U.S. Taxation of Investment Income of Individuals

"The hardest thing in the world to understand is the income tax."

Albert Einstein[1]

EXECUTIVE SUMMARY

The United States has established a synthetic tax system, which aims to tax income comprehensively at progressive rates. The system is a hybrid that combines income and consumption taxation, including state sales taxes, excise taxes, and preferential tax treatment of retirement savings. The U.S. Congress initiates federal income tax law, which the U.S. Department of Treasury and the Internal Revenue Service enforce and interpret through administrative guidance. The courts add another interpretative layer to tax issues raised in litigation. American tax justice and fairness drive the pursuit of horizontal and vertical equity despite the inescapable challenges of a marriage on tax filing status.

The U.S. tax system relies on capital-export neutrality principles to prevent the flight of domestic capital and on capital-import neutrality principles to attract foreign investment. Two different tax regimes apply depending on source of income and an individual taxpayer's characterization as either a "domestic" taxpayer, including U.S. citizens and resident aliens, or a "foreign" taxpayer, such as nonresident aliens. U.S. federal income tax liability arises for nonresident aliens only their income derived from foreign sources. The United States asserts broad extraterritorial jurisdiction to tax its citizens and resident aliens on worldwide income from both U.S. and foreign sources but alleviates potential double taxation through creditability of foreign tax paid and use of tax treaties. U.S. citizens and resident aliens who expatriate are subject to an exit tax on the fair market value of all assets and to continuous taxation for ten years since the expatriation. Concerned with tax evasion, the U.S. government recently strengthened enforcement and reporting efforts by targeting U.S. citizens and resident aliens

[1] Internal Revenue Service, *Tax Quotes*, http://www.irs.gov/newsroom/article/0,,id=110483,00.html (last visited Mar. 20, 2011). I view Einstein's statement as speaking unpretentiously to the complexities arising from modern income tax systems functioning in a highly mobile cross-border world.

with financial accounts abroad. Taxpayers are encouraged to disclose financial assets held offshore or become subject to severe penalties and potential criminal prosecution.

U.S. citizens and resident aliens may take home some investment income tax-free as long as it amounts to less than the sum of applicable personal exemptions and itemized or standard deductions. Further, they may take specified deductions to arrive at taxable income which also are available to foreign taxpayers engaged in a U.S. trade or business or whose investment income arises directly from such business. Nonresident aliens' income derived from a trade or business conducted in the United States is taxed at the usual ordinary income tax rates that are applicable to domestic taxpayers.

Nonresident aliens' investment income, including interest, dividends, rents, and royalties, is taxed through a withholding mechanism at a flat rate of 30 percent. Moreover, any gains they realize on transfer of interests in U.S. real property are also subject to withholding tax. Tax treaty benefits, which may vary by treaty, can reduce tax on U.S.-source dividends and eliminate withholding taxes on interest and royalties. Both domestic and foreign taxpayers are subject to the Alternative Minimum Tax, a secondary tax system with a broader tax base. The rules of Subpart F limit the ability of U.S. citizens and resident aliens to take advantage of earning foreign-source income and deferring U.S. tax on it.

A somewhat complex regime applies to the gains and losses that U.S. citizens and resident aliens realize from sale or exchange of capital assets where taxable amounts are calculated through a netting process. Capital gains are included in gross income when realized and are recognized unless nonrecognition applies to the underlying sale or exchange. Generally, short-term capital gains are taxed at ordinary income tax rates as is income from labor, interest, ordinary dividends, rents, and royalties.

Deduction of capital losses is limited to constrain the impact of the lock-in effect and the cherry-picking problem, which validate a taxpayer's ability to time selectively the realization of gains and losses. Subject to an annual limit, capital losses may offset only long-term capital gains, which are taxed at preferential rates that apply to qualified dividends, a defined category of dividends established by the 2004 JOBS Act. To stimulate the economy, the executive branch lowered both ordinary income and capital gain tax rates during President George W. Bush's term. The highest marginal preferential rate of 28 percent was reduced to 15 percent while taxpayers in the two lowest tax brackets benefited from a zero-percent tax rate until December 2010 when President Obama extended the tax cuts for another two years.

Scholars point to excessive leverage as one of the primary contributors to the 2008 financial crisis. The latter was influenced by tax preferences for home ownership and corporate debt over equity financing, and these preferences distorted investment patterns. U.S. citizens and resident aliens may deduct interest on borrowing for investment purposes to the extent of investment income net of investment expenses. Home mortgage and home equity interest are also deductible.

Whether domestic or foreign, taxpayers engaged in a U.S. trade or business may deduct any interest incurred on borrowing for business or investment purposes. In contrast, corporate earnings financed by equity are taxed twice and no deduction is allowed for the cost of equity. Financial innovation encourages taxpayers to manipulate the tax consequences of their investments by combining their preferred economic characteristics in hybrid financial instruments with multiple features of equity and enough features of debt to attract the interest expense deduction.

Solutions proposed by scholars and policy makers have prompted cost-benefit analysis with tax neutrality and elimination of debt bias as its end goals. On the corporate side, a series of alternatives include enforcement of thin capitalization rules, corporate integration subjecting debt and equity to a single tax, allowance for the cost of corporate equity, dividend imputation, and a comprehensive business income tax. The adoption of value added tax in the United States, in the form of income-based consumption tax, has been suggested as a supplement to the federal income tax and one way to reduce the current fiscal deficit.

The exclusion of imputed rental income also promoted overinvestment in owner-occupied housing. Debt-neutral taxation within a comprehensive tax system requires full taxation of imputed rents and capital gains realized from sales in combination with full deduction of mortgage interest payments. Commentators advocate subsidizing homeownership through a tax credit rather than a deduction for mortgage interest.

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I. FEDERAL INCOME TAX FRAMEWORK IN THE UNITED STATES.

As a comprehensive tax system, the United States functions according to the Haig-Simons definition, which is considered a baseline concept of economic income and a touchstone of the U.S. federal income tax system. According to the Haig-Simons definition, income equals wealth, whether expended or saved, and it represents the sum of wealth accumulated at year-end and consumption during the year.[2] In other words, income equals accretion indicated by an increase in consumption plus changes in net worth.[3] This definition intends to measure a taxpayer's total economic well-being and seeks to tax all income comprehensively, regardless of the income's form and source.[4] In a Haig-Simons world of taxation, all investment income would be taxed currently.[5] For administrative facility and as a result of policy choices, U.S. tax law reflects compromises and does not necessarily tax as currently and comprehensively.[6]

A. SOURCES OF TAX AUTHORITY

The Constitution of the United States provides for three separate and equal interacting branches of legal authority, which shape the U.S. tax laws and regulation: Legislative,

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[2] JOSHUA D. ROSENBERG AND DOMINIC DAHER, THE LAW OF FEDERAL INCOME TAXATION 53 (2008). *But see* I.R.C. §1272 (requiring inclusion in gross income of original issue discount) *and* I.R.C. § 1256 (requiring inclusion in gross income of annual unrealized gain related to straddle positions).
[3] HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); *see also* ROBERT M. HAIG, THE CONCEPT OF INCOME--ECONOMIC AND LEGAL ASPECTS, IN READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959). Individual income reflects "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights" between two specified periods. *Id.*
[4] Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX L. REV. 153, 159-60 (Winter 1995). Accumulation includes savings, changes in personal debt and in the value of the taxpayer's assets, no matter whether any appreciation or depreciation has actually been realized. *Id.*
[5] *Id.* at 159.
[6] *Id.* For example, capital gains and losses are taxed only upon realization. *Id. See* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

Executive, and Judicial.[7] The U.S. Congress has general taxing powers and authority to enact federal statutes and to create agencies that enforce the laws.[8] Under the Sixteenth Amendment to the U.S. Constitution, Congress enacted the Internal Revenue Code of 1986 (the Code), which is one of the main sources of U.S. federal income tax law.[9]

Within the executive branch, the U.S. Department of Treasury (Treasury) is responsible for administering the federal tax laws, and Treasury often delegates most of this responsibility to an agency under its command, the Internal Revenue Service (IRS).[10] While Treasury retains a supervisory function, the IRS administers and enforces the tax laws, and the two share the duties of providing guidance to taxpayers on interpreting the tax laws in the form of treasury regulations, revenue rulings, revenue procedures, and other resources.[11] Publication of IRS positions has contributed to a uniform, fair federal tax system.[12]

Judicial interpretation of the Code and IRS positions on the Code establishes case law as another principal source of tax law.[13] The Tax Court exercises a limited jurisdiction to decide solely tax disputes between taxpayers and the IRS.[14] Taxpayers also have access to the U.S. District Courts and the Court of Federal Claims, but to exercise this right, a taxpayer must

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[7] U.S CONST. art. I, Sec. 8 ("The Congress shall have the power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."). The Sixteenth Amendment was adopted on February 25, 1913, and Congress enacted the first income tax act on October 3, 1913. UNDERSTANDING IRS COMMUNICATIONS ¶ 13 (CCH Tax Law Eds., 2d ed. 2000). Tax legislation originates in the House of Representatives in the Ways and Means Committee and proceeds through the Senate Finance Committee to reach the President who either signs into law or vetoes the final version.
[8] U.S CONST. art. I, II, III.
[9] The Internal Revenue Code was enacted under Title 26 of the United States Code. UNDERSTANDING IRS COMMUNICATIONS ¶¶ 20, 22 (CCH Tax Law Eds., 2d ed. 2000).
[10] The Secretary of Treasury heads the U.S. Department of Treasury while the IRS Commissioner heads the Internal Revenue Service.
[11] *Id.* at ¶¶ 34, 70. IRS rules and regulations are published in the Federal Register, and official revenue rulings and procedures are published in the Internal Revenue Bulletin. *Id.* at ¶ 50. Treasury regulations are generally interpretative regulations that explain the IRS's positions on sections of the Code; they can also be legislative regulations promulgated under specific authority by a Code section. *Id.* at ¶ 71.
[12] *Id.* at ¶¶ 51, 52. IRS rules and regulations are published in the Federal Register, and official revenue rulings and procedures are published in the Internal Revenue Bulletin. *Id.* at ¶ 50.
[13] *Id.* at ¶¶ 22, 40, 41.
[14] *Id.* ¶ 40.

first prepay in full the amount of disputed tax or have a claim for refund rejected by the IRS.[15] The U.S. Courts of Appeals hear appeals from the Tax Court and the other courts of first instance.[16] As the final judicial authority on the meaning of federal statutes and questions of federal law, the U.S. Supreme Court reviews all appellate decisions.[17] Ultimately, the U.S. Constitution, federal statutes, treaties, treasury regulations, IRS documents, and judicial decisions are the primary legal authorities that carry the most weight in the interpretation and resolution of tax issues.[18]

In tandem with synthetic tax systems, and unlike schedular ones, the U.S. federal income tax system seeks to tax accession to wealth regardless of its source.[19] A taxpayer's gross income is the starting point of computing the taxpayer's U.S. tax liability, and items of income are expressly included or excluded from gross income.[20] Gross income includes all types of earnings, such as compensation for services, business income, interest, rents, royalties, dividends, alimony, annuities, insurance income, pensions, and discharge from indebtedness.[21] U.S. federal income tax is imposed on an individual's taxable income, which equals an individual's gross income minus certain deductions and tax credits.[22] This formula allows for taxation on a net basis. Tax liability is determined by multiplying the individual's taxable income by a tax rate that corresponds to that individual's tax bracket.[23]

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[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] GAIL LEVIN RICHMOND, FEDERAL TAX RESEARCH 6 (Foundation Press, 8th ed. 2010).
[19] I.R.C. § 61 (". . . income from whatever source derived"); William B. Barker, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 CATH. U. L. REV. 7, 18, n. 68-70 (1996). The doctrine of source arises in schedular tax systems as the schedular tax system adopted by the United Kingdom.
[20] *See* I.R.C. §§ 61, 71-140.
[21] I.R.C. § 61.
[22] I.R.C. §§ 61, 62, 63.
[23] *See* § I.R.C. § 1.

