty in the model treaty. From the American perspective, the distinction presented a

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1927 and 1928 meetings, representatives from fourteen additional governments were added to the Committee’s membership, including delegates from the Soviet Union and many of the nations carved out of the former Austro-Hungarian Empire. For a complete list of attendees, see HERNDON, *supra* note 103, at 175.

The drafting work of 1926–1928 culminated in the adoption of three different model income tax treaties, denominated Draft Conventions No. I-a, I-b, and I-c. Unlike Draft Convention No. I-a, neither I-b nor I-c maintained the distinction between impersonal and personal taxes. Draft Convention No. I-b assigned priority of taxation to the state of domicile, while Draft Convention No. I-c incorporated elements of both I-a and I-b. See 1928 Report, *supra* note 5.

245. Post-war France levied taxes on eight specific categories of income with rates ranging from 6% to 18%, depending on the category and size of the income, as well as a global income tax with graduated rates ranging from 1.2% to 30%. See HERNDON, *supra* note 103, at 63. Everyone agreed that the schedular taxes were impersonal and the global tax was personal. See *id.*

246. A number of alternatives presented themselves. For instance, the American “normal” tax might be treated as impersonal, though levied on the global income of residents and citizens and the full amount of American-source income of nonresident aliens. See Carroll, *supra* note 120, at 13–14. Alternatively, the income tax as a whole might be treated as impersonal when levied on nonresident aliens—this was the view favored by Adams. See Adams, *Draft Convention*, *supra* note 123, at 1. Meanwhile, Seligman, the inventor of the personal/impersonal distinction would probably have characterized only the corporate income tax as impersonal. See SELIGMAN, *supra* note 81, at 105–06 (classifying business taxes as “semi-personal,” a category which, like a strictly impersonal tax, is “primarily a tax upon a thing”).

247. We use the term “unified” rather than the more common “global” in an effort to avoid (further) confusion. Such a system generally is contrasted to a “schedular” system. See AULT ET AL., *supra* note 13, at 155.

substantive risk: if all or substantially all of the American tax system were classified as personal, then the United States would lose the right to tax based on source, and the U.S. income of non-resident aliens would be free of U.S. tax liability.<sup>248</sup> The distinction placed similar, though not identical, pressures on the British system, but given the British commitment to residence-based taxation, the British representatives were less concerned about losing jurisdiction over British-source income of nonresidents. From the British perspective, the problem was that the personal/impersonal distinction threatened the international competitiveness of British business. British residents doing business abroad would be subject to the full brunt of British income taxes, which were strictly residence-based, plus the source-based portion of foreign income taxes. Competitors from other nations, however, while subject to the same foreign source-based foreign levies, would either be exempt from home country taxes on their foreign source income or, in countries that allowed a credit for foreign taxes, would face at most a portion of their home income taxes. Such a situation would have put pressure on Great Britain to grant a foreign tax credit.<sup>249</sup> Indeed, prior to the beginning of American involvement in 1927, the British representative and the other Experts had discussed a number of compromise measures.<sup>250</sup>

International competitiveness was of less immediate concern to the United States because the U.S. already protected its businesses

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248. The disparities in the importance of the American surtaxes and normal taxes contributed to the problem. One possibility that was floating in the American delegation was to have the American normal tax classified as impersonal, and thus levied on the basis of source. See Carroll, *supra* note 120, at 13-14. This compromise would have mirrored the earlier system proposed by the International Chamber. See *supra* notes 286-87 and accompanying text. The objection in 1927, as during the Chamber process, was that the American normal tax, at 5%, represented too small a share of the overall American fiscal system. The personal/impersonal compromise would have left the American system far more residence-based than the U.S. delegation desired. If the normal tax were raised to 10%, the analysis might have been different, see Carroll, *supra* note 120, at 14, but apparently such a change to domestic tax laws was beyond serious contemplation.

249. The threat posed to Britain by the personal/impersonal distinction is discussed in Carroll, *id.* at 11-12.

250. Generally, these measures involved concessions in the source rules associated with impersonal taxes. Perhaps the most important of these was the removal of the right of payor nations to tax outgoing interest, which appeared in the 1927 draft, but was removed from the 1928 draft. See HERNDON, *supra* note 103, at 186-87. At the same time, the British were wrangling these concessions, they were also conceding that they would need to grant an FTC to residents for taxes paid abroad on foreign-source income. See *id.* at 218-19.



with an FTC. However, the loss of much jurisdiction over domestic-source income of nonresidents would have exerted fiscal pressure on the FTC. Moreover, if U.S. tax treaties stated that the U.S. income taxes should be residence-based, the political viability of the FTC, which effectively surrendered much residence-based taxation, might have been threatened.

When Adams arrived on the scene, his primary goal was to emphasize the uncertainty surrounding the personal/impersonal distinction so as to protect the ability of the United States to tax nonresidents on U.S. source income. He argued that “[t]he recent discussions of the Committee of Experts make it plain that the items ‘personal tax’ and ‘impersonal tax’ are ambiguous.”<sup>251</sup> Accordingly, he proposed to do away with the personal/impersonal distinction, replacing it instead with the tautological categories “origin taxes” and “residence taxes.”<sup>252</sup> Origin taxes were defined as those levied on non-residents based on source, while residence taxes were those levied on residents based on worldwide income.<sup>253</sup> Under Adams’ plan, nations would be permitted both forms of taxation—thereby protecting the right of the United States to levy both its normal and surtaxes on nonresidents—and double taxation would be avoided by virtue of credits against residence taxes for origin taxes paid abroad.<sup>254</sup> In essence, Adams’ plan simply would have written the American international tax system into a model treaty. Even the source rules of Adams’ plan were substantially the same as those of existing U.S. legislation.<sup>255</sup>

Adams introduced his proposal mid-way through the 1927 meeting. Given the late date, Adams did not press for a formal vote on the proposal, but succeeded in keeping it before the Committee for future consideration.<sup>256</sup> By the time it met again, in

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251. Adams, *Draft Convention*, *supra* note 123, at 1. Adams’ concern about the uncertainty of the terms was also echoed by outside critics. See, e.g., May, *supra* note 128, at 72 (“The practical value of the distinction [between personal and impersonal taxes] has been questioned, and it must be admitted that the modern income tax is usually in some respects a personal and in other respects an impersonal tax.”).

252. See Adams, *Draft Convention*, *supra* note 123, at 3.

253. See *id.*

254. See *id.*

255. See Carroll, *supra* note 120, at 29.

256. Minutes of the Fifth Meeting of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations 9–10 (Apr. 8, 1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder).

Geneva in 1928, the Committee had accepted the idea that disparities in fiscal systems would require the Experts to draft more than one model treaty.<sup>257</sup> Accordingly, the Geneva conference, which marked the conclusion of the work of the Technical Experts, adopted three different treaties: one for use by pairs of nations with mixed income taxes (Draft I-a—a slightly modified version of the 1927 draft), one for pairs with unitary systems (I-b), and one for pairs with dissimilar systems (I-c).

Adams and the British representative drafted I-b, which ultimately reflected a combination of the American and British positions.<sup>258</sup> The treaty made no mention of the terms “personal” and “impersonal,” instead articulating a general preference for residence-based taxation (the British position).<sup>259</sup> But Model I-b also permitted source-based taxation on certain classes of income, most notably business income.<sup>260</sup> The treaty also called for nations to grant credits to residents for foreign-source taxes paid abroad—the Adams trademark.<sup>261</sup> In sum, the treaty substantially addressed Adams’ primary concerns, protecting U.S. taxation of most categories of U.S.-source income. Models I-b and I-c also pointed toward the future direction of the international treaty movement, in their rejection of the personal/impersonal distinction and in the move toward residence-based taxation of interest and dividends.<sup>262</sup>

If the great intellectual task of the 1927 and 1928 meetings was the adjustment of the 1925 Report to the realities of the world’s fiscal systems, the great political difficulty was mediating the continuing tension between creditor and debtor nations. The most visible sign of this tension was agitation, primarily from the British representative, for allocation of more income to residence countries.<sup>263</sup> The British desired most to eliminate source-based taxation of interest and dividends, a position that sparked the most bitter exchanges during the conferences.<sup>264</sup> Although not success-

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257. See HERNDON, *supra* note 103, at 174-75.