The United States has expressed some ambivalence in its treatment toward income or consumption as its preferable tax base.[24] The tax system functions as a hybrid that combines income and consumption taxes.[25] Consumption taxes take the form of either value added tax (VAT) or sales tax paid when consumers make purchases and imposed on the value of goods or services.[26] Much of the revenue of state and local governments in the United States comes from sales and property taxes.[27] Most states impose sales taxes, and the federal government imposes sales taxes in the form of excise taxes.[28] Recent legislative actions have allowed for preferential tax treatment of retirement savings under the Code and have introduced elements of consumption in the federal income tax system.[29]

B. INDIVIDUALS AS TAXPAYERS

In its treatment, the Code distinguishes between U.S. persons and foreign persons.[30] U.S. persons include citizens and resident aliens of the United States.[31] Resident aliens are

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[24] Kurtz, *supra* note 4, at 158. *See* Alan J. Auerbach, *Should Interest Deductions Be Limited*?, in UNEASY COMPROMISE, INTRODUCTION 9-11 (Henry J. Aaron, Harvey Galper & Joseph A. Pechman eds., 1988).
[25] The debate about a preferable tax base for direct taxation has come down to a choice between consumption or income because wealth generally has been ruled out due to difficulties with calculating wealth on a periodic basis. Kurtz, *supra* note 4, at 158. *See* C. EUGENE STEUERLE, TAXES, LOANS AND INFLATION (Brookings Institution Press 1985); DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 2 (Harvard University Press 1986).
[26] Kurtz, *supra* note 4, at 160. See discussion on Value Added Tax *infra* Part III.D.i.
[27] U.S. Census Bureau, *State and Local Government Finances by Level of Government and by State: 2007-08*, *available at* http://www.census.gov/govs/estimate/ (last visited Mar. 20, 2011).
[28] Kurtz, *supra* note 4, at 160. Forty-five states and the District of Columbia currently have a sales tax on most tangible items. In addition, New Hampshire has a tax on lodging and meals, Montana taxes lodging, and Delaware taxes lodging and auto rentals. Only Alaska and Oregon have no sales tax. State by State Tax Rates for Travel Season, 4 St. & Loc. Tax Weekly (RIA) No. 24, at 8 - 9 (June 21, 1993). Kurtz, *supra* note 4, at, 160. *See, e.g.*, I.R.C. §§ 4001- 4003 (imposing tax on first retail sale of passenger vehicles over $30,000). In some cases, the tax is collected earlier in the production process. *See, e.g.*, I.R.C. §§ 4081- 4084 (imposing tax on wholesale gasoline transactions), I.R.C. §§ 4091- 4093 (imposing tax on wholesale diesel and aviation fuel transactions).
[29] Linda M. Beale, *Congress Fiddles While Middle America Burns: Amending the Amt (And Regular Tax)*, 6 FLA. TAX REV. 811, 827 (2004). In 2001, Congress enacted legislation that increased traditional IRA, Roth IRA, and 401(k) account contributions and added a Saver's Credit. Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107th Cong. §§ 601(a), 611(d) (2001). Flexible health savings accounts allow deductions for these contributions, and the earnings from them are not includible in gross income. I.R.C. § 223; Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. 108-173, 117 *Stat*. 2066, H.R. Conf. Rep. 108-39, 108th Cong. (2003). These changes benefit only taxpayers able to increase their savings because they have adequate income beyond their basic consumption. Beale, *supra* note 29, at 827.
[30] *See* I.R.C. § 7701(a)(30), (b). Both U.S. citizens and resident aliens are taxed under the progressive tax rates of Section 1 unlike nonresident aliens who are taxed under the rates in Section 871. *See* I.R.C. §§ 1, 871.

individuals who meet the substantial presence test, are U.S. lawful permanent residents according to U.S. immigration law, or elect resident alien treatment.[32] Defined by exclusion, nonresident aliens are individuals who are neither U.S. citizens nor resident aliens.[33]

The United States asserts broad extraterritorial jurisdiction under customary international law to tax its citizens on worldwide income regardless of whether that income derives from U.S. or foreign sources.[34] In contrast, nonresident aliens have U.S. tax liability only on their income derived from foreign sources.[35] Like U.S. citizens, resident aliens are allowed to take deductions generally unavailable to nonresident aliens, including deductions for losses arising from investment activities.[36] At the end of the day, tax treatment varies according to the source rules applicable to different items of income.[37]

C. TAX LIABILITY CALCULATION

When calculating their federal income tax liability, U.S. taxpayers subtract personal exemptions and specified deductions from gross income to arrive at their adjusted gross

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In addition, corporations organized in the United States or under U.S. law are viewed as domestic corporations and treated as U.S. persons while corporations organized outside the United States or under non-U.S. law are regarded as foreign corporations and treated as foreign persons. *See* I.R.C. §§ 7701(a)(1), (3), (4), (9), (30)(C).

[31] *See* I.R.C. § 7701(a)(1), (9), (30)(A)..

[32] *See* I.R.C. § 7701(b)(1)(B). To satisfy the substantial presence test, an individual must be physically present in the United States for at least 31 days in current calendar year and at least 183 over 3 years according to prescribed formula. I.R.C. § 7701(b)(3)(A). The U.S. immigration laws determine whether an individual qualifies as a lawful permanent resident of the United States. *See* I.R.C. § 7701(b)(1)(A)(i), (b)(4).

[33] *See* I.R.C. § 7701(b)(1)(A).

[34] CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS ¶¶ 1070, 1155 (3d ed. 2006).

[35] Id. at ¶ 1040.

[36] Id. at ¶ 1070; I.R.C. § 7701(a)(4). Resident aliens are individuals who meet the "green card test" as U.S. permanent residents under the immigration laws or meet the "substantial presence test" by spending a significant amount of time in the United States. I.R.C. § 7701(b). If a non-U.S. citizen is able to show having a "tax home" in a country other than the United States to which a "closer connection exists," the person will not be taxed as a resident alien even if the substantial presence testis satisfied. I.R.C. § 7701(b)(3)(B). *See also* I.R.C. § 162(a)(2). A "closer connection" to a foreign country exists if the person "has maintained more significant contacts" with that country than the United States according to a multi-factor test. Reg. § 301.7701(b)-2(d)(1). Investment activities, in this context, are activities other than conduct of an active U.S. trade or business.

[37] *See* I.R.C. §§ 861, 862.

income.[38] A taxpayer would subtract from adjusted gross income the greater of the taxpayer's standard deduction or itemized deductions to arrive at taxable income.[39] Personal exemption deductions are allowed to the taxpayer, the taxpayer's spouse, and each of the taxpayer's dependents.[40] Applicable personal exemptions are based on the number of a taxpayer's dependents while the standard deduction is based on marital status. In essence, the standard and itemized deductions and personal exemptions represent predetermined amounts of tax-free income available to taxpayers.

U.S. federal income tax is levied on a taxpayer's net income because the taxpayer incurs a tax liability on gross income net of deductions, exemptions, and reduced by credits.[41] U.S. taxpayers may take tax credits to reduce the tax imposed on their taxable income on a direct, dollar-for-dollar basis.[42] Unlike tax credits, deductions and exclusions from gross income are applied against a taxpayer's taxable income and can reduce the tax liability only by an amount equal to the taxpayer's tax rate multiplied by taxable income.

The Alternative Minimum Tax (AMT) is a secondary tax system, which applies in parallel to the regular income tax. When enacting the AMT, Congress intended to ensure that no taxpayer with significant economic income could avoid tax liability through unwarranted use of exclusions, deductions, and credits.[43] For this reason, the AMT starts with a broader tax base than the regular income tax, reduces it by fewer deductions, exclusions, and credits than

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[38] I.R.C. §§ 61, 62.
[39] I.R.C. §§ 62, 63. *See* IRS Form 1040. Itemized deductions include all deductions other than the personal exemption deduction and deductions allowable in computing adjusted gross income. *Id.* at 63(d). The standard deduction ensures that low-income taxpayers are free from obligation to pay tax on income they would use to cover basic necessities, and it also frees taxpayers, who use it, from having to keep records of their itemized deductions.
[40] I.R.C. § 151.
[41] *See* I.R.C. §§ 21-54AA, 55-59, 61-140, 151-153, 161-183, 211-224, 261-280H..
[42] *See* FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 941 (15th ed. 2009).
[43] S. Rep. No. 99-313, at 518-19 (1986), reprinted in 1986-3 C.B. vol. 3.

the ones otherwise used to arrive at taxable income, and applies flatter tax brackets.[44] The AMT reincorporates in its tax base a number of tax preferences that are otherwise deductible, including a disallowance of the deduction for interest on home equity loans and the otherwise excluded tax-exempt interest on private activity bonds.[45]

D. TAX RATES

The Code imposes tax at ordinary and capital tax rates under the two regimes that differentiate between two general sources of income. By imposing two different sets of tax rates, the Code distinguishes ordinary income from gains and losses realized upon sale of capital assets.[46] Broadly speaking, a capital asset is an income-producing investment asset unlike an asset used in an operating business.[47]

Ordinary income tax rates apply on taxable income according to rate schedules for four possible filing statuses: head of household, individual, married filing separately, and married filing a joint return.[48] An implicit tax rate of zero results from tax-free income that individual taxpayers may keep without incurring a tax liability if that income that does not exceed their personal exemptions and standard or itemized deductions.[49]

Historically, gains and losses derived from capital assets have been taxed at capital gains tax rates, which are lower than the corresponding ordinary income tax rates.[50] Likewise, the highest marginal capital gains tax rates have been consistently lower than the ones applied

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[44] Beale, *supra* note 29, at 813. *See* I.R.C. §§ 55-59.
[45] Beale, *supra* note 29, at 813; I.R.C. §§ 56(a)(1), (e), 57(a)(5).
[46] I.R.C. § 1. *See* I.R.C. §§ 1221, 1222, 1223, 1231.
[47] *See* I.R.C. § 1221. For example, inventory and depreciable property used in a business are not capital assets. *Id.*
[48] *See* I.R.C. § 1(a)-(d). A surviving spouse is a taxpayer whose spouse died in one of the preceding two taxable years and who maintains a household for a child or another dependent. I.R.C. § 2(a). A head of a household is defined by exclusion as an individual is not a surviving spouse and is not married at the end of the taxable year, but maintains a household for the taxpayer's dependent, either a parent or a qualifying child. I.R.C. § 2(b).
[49] At the same time, personal exemptions and certain itemized deductions are subject to limitations and phase-out as a taxpayer's income increases beyond certain threshold amounts. I.R.C. §§ 67, 68, 151(d)(3).
[50] *See* I.R.C. § 1(h).

to ordinary income.[51] If a taxpayer holds a capital asset for a year or less before the sale, the capital gain is a short-term one.[52] Long-term capital gains are taxed at preferential capital gain rates while short-term capital gains are taxed at ordinary income rates.[53] Generally, the tax rate that applies to capital gains other than short-term ones depends on the particular type of underlying capital asset.[54]

In 2003, President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2004 JOBS Act).[55] The 2004 JOBS Act reduced the maximum long-term capital gains tax rate from 28 to 15 percent and established a 5 percent long-term capital gains tax rate for taxpayers in the 10-percent and 15-percent ordinary income tax brackets.[56] In 2010, the preferential capital gain rate was zero for taxpayers whose marginal tax rates are 10 and 15 percent, and was set at 15 percent for taxpayers in the upper tax brackets.[57] On December 17, 2010, President Obama extended for two more years the so-called "Bush-era tax cuts" by extending the 2010 ordinary income and capital gains tax rates when he signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act).[58]

The distinct tax rates applicable to ordinary income and capital gains create incentives for high-bracket taxpayers to earn and characterize their taxable income as capital gains. This way, high-bracket taxpayers could pay less tax on capital gains than they would have paid on

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[51] *See* I.R.C. § 1(h).
[52] *See* I.R.C. § 1.
[53] I.R.C. § 1.
[54] *See* I.R.C. §§ 1(h), 1222.
[55] Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R. 2, Cong 108th (2003).
[56] Id.
[57] Tax Foundation, *Federal Capital Gains Tax Rates, 1988-2011*, in TAX DATA (Aug. 30, 201), *available at* http://www.taxfoundation.org/taxdata/show/2088.html (last visited Mar. 20, 2011).
[58] Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, H.R. 4853, 111th Cong. (2010). The "Bush-era tax cuts" were originally enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), H.R. 1836, 107th Cong. (2001) and Increase Prevention and Reconciliation Act of 2005 (TIPRA) Pub. L. 109-222, 120 Stat. 345, H.R. Conf. Rep. 109-455 (2006).

the same amount of ordinary income. For example, a taxpayer whose marginal tax rate on ordinary income is currently 35 percent will be taxed on $100,000 of income from sale of stock at a capital gain rate of 15 percent and will owe $15,000 of tax on the gain instead of $35,000, thus saving $20,000 of tax.[59]

E. TAX TREATIES

The statutory provisions of the Code apply to a nonresident alien in the absence of a bilateral tax treaty negotiated between the nonresident alien's country of citizenship and the United States.[60] U.S. tax treaties reallocate taxing jurisdiction and usually reduce or eliminate U.S. taxes on certain items of U.S.-source income of residents of the treaty partner country.[61] Notably, U.S. tax treaty benefits are available only to "residents" of a treaty country who are liable for tax under the laws of that country.[62] U.S. tax treaties also reduce or eliminate taxes to the treaty partner country on U.S. citizens' and resident aliens' income derived from the treaty partner country.[63] Both the United States and its treaty partner agree that neither will tax the other's citizens more heavily than its own under the same circumstances.[64]

While the U.S. Model Tax Convention serves as a foundation for negotiating bilateral tax treaties, actual provisions and benefits arising under individual treaties may vary. Although tax treaties usually produce tax outcomes that are more beneficial to taxpayers than the Code does, nonresident aliens may choose not to exercise their treaty rights.[65] A taxpayer has the

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[59] Yoseph M. Edrey, *What Are Capital Gains and Losses Anyway?*, 24 VA. TAX REV. 141, 170-72 (2004).
[60] *See* I.R.C. § 894(a)(1).
[61] Gustafson, *supra* note 34, at ¶ 1255. *See* United States Model Tax Convention of November 15, 2006, art. 4(2) (May 8, 2007) [hereinafter 2006 U.S. Model Treaty].
[62] *See* 2006 U.S. Model Treaty, art. 4(2). Because of the Savings Clause, U.S. treaties do not reduce the U.S. tax liabilities on the income of U.S. citizens and resident aliens. *See* 2006 U.S. Model Treaty, art. 1(4).
[63] Gustafson, *supra* note 34, at ¶ 1255.
[64] *See* 2006 Model Treaty, art. 24.
[65] Gustafson, *supra* note 34, at ¶ 3200.

right to elect tax treatment under a treaty or the Code, but must remain consistent in that election and the treatment of the same item or type of income.[66]

U.S. law does not give preferential status to tax treaty provisions but treats them as equal in status to statutes in the Code.[67] The courts prefer to reconcile tax treaties with the Code when deciding on outcomes of tax issues.[68] If, however, a provision of a tax treaty conflicts with Code, the legal authority that came into effect later in time prevails.[69] Hence, statutory tax law enacted by the U.S. Congress can override tax treaties negotiated by the executive branch and vice versa.[70] To avoid a treaty override that may cause potential breach of treaty obligations, Congress allows time for renegotiation of affected treaties before the enacted law comes into force.

F. CROSS-BORDER TAX EVASION

Concerned with tax evasion arising from cross-border financial activities of individual taxpayers, the U.S. government recently strengthened its enforcement efforts with respect to taxation of investment income. U.S. citizens and resident aliens, who have financial interest in, or signature authority over, foreign financial accounts with aggregate value exceeding $10,000, must file a Report of Foreign Bank and Financial Accounts (FBAR).[71] FBAR reporting is

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[66] *Id*. *See* Rev. Rul. 84-17 1984-1 C.B. 308 (holding that a taxpayer may not elect to have some U.S. business activity treated under a treaty and other U.S. business activities treated under the Code).

[67] U.S. CONST., art. VI, § 2 (Supremacy Clause); I.R.C. § 7852(d)(1).

[68] *Pekar v. Comm'r*, 113 T.C. 158, 161 (1999) (finding the AMT foreign tax credit limitation compatible with U.S. tax treaty obligations to limit double taxation), *Xerox Corp. v. United States*, 41 F.3d 647, 658 (Fed. Cir. 1994) ("[T]acit abrogation of prior law will not be presumed and, unless it is impossible to do so, treaty and law must stand together in harmony.").

[69] Gustafson, *supra* note 34, at ¶ 1295. See Restatement (Third) of the Foreign Relations Law of the United States § 115 (A.L.I. 1986).

[70] Section 897, which codifies The Foreign Investment in Real Property Tax Act in 1980 (FIRPTA), is an example of such conflict because it taxed capital gains from sales of U.S. property, including stock of U.S. corporation although tax treaties that were in force when FIRPTA was enacted excluded from taxation such capital gains. I.R.C. § 897 (1980).

[71] Bank Secrecy Act of 1970, H.R. 975, 91st Cong., 31 C.F.R. 103.24 (2010); I.R.S. Notice 2010-23, 2010-11 (March 15, 2010); Treas. Dept. Form TD F 90-22.1. Internal Revenue Service, FAQs Regarding Report of

intended to help the U.S. government identify U.S. citizens and resident aliens who may be using foreign financial accounts to circumvent U.S. tax law by generating and maintaining unreported income abroad.[72] Upon discovery of a taxpayer's unreported foreign bank account, the IRS may impose penalty for willful failure to disclose as high as 50 percent of the highest value of the account for each of the past six years, plus back taxes and civil penalties; plus, the taxpayer risks criminal prosecution.[73] In parallel to FBAR reporting, the IRS is running a voluntary disclosure program where criminal prosecution will be waived for taxpayers who come forward.[74] Potential monetary penalties may still apply, but the IRS has refused to disclose their magnitude.[75]

The Foreign Account Tax Compliance Act (FATCA) is another legislative initiative to combat tax evasion by U.S. persons holding investments in offshore accounts.[76] Starting in 2011, U.S. citizens and resident aliens must report to the IRS on assets held in financial accounts outside the United States with an aggregate value in excess of $50,000.[77] The penalty for willful failure to report could be as high as $10,000 and can reach up to $50,000 for

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Foreign Bank and Financial Accounts (FBAR) - Filing Requirements (March 9, 2011), *available at* http://www.irs.gov/businesses/small/article/0,,id=210244,00.html (last visited Mar. 20, 2011).

[72] Internal Revenue Service, Report of Foreign Bank and Financial Accounts (FBAR) (March 9, 2011), *available at* http://www.irs.gov/businesses/small/article/0,,id=148849,00.html (last visited Mar. 20, 2011).

[73] *See* I.R Robert E. McKenzie & Adam S. Fayne, *IRS FBAR Disclosure Program Misses Opportunities*, in FORBES, IRS Watch (October 10, 2010), *available at* http://blogs.forbes.com/irswatch/2010/10/08/irs-fbar-disclosure-program-misses-opportunities/ (last visited Mar. 20, 2011). The maximum civil penalty for a non-willful failure to file is $10,000. Nixon Peabody, *Report of Foreign Bank and Financial Accounts ("FBAR") due on June 30* (June 17, 2009), *available at* http://www.nixonpeabody.com/publications_detail3.asp?ID=2783 (last visited Mar. 20, 2010).

[74] See I.R Robert E. McKenzie & Adam S. Fayne, *IRS FBAR Disclosure Program Misses Opportunities*, in FORBES, IRS Watch (October 10, 2010), *available at* http://blogs.forbes.com/irswatch/2010/10/08/irs-fbar-disclosure-program-misses-opportunities/ (last visited Mar. 20, 2011).

[75] *See id.*

[76] I.R.S. Notice 2010-60, 2010-37 (Sept. 13, 2010). The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, H.R. 2847, 111th Cong. (2010).

[77] Internal Revenue Service, *Summary of Key FATCA Provisions* (Feb. 25, 2011), *available at* http://www.irs.gov/businesses/corporations/article/0,,id=236664,00.html (last visited Mar. 20, 2011). U.S. citizens and resident aliens must report these financial assets on a new form attached to their tax return in taxable years beginning on or after January 1, 2011. *See* IRS Form 8938.

continued failure after IRS notification.[78] Under FATCA, foreign financial institutions must report directly to the IRS information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold ownership interest of 10 percent or more.[79]

Yet another tool in the U.S. tax evasion arsenal are bilateral Tax Information Exchange Agreements (TIEAs). The information exchange procedure under TIEAs allows the U.S. Competent Authority[80] to request copies of original documents, files related to tax records and bank accounts, and other information need by the IRS to enforce U.S. tax laws.[81] Over the past eight years, the United States has signed TIEAs with a number of low-tax jurisdictions and tax havens, including the Cayman Islands, Bermuda, the Netherlands Antilles, Isle of Man, Jersey, Monaco, and Lichtenstein.[82]

II. Taxation of Investment Income in the United States.

A. U.S. CITIZENS AND RESIDENT ALIENS

Taxation of investment income results in complexity due to the varied tax treatment of income according to its source.[83] Some investment income is taxed fully and currently, other types of investment income are deferred until realized, and third ones are simply exempt from

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[78] Underpayments of tax attributable to non-disclosed foreign financial assets will be subject to an additional substantial understatement penalty of 40 percent. Internal Revenue Service, *Summary of Key FATCA Provisions* (Feb. 25, 2011), *available at* http://www.irs.gov/businesses/corporations/article/0,,id=236664,00.html (last visited Mar. 20, 2011).

[79] *Id.*; Compliance Technologies International, LLP, *8 FATCA Facts*, *available at* http://1441compliance.com/fatca_facts.aspx (last visited Mar. 20, 2011).

[80] The U.S. competent authority initiates and conducts communication with the tax authorities of countries with which the United States has applicable tax treaties.

[81] *See, e.g.*, Tax Information Exchange Agreement, U.S.–Monaco, Sept. 8, 2009.

[82] OECD, *Tax Information Exchange Agreements (TIEAs): United States*, Global Forum on Transparency and Exchange of Information for Tax Purposes, *available at* http://www.oecd.org/document/12/0,3746,en_21571361_43854757_44261772_1_1_1_1,00.htm (last visited Mar. 20, 2011).

[83] Kurtz, *supra* note 4, at 156.

taxation.[84] Tax rates imposed on capital gains are usually lower and more favorable than an individual's corresponding tax rates on ordinary income, which includes dividends, rent, royalties, and interest income.[85] Employers must withhold Federal, state, and local payroll taxes from employees' earned income, such as salaries and other compensation. Payroll taxes include Social Security and Medicare taxes levied on both employees and employers as a percentage of income from employment.[86] Investment income is fully exempt from payroll taxes, which otherwise impose additional tax of 15.3 percent.[87]

i. Interest

Interest on deposits and debt instruments is included in gross income and taxed at ordinary income rates.[88] Still, this general rule comes with exceptions. For example, interest income from municipal bonds is exempt from federal income tax.[89] Municipal bond purchasers can receive interest payments from state or local governments that issued such bonds without including the amount of the interest payments in their taxable income.[90] Subject to tax is the imputed income from interest-free or below-market loans where interest on the loan is forgone

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[84] *Id.* For example, interest income from original issue discount is taxed on a current basis. *See* I.R.C. §§ 1271-1275. Appreciation in value is taxed upon disposition when income is realized through sale or exchange. *See* I.R.C. § 1001. Interest from state and local bonds is tax-exempt. *See* I.R.C. § 103(a).
[85] I.R.C. § 1(h). See *infra* Part I.D for a discussion of ordinary income and capital gains rates.
[86] Social Security Online, Social Security & Medicare Tax Rates (Dec. 29, 2010), *available at* http://www.ssa.gov/oact/progdata/taxRates.html (last visited Mar. 20, 2011).
[87] *Id.*; Beale, *supra* note 29, at 833.
[88] I.R.C. § 61(a)(4) (Gross income includes "[i]nterest.") Banks, insurance companies, and other financial institutions that pay interest on debt or deposits have an obligation to report interest paid to each individuals during the taxable year that is in excess of 10 dollars. I.R.C. § 6049(a), (b).
[89] *See* I.R.C. § 103(a). All else being equal, economic theory indicates that when the after-tax yield on taxable bonds is equal to the untaxed yield on tax-exempt bonds, the marginal investor in tax-exempt municipal bonds will be indifferent between purchasing either municipal bonds or taxable bonds (such as corporate or U.S. Treasury bonds). *See* Patrick Manchester, *Be Kind to Your Foreign Investor Friends*, 98 GEO. L.J. 1823, 1830 (2010).
[90] *See* I.R.C. § 103(a). Because they do not pay taxes on interest income received from such bonds, municipal bond purchasers are willing to accept lower interest rates on municipal bonds than they would otherwise receive from taxable bonds. *See* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 3-4 (7th ed. 2004). In contrast and supplement to Section 103, in 2009, Congress added two types of Build America Bonds as part of the economic stimulus package that will be subject to federal taxation. *See* I.R.C. § 54AA (West Supp. 2009). Both entities and individuals can invest in one while only state and local governments can benefit from direct subsidies through the other. *See* I.R.C. § 54AA(a)-(b), (g).