258. See *id.* at 235.

259. See *id.* at 235-39.

260. See *id.*

261. See *id.* at 238-39.

262. See *id.* at 235-41.

263. The locus of this conflict (at least in 1927 and during the 1928 discussion of I-a) was the source rules applicable to impersonal taxes. Although impersonal taxes were supposedly only to be levied based on source, this principle was never sacred, and various exceptions grew up over time.

264. See *id.* at 240. In one such exchange, the Belgian Expert accused the British

ful in changing the source rules of I-a, the British arguments prevailed in I-b and influenced I-c.<sup>265</sup>

Although the United States, like Great Britain, was also a creditor nation, the U.S. was less concerned with interest and dividend rules than with business income. On the latter issue, the American preference for source-based taxation did not conflict with its interest in reducing taxes levied by other nations on American businesses. While Adams wanted both to improve the competitiveness of American businesses and to reduce the revenue cost of the FTC, his primary concern was to rationalize source-based taxation to preclude taxation by all conceivable sources.<sup>266</sup> Aside from elimination of the personal/impersonal distinction, this seemed to be the chief goal of the American delegation. Mitchell

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Expert of putting his nation's economic interests ahead of the general interests, and claimed that the British position would reduce debtor nations to "economic servitude." See Minutes of the Tenth Meeting of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, 6-7 (Apr. 12, 1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder).

265. Under Draft Treaty I-c, interest and dividend income were allocated to the nation of the recipient (the British position); however, the nation of the payor was entitled to levy a withholding tax on the income at the source, in which case the recipient nation was expected to exempt the income or provide a credit for the foreign tax. See HERNDON, *supra* note 103, at 239-40. This approach seems the closest of the three to the subsequent development of the international model treaty by the OECD. The current version of the OECD Treaty sources interest and dividends to the nation of the recipient, but permits limited withholding taxes by the payor-nation. See OECD Model Treaty, *supra* note 188, art. 10-11. Today the U.S. Model Treaty differs from the OECD Treaty, and more closely resembles Draft Treaty I-b, by prohibiting payor-nation withholding taxes. See RICHARD DOERNBERG, INTERNATIONAL TAX IN A NUTSHELL 101 (1993).

With respect to most other source rules, the three League models of 1928 were in closer agreement. For instance, income from immovable property was sourced to the nation where the property was situated, while wages and salaries were to be taxed in the nation in which the employment was carried out. The current OECD Treaty mirrors most of these consensus source rules of 1928, although there have been some technical modifications. For instance, income from immovable property is sourced to the place where situated (Article 6) and the remuneration for "dependent personal services" depends on the place of employment (Article 15), but the current model distinguishes "independent personal services," the income from which is sourced to residence (Article 14). Similar provisions are found in Articles 14 and 15 of the U.S. Model Treaty.

As noted earlier, Adams' 1921 Act sourced dividends and interest to the nation of the payor (which is still the position of U.S. domestic law). The 1921 Act, however, foreshadowed other aspects of the 1928 Model Treaties, including their treatment of income from immovable property and personal services. See Revenue Act of 1921, ch. 136, § 217(a), 42 Stat. 227, 244. Again, these source rules generally remain intact in current U.S. law. See I.R.C. §§ 871(b), 897(c) (1994).

266. See Carroll, *supra* note 109, at 693-94.

Carroll, Adams' assistant in 1927 and 1928, recalled the growing problem facing American businesses abroad:

After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States firm on profits from advertising its wares and receiving mail orders from customers in its territory.

In the early 1920s, the British Board of Inland Revenue sought to impose liability . . . [on] sales through a local commission agent . . . [e]ven if the nonresident and his British intermediary took pains to conclude the contract abroad . . . .<sup>267</sup>

In the face of this concern with expanding jurisdiction over business income, the Committee of Technical Experts adopted the "permanent establishment" safeguard: only the nation in which the permanent establishment of a business enterprise was located could legitimately levy source-based taxes on the enterprise's income.<sup>268</sup> If the enterprise possessed permanent establishments in the territories of both treaty partners (say a head office in one nation and a branch office in the other), then both partners were entitled to tax the enterprise's income, using some method of apportionment agreed to beforehand.<sup>269</sup> The 1928 treaties expressly excluded independent sales agents from the definition of "permanent estab-

267. *Id.* at 700. A business representative described the problem as follows:

Any plan which seeks to avoid double taxation by subjecting business income to taxation only in the country where made . . . necessarily raises an issue as to where income is earned. Further, it would be quite possible to have an international correlation of income tax laws such as would theoretically eliminate double taxation and yet the same would continue to exist under cover because of conflicting and overlapping theories of allocation by which two or more countries might consider the same income earned within their borders.

Letter from Elliott, Law Department of International Harvester Company, to T.S. Adams 1 (May 8, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921-22 folder).

268. Permanent establishments were defined as:

The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.

HERNDON, *supra* note 103, at 195 (quoting Draft Convention No. I-a, art. 5, *reprinted in* 1928 Report, *supra* note 5, at 7-9).

269. *See* HERNDON, *supra* note 103, at 196.

lishment.”<sup>270</sup> The United States, a major net exporter of goods in the 1920s, thus relieved its businesses of much foreign taxation with the permanent establishment rule, while preserving the spirit of source-based taxation. Adams later declared that the permanent establishment rule was “the most important field of agreement” among the Technical Experts.<sup>271</sup> Indeed, the “permanent establishment” threshold for business taxation has proven remarkably durable, remaining a central component of both the OECD (Article 7) and U.S. (Article 5) Model Treaties. By contrast, under U.S. statutory law, a foreign resident is subject to U.S. taxation on income that is “effectively connected” with a U.S. trade or business, regardless of whether a permanent establishment is involved.<sup>272</sup> Under the 1921 Act, a nonresident alien could become liable for U.S. taxes merely for conducting a sale in the United States.<sup>273</sup>

Although the League did not at this time take up the apportionment of business income in a serious way, it did introduce the principle of arm’s-length allocation in the context of its permanent establishment clause.<sup>274</sup> With the notable exception of the United States, which had endorsed such a method in the 1921 Act, this method was until then unknown.<sup>275</sup>

270. *See id.*

271. Adams, *Double Taxation*, *supra* note 3, at 108.

272. *See* I.R.C. §§ 871(b), 882(a) (1994).

273. *See* Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244–45.

274. *See* Draft Convention No. I-a, art. 5 cmt., *reprinted in* 1928 Report, *supra* note 5, at 12 (“The words ‘*bona fide* agent of independent status’ are intended to imply absolute independence, both from the legal and economic point of view. The agent’s remuneration must not be below what would be regarded as a normal remuneration.”).

275. One imagines that Adams would have also been sympathetic to a formulary system such as the one he helped develop in Wisconsin; he seems to suggest as much in an essay written shortly before his death. *See* Adams, *Double Taxation*, *supra* note 3, at 121–22. Moreover, Adams’ 1921 Act called for the Commissioner of Internal Revenue to develop “formulas of general apportionment” to allocate income from sources partly within and partly without the United States, such as income arising from the manufacture of goods in one country and sale in another. *See* Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244–45. This aspect of the 1921 Act source rules seems to have been somewhat less durable than others: current U.S. law employs a direct method of apportionment via the “effectively connected” test, rather than an indirect formulary apportionment. *See, e.g.*, AULT ET AL., *supra* note 13, at 435.