as a gift, compensation for services, transaction between corporations and shareholders, be it for federal tax avoidance or other purposes.[91] The borrower of interest-free or below-market loans is taxed on the spread – the difference between the amount of interest paid and the applicable federal rate.[92] These rules prevent family members from reducing the family's overall tax liability by having children, who generally are taxed at lower rates, earn income on an interest-free loan from their parents.[93]

Original Issue Discount (OID) interest income is currently includible in a recipient taxpayer's gross income as ordinary income, rather than as capital gains.[94] OID results when a debt instrument is issued at a price lower than the amount to be paid upon the instrument's maturity.[95] In other words, OID interest is the difference between consideration paid upon issuance and consideration paid upon maturity.[96]

Interest income is generally sourced to the residence of the debtor paying the interest, as determined at the time when the interest is paid.[97] Interest payments received from U.S. residents and U.S. corporations are characterized as U.S.-source income.[98] Hence, a taxpayer who receives interest payments from U.S. borrowers would be receiving U.S.-source interest

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[91] I.R.C. § 7872(c)(1)(A)-(E).
[92] I.R.C. § 7872. Congress enacted this statute to recognize that the economic benefit from use of funds at below-market rates is equivalent to receipt of income in the amount of interest saved. The Internal Revenue Service publishes the applicable federal rates monthly. See I.R.C. § 1274(d).
[93] JOSHUA D. ROSENBERG AND DOMINIC DAHER, THE LAW OF FEDERAL INCOME TAXATION 48 (2008).
[94] I.R.C. § 1272.
[95] Edrey, *supra* note 60, at 156. *See generally* I.R.C. §§ 1271-78. For OID purposes, debt instrument means a bond, note, or other evidence of indebtedness where current consideration is exchanged for promised future consideration. I.R.C. § 1275.
[96] Edrey, *supra* note 60, at 156. The Code defines OID as the excess of a debt security's stated redemption price at maturity over its issue price. I.R.C. § 1273(a)(1). The issue price is the debt security's purchase price, and the stated redemption price at maturity includes all payments made on the debt instrument except for qualified stated interest payments. I.R.C. § 1273(a)(2), (b). OID is deemed to be *de minimis* and equal to zero if it amounts to less than .25 percent of the stated redemption price at maturity. I.R.C. § 1271(a)(1).
[97] I.R.C. §§ 861(a)(1), 862(a)(1); Reg. § 1.861-2(a)(2)(i).
[98] I.R.C. § 861(a)(1). Domestic partnerships and foreign partnerships engaged in a U.S. trade or business are U.S. residents . Reg. § 1.861-2(a)(2).

income.[99] Interest is foreign-source income if paid by a borrower residing in any country other than the United States, including foreign corporations, nonresident aliens, and U.S. citizens living abroad.[100] However, interest on deposits held at foreign branches of commercial banking and savings institutions is characterized as foreign-source income even if the actual payor is a U.S. corporation.[101] Interest paid by a U.S. debtor is foreign-source if 80 percent or more of the debtor's gross income is from foreign sources and is attributable to the active conduct of a foreign trade or business.[102] Interest paid by the U.S. trade or business of a foreign corporation is treated as paid by a U.S. corporation and is U.S.-source.[103]

Although interest income and expenses are not necessarily netted against each other and taxpayers are taxed on interest income on gross basis, they can deduct interest expenses. Deductibility of interest depends on the purpose of the borrowing.[104] Interest expenses incurred on borrowing for business and investment purposes are deductible subject to tax avoidance limitations.[105] Interest on debt allocable to property held for investment is considered investment interest,[106] and the deduction for investment interest may not exceed net investment income earned during the taxable year.[107] Net investment income equals the excess of investment income from property held for investment over investment expenses for the production of investment income.[108] Interest in excess of net investment income may be

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[99] I.R.C. § 861(a)(1).
[100] I.R.C. § 862(a)(1).
[101] I.R.C. § 861(a)(1)(B)(i).
[102] I.R.C. § 861(a)(1)(A), (c)(1).
[103] I.R.C. § 884(f)(1).
[104] *See* I.R.C. § 163.
[105] *See id.*
[106] I.R.C. § 163(d)(3)(A). Investment interest does not include qualified residence interest and interest taken into account in the calculation of passive loss limitation under Section 469. I.R.C. § 163(d)(3)(B).
[107] I.R.C. § 163(d).
[108] I.R.C. § 163(d)(1). Investment income equals gross income from property held for investment that generates interest, dividends, royalties, or annuities not derived in the ordinary course of a trade or business and net gain attributable to the disposition of property held for investment. I.R.C. § 163(d)(4)(B), (d)(5). Investment income may include long-term capital gains and qualified dividends only if the taxpayer elects not to apply the preferential

carried forward and treated as deductible in the next taxable year.[109] Interest paid on borrowings for personal purposes, such vacation or purchase of a personal automobile, is not deductible.[110] Nonertheless, qualified residence interest, known as home mortgage interest, is an exception that allows individual taxpayers to deduct interest paid on borrowing incurred to purchase a home.[111]

ii. Dividends

Dividends are distributions of cash, securities, and property other than stock that a corporation makes to its shareholders out of the corporation's current and accumulated earnings and profits.[112] Dividends are included in gross income and are taxed at the ordinary income rates.[113] Distributions of stock dividends, however, are excluded from gross income except when made in lieu of distributions of cash or stock, at the shareholder's election.[114]

Qualified dividends are dividends in a class of their own because they must meet specific criteria to be taxed as net capital gains at the preferential long-term capital gains tax rate instead of the ordinary income rate applicable to ordinary dividends.[115] Qualified dividends include dividends from U.S. corporations and qualified foreign corporations whose

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capital gains rates to them. *See* I.R.C. §§ 1(h)(11)(B), 163(d)(4)(B), 1222(11). Investment expenses are deductions, other than ones for interest, that are directly connected with the production of investment income. I.R.C. § 163(d)(4)(C).

[109] *See* I.R.C. § 163(d)(2).

[110] *See* I.R.C. § 163.

[111] I.R.C. § 163(h). The Code defines qualified residence interest is defined as interest on acquisition indebtedness and home equity indebtedness in connection with the taxpayer's personal residence or one other residence even if rented for some time during the taxable year. I.R.C. § 163(h)(3), (h)(4). Acquisition indebtedness is mortgage debt used to purchase a home, the taxpayer's primary residence and one other residence selected by the taxpayer. I.R.C. § 163(h)(3)(B)(i). Home equity indebtedness is any debt, other than acquisition indebtedness, that is secured by the residence and does not exceed its fair market value. I.R.C. § 163(h)(3)(C)(i). Commentators have suggested that when Congress enacted the tax allowance for home equity loans, it turned houses into credit cards. *See, e.g.*, Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 238 (2010).

[112] I.R.C. §§ 316(a), 317(a).

[113] I.R.C. §§ 61(a)(7) (Gross income includes "[d]ividends."), 316(c)(1).

[114] I.R.C. § 305.

[115] I.R.C. § 1(h)(11)(A).

stock readily tradable on U.S. securities market, incorporated in a U.S. possession or eligible for benefits of U.S. tax treaty.[116] However, dividends from mutual savings banks and tax-exempt organizations, and dividends paid on employer securities invested in compensation are not qualified dividends.[117] A minimum holding period requirement applies to the underlying stock, and it must be held for at least 61 days within a specified 121-day period of the dividend record date.[118] The 2010 Tax Relief Act extends the qualified dividend treatment for dividends passed through from a regulated investment company (RIC), real estate investment trust (REIT), and other qualified pass-through entities.[119] For a distribution from a mutual fund to be treated as a dividend, it must be designated as such.[120] The mutual fund's qualified dividend income for the taxable year must be less than 95 percent of the fund's gross income.[121]

Until 2003, both qualified and ordinary dividends were taxed at ordinary income rates.[122] The 2004 JOBS Act changed this treatment to tax qualified dividends at the reduced tax rates on net capital gains to the two capital gains brackets from 10 and 20 percent to 5 and

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[116] I.R.C. § 1(h)(11)(B)(i), (B)(ii), (C)(i), (C)(ii).
[117] I.R.C. § 1(h)(11)(B)(ii).
[118] I.R.C. §§ 1(h)(11)(B)(iii), 246(c).
[119] *See* Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act), H.R. 4853, 111th Cong. (Dec. 16, 2010).
[120] Typically, mutual funds and real estate investment trusts are organized as regulated investment companies (RIC). Investopedia, *What Does Regulated Investment Company - RIC Mean?*, *available at* http://www.investopedia.com/terms/r/ric.asp (last visited Mar. 20, 2011). Distributions designated by RICs as qualified dividends receive preferred treatment because they are taxed most favorably as long-term capital gains when received by the RIC's shareholders. However, this provision addresses only dividends from RICs that are U.S. corporations but are not real estate investment trusts, charitable organizations, or farmers' cooperative associations. *See* I.R.C. §§ 501, 521, 856. Under the Investment Company Act of 1940, a regulated investment company (RIC) is a U.S. corporation, which is registered as a management company or unit investment trust, has elected to be treated as a business development company, or is excluded from registration as a common trust fund or similar fund. I.R.C. § 851(a). In addition, a RIC must: (1) file with its return for the taxable year an election to be treated as a RIC, (2) keep a minimum percentage of its assets invested in cash, securities, and other investments, and (3) derive at least 90 percent of its gross income from dividends, interest, and other investment income derived with respect to its business of investing in such stock, securities, or foreign currencies. I.R.C. § 851(b).
[121] I.R.C. § 854(b)(1)(B)(i). This "gross income" is calculated as the excess of net short-term capital gain from sales or other dispositions of stock or securities, over the net long-term capital loss. I.R.C. § 854(b)(1)(B)(ii).
[122] *See* Beale, *supra* note 29, at 831. *See* Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA), H.R. 1836, 107th Cong. (2001).

15 percent, respectively, and further to zero percent and 15 percent in 2008.[123] In 2005, legislation extended these provisions until 2010 and lowered the tax rate on qualified dividends and long-term capital gains to zero from 5 percent for low- to middle-income taxpayers in the 10-percent and 15-percent ordinary income tax bracket.[124] On December 17, 2010, President Obama signed into law the 2010 Tax Relief Act, which extended through December 31, 2012 the latest changes enacted to the taxation of qualified dividends.[125]

Dividends from U.S. corporations are generally treated as U.S.-source income, and dividends from foreign corporations are characterized as foreign-source income.[126] Although dividends paid by a U.S. corporation are normally U.S.-source income, a portion of the dividends of a U.S. corporation will be exempt from tax if the corporation earns 80 percent or more of its gross income from foreign sources by actively conducting a foreign trade or business.[127] This portion will be determined based on the percentage of gross income derived from foreign sources in the last three years.[128] The dividends will be U.S.-source income in proportion to the ratio of gross income effectively connected with a U.S. trade or business to total gross income.[129] If 25 percent or more of a foreign corporation's gross income from all sources over this period is effectively connected with a U.S. trade or business, the corporation's dividends will be treated partially as from U.S. sources.[130]

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[123] *See* Beale, *supra* note 29, at 831. Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R. 2, 108th Cong. (2003). *See generally* Joint Committee on Taxation, Summary of Conference Agreement on H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003," (JCX-54-03, May 22, 2003) (overview of tax changes), *at* http://www.house.gov/jct/x-54-03.pdf
[124] Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), H.R. 4297, H.R. Conf. Rep. 109-45, Cong. 109th (2006).
[125] Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act), H.R. 4853, 111th Cong. (Dec. 16, 2010).
[126] I.R.C. §§ 861(a)(2), 862(a)(2).
[127] I.R.C. § 871(i)(2)(B).
[128] I.R.C. § 871(i)(2)(B).
[129] I.R.C. § 861(a)(2).
[130] I.R.C. § 861(a)(2)(B). The test period is the three years ending with the tax year preceding declaration of dividend.

iii. Rents and Royalties

Rental receipts from real and personal property are included in gross income and taxed at ordinary income rates, and so are receipts from royalties.[131] Income from rents and royalties is sourced to the place where the property is located or used.[132] As to rented tangible property, the physical location of the property determines the source of rental income.[133] As to intangible property, the location where the rights to the intangible property are used is generally the country in which the property derives its legal protection.[134] An individual taxpayer must have an ownership interest in the intangible property whose license or sale generates royalty income.[135] Otherwise, income derived from alleged royalties may be re-characterized as compensation for services and sourced to the place where the related services were performed.[136] Taxpayers may offset rental income by deducting a portion of the cost of the rental property each year in the form of depreciation deductions and can so recover the cost of rental property over its limited useful life.[137] If the rental property does not have a limited useful life, as raw land does not, the taxpayer is not permitted depreciation deductions and can recover the asset's cost only when ultimately selling or exchanging it.[138]

iv. Capital Gains and Losses

Gains realized from property transactions are included in gross income.[139] The U.S.