Regardless of his own personal preferences, Adams did not press the apportionment issue during the 1927 and 1928 League conferences, perhaps in recognition of the great disparity in existing systems of apportionment. For a description of then existing systems, see Carroll, *supra* note 109, at 704–05. Surely, taking up the problem of apportionment would have threatened the fragile set of compromises reflected in the

V. LESSONS ABOUT INTERNATIONAL TAX POLICY FROM  
ADAMS' "ORIGINAL INTENT"

The common attribution of the foundations of U.S. international tax policy to the 1923 Economists' Report—Seligman's work—has exaggerated Seligman's importance and downplayed Adams' central role. It also has offered comfort to today's analysts who quest for discovery or refinement of a unifying theory of international taxation as the fountainhead of answers to current questions of international tax policy, and in some instances has provoked mistaken claims of an unbroken lineage of a U.S. policy emphasis on residence-based over source-based taxation, which we have shown here to be false. In sharp contrast, T.S. Adams regarded the claims of the country of source as primary to the claims of the country of residence, particularly in business taxation, and explicitly rejected the potential usefulness of any grand theory, of what he called "broad dogmatic generalization" in making international tax law.

A. *Theory vs. Practical Wisdom*

In studying Adams' work on international taxation, one labors in vain to find a clear First Principle from which his tax proposals flowed. He regarded "[i]dealism as a striving after perfect truth or justice," as "mostly a nuisance," which "does more harm than good, if injected into practical affairs."<sup>276</sup> He regarded John Stuart Mills' observation that "[t]he ends of government are as comprehensive as those of the social union" as the "deepest truth applicable to taxation and taxmaking."<sup>277</sup> Adams was also clear in his view that "[d]ouble taxation cannot be brought within reasonable limits by constitutional restraints or by theories of jurisdic-

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model treaties of 1928. The League subsequently published a model Allocation Convention in 1935. *See id.* at 705–06. This Convention called for permanent establishments to be taxed based on the income that each would have earned hypothetically were it a distinct and separate enterprise. *See id.* This standard has largely been carried forward into Article 7 of the current OECD Treaty.

For an extended treatment of the allocation problem circa 1932, see Mitchell Carroll, *A Brief Survey of Methods of Allocating Taxable Income Throughout the World*, in LECTURES ON TAXATION 131 (Roswell Magill ed., 1932).

276. T.S. Adams, *Ideals and Idealism in Taxation*, 18 AM. ECON. REV. 1, 5 (1928) [hereinafter Adams, *Ideals and Idealism*].

277. *Id.*

tion resting on the essential nature of particular taxes.”<sup>278</sup> Instead, he viewed the economic self-interest of nations and private actors as the controlling political force. Adams generally avoided reasoning deductively from simple starting assumptions to concrete policy prescriptions. His work reflected a subtle balancing act involving a large number of interrelated imperatives and instincts.

Adams strove to achieve fair, nondiscriminatory taxation; greater exports of American goods and capital; protection of U.S. taxation of U.S.-source income; maximally administrable taxes (which to him generally implied source-based taxation); some protection of progressive rate structures; elimination of inefficient tax avoidance devices; maintenance and export of the American FTC mechanism; and clarity and international uniformity in international rules for determining the source of various categories of income. Adams’ work was an amalgam of principled idealism, national self-interest, and political and administrative practicality. Adams may fairly be criticized for a lack of theoretical coherence and for his inattention to the kinds of economic principles that dominate debate today, such as worldwide wealth maximization, capital export neutrality, and capital import neutrality.<sup>279</sup>

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278. Adams, *Double Taxation*, *supra* note 3, at 124.

279. Reading Adams’ works today, it may seem odd that Adams was even considered an economist during his own time. In fact, Adams was an influential economist who was awarded with positions of leadership by his colleagues. *See supra* notes 28, 42 and accompanying text. Adams’ writing focuses far less on abstract reasoning and the models of classical economics than on institutional structure and capacity, technical aspects of drafting and implementing legal regulations, and the empirical study of actual practices of real people. These interests and methods made Adams a participant in what Herbert Hovenkamp has called “the first great law & economics movement,” which he dates to the late nineteenth and early twentieth centuries. *See Hovenkamp, supra* note 28, at 994. During the late nineteenth century, when Adams was a student, economics was in a state of turmoil, as the discovery of marginal analysis had undermined the assumptions of British Classicism and the arrival of German Historicism in America had provided new perspectives on the social sciences. *See id.* at 995–96. There was “uncertainty within the economic community as to whether economics was a behavioral, historical, or a purely formal science.” *Id.* at 996. Henry C. Adams, a professor at Johns Hopkins at the same time T.S. Adams was a graduate student there, played a pioneering role in bringing the German approach to America, rejecting laissez-faire dogma in favor of highly particularized, industry-by-industry analyses of the appropriate role of government regulation. *Id.* at 997–98. Concurrently, the founders of institutionalism were bringing to economics the understanding that people are not simply rational wealth-maximizers, and that “ideology, technology, history, habit, previous investment, and lack of information or difficulty in communication drive both individual human motivation and institutional structure.” *Id.* at 1014. T.S. Adams clearly absorbed the lessons of the institutionalists. Indeed, the American Economic Association, of which T.S. Adams was a long-time member and ultimately

Yet Adams' lack of theoretical pronouncements was no accident; he was not ignorant of the theory of his day. Thomas Sewall Adams expressly rejected the utility of theory in his fight against international double taxation, regarding theory as endlessly malleable.<sup>280</sup> He considered it child's play to manipulate theory to advance parochial interests and private agendas. He insisted, "[p]rove to Jurisdiction *A* that a given tax, *X*, logically belongs to Jurisdiction *B*, and—if self-interest so dictates—*A*, in the long run, will develop some subtle modification of tax *X* which the accepted theory of jurisdiction assigns to *A*."<sup>281</sup> In particular, Adams criticized Seligman's theory of economic allegiance:

As a theoretical guide through the tax maze which we are discussing, economic authorities whom both the business and the scientific worlds properly respect, have sponsored a theory of "economic allegiance." I find this theory, I regret to say, little more than a generalized label covering a number of separate judgments which the authors of the theory have reached about the expedient place to tax certain persons or transactions, conclusions based upon diverse considerations which unfortunately vary with the business habits and stage of development of the various countries of the world. With most of the judgments under this theory I happen to agree. But their justifications are practical not "scientific," and "economic allegiance" is distinctly different in different states. The theory leads many of its advocates to endorse exaggerated claims concerning the rights of the jurisdiction of domicile. These exaggerated claims rest partly on the fact that their advocates are citizens of creditor states. In part also, they reflect an unconscious rationalization of the democratic urge towards progressive taxation. People come to believe that the rich ought to pay higher rates of taxation than the poor. And then they build up ambitious theories of taxation or tax

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president, was actually founded in 1885 as a forum for institutional economics. *Id.* at 1021–22. Since Adams' time, of course, the uncertainty over the nature of economics as a discipline has been resolved in favor of "formal science." The oddity today of considering Adams an economist reflects the shift of the discipline's field of vision. *See id.* at 1056.

280. In other contexts, too, Adams took something of an agnostic position on grand theoretical systems. In the conclusion to a textbook on the heated labor problems of his day, Adams wrote: "[W]e may be moving towards socialism or we may be moving towards anarchism, but whithersoever we do move, socialism, anarchism and every other 'ism' must stand or fall on the wisdom of its immediate proposals." THOMAS SEWALL ADAMS & HELEN L. SUMNER, *LABOR PROBLEMS* 546 (1905).

281. Adams, *Double Taxation*, *supra* note 3, at 125.



jurisdiction whose only inner logic is that they serve the will to tax progressively . . . .<sup>282</sup>

The dispute between Adams and Seligman over economic allegiance was but one of a series of similar disagreements between the two scholars over the proper role of theory in tax law-making. For instance, Seligman, though subsequently a drafter of New York's state income tax, initially disapproved of state income taxes because of the difficulty of apportioning business income among different states involved in a transaction.<sup>283</sup> Adams, however, argued that states should not be deterred for that reason. He insisted that reasonably fair—if not theoretically sound—apportionment formulas could in fact be worked out by the states.<sup>284</sup> In a similar vein, Adams responded to Seligman's criticism of the Wisconsin apportionment scheme: "[It] can never be 'absolutely' correct because there is nothing absolute about it, but it can be 'fair and reasonable.'" <sup>285</sup>

It is no surprise that Adams rejected all *a priori* jurisdictional claims and regarded theory as generally inconclusive:

As regards the proper place or jurisdiction in which income or property should be taxed, there are, not one, but many principles or bases of taxation which are theoretically valid. Under the income tax, for illustration, some tax may properly be collected in the country where the taxpayer resides, some in the country of which he is a citizen, some where the income is realized or received, some where the income is earned—and the process of earning frequently extends over two or more countries. All of these places or jurisdictions may be different and in all of them, theoretically, a valid tax may be imposed.<sup>286</sup>

Adams was clear that taxation based solely on residence was neither practical nor politically realistic. He regarded residence as a particularly impractical guide to the taxation of business income:

Here is a corporation whose owners live in jurisdiction A, whose factory is in jurisdiction B, whose main offices are in jurisdiction

282. *Id.* at 126.

283. See EDWIN R.A. SELIGMAN, *THE INCOME TAX* 647–49 (1911).

284. See T.S. Adams, *Annual Address of the President, Sept. 9, 1914*, 8 NAT'L TAX ASS'N PROC. 199, 200 (1914).

285. Letter from T.S. Adams to E.R.A. Seligman 2 (Mar. 30, 1914) (available in E.R.A. Seligman Papers, Columbia University, Misc. Correspondence Section).

286. American Suggestions, *supra* note 56, at 1.

C, and whose principal sales department is in jurisdiction D. It needs no discussion to prove that each of these jurisdictions will demand and in the long run will succeed in collecting some tax, although the personal income tax would ordinarily be collected in only two of these jurisdictions, and many advocates of the income tax would confine the collection to jurisdiction A, in which the individual owners reside.<sup>287</sup>

Adams regarded the problem of the taxation of international shipping profits as presenting an important instance of the general difficulty:

The taxation of a foreign shipping company under a national income-tax law is a particularly difficult thing, as will appear if you stop to think of the problem presented. A tramp steamer comes from abroad and stopping, perhaps only a few days, takes a lucrative cargo from New York, and moves off, perhaps not touching again at the port for eighteen months or more. The allocation of shipping profits to particular ports is intrinsically difficult.<sup>288</sup>

Under these circumstances, shipping companies face a significant threat of multiple taxation. With no natural means of allocation, many nations could potentially overreach and tax a disproportionately large share of the company's profits. In fact, however, in the early 1920s little—though not zero—double taxation of shipping companies actually occurred. Notwithstanding the legal authority to tax foreign ships, in most countries “[t]he prevailing custom is to tax only in the country of registry . . . .”<sup>289</sup> Thus, shipping profits represented a problem for theorists, but not for businesses or governments. Adams moved to translate custom into law, and by so doing to prevent the potential double taxation from becoming actual. He refused to be distracted by the theoretical difficulties of the problem:

To prevent this injustice [double taxation] the easiest course would seem to lie in formally adopting . . . the principle now for the most part followed by the leading maritime nations of the world. It is more important to secure the adoption of one uni-

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287. Adams, *Taxation of Business*, *supra* note 58, at 189.

288. Adams, *Aspects of Double Taxation*, *supra* note 65, at 194.

289. American Section Memo, *supra* note 192.

form rule than to insist that an exactly correct theoretical rule be developed.<sup>290</sup>

Adams pushed both the International Chamber of Commerce and the League of Nations to encourage nations only to tax shipping companies based on registry or on the company's real center of management, and also to extend this allocational rule to the fledgling air transportation industry.<sup>291</sup> The 1928 League drafts reflected Adams' position,<sup>292</sup> and, so popular was the proposal, virtually all maritime nations incorporated the shipping rule in their own domestic legislation.<sup>293</sup>

In assessing the lessons of the shipping rule, Adams observed:

This substantial achievement in the movement . . . does not represent an application or result of any fundamental theory of "economic allegiance" or natural law of jurisdiction. On the contrary, it is in conflict with the principle of allocation recognized by a large majority of the leading tax experts of the world: the principle that in allocating the profits of a business enterprise doing business in more than one country, an appropriate share of the profits shall be assigned to each country in which the enterprise has a "permanent establishment". . . important shipping companies usually have permanent establishments in each country from which they regularly derive a substantial volume of traffic. . . .

The immunity from double (income) taxation which the maritime shipping industry enjoys is a direct result of . . . the International Chamber of Commerce, working along lines of administrative "least resistance."<sup>294</sup>

Indeed, "working along lines of administrative least resistance" seems a nice description of Adams' typical *modus operandi*, and distinguishes him from theory purists of his day and ours. Adams' skepticism of theory did not, however, translate into unrestrained cynicism. He did see an important role for "ideals and idealism in taxation."<sup>295</sup> For Adams, the key to good tax law and good tax

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290. *Id.* at 2-3.

291. *See id.*; *see also* HERNDON, *supra* note 103, at 207.

292. *See* HERNDON, *supra* note 103, at 205-07.

293. *See* Adams, *Aspects of Double Taxation*, *supra* note 65, at 194-95.

294. Adams, *Double Taxation*, *supra* note 3, at 106-07.

295. This phrase is the title of an eloquent essay by Adams, *see* Adams, *Ideals and Idealism*, *supra* note 276. In the essay, Adams called on economists to adopt a more realistic attitude towards their role in the formulation of tax laws:

treaties was the principle of “enlightened self-interest”—finding the places where ideals and practical politics coalesced. He insisted that “we shall eliminate, in the long run, only that measure and degree of multiple taxation which the competing jurisdictions believe harmful to themselves.”<sup>296</sup> Of the prospects for treaties restraining double taxation, Adams wrote: “The surprising and optimistic phenomenon, however, is the number of agreements which an enlightened self-interest makes possible, when the matter is approached on practical grounds.”<sup>297</sup> Given the necessary constraints of self-interest, Adams envisioned limited treaties representing incremental reforms. During the Chamber of Commerce effort, Adams argued:

[a]ctual progress in the elimination of double taxation can best be secured at the present time by endeavoring to agree upon, and after such agreement, to secure the adoption by the principal commercial nations, of a few definite proposals of a comparatively restricted scope, which have been found in practice or which, after careful consideration, promise to reduce or eliminate important cases of double taxation.<sup>298</sup>

Again, the treatment of international shipping profits was a paradigm—a modest reform advancing the ideal of reducing double taxation, but consistent with national self-interest and administrative constraints. Later, after the League process generated substantial consensus on allocation rules except for those governing interest and dividends, Adams urged the nations of the world to

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The world needs the economist’s version of the truth when it is fashioned after mature study. But let the economist cherish no illusion that it will prevail; that belief is merely a bit of intellectual arrogance with which the scholar quiets the growling of his own particular form of inferiority complex. The economist’s “truth” is only one factor in the contest we call taxation. He little knows when he launches it, on what side it will eventually fight, or in what unsuspected ways it will count and tell. Wearing the white armor of “science,” it will fight side by side with grimy forces seeking their own so-called selfish ends. It will emerge from the contest a battered and a better truth. It will have gained from, as much as it will have given to, its fellow contestants. It will have proved to be no better and no holier than many of its fellows. It will have proved more effective, the more completely its author—the economist—recognized in advance its limitations, its functions, and the character of the other contestants.