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[131] I.R.C. § 61(a)(5), (6) (Gross income includes "[r]ents" and "[r]oyalties.")
[132] I.R.C. §§ 861(a)(4), 862(a)(4). These sourcing rules apply to intangible property including "patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property." *Id.*
[133] I.R.C. §§ 861(a)(4), 862(a)(4).
[134] Gustafson, *supra* note 34, at ¶ 2015.
[135] *See, e.g.*, *Ingram v. Bowers,* 57 F.2d 65 (2d Cir. 1932).
[136] *Boulez v. Comm'r,* 83 T.C. 584, *aff'd*, 810 F.2d 209 (D.C. Cir. 1987); *Patterson v. Texas Co.*, 131 F.2d 998, 1001 (5th Cir. 1942); *Ingram v. Bowers,* 57 F.2d 65 (2d Cir. 1932).
[137] *See generally* I.R.C. §§ 161, 162, 167.
[138] *See generally* I.R.C. §§ 179, 1001, 1011.
[139] I.R.C. § 61(a)(3) (Gross income includes "[g]ains derived from dealings in property.").

system imposes tax on the change in value of property only when taxpayers realize capital gains or losses upon sale or exchange of the investment property.[140] A taxpayer realizes a gain if the amount received from the property exceeds the taxpayer's unrecovered investment in the property, which often is the property's original cost.[141] Losses are realized when the amount received is less than the taxpayer's unrecovered investment in the property.[142] Taxpayers can recover the cost of investment property upon sale free of tax because tax is imposed only on the incremental value exceeding the investment's cost.[143] For example, assume that a taxpayer purchases investment bonds for $1 million. Two years later, the taxpayer sells the bonds for $3 million and realizes long-term capital gains of $2 million. The taxpayer must include in gross income this amount of $2 million as a capital gain, which will be taxed at long-term capital gains tax rates.

Gain from the sale of depreciable real property can be characterized as capital gain.[144] Capital gains on sale or exchange of collectibles and sale of qualified small business stock are taxed at long-term capital gain rates.[145] Collectibles include artwork, antiques, rugs, gems, metals, stamps, coins, and wines.[146] Qualified small business stock is stock of a U.S. corporation that has assets of $50 million or less and uses at least 80 percent of the value of

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[140] See *infra* Part II.A.vi for a discussion of the realization requirement.
[141] Gain from disposition of property is the excess of the amount received ("amount realized") over the taxpayer's unrecovered investment ("adjusted basis") of the property; loss, on the other hand, is the difference going in the opposite direction. I.R.C. § 1001(a). Amount realized is the sum of money and fair market value of any other property received. I.R.C. § 1001(a). Adjusted basis includes the original basis of the property as adjusted to take into consideration deductions for depreciation and amortization and increases in value resulting from capitalized expenses. I.R.C. §§ 1011, 1012; 1016(a). With the exception of property received by gift or from a decedent, original basis is usually cost. I.R.C. §§ 1012, 1014(a), 1015(a).
[142] I.R.C. § 1001(a). *See also* I.R.C. §§ 1012, 1014(a), 1015(a), 1016(a).
[143] *See* I.R.C. § 1001(a).
[144] I.R.C. § 1231.
[145] I.R.C. § 1(h)(4).
[146] I.R.C. §§ 1(h)(5)(A), 408(m).

these assets in the conduct of one or more qualified businesses.[147] Taxpayers may exclude from income 50 percent of the gain from sale or exchange of qualified small business stock.[148] Shareholders of regulated investment companies (RICs)[149] are taxed on undistributed capital gains, which would be treated as capital gain dividends if had they been distributed.[150]

Donors, who contribute appreciated property to a qualified charitable organization, may deduct the fair market value of the contributed property as part of their itemized deductions.[151] However, this favorable treatment, creating potential for a large deduction, is subject to certain limitations.[152] In certain circumstances, the donor may not deduct fair market value but must deduct only the property's adjusted basis.[153] This is the case if the contributed property would have produced a short-term capital gain or ordinary income had it been sold because the property was not a capital asset in the donor's hands.[154] For example, Pat Rich, a dealer of antiques, purchased a rare mini bookcase for $10,000 when he was shopping for antiques at Les Puces de Saint-Ouen in Paris and donated it to the National Portrait Gallery upon his return to Washington, DC. In the United States, the bookcase has a fair market value of $70,000, but Pat's charitable contribution deduction would be limited to $10,000, the cost of the bookcase, because Pat was in the business of dealing antiques and a sale of the bookcase would have produced ordinary income otherwise.

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[147] I.R.C. § 1202(a), (c), (d). The corporation must a U.S. "C" corporation, and but "C" corporations engaged in the law, accounting, health, athletics, brokerage services, banking, or farming would not qualify. I.R.C. § 1202(e).
[148] I.R.C. § 1202(a), (d).
[149] See Part I.A.ii, n. 121 for a definition and discussion of regulated investment companies.
[150] I.R.C. § 852(b)(3)(D).
[151] I.R.C. § 170(a)(1), (c).
[152] I.R.C. § 170(b)(1)(C), (b)(1)(D), (e). Contributions that exceed $500 are subject to strict substantiation requirements where, depending on the specific amount of deductions claimed, the taxpayer may need to provide a qualified appraisal of the property or at least description of the property. I.R.C. § 170(f)(11). These requirements do not apply to publicly traded securities. I.R.C. § 170(f)(11)(A)(ii).
[153] I.R.C. § 170(e)(1)(A).
[154] *Id.*

A donor's charitable contribution deductions are subject to an annual limit of 30 percent of the donor's adjusted gross income unless the donor elects to take a deduction limited by the donor's basis in the contributed property.[155] If opting out of a limited deduction, the donor can carry forward the excess contribution and deduct it in the next five years.[156] Deductions for charitable contributions to private foundations are also limited to the donor's adjusted basis in the contributed property.[157]

Capital gains from the sale of personal property, such as stocks, bonds, or securities, are sourced to the residence of the seller.[158] Losses from the sale of personal property fall in the same source category that would have been obtained if gain had been realized.[159] For purposes of this source rule, U.S. residents are U.S. citizens, a resident alien who does not have a tax home in a foreign country, and a nonresident alien with a tax home in the United States.[160] Thus, a nonresident alien with a tax home in Budapest or Shanghai will not have a U.S. tax liability from sale of stock on the New York stock exchange, the Chicago Mercantile Exchange, or even NASDAQ. The result will be the same for a resident alien who works and lives in the Seychelles. Yet a U.S. citizen who resides in Monaco and sells Google shares on NASDAQ will owe tax on the gain.

Capital gain from the sale of real property, such land or buildings, is sourced to the property's location.[161] Hence, sale of a luxury apartment building located in Miami Beach, Florida will generate U.S.-source capital gain that will be subject to U.S. tax. On the other hand, sale of a studio located in London will be foreign-source income and will be subject the

[155] I.R.C. § 170(b)(1)(C)(i), (e).
[156] I.R.C. § 170(b)(1)(C)(ii).
[157] I.R.C. § 170(b)(1)(D).
[158] I.R.C. §§ 861(a)(5), 862(a)(5).
[159] I.R.C. § 865(j).
[160] I.R.C. § 865(a), (g).
[161] I.R.C. §§ 861(a)(5), 862(a)(5).

seller's gain to U.S. tax only if the seller is a U.S. citizen or a resident alien.

Taxpayers engaged in their own businesses may realize income when selling depreciable property or intangible assets. According to a recapture rule, gain realized from the sale of depreciable property will be treated as U.S.-source to the extent that depreciation deductions were previously allocated against U.S. source income.[162] If depreciation deductions offset foreign-source income, the recaptured gain is foreign-source.[163] If the sale price for an intangible asset is fixed, the residence of the seller generally determines the source of income.[164] However, if sales proceeds are contingent on the productivity, use, disposition of the intangible property, the source of income will be determined by reference to the royalty rules.[165] As a result, a nonresident alien who transfers fully his or her rights to a patent for $5 million will not owe any U.S. tax because the income will be foreign-source.

v. Investment Losses

Capital losses may be offset only against capital gains and are generally not deductible from ordinary income. Capital loss deductions are limited to the excess of capital losses over capital gains of up to $3,000 per taxable year.[166] This limitation to the dollar amount applies to the total of allowable capital losses for the taxable year, combining both long-term and short-term ones.[167] Still, individuals may carry forward indefinitely the excess of capital losses disallowed and deduct them in the future at a rate of up to $3,000 per year.[168]

[162] I.R.C. § 865(c).
[163] I.R.C. § 865(c).
[164] I.R.C. § 865(d).
[165] I.R.C. § 865(d).
[166] I.R.C. § 1211.
[167] I.R.C. § 1211(b).
[168] I.R.C. §§ 1211(b), 1212(b)(1).

Investment theft losses that result from non-business, for-profit transactions may qualify for deduction.[169] Victims of fraud or embezzlement can take related losses to reduce their ordinary income, recoup any previously paid taxes, or minimize future tax obligations.[170] Taxpayers must first take reasonable action to recover the loss and not doing so disqualifies the loss from deduction.[171] Moreover, deductions for such losses due to investment fraud must satisfy a number of technical requirements and frequently prompt IRS scrutiny.[172]

Losses realized on the sale of a personal residence and other personal assets are not deductible, but U.S. citizens and resident aliens may exclude from gross income gains from sale of principal residence of up to $250,000.[173] Taxpayers may qualify for this exclusion only every two years unless the sale is motivated by the taxpayer's move due to change of employment, health reasons, or other unforeseen circumstances.[174]

Individual taxpayers must net capital gains and losses, according to their short-term and long-term character, by netting each category separately.[175] Thus, long-term capital gains are netted against long-term capital losses, and short-term capital losses are netted against short-term capital gains.[176] If the taxpayer ends up with a net long-term gain and a net short-term loss after this netting process, the taxpayer must net the net long-term gain against the net short-term loss to compute his or her ultimate net capital gain.[177] If the net long-term gain

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[169] I.R.C. § 165(c)(2) ([losses] "incurred in any transaction entered into for profit").
[170] Bart H. Siegel, *Maximize Tax Benefits Under IRC Section 165*, J. ACCOUNTANCY (April 2005), *available at* http://www.journalofaccountancy.com/Issues/2005/Apr/MaximizeTaxBenefitsUnderIrcSection165.htm (last visited Mar. 20, 2011).
[171] *Id*.
[172] *Id*.
[173] I.R.C. §§ 165(c), 121(a), (b). For this exclusion to apply, the taxpayer must have owned and occupied the taxpayer's home as his or her principal residence for at least two of the last five years prior to the sale or exchange. I.R.C. 121(a).
[174] I.R.C. § 121(b)(3), (4).
[175] I.R.C. § 1222.
[176] *Id*.
[177] I.R.C. § 1222(11).

exceeds the net short-term loss, the long-term capital gain rates apply to the excess.[178] If, on the other hand, the net short-term loss exceeds the net long-term gain, the taxpayer may deduct the short-term loss to the extent of the long-term gain plus the $3,000 allowance for capital losses.[179] Any non-deductible excess generates a net capital loss.[180]

For example, assume that Ms. Dalton ends up with a $20,000 net short-term capital loss after netting a $60,000 short-term capital loss against a $40,000 short-term capital gain. Ms. Dalton also has a net long-term capital gain of $100,000, which derives from the sum of $10,000 gain from the sale of depreciable property, $20,000 gain from the sale of land, and $70,000 gain from the sale of eBay stock that she had held for over three years. Netting the $20,000 net short-term capital loss and her $100,000 net long-term capital gain results in a net capital gain of $70,000. Because Ms. Dalton's marginal ordinary income tax rate is 35 percent, this net capital gain is taxed at the 2010 preferential capital gain rate of 15 percent.

vi. Realization Requirement

Most individual taxpayers in the United States report their taxable income on the cash method of accounting, based on the timing of their actual income receipts and payment of expenses.[181] Business and other taxpayers tend to report income on accrual basis, as their economic income and liabilities accrue.[182] Investment income is taxed only when realized and

[178] I.R.C. § 1(h).
[179] I.R.C. § 1211.
[180] *Id.*
[181] *See* I.R.C. § 446; Reg. § 1.446-1. Under the cash method of accounting, a taxpayer includes an item in income when the item is actually received, in cash or cash equivalents, or constructively received by being set apart and made available to the taxpayer. I.R.C. § 451(a); Reg. § 1.451-1(a), -2(a), -2(b); Rev. Rul. 60-31, 1960-1 C.B. 174. Cash method taxpayers deduct expenses when the expenses are paid unless the expense creates an asset with useful life extending substantially beyond the taxable year, so that the expense is no longer deductible but must be capitalized instead. I.R.C. § 461(a); Reg. § 1.461-1(a).
[182] *See* I.R.C. § 461(a); Reg. § 1.461-1(a). Under the accrual method, an individual taxpayer may include an item in gross income when all events have occurred for the taxpayer to have an absolute, fixed right to income, rather than one that is still contingent on some event, and when the amount of income is readily identifiable because it can be determined with reasonable accuracy. I.R.C. § 451(a); Reg. § 1.446-1(c)(1)(ii)(A).

not necessarily when it economically accrues.[183] Thus, gains or losses may occur as property values fluctuate, but they are subject to tax only when a realization event prescribed by the tax law occurs.

Gains are counted and included in gross income when realized and are recognized unless a specific nonrecognition rule in the Code applies to the sale or exchange.[184] Nonrecognition generally applies when a taxpayer has not effectively disposed of investment property but has only exchanged the property and has continued the original investment in another form.[185] Gains and losses are realized but not recognized in nontaxable exchanges because the "new property is substantially a continuation of the old investment that still has not been liquidated."[186] For example, a taxpayer would not recognize gain if exchanging like-kind property held for investment, such as one commercial building for another building of equal value, because taxpayer engages in "like-kind" exchange and nonrecognition applies.[187] Tax on the gain realized in a nonrecognition exchange is deferred until the taxpayer sells the new property received in the exchange.[188] Deferral of tax on gains is advantageous to taxpayers because it allows them to realize savings by investing the deferred tax and earning income on it until a tax liability has to be paid in the future.

Taxation of capital gains upon a realization event somewhat discourages investors from

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[183] Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L. J. 1, 15 (2007). The cash method of accounting allows taxpayers to manipulate the timing of inclusions of income and deductions for expenses because it tolerates some mismatch between inclusions and deductions. Certain regimes deviate from the realization requirement and impose tax on unrealized gains, often with a punitive slant (*e.g.*, the passive foreign investment company rules of I.R.C. §§ 1291-1298), some are intended to prevent an investor from deferring taxes by restructuring an investment (*e.g.*, the original issue discount rules of I.R.C. § 1273), and some assume that a taxpayer does have access to liquid funds (*e.g.*, the mark-to-market rules for dealers in securities I.R.C. § 475). *Id.* at n. 84.
[184] I.R.C. § 1001(c).
[185] *See,.e.g.*, I.R.C. §§ 354, 361, 721, 1031.
[186] JOSHUA D. ROSENBERG AND DOMINIC DAHER, THE LAW OF FEDERAL INCOME TAXATION 297 (2008). *See* Reg. § 1.1002-1(c).
[187] I.R.C. § 1031.
[188] *See generally* I.R.C. § 1001.

taking on risky investments because the tax reduces expected net returns to an after-tax amount.[189] In turn, investors adapt their behavior to defer realization of capital gains because such deferral can increase the after-tax return on their investments.[190] Thus, they may prefer to hold on to stocks, bonds, and securities that offer low returns instead of selling these investments and using the proceeds to purchase new, more productive ones.[191] This phenomenon is known as the lock-in effect, a notion acknowledging that tax on capital gains may lead to avoidance of realization and may ultimately lead to economic stagnation.[192] Deduction of capital losses is limited primarily to constrain taxpayers' ability to choose when to realize their gains and losses.[193] Absent this limitation, a taxpayer could choose to sell an asset with a built-in loss to obtain a tax loss while retaining assets with built-in gains and deferring tax until these assets are sold.[194]

On another note, if the United States were to eliminate the preference for capital gains and tax them at ordinary rates, it should eliminate the preference for capital losses as well, to obtain parity in tax treatment.[195] Allowing deductions for capital losses at ordinary tax rates would create a cherry-picking problem by giving incentives to taxpayers to sell capital assets when most convenient to realize large losses that can offset ordinary taxable income.[196]

vii. Investment Expenses

Generally, investment income of nonresident aliens is subject to withholding tax applied on the gross amount of income, and nonresident aliens do not get to utilize deductions for

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[189] Edrey, *supra* note 60, at 171.
[190] Ivkovic, Zoran, Poterba, James & Weisbenner, Scott, *Tax-Motivated Trading by Individual Investors* (Nt'l Bureau of Econ. Research, Working Paper No. 10275, 2004), *available at* http://www.nber.org/papers/w10275.
[191] Edrey, *supra* note 60, at 170-71.
[192] *Id.*
[193] Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 57 (1996).
[194] *Id*.
[195] Edrey, *supra* note 60, at 171.
[196] *Id.*

investment expenses.[197] In contrast, U.S. citizens and resident aliens may take deductions for expenses incurred for investment activities during the taxable year.[198] To be allowed as deductions, the expenses must be ordinary and necessary for the activity, be reasonable in amount, and bear a proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.[199] Deductible investment expenses typically include fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments.[200] Included also are expenses for management, conservation or maintenance of rental buildings and expenses related to the purchase of bonds even if they will produce yield in a future taxable year.[201] Expenses related to property held for investment would qualify even if the property is unlikely to be sold at a profit, does not currently and will not otherwise produce income, and is held merely to minimize a loss.[202]

However, taxpayers may not deduct expenses for carrying on transactions related to the taxpayer's trade or business or expenses on investment property made primarily as a sport, hobby, or recreation, which are not allowable due to their non-investment nature.[203] The following are non-deductible as investment expenses: commuter's expenses, the cost of rental of a safe-deposit box for storing jewelry, expenses for special training or improving personal appearance, and expenses incurred in seeking employment.[204] Legal expenses incurred to

[197] I.R.C. § 871(a), (b); Gustafson, *supra* note 34, at ¶ 4000. If nonresident aliens' investment income derives from a U.S. trade or business, they may take certain deductions for expenses. See *infra* Part II.B for a discussion of withholding tax on FDAP investment income.
[198] I.R.C. § 212.
[199] I.R.C. § 212(1), (2); Reg. § 1.212-1(c).
[200] Reg. § 1.212-1(g).
[201] Reg. § 1.212-1(b).
[202] *Id.*
[203] Reg. § 1.212-1(d).
[204] Reg. § 1.212-1(f). *But see* I.R.C. § 162.

defend or perfect title to property in recovering the property are not deductible, but attorneys' fees paid in a suit to collect accrued rents are deductible.[205]

The Tax Court once held that a tax lawyer was not entitled to an investment loss deduction because the loss resulted from a voluntary expense that the lawyer was under no legal obligation to make.[206] This case arose from the lawyer's assistance with a purchase arrangement of a purported authentic painting of George Washington that was located in England.[207] Assisting two clients, who were also his friends, the lawyer contributed funds to help offset currency losses from the devaluation of British pounds.[208] The Tax Court denied the investment loss deduction, reasoning that the painting venture was not an activity he undertook for profit, the lawyer received no fees for his assistance, and the expense did not bear a reasonable and proximate relationship to the production of income.[209]

viii. Foreign Tax Credit

Taxing U.S. citizens and resident aliens on worldwide basis creates potential for double taxation because their foreign-source income may be subject to foreign tax as well. One way to mitigate double taxation is by use of the foreign tax credit, which allows U.S. citizens and resident aliens to take a direct credit, on a dollar-for-dollar basis, against their U.S. tax liability for an amount of tax paid to a foreign country.[210] For the foreign tax to qualify as a creditable income tax, its predominant character must be of an income tax by U.S. standards.[211] This

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[205] Reg. § 1.212-1(k).
[206] *Investment Research Associates, Ltd., et al. v. Comm'r*, T.C. Memo. 1999-407.
[207] *Id*.
[208] *Id*.
[209] *Id*.
[210] I.R.C. § 901. Only U.S. citizens and resident aliens, who are potentially subject to double taxation, qualify to use the foreign tax credit.
[211] Gustafson, *supra* note 34, at ¶5060 citing Reg. § 1.901-2(a)(3)(i). This standard is satisfied if the foreign income tax meets three requirements as to: (1) realization, (2) a gross receipts, and (3) net income. Reg. § 1.901-2(b). The tax will meet the realization requirement if is imposed upon a realization event under the Code or on events occurring before a realization event under U.S. tax principles. Reg. § 1.901-2(b)(2). The gross receipts

direct foreign tax credit is available to individuals earning income abroad or receiving dividends, interest, royalties, and rents, from which taxes have been withheld.[212] The credit is limited to foreign taxes paid on foreign-sourced income.[213] Moreover, the credit is limited to the amount of U.S. tax paid with respect to that foreign-sourced income on which the tax was paid with respect to two general types of income: active and passive.[214] By its nature, most investment income falls in the passive income category and is subject to the limitation to passive income.

ix. Tax upon Expatriation

The United States taxes nonresident aliens only on U.S.-source income, but imposes tax on the worldwide income of U.S. citizens and resident aliens, irrespective of their country of residence. This disparate treatment creates incentives for U.S. citizens and resident aliens to pursue tax-motivated expatriation, so they could save U.S. tax on their income from foreign sources. To counter the effects of a potential mass exodus, the United States subjects to tax U.S. citizens renouncing their citizenship and permanent residents terminating their U.S. residency if their annual incomes or net worth exceed certain thresholds for ten years after changing their status.[215] Exception from these rules is made for a limited number of dual citizens.[216] However, subject to tax will be an individual whose average annual tax liability has been of $139,000 or more in the past five-years preceding the expatriation date, whose net

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requirement will be satisfied if the tax is calculated on the basis of gross receipts or an amount calculated so that it avoid overstatement of gross receipts. Reg. § 1.901-2(b)(3).
The foreign tax meets the net income requirement if it allows for recovery of significant, actual costs and expenses. Reg. § 1.901-2(b)(4).

[212] I.R.C. § 901. The direct foreign tax credit is also available to partners of partnerships with foreign income who may be individual taxpayers rather than business entities subject to tax.

[213] I.R.C. § 901.

[214] I.R.C. § 904(d). This limitation intends to prevent taxpayers from using foreign tax credits from a high-tax foreign jurisdiction to offset U.S. tax on U.S.-source income and from using credits from passive income to offset active income.

[215] *See* I.R.C. § 877(a)(2).

[216] *See id.*.

worth as of that date is $2,000,000 or more, or who fails to certify under penalties of perjury that he or she has complied with all United States federal tax obligations for the preceding five years.[217] In addition, expatriates are subject to exit tax on the net gain from their worldwide assets if they had been sold at their fair market value on the day before expatriation, and only the first $600,000 of net gain is excluded.[218]

x. Restrictions on Cross-Border Deferral

U.S. citizens and resident aliens could take advantage of the tax regime applicable to foreign persons by earning income through a foreign corporation. This way, they could defer tax on their foreign-source income because it would not be subject to U.S. income tax until repatriated to the U.S. shareholder through a distribution, or until the U.S. shareholder sells stock in the corporation. However, U.S. tax law has established regimes intended to limit deferral for U.S. citizens and resident aliens acting through foreign corporations.[219] Most prominent and widely applicable are the subpart F rules, which require that certain types of income of foreign corporations be included immediately in a U.S. shareholder's taxable income as if the foreign corporation had distributed this income as a dividend.[220] This regime requires current recognition of income earned through a foreign personal holding company, which

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[217] *See* I.R.C. § 877(a)(2).

[218] I.R.C. § 877A, Heroes Earnings Assistance and Relief Tax Act of 2008, H.R. 6081, 110th Cong. (2008). *See* I.R.C. § 877A(a), (g). The Act became effective on June 17, 2008 and applies to individuals who expatriate on or after that date. The net gain amount is adjusted for inflation starting in 2009 to $626,000. In 2010, the inflation-adjusted exclusion is $627,000. The tax base includes investment assets and respective capital gains or losses, and no losses from wash sales may be taken. I.R.C. § 877A(a).