*Id.* at 8.

296. Adams, *Double Taxation*, *supra* note 3, at 125.

297. *Id.*

298. American Section Report, *supra* note 77, at 1; *see also* Adams, *Double Taxation*, *supra* note 3, at 125 (arguing that double taxation could only be averted through agreements based upon “practical grounds”).

sign a multilateral agreement institutionalizing all of the consensus rules, but leaving interest and dividends for another day.<sup>299</sup> Adams saw little sense in pushing his ideals beyond what the international community perceived as its own interests.<sup>300</sup> In a different context, he wrote, "The dominating factor of economic interest in taxation determines to a large extent the role or place of idealism in taxation. . . . [A]las for the idealist whose convictions call for a forthright and conscious sacrifice of the obvious economic interest of the majority."<sup>301</sup>

### B. *Adams' Emphasis on Collectibility, Certainty and Simplicity*

Given his emphasis on practicality over theory, it is not surprising that Adams' policy judgments were often driven by concerns for the enforcement and collection of taxes. While in Wisconsin, Adams had witnessed firsthand the inequities that resulted from a tax system that was not successfully enforced. In particular the old personal property taxes in Wisconsin and across the country were notorious for failing to capture intangible wealth, such as stocks and bonds.<sup>302</sup> As a result of evasion by urban business classes, the weight of taxation fell disproportionately on the owners of real property, which, in Wisconsin at the turn of the century, primarily meant cash-strapped farmers. The Wisconsin farmers fought back, demanding and eventually winning a state income tax.<sup>303</sup> To Adams, the lesson must have been clear: widespread evasion resulted in unfairness and the delegitimization of a tax system. Thus, Adams was profoundly concerned about the administrability of any tax proposal.<sup>304</sup>

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299. See Adams, *Double Taxation*, *supra* note 3, at 107.

300. *Id.* ("On certain subjects, the taxation of interest and dividends in particular, there are deep seated differences of opinion and interest which show few signs of disappearing.")

301. Adams, *Ideals and Idealism*, *supra* note 276, at 4.

302. See JOHN D. BUENKER, *THE INCOME TAX AND THE PROGRESSIVE ERA* 30-31 (1985). For a discussion of the particular failings of the Wisconsin property tax, see BROWNLEE, *supra* note 103, at 45-46; Adams, *Wisconsin Income Tax*, *supra* note 30, at 572. In one of his first published writings, Adams criticized the Maryland tax system for similarly failing to capture the wealth represented by personalty. See Adams, *Taxation in Maryland*, *supra* note 107, at 73.

303. See BROWNLEE, *supra* note 103, at 44-64 (recounting the history of the Wisconsin income tax and describing the mobilization of rural interests behind the income tax proposal).

304. Adams often expressed fears about the imminent demise of the income tax. For

Adams' sense of the moral wrongness of tax systems that lend themselves to evasion is particularly evident in his writings on the tax system imposed on Puerto Rico by Spain.<sup>305</sup> He wrote, "[T]he direct taxes were largely evaded through the complexity of the law and the venality of the officials, while the greater burden of the indirect taxes was shifted from those who owned property and were able to protest effectively, upon a sodden, inarticulate peon class . . . ."<sup>306</sup>

To understand the centrality of collection and enforcement in Adams' work, it is important to realize that, to Adams, tax avoidance implicated concerns that went well beyond simple losses of revenue to the Treasury. Adams felt that the very legitimacy of the income tax was threatened by widespread avoidance and evasion. Moreover, tax avoidance might result in the diversion of capital to unproductive purposes, which is a concern that was evident in Adams' resistance to the spread of tax-exempt securities in international markets.<sup>307</sup>

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example, he wrote, "The probability is strong that in four or five years the income tax will, as a matter of practical politics, be past patching." WITTE, *supra* note 40, at 91 (quoting a letter from Adams to the Ways and Means Committee) (emphasis omitted). Elsewhere, he observed, "A successfully administered income tax I believe to be an essential part of financial democracy. Personally, therefore, I should regard its breakdown as something in the nature of a political tragedy." Thomas S. Adams, *Should the Excess Profits Tax Be Repealed*, 35 Q.J. ECON. 363, 370 (1921).

In addition to the failure of certain state property taxes, Adams also witnessed first-hand the rise and fall of the federal excess profits tax on business income. Adams himself changed over time from a supporter to an opponent of the tax; in the end, he felt that the complexity of the excess profits law exceeded the administrative capacity of the federal government. *See id.* at 371. Indeed, the problems of the excess profits tax contributed to Adams' fears about the future of the income tax: "No federal administration, in my opinion, is capable during the next five or six years of carrying with even moderate success two such burdens as the income tax and the excess profits tax." *Id.* at 370. Adams has been deemed the "most influential" authority behind the eventual repeal of the excess profits tax. *See Rader, supra* note 32, at 419.

305. *See* T.S. Adams, *The Financial Problems of Porto Rico*, 17 ANNALS AM. ACAD. POL. & SOC. SCI. 444, 445 (1901) [hereinafter Adams, *Financial Problems*]; Thomas S. Adams, *Porto Rican Finance Under the Spanish and American Governments*, 3 PUBS. AM. ECON. ASS'N 314, 330 (1902).

306. Adams, *Financial Problems, supra* note 305, at 445.

307. Tax avoidance generally, and investment in tax-exempt securities specifically, also presented a threat to the ability-to-pay principle of income taxation. It might be argued that tax-exempt securities do not threaten ability-to-pay because tax-exempts typically carry lower interest rates than other bonds, with the foregone interest representing an implicit tax on the bondholder. Adams, however, believed that the interest rates of tax-exempts did not reflect the tax savings received by taxpayers in the highest brackets, and thus provided a windfall to those taxpayers who needed it least. *See* T.S. Adams, *Untitled*

Adams was particularly sensitive to the potential for tax avoidance in the international arena. Adams argued, "The modern habit of living or incorporating in one jurisdiction and holding property or doing business in another has led to much unjust double taxation, but it has also led to a large volume of tax evasion."<sup>308</sup> In Adams' mind, the causes of, and the solutions to, tax evasion and double taxation were intimately connected.<sup>309</sup> An in-

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*Speech on Tax-Exempt Securities*, 15 NAT'L TAX ASS'N PROC. 261, 264 (1922) [hereinafter Adams, *Untitled Speech*].

The American foreign tax credit lessened the incentives for other nations to become tax havens, or otherwise to compete with one another by providing tax relief for the residents of other nations, such as by floating tax-exempt bonds in international capital markets. Thus, one of Adams' chief targets in the 1927 and 1928 League of Nations conferences was tax-exempt securities issued by foreign governments, paralleling a similar crusade by his boss, Treasury Secretary Andrew Mellon, against the federal tax exemption for state and local government bonds. For a discussion of Mellon's position, see PAUL, *supra* note 93, at 132-33. In reaction to the high marginal rates of the 1918 Act, high-income Americans had turned to tax-exempt securities on a massive scale; hence, "the wealthier taxpayers" were effectively escaping surtaxes (and the yield of the income tax was "shrinking rapidly"). See Adams, *Fundamental Problems*, *supra* note 61, at 529; see also Adams, *Untitled Speech*, *supra*, at 262-63 (noting that reported taxable income of taxpayers earning more than \$300,000 a year dropped by more than half between 1916 and 1919 notwithstanding general economic prosperity). Such securities "pervert[ed] the normal and natural habits of investment," see *id.* at 264, and perhaps, as Mellon said, "le[d] in many cases to unnecessary or wasteful public expenditures." LOVE, *supra* note 94, at 58 (quoting a letter from Secretary Mellon to Congressman Green). Critics argued that Americans only invested in tax-exempt government bonds as a means of escaping federal income taxes. See WITTE, *supra* note 40, at 88. In a similar vein, Adams viewed with alarm the tendency of foreign governments to offer bonds whose interest was free of taxation by the issuing government. See Minutes of Meeting of Committee on Double Taxation and Tax Evasion on April 7, 1927, at 5 (available in T.S. Adams Papers, Yale University, Box 16, April 7-8 1927 folder) ("[I]t would be disastrous for Europe to be flooded with securities entirely exempt from taxation, as was the case in the United States."). In the interests of discouraging the further development of tax-exempt securities in international capital markets, Adams supported amendments to the 1927 and 1928 draft treaties that would have provided for residence-based taxation of interest that was not taxed by the source state—a reversal of his typical pro-source position. See *id.* at 2; see also HERNDON, *supra* note 60, at 188. Adams' efforts failed with respect to Draft Convention No. I-a, see HERNDON, *supra* note 103, at 188-89, but the interest provision of Draft Convention No. I-b, allocating interest to residence under all circumstances, may in part have reflected Adams' attempt to preserve a safeguard against tax-exempt securities.

In addition to tax-exempt securities, other forms of tax avoidance that were of particular concern to Adams included: incorporation for purposes of avoiding surtaxes on income, gifts to family members, the sale of securities at a loss, and "extravagant and doubtful expenditure" by corporations (including much advertising). See Adams, *Fundamental Problems*, *supra* note 61, at 532-36.

308. Adams, *Double Taxation*, *supra* note 3, at 112-13.

309. The connection was also apparent to the League of Nations, which assembled the

ternational tax system that carefully constrained double taxation would both lessen the incentives for tax evasion and imply a degree of international cooperation and administrative competence that would lessen the opportunities for avoidance. Thus, Adams could conclude that “[m]easures to prevent double taxation, if properly devised, will result in almost as much gain as loss to the fiscal authorities cooperating.”<sup>310</sup>

In the domestic arena, Adams was an outspoken advocate for simplicity in taxation.<sup>311</sup> Not surprisingly, he brought the same concerns with him to the problems of international tax. Adams declared himself more interested in developing simple, administrable rules for the allocation of income to countries of source than in getting the allocations themselves “correct.”<sup>312</sup> Adams presented the 1921 source rules to Congress as “altogether in the interests of simplicity and clarity.”<sup>313</sup> Later, in discussing the “primary conditions” that should shape the drafting of a model treaty, Adams wrote: “There is a final condition of momentous importance—that of simplicity. There will be great administrative difficulties in enforcing even the simplest of Bilateral Conventions. The

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Committee of Technical Experts to draft model treaties dealing with both double taxation and tax evasion. See HERNDON, *supra* note 103, at 58.

310. Adams, *Double Taxation*, *supra* note 3, at 126. Much of this reasoning likely rests upon an understanding that tax systems—particularly income tax systems—cannot function without a substantial amount of voluntary taxpayer compliance and honesty. Adams observed, “The American taxpayer . . . has been compared, confused, and used synonymously with the liar. As a matter of fact, when confronted with an equitable tax and a fearless assessor, he is amazingly honest.” Adams, *Wisconsin Income Tax*, *supra* note 30, at 575 (emphasis added). The implication is that an inequitable tax—and Adams clearly felt that double taxation deserved that label—will produce dishonest taxpayers. Charles Bullock, a Harvard professor and colleague of Adams on the National Tax Association, made a similar point: “Not taxation itself, but unfair, excessive, and discriminating taxation is what has made the average American a tax-dodger.” Charles J. Bullock, *The Federal Income Tax*, 8 NAT’L TAX ASS’N PROC. 264, 274 (1914).

311. Adams argued that “complexity [in tax legislation] is a major evil, involving the taxpayer in a cloud of uncertainty, stimulating evasion and rebellion, clogging the administrative machine, and bringing the tax into disrepute.” Adams, *Fundamental Problems*, *supra* note 61, at 552. Adams felt that the fundamental problem of the net income tax, and of ability-to-pay taxation generally, was the inherent complexity of calculating the tax. Although Adams recognized that public sentiment heavily favored the ability-to-pay principle, he declared that he would “vote for simplicity and inequality, selecting many simple taxes at light rates rather than more equitable but more complex taxes at heavier rates.” *Id.* at 553.

312. See, e.g., American Section Report, *supra* note 77, at 2-3 (“It is more important to secure the adoption of one uniform rule than to insist that an exactly correct theoretical rule be developed.”).

313. 1921 Hearings, *supra* note 39, at 66.



execution of an ambiguous and complicated convention will prove virtually impossible.”<sup>314</sup> Adams thus opened the 1927 conference of the Technical Experts with a call for greater clarity in drafting,<sup>315</sup> and continued to raise the issue throughout the meetings of the Technical Experts, most notably in his efforts to have the committee dispense with the confusing personal/impersonal distinction.<sup>316</sup>

Concerns for collectibility, enforcement and administrability also shaped Adams’ preferences regarding source rules for specific categories of income. He insisted: “[I]n agreements allocating tax sources for the purpose of preventing double taxation, the tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax.”<sup>317</sup> Adams felt that this principle motivated many of the source rules that were already widely accepted internationally, such as the allocation of real estate to the state where it was located for purposes of property, income, and death taxes:

There is probably no very recondite economic or juristic theory behind this approximate agreement to allocate taxes in respect of real estate to the jurisdiction of situs. It certainly interferes with progressive rating upon the entire income, estate or inheritance, and conflicts with the theories usually advanced by defendants of progressive income and inheritance taxes to explain or justify them. The explanation probably lies in a mixture of considerations arising chiefly in custom, administrative practicability, and the will to avoid double taxation . . . . For a good many generations wisdom will lie in giving the tax to the jurisdiction that can successfully administer it.<sup>318</sup>

Adams approved of the real estate rule for its ease of enforcement.

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314. Adams, *Draft Convention*, *supra* note 123, at 2.

315. See Minutes of Meeting on April 5, 1927, at 2 (available in T.S. Adams Papers, Yale University, Box 16).

316. See Adams, *Draft Convention*, *supra* note 123, at 1. Adams, in fact, had a long-running dispute with Seligman over the utility and clarity of the distinction. See Letter to E.R.A. Seligman (Aug. 9, 1911) (available in T.S. Adams Papers, Yale University, Box 25, 1911-1912 folder) (“There is no common understanding of the terms ‘real’ [impersonal] and ‘personal’ taxes. . . . Ought we to place so much emphasis upon a general concept which is not clearly understood?”).

317. Adams, *Double Taxation*, *supra* note 3, at 112.

318. *Id.* at 105-06.

Adams also expressed concerns over source rules that were open to taxpayer manipulation, such as the U.S. Attorney General's rule that sourced business income to point of sale.<sup>319</sup> Such opportunities for manipulation raised all of the concerns about tax avoidance that led Adams to place so much emphasis on administrability.

Adams had an additional reason for stressing enforceability in source rules: rules based on administrative practicability stood the best chance of gaining widespread international acceptance. Adams believed that nations would surrender tax jurisdiction only so long as they could do so without incurring significant financial harm: "[W]e shall eliminate, in the long run, only that measure and degree of multiple taxation which the competing jurisdictions believe harmful to themselves."<sup>320</sup> Adams was sure that nations would most easily be swayed to surrender jurisdiction over income that they could not tax effectively anyway: "[A]greements to abolish or restrain double taxation must be based on a variety of practicable grounds, among which the possibility of successful administration is the most important."<sup>321</sup>

Adams, so committed to the ends of reducing double taxation, kept political salability and stability very much in mind while designing the means. In his work on tax policy, Adams was an economist in the service of politics. He would be more than a little disappointed at the monumental complexity which is the hallmark of this nation's international tax rules today.