[219] These regimes include: the foreign personal holding company provisions (formerly I.R.C. §§ 551-558), foreign investment company rules (formerly I.R.C. § 1246), passive foreign investment company provisions (I.R.C. §§ 1291-1298), and Subpart F (I.R.C. §§ 951-964).

[220] I.R.C. § 951. U.S. shareholders of controlled foreign corporations must include in income their pro rata sum of the foreign corporations Subpart F income. I.R.C. § 957(a)(1). A controlled foreign corporation is a corporation organized under foreign law, where U.S. shareholders own more than 50 percent of its combined voting power of all classes of stock or more than 50 percent of the value of its stock on any day during the corporation's taxable. I.R.C. §§ 957(a), 7701(a). U.S. taxpayers, who own 10 percent or more of the total combined voting power of all classes of stock entitled to vote in such foreign corporation, are considered U.S. shareholders for purposes of Subpart F. I.R.C. §§ 951(b), 957(c), 7701(a)(30).

includes most types of passive income, such as interest, dividends, rents, royalties as well as gains from sale of bonds, stock, or securities producing such income.[221]

xi. Kiddie Tax

The progressive tax rates on ordinary income encourage individuals in high-income tax brackets to seek ways to shift income. One possibility is shifting income to family members in low-income tax brackets, such as their children, who may have some investment income but do not yet earn income from employment. Creative tactics of this sort have led to the introduction of the so-called kiddie tax, which means to prevent income shifting among family members.[222] The kiddie tax mandates that a child's unearned income over a certain amount be taxed at the parent's highest marginal tax rate.[223] Unless the child earns income that exceeds one-half of the child's support, the kiddie tax would apply to a child who does not file a joint return and is 18 or younger or a full-time student between 19 and 23 years old.[224]

B. NONRESIDENT ALIENS

The United States taxes nonresident aliens only on their U.S.-source income under two separate regimes.[225] The regimes distinguish between a nonresident alien's income effectively connected with the conduct of a United States trade or business (USTB) and fixed, determinable, annual, or periodic (FDAP) income derived from income-producing property and not effectively connected to a USTB.[226] A nonresident alien's U.S.-source USTB income is

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[221] I.R.C. § 954(c)(1)(A), (B)(i).
[222] Mervin M. Wilf, *IRA and Retirement Plan Distribution Planning: Separate Accounts and Related Planning Alternatives* 63, American Law Institute - American Bar Association Continuing Legal Education: Planning Techniques for Large Estates (November 15 - 19, 2010).
[223] *See* I.R.C. § 1(g)(1), (2). The threshold amount is $1,900 for taxable year 2010.
[224] *See id.*
[225] I.R.C. §§ 871, 872.
[226] I.R.C. § 871(a), (b); Gustafson, *supra* note 34, at ¶ 3005. A nonresident alien engaged in USTB must file a tax return even if the nonresident alien's income is exempt and did not come from the USTB or a U.S. source.

taxed on net basis, after allowable deductions are applied, at the usual graduated rates.[227] Nonresident aliens' U.S.-source FDAP income from non-business activities is subject to withholding at a flat rate of 30 percent, or a lower treaty rate.[228] Occasionally, tax withheld from FDAP income may exceed the nonresident alien's actual tax liability.[229]

FDAP income is statutorily defined as "fixed or determinable annual or periodical" income and generally refers to items of investment-related income of recurring nature.[230] FDAP income expressly includes interest, dividends, rents, salaries, wages, premiums, and annuities.[231] However, a payment may be categorized as FDAP income even if not made annually or periodically but conveyed by a lump sum.[232] For example, because OID typically does not involve interest payments on annual basis, withholding tax is imposed on OID when the debt obligation is paid or when the nonresident alien holder sells or exchanges it.[233] Because FDAP withholding tax is imposed on gross income, nonresident aliens do not get to utilize deductions or credits that may otherwise apply.[234] When effectively connected with a nonresident alien's USTB, investment income and capital gains will be taxed at ordinary

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Internal Revenue Service, Taxation of Nonresident Aliens, *available at* http://www.irs.gov/businesses/small/international/article/0,,id=96477,00.html. *See also* Pub. 519, *U.S. Tax Guide for Aliens* (last visited Mar. 20, 2011). If the nonresident alien's USTB income consists only of wages of amount lower than the personal exemption amount, the non-resident alien is not required to file a tax return. For example, nonresident alien students, teachers, or trainees who are temporarily present in the United States on a non-immigrant visa, are considered engaged in a USTB.

[227] The usual graduated rates are the ones applicable to U.S. citizens and resident aliens.

[228] I.R.C. § 871(a).

[229] *See, e.g.*, Rev. Rul. 85-193, 1985-2 C.B. 191 (holding that the amount of withholding tax on debt obligations is based on gross amount of interest paid on interest payment date even if nonresident alien may have purchased debt at price including principal and interest accrued to date of purchase).

[230] I.R.C. § 871(a)(1).

[231] *Id.*

[232] Reg. § 1.1441-2(b)(1)(ii); *see Comm'r v. Woodhouse*, 337 U.S. 369 (1949) (holding that a single sum advanced as a royalty payment in full cannot render income exempt from tax solely by the reason of the form of the payment); *Central de Gas de Chihuahua, S.A. v. Comm'r*, 102 T.C. 515 (1994) (holding that actual payment of FDAP income is not a pre-requisite as deemed payment is sufficient).

[233] I.R.C. §§ 871(a)(1)(C), 881(a)(3).

[234] I.R.C. § 871(a), (b); Gustafson, *supra* note 34, at ¶ 4000.

income tax rates, rather than at the 30 percent tax rate on FDAP income.[235]

The IRS collects tax on FDAP income by imposing the collection burden on withholding agents.[236] The withholding mechanism arises from the limited power of the U.S. government to enforce U.S. tax laws extraterritorially and the lack of comity.[237] Often, the only subject within the U.S. government's jurisdictional reach may be the investment asset itself, which may be liquidated or removed before the IRS can collect the tax liability.[238] Collection of tax on investment income is assured by imposing the withholding obligation on withholding agents that are persons and entities normally in the United States and subject to broad IRS collection powers.[239] Moreover, this mechanism facilitates tax administration as withholding based on a flat tax followed by elective filing of a tax return is less complex than allowing deductions and exemptions combined with applying progressive tax rates.[240]

i. Interest

Apart from several exceptions, U.S.-source interest income is generally FDAP income and subject to 30 percent withholding tax unless a lower treaty rate applies.[241] Even though U.S.-source, interest earned on certain deposits at U.S. banks and savings institutions is exempt from the 30 percent withholding tax to encourage nonresident aliens to use U.S. financial institutions.[242] Moreover, U.S.-source interest is exempt if paid by a U.S. corporation with 80 percent or more of its gross income deriving from an active foreign business.[243] Interest from

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[235] I.R.C. § 864(c)(2), (3).
[236] I.R.C. § 1441(a), (b). Withholding has broad scope and reach because withholding agents include all persons, in whatever capacity acting, having control, receipt, custody, disposal, or payment of any of the items of FDAP income specified in Section 1441(a) to nonresident aliens. *See id*; Reg. § 1.1441-1.
[237] Gustafson, *supra* note 34, at ¶¶ 4000, 4005.
[238] *Id.* at ¶ 4005.
[239] *Id.* at ¶¶ 4120, 4140.
[240] *Id.* at ¶¶ 4125, 4175.
[241] I.R.C. § 871(a)(1)(A).
[242] I.R.C. § 871(i)(2)(A).
[243] I.R.C. § 861(a)(1)(A), (c).

portfolio debt investments, such as publicly traded debt securities either in registered or bearer form, is also exempt from withholding tax.[244] This exemption does not apply to interest paid to a nonresident alien who is a shareholder with voting power of ten percent or more over the borrowing U.S. corporation.[245] Portfolio debt interest is not exempt if the interest amount is not fixed but is contingent on earnings or change in property value, which may fluctuate in the future.[246]

ii. Dividends

Dividends paid by a U.S. corporation are generally U.S.-source FDAP income and subject to 30 percent withholding tax unless a lower treaty rate applies.[247] However, dividends paid by a U.S. corporation are wholly or partially exempt from withholding tax if the U.S. corporation earns 80 percent or more of its gross income from an active foreign business.[248] The exempt portion of the dividend is determined based on the percentage of the U.S. corporation's gross income earned from the active foreign business to its gross income derived from all foreign sources.[249]

iii. Rents and Royalties

A nonresident alien's rental income from U.S. real property not effectively connected with a USTB is subject to tax on the amount of gross rent at the 30 percent withholding rate.[250] To be taxed at the usual rates and to be able to utilize trade or business deductions, a

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[244] I.R.C. § 871(h).
[245] I.R.C. § 871(h)(3).
[246] I.R.C. § 871(h)(4). Interest is deemed contingent if the amount of interest is determined by reference to receipts, sales, or cash flow, income or profits, changes in property value of the debtor or a related person, or the interest is dependent on dividend or partnership distributions of the debtor or a related person. *Id.*
[247] I.R.C. § 871(a)(1)(A).
[248] I.R.C. § 871(i).
[249] I.R.C. § 871(i)(2)(B).
[250] I.R.C. § 871(a).

nonresident alien may elect to be treated as if engaged in a USTB with respect to the U.S. real property.[251] As FDAP income, royalties are taxed at the 30 percent withholding rate.[252]

iv. Capital Gains and Losses

Gains from the purchase and sale of property, which is not effectively connected with a USTB are not treated as FDAP income.[253] Still, exceptions to this rule exist. U.S.-source gains from the sale of intangible property, such as patents, trademarks, and copyrights, can be FDAP income to the extent that the gains arise from payments contingent on the productivity, use or disposition of the property sold.[254] A nonresident alien is subject to tax on U.S.-source capital gains from sale of capital assets that exceed his or her losses, only if that nonresident alien has spent more than 183 days in the United States during the taxable year.[255] Nonresident aliens may not take deductions for capital losses.

v. Gains from Sale of U.S. Real Property Interest

Prior to 1981, nonresident alien investors were assured that their gains from sale of U.S. real property would be exempt from tax and that associated rental income would be taxed on net basis as USTB income. The enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) closed a capital gain loophole for foreign investors in U.S. real estate because it treats gain on disposition of an interest in U.S. real property as income effectively connected with a USTB.[256] Disposition can take the form of purchase, exchange, gift, or

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[251] I.R.C. § 871(d). *See also* I.R.C. § 162 (allowable deductions for business expenses). The non-resident alien must be the property's owner to make this election. Gross income effectively connected with a USTB is reduced by deductions for expenses that are connected with that effectively connected income. I.R.C. § 873(a).
[252] I.R.C. § 871(a).
[253] Reg. §1.1441-2(b)(2)(i).
[254] I.R.C. § 871(a)(1)(D).
[255] I.R.C. § 871(a)(2).
[256] *See* I.R.C. §§ 871(b), 897(a)(1). This treatment obtains unless AMT produces higher tax. *See* I.R.C. § 55.

transfer.[257] Gain from disposition of U.S. real property interest can be re-characterized as U.S.-source and become subject to tax under FIRPTA even if the transaction is solely between nonresident aliens or foreign corporations and negotiations take place outside the United States.[258] To ensure collection, FIRPTA imposes a withholding obligation on transferees of U.S. real property interests who are required to withhold 10 percent of the gross amount of the purchase price.[259] If the tax withheld can exceed the actual tax liability and the actual cash payment received, the nonresident alien may claim a refund for the difference.[260]

For purposes of FIRPTA, U.S. real property interest is an interest in real property located in the United States.[261] U.S. real property interests include stock in a U.S. real property holding corporation, a U.S. corporation that holds 50 percent or more of specified assets in the form of U.S. real property.[262] Under FIRPTA, a foreign corporation is required to withhold tax at 35 percent, rather than the usual 10 percent, when distributing U.S. real property interest to its shareholders whether as dividend, in liquidation, or in redemption of stock.[263]

vi. Tax Treaties

Negotiated pursuant to the U.S. Model Treaty, bilateral tax treaties typically reduce or eliminate withholding tax on some items of investment income that are not attributable to a USTB conducted through a permanent establishment.[264] When they do, tax treaties generally

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[257] *See* I.R.C. § 1445.
[258] I.R.C. § 861(a)(5).
[259] *See* I.R.C. § 1445(e). Limited exceptions apply to free a transferee from this withholding obligation. I.R.C. § 861(b).
[260] I.R.C. § 1445(c).
[261] I.R.C. § 897(c)(1)(A)(i). U.S. real property interest includes an interest in a mine, well, or other natural deposit. Id. It also includes leasehold interests and options to acquire U.S. real property. I.R.C. § 897(c)(6).
[262] I.R.C. § 897(c)(2). The value of the U.S. corporation's U.S. real property interests would have to be equal or exceed 50 percent of the sum of the fair market value of the following specified assets, excluding passive investment property: (1) U.S. real property interests (2) real property located outside of United States, and (3) assets used or held for use in a trade or business. *Id.*
[263] I.R.C. §§ 897(d), 1445(e)(2).
[264] Gustafson, *supra* note 34, at ¶ 1255.

reduce tax on U.S.-source dividends to 15 percent and eliminate withholding taxes on U.S.-source interest and royalties.[265] Investment income attributable to a permanent establishment in the United States is included in determining net income that will be taxed as USTB income at the usual rates. U.S.-source capital gains not attributable to a permanent establishment generally are not subject to US tax, unless they arise from sale of real property or from US real property interest in which case, they are taxed under FIRPTA.[266] Tax rates applicable to investment income under bilateral tax treaties appear in Appendix B.