### C. *Source vs. Residence*

Normative analysis of international tax policy by economists today emphasizes the goal of worldwide economic efficiency with a policy of capital export neutrality as its instrument. This, in turn, has led for calls for residence-based taxation of income earned worldwide.<sup>322</sup> But regardless of the modern economists' analysis,

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319. See *supra* text accompanying notes 143-45. Adams voiced similar concerns about an International Chamber proposal to tax income "where earned." 1922 Chamber Memo, *supra* note 185, at 9.

320. Adams, *Double Taxation*, *supra* note 3, at 125.

321. *Id.* at 124-25.

322. See, e.g., BRADFORD, *supra* note 50, at 89-90 ("A number of considerations point to the residence principle as the more desirable principle to establish"); PRESIDENT'S TAX PROPOSALS, *supra* note 50, at 383 ("The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered ap-

Thomas Sewall Adams' view that countries where income is earned will insist on taxing business income earned within their borders remains as true now as in his time. Thus, Adams' view that the only *unilateral* action available to eliminate potential double taxation of such income is for countries of residence to defer to countries of source either by exempting such income or allowing a foreign tax credit is as valid at the end of this century as it was at the beginning.

Vigorous policy debate is now taking place over proposals to replace the U.S. foreign tax credit system with an exemption for foreign source income.<sup>323</sup> Again, Adams' views of the reasons to choose between a foreign tax credit and an exemption system are instructive. In general, Adams' reasons for preferring the foreign tax credit mechanism—particularly his appreciation of its role in counteracting a “race to the bottom” in taxation by source countries—have lost none of their persuasiveness. Indeed, current calls for replacing the U.S. income tax altogether with some form of consumption tax can be viewed potentially as a major development in such a race. Such a change would transform the United States into the world's major tax haven for income from capital.<sup>324</sup> Improving the “international competitiveness” of American investors and businesses is a rallying cry of proponents of such a change.<sup>325</sup> Ironically, this kind of massive change in the U.S. tax system would probably inspire many countries, which have, so far, exempted foreign source income from tax, to embrace a foreign tax credit system of the sort first put into place in the United States more than seventy-five years ago.

On the other hand, the complexities of the existing foreign tax credit law, which have developed principally to prevent averaging of foreign taxes across different kinds of income and to protect the U.S. tax base on U.S. source income, are extremely costly for taxpayers to comply with and for the IRS to administer. Other countries—Australia and Canada, for example—have effectively com-

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appropriate to promote tax neutrality in investment decisions.”)

323. See, e.g., KEMP COMMISSION REPORT, *supra* note 14, at 449–50; see also HUFBAUER, *supra* note 12, at 93 (1992) (arguing that U.S. should abolish the foreign tax credit and adopt a territorial system for taxing foreign corporate income).

324. See Reuven S. Avi-Yonah, *The International Implications of Tax Reform*, 69 TAX NOTES 913, 917 (1995).

325. See, e.g., KEMP COMMISSION REPORT, *supra* note 14, at 426 (calling for a flat-rate tax system to stimulate investment).

bined foreign exemption and tax credit methods to reduce some of the complexities, without shifting to a "territorial" policy that limits taxation to income earned within their borders or abandoning their claims to residual taxation of foreign source income. Some European countries, including, for example, Germany and the Netherlands, have gone even further in providing an exemption for foreign source business income.

The potential advantages of introducing exemption elements for business taxation surely merit reexamination in the United States today. Thomas Adams identified the principal concerns. In his proposals for an exemption for foreign traders, Adams would have restricted an exemption system to active business income. He refused to consider extending such relief to passive investment income, which, even then, he knew to be much more mobile and manipulable. Second, Adams knew that exemptions should be limited to foreign source income which is subject to taxation abroad comparable to that which would be imposed by the United States. This probably is best evinced by his concerns with the international issuance of tax exempt bonds. Some such "comparability" test is now used by most countries that have exemption systems. Third, Adams' emphasis on clear, explicit and, to the extent possible, uniform source rules would be even more critical if the United States were to exempt foreign source business income. Likewise, Adams' concerns with related party transactions, such as payments of interest and royalties, makes clear that an exemption system would not be free of many of the issues that have for so long plagued implementation of a foreign tax credit system. In sum, Adams' insights are valuable in informing our own analysis of the issues raised in substituting for the foreign tax credit an exemption of limited categories of foreign source income.

Even on somewhat narrower issues of international tax policy, asking how Thomas Sewall Adams would have approached the question often is enlightening. For example, in 1989, the United States added section 163(j) to the Internal Revenue Code to limit deductions for interest paid on debt to related parties.<sup>326</sup> This provision was intended to limit the ability of foreign-owned businesses to avoid payment of U.S. tax on U.S. source income by paying deductible interest rather than dividends.<sup>327</sup> The 1993 Act

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326. See I.R.C. § 163(j) (1994).

327. See H.R. REP. NO. 101-247, at 1240-50 (1989), reprinted in 1989 U.S.C.C.A.N.

extended these limitations to additional forms of debt between related parties and to certain third-party debt guaranteed by related entities. These limitations have been frequently criticized by commentators (apart from their complexities which are substantial) principally on the ground that, in addition to attacking tax-avoidance transactions designed to shift income from the United States to a tax-haven country that imposes low or no taxes on such income, this provision also denies interest deductions for payments from the United States to another country with equivalent or even higher tax rates. In so doing, it overrides the ability of U.S. treaty negotiators to concede U.S. tax jurisdiction over such amounts to other countries. If, however, following T.S. Adams, one takes as a prime goal of U.S. international tax policy the collection of U.S. tax on U.S. source income, the provision looks sensible and important, the rate of tax in the foreign country becomes irrelevant, and the major question for the United States becomes whether the provision is appropriately broad and effective. Adams would also be clear that it is the responsibility of the country of residence to alleviate any double taxation that might result.

#### D. *Multilateral vs. Bilateral Treaties*

Thomas Adams recognized early that a multilateral, rather than bilateral, approach to tax treaties was desirable. He pressed for a multilateral solution to the problem of international taxation, despairing of the complexity, administrability, and manipulability of taxation under a large number of bilateral tax treaties. He was optimistic about the prospect. “[I]t is entirely practicable for the great nations of the world to get together and adopt a uniform multilateral treaty by which double taxation could be eliminated, except for these items of bond interest and dividends.”<sup>328</sup> But Adams was unsuccessful in getting the League of Nations to shift its approach to double taxation from a model bilateral treaty to a multilateral agreement. He claimed that the League’s approach “would result in a tangle of conflicting solutions applicable to the nationals of different countries, which [would] be highly complicated and highly mysterious, and about as bad as the situation now

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1906, 2710–20.

328. Adams, *Aspects of Double Taxation*, *supra* note 65, at 196.

exists."<sup>329</sup> However, no action was taken on Adams' proposal for a multilateral treaty during the 1928 League conference.<sup>330</sup>

Modern attempts at multilateral tax treaties, even on a regional basis, have also enjoyed limited success at best. There was a brief Andean effort in 1971 and a similarly unsuccessful Caribbean tax agreement.<sup>331</sup> Probably the most successful example is the Nordic tax treaty, but one thoughtful observer has remarked that it serves principally to confirm that cultural regional cohesion has advantages in taxation as elsewhere.<sup>332</sup>

The European community has abandoned the idea of a multilateral tax treaty in favor of an effort to harmonize the domestic tax laws of the member states.<sup>333</sup> To date, there has been relatively little progress toward harmonization in the income tax arena. Probably the most notable effort has been the Ruding Committee's attempt to chart a path for greater uniformity in cross-border transactions involving countries with integrated corporate tax systems.<sup>334</sup>

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329. *Id.* at 195. Adams foreshadowed this argument with his earlier advocacy of a single, nationwide standard for the apportionment of railway property for purposes of state taxation: "[C]ompeting state jurisdictions should not—by using different methods of apportionment—tax the same property twice; and . . . no interstate railway company, by reason of existing laxity and confusion, should escape without the full taxation of all its property in one state or another." T.S. Adams, *Valuation of Railway Property for Purposes of Taxation*, 23 J. POL. ECON. 1, 5 (1915).

330. See HERNDON, *supra* note 103, at 230.

331. See, e.g., Bruce Zagaris, *Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options*, 47 BULL. INT'L FISCAL DOCUMENTATION 129, 137 (1993); C. Gaston Perera, *Double Tax Treaties in the Eastern Caribbean*, 1993 BRIT. TAX REV. 395, 398.

332. See Vital, *supra* note 7, at 34–35.

The texts of the two multilateral Nordic double tax treaties show the strong influence of the bilateral treaties that they replaced, and, behind them, the work of the OECD of which all five states are members. There are no major new concepts or approaches in these agreements, which in some clauses resort to lists to cover the differences between the treaty partners. But they have shown that, given a common cultural and economic background, genuine multilateral cooperation on an evolving basis is achievable.

DAVID W. WILLIAMS, TRENDS IN INTERNATIONAL TAXATION 87 (1991).

333. Article 220 of the EEC Agreement urges the adoption of bilateral treaties for the elimination of double taxation. The first efforts at harmonization have focused on value-added taxes and have been underway for thirty years.

334. See RUDING COMMITTEE REPORT, *supra* note 18. For critical views on the Ruding Report, see John Chown, *Commentary on the Ruding Report*, 32 EUROPEAN TAXATION 123 (1992); Maarten J. Ellis, *A Practitioner's View of the Ruding Report*, 32 EUROPEAN TAXATION 129 (1992); Rijkele Betten, *Aspects of a Future EC Corporate Tax System: Commentary on the Ruding Report and the Commission Guidelines*, 32 EUROPEAN TAXATION 314 (1992). For views of Committee members themselves on the Ruding Re-

If anything, the need for multilateral cooperation has increased since Adams' time, but the likelihood of such action seems no brighter today. Ironically, the enormous success of the network of bilateral treaties, which began with the League of Nations Model in 1928 and has remained remarkably stable through the most recent OECD model in 1992, itself serves to inhibit multilateral action.<sup>335</sup> The habit and flexibility of dealing bilaterally, along with the entrenchment of the principles of the League of Nations model, make it extremely difficult to move in the tax area toward the kind of multilateral negotiating practice that, for example, occurs through the General Agreement on Trades and Tariffs (GATT) in the international trade arena. Professor Richard Vann of Australia has best described the difficulty:

Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words the OECD Model is the culmination of 50 years of development, rather than a new departure.<sup>336</sup>

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port, see F. Vanistendael, *Round Table on the Ruding Report: Some Basic Problems on the Road to Tax Harmonization*, 33 EUROPEAN TAXATION 22 (1993); Ken Messere, *Round Table on the Ruding Report: A Personal View on Certain Aspects of the Ruding Committee Report and the EC Commission's Reaction to It*, 33 EUROPEAN TAXATION 2 (1993).

The Ruding Report recommended community-wide minimal rates of corporate taxation, the adoption of standard procedures for resolving transfer pricing disputes, harmonized methods for depreciation and stock valuation and carry-back of losses. Not much has come of the Ruding Committee's proposals so far.

335. The 1928 Model was the basis for the 1964 OECD Model Treaty. See OECD FISCAL COMMITTEE, DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL (1963). The 1977 Model changed relatively little and even the 1992 Model had relatively few changes. See Ken Messere, *The 1992 OECD Model Treaty: The Precursors and Successors of the New OECD Model Tax Convention on Income and Capital*, 33 EUROPEAN TAXATION 246, 248-49 (1993).

336. Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?*, 45 BULL. INT'L FISCAL DOCUMENTATION 99, 103 (1991). Indeed, one of the few occasions when the 1920s League effort failed to have lasting success was in the proposal for a multilateral dispute resolution procedure. See *supra* notes 203, 244.

This status quo will continue to be difficult to displace.

#### CONCLUSION

While the structure for international taxation put in place in the 1920s has been remarkably stable, modern theories have emerged to explain and evaluate that system and its alternatives. As we have discussed in this Article, the current theories contending for supremacy in this area are capital export neutrality, capital import neutrality and the misnamed national neutrality.<sup>337</sup> It has by now become well-known in the tax policy literature that it is simply not possible to implement both capital import and capital export neutrality simultaneously.<sup>338</sup> Our favorite way of making this point is in terms of an irreconcilable conflict among the following three simple principles:

Principle 1: People should pay equal taxes on their income regardless of the country that is the source of that income. In particular, U.S. taxpayers should be treated equally regardless of the source of their income.

Principle 2: All investments in the United States should face the same burden regardless of whether a U.S. person or a foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

Principle 3: Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.<sup>339</sup>

The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, an identical tax base, and identical choices between

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337. See *supra* notes 85-91, 171-78 and accompanying text; see also JOINT COMMITTEE ON TAXATION, *supra* note 25, at 246.

338. See, e.g., JOINT COMMITTEE ON TAXATION, *supra* note 25, at 246.

339. This way of putting the dilemma was first expressed in a speech given on March 1, 1990 to the U.S. chapter of the International Fiscal Association by Michael Graetz, when serving as Treasury Deputy Assistant Secretary (Tax Policy) in Philadelphia, Pennsylvania. See *International Tax Policy Makers Should Strive for Balance*, *Treasury Official Says*, BNA DAILY TAX REPORT, Mar. 2, 1990, at G-7. The speech was subsequently delivered again and published by Kenneth W. Gideon, then the Assistant Secretary. See Kenneth W. Gideon, *Dinner Speech*, 9 AM. J. TAX POL'Y 71, 72-74 (1991). Principle 1 states a requirement of capital export neutrality. Principle 2 states a version of capital import neutrality, although it also expresses a desire for nondiscrimination either in favor of or against foreign-owned businesses and investments.



source and residence based taxation. That has never happened, and it never will. Even if it ever did, there would be no way to keep such a system in place without violating Principle 3. Moreover, bilateral treaties in which the United States gives benefits to certain foreign investors or foreign-owned businesses, in exchange for their countries giving reciprocal benefits to U.S. persons, will also defeat the ability to satisfy simultaneously both Principles 1 and 2. This difficulty makes compromises between these principles inevitable. Such compromises, in turn, have made the tax law governing international transactions subject to routine complaints of competitive disadvantage by U.S. companies depending on where they are competing and against whom. As a result, in practical political terms, the modern theories have proved little more useful than the ancient theories, such as "economic allegiance," which they have replaced.

In the meanwhile, as we wait for improvements in theory and knowledge, we could do much worse than to follow the basic principles and priorities established for international tax rules by T.S. Adams. We should remember that it was not economic theory, but first, concerns for the essential unfairness of both double taxation and zero taxation, and second, a preference for source-based taxation of business income, based on the view that the nations where such income is earned both are entitled to a share of that income and will claim such a share, that most shaped his policy recommendations and, in turn, U.S. tax policy. In addition, T.S. Adams' approach emphasized the enlightened selfishness of nations; certainty, administrability and enforceability of international tax rules; and nondiscrimination against foreigners. Finally, given T.S. Adams' role in helping to fashion a stable and generally successful international income tax regime for the United States and his influence in the League of Nations tax treaty effort, we probably should take with a grain of salt Adams' general admonition that anyone "who trusts wholly to economics, reason and justice, will in the end retire beaten and disillusioned," in that "hard game" of tax lawmaking.<sup>340</sup>

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340. Adams, *Ideals and Idealism*, *supra* note 276, at 12.