C. PRINCIPLE OF EQUITY

Equity was among the elements Adam Smith proposed as integral to an adequate tax system, in addition to simplicity, certainty, and fiscal responsibility.[267] The equity concept has vertical and horizontal dimensions, both of which are derivative from a taxpayer's ability to pay tax.[268] Because the "ability to pay" concept is considered a fundamental criterion of tax justice and fairness, its significance calls for a solid definition: Is income or is wealth the appropriate measure of a taxpayer's ability to pay, or are both similarly adequate?[269]

i. Horizontal Equity

Horizontal equity dictates that individuals situated in similar economic circumstances

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[265] 2006 U.S. Model Treaty, art. 10 (dividends), art. 11 (interest), art. 12 (royalties).
[266] 2006 U.S. Model Treaty, art. 13 (gains). See *infra* Part II.B.v for a discussion of taxation under FIRPTA.
[267] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1970 ed.), cited in Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 468 (1987).
[268] RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES (1954); Beale, *supra* note 29, at 820.
[269] Beale, *supra* note 29, at 820. Debates aside, the realization requirement applies equity principles because it functions to impose tax based on a taxpayer's ability to pay. Brunson, *supra* note 184, at 15. The realization requirement imposes tax not on unrealized appreciation and depreciation but on investment income once the taxpayer has realized actual gains or losses.

should shoulder a comparable tax burden according to their similar abilities to pay.[270] Targeted tax expenditures, such as deductions and credits, could affect horizontal equity throughout the tax system because they may favor certain types of economic behavior over others among taxpayers in similar financial conditions.[271] Applying a single, flat rate across categories of income, regardless of source, promotes horizontal equity.[272] Yet critics assert that a flat tax violates horizontal equity by its one-size-fits-all nature and by shifting the income tax burden on low-income taxpayers when taxing their welfare and unemployment payments.[273]

Some assert that with respect to taxation of financial instruments, "the same tax treatment should apply to economically comparable bets" to create horizontal equity among investments of similar risk profiles although political and administrative barriers stand in the way of this sort of consistency.[274] Scholars have argued that exempting municipal bond interest from tax is horizontally inequitable because it creates a situation in which two taxpayers with identical incomes would incur different tax liabilities if one of them invested in taxable bonds while the other one invested in tax-exempt municipal bonds.[275]

ii. Vertical Equity

[270] Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, Nov. 1984-11/01/1984 ("[a] tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income.").

[271] Brunson, *supra* note 184, at 15 (Fall 2007) ("Taxing similar activities differently causes behavioral distortions and unfairness."), *quoting* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law* 9 (Chicago Working Papers in Law and Economics (2d Series), Working Paper No. 62, 1998), *available at* http://www.law.uchicago.edu/Lawecon/WkngPprs_51-75/62.Weisbach.Line.complete.pdf.

[272] Jay M. Howard, *When Two Tax Theories Collide: A Look at the History and Future of Progressive and Proportionate Personal Income Taxation*, 32 WASHBURN L.J. 43, 73 (1992). The equitable aims of the Bradley-Gephardt, Kemp-Kasten, and Hall-Rabushka flat tax proposals share an attempt to increase equity through expanding the income base, personal exemptions, and excluding low-income taxpayers from tax liability, and the Hall-Rabushka plan satisfies horizontal equity by applying one rate to all "income, wages, and business income alike." *Id.* at 73-74 (quoting ROBERT E. HALL AND ALVIN RABUSHKA, THE FLAT TAX 22 (1985)).

[273] 32 WASHBURN L.J. 43, 74 (1992).

[274] Brunson, *supra* note 184, at 16; David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886, 1889-90 (2004).

[275] *See* Manchester, *supra* note 90, at 1826; Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735, 742 (1979).

Modern theories of law and society focus on a framework of distributive justice arising from personal liberty principles.[276] In this framework, the tax system aims to allocate the tax burden without requiring a sacrifice from those fundamentally unable to pay and to move society towards a more egalitarian distribution of resources.[277] Vertical equity stands for the principle that individuals with differing economic circumstances should pay more or less tax according to their different abilities to pay. Vertical equity supports a progressive tax system with rates ranging from relatively high rates applicable at the top of the scale to zero percent for taxpayers at the bottom, which is the functional equivalent of exemption from tax.[278]

Generally, the greater an individual's total income, the more likely it is that capital gains represent a large proportion of it.[279] For this reason, the distribution of the capital gains tax preference has always been skewed to benefit individuals with the highest incomes as a result of the concentration of individual ownership of capital assets at those income levels.[280] As an individual's income increases, so do that individual's tax liability and the value of utilizing and maximizing the availability of preferences and deductions and to counter the tax system's built-in vertical equity mechanisms.[281] Recipients of substantial amounts of investment income that is taxed at the ordinary rates may be able to make significant charitable contributions, which

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[276] Beale, *supra* note 29, at 821-22.
[277] *Id.*
[278] *Id.* at 820. Thomas Griffith proposes that redistributively progressive tax increases people's happiness because it places primary importance of relative, rather than absolute, incomes. *Id.* at 21; *see* Thomas D. Griffith, *Progressive Taxation and Happiness*, 45 B.C.L. REV. 1363, 1381-88 (2004); *see also* Marjorie E. Kornhauser, *Educating Ourselves Towards a Progressive (and Happier) Tax: A Commentary on Griffith's Progressive Taxation and Happiness*, 45 B.C.L. REV. 1399, 1401-02 (2004).
[279] John W. Lee, III, Class Warfare 1988-2005 *Over Top Individual Income Tax Rates: Teeter-Totter from Soak-The-Rich to Robin-Hood-In-Reverse*, 2 HASTINGS BUS. L.J. 47, 52 (2006); *see* Lee A. Sheppard, *The Rentier Society*, 108 TAX NOTES 176 (2005).
[280] John Lee, *Class Warfare 1988-2005 Over Top Individual Income Tax Rates: Teeter-Totter from Soak-the-Rich to Robin-Hood-in-*Reverse, 2 HASTINGS BUS. L.J. 47, 51 (2006).
[281] *See* Jay M. Howard, *When Two Tax Theories Collide: A Look at the History and Future of Progressive and Proportionate Personal Income Taxation*, 32 WASHBURN L.J. 43, 73 (1992). Often wealthy taxpayers, who can afford professional advice, are able to assertively pursue tax reduction strategies to minimize their tax liabilities and bring about results not necessarily intended by legislators and regulators. *See id.*

reduce their tax bills even further.[282]

Some commentators believe that provisions that move the tax system closer to a consumption tax system, without maintaining significant other taxes on wealth or wealth transfers, benefit most the highest income taxpayers and leave the tax burden falling most heavily on wage earners.[283] Even consumption tax advocates admit that wealthy individuals have very high savings rates and so benefit greatly from the capital gain rate cuts of the 2004 JOBS Act.[284] In contrast, ordinary wage earners spend on basic consumption most or all of their after-tax income, which has already been subjected to a payroll tax burden.[285]

The mortgage interest deduction violates vertical equity not only in housing policy but in tax policy as well by creating a preference for homeowners over renters.[286] Moreover, within the owners' group, it favors high-income homeowners over moderate-income owners of modest homes because the former are more likely to maximize the value of the mortgage interest deduction by itemizing deductions. Some have asserted that exempting municipal bond

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[282] Beale, *supra* note 29, at 833. The media reported that in 2004 Bill Gates intended to contribute to his foundation a $3 billion dividend from Microsoft that would be taxed at the 15 percent rate, while the charitable deduction for contributing the dividend income to the Gates Foundation will offset his ordinary income, taxed at a 35 percent rate. *See id*.; Floyd Norris, *The $32 Billion With a Bonus in Tax Breaks*, N.Y. TIMES, July 22, 2004, at C1.

[283] *See* Beale, *supra* note 29, at 831-32; Robin Cooper Feldman, *Consumption Taxes and The Theory of General and Individual Taxation*, 21 VA. TAX REV. 293, 296 (2002). The wealthiest taxpayers' income consists largely of investment income. Beale, *supra* note 29, at 831-32.

[284] *Id.* at 837. *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1151 (1974).

[285] Beale, *supra* note 29, at 837 (2004). *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1151 (1974).

[286] *See* I.R.C. §§ 163(h), 164(a) (1988); Philip Halpern, *Creating Fair and Efficient Subsidies for Home Ownership*, 4 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 125, 131 (Spring 1995).
Thus, two taxpayers with identical total income and houses may be taxed differently if one owns his or her house and the other rents because mortgage interest on owner-occupied housing is tax deductible.
Yair Holtzman, *Challenges in Achieving Transparency, Simplicity, and Administering of the United States Tax Code*, 26 J. MGMT. DEV. 418, 424 (2007).

interest from tax violates vertical equity because higher-income taxpayers benefit from the exemption to a greater extent than lower-income taxpayers.[287]

iii. Marriage Penalty and Bonus

The tax rates for married couples that file joint returns are the lowest of all four schedules for individual taxpayers. Hence, married couples are encouraged to file jointly because it saves them tax. Marriage can lead to a "marriage bonus," or "marriage subsidy," if it reduces the couple's combined tax liability.[288] On the other hand, the additional tax burden imposed by marriage results in a "marriage penalty" when a married couple's tax liability exceeds the two income earners' combined tax liabilities as singles.[289] The calculation comparing the two spouses' tax liabilities as single against their tax liability as married shows that the existence and magnitude of this phenomenon depends on the distribution of income between the two spouses.[290] A couple would typically experience a marriage bonus if one spouse earns the entire family's income while the other has no income and no potential tax liability.[291] Hence, single-earner couples are likely to gain a tax subsidy through marriage while dual-income couples are most likely candidates for a marriage penalty, especially if their incomes are substantial and similar in amount.[292]

In 2004, Congress enacted legislation to reduce the effect of the marriage penalty by making the tax rates in the 10-percent and 15-percent brackets for married filing jointly two

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[287] *See* Manchester, *supra* note 90, at 1826; Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 179 (1998). See *infra* Part II.A.i for a discussion of the municipal bond interest exemption.
[288] Brookings Institution, *Marriage Penalty* (Joseph J. Cordes et al., eds., Urban Institute Press 2d ed. 2010), *available at* http://www.taxpolicycenter.org/taxtopics/encyclopedia/Marriage-Penalty.cfm.
[289] *Id.*
[290] *Id.*
[291] *Id.*
[292] *Id.*

times the tax rates of individual taxpayers in the same brackets.[293] The 2010 Tax Relief Act effectively extends relief from the marriage penalty by extending increases in the basic standard deduction for a married couple filing jointly to twice that of a single individual.[294] The Act also continues the expanded size of the 15-percent bracket for married couples filing jointly to twice the size of the bracket for single filers.[295]

Use of the family as the taxable unit and imposition of progressive taxation has led to the marriage bonus or penalty.[296] Because current tax law treats the family as the unit of taxation, married couples are treated equally, and the single-earner couple has the same marital tax liability as the dual-earner couple.[297] The marriage bonus phenomenon reinforces the notion the current U.S. tax system seeks to establish horizontal equity between married couples, rather than between individuals, and to promote vertical equity by use of progressive tax rates. If the system were to become marriage-neutral, as it was until 1948, the tax liability of a couple would not change with marriage because the tax system would use the individual as the unit of taxation.[298] Accordingly, families with equal incomes would no longer be treated equally if the progressive rates were to remain in force.[299] Therefore, a progressive tax system faces a trade-off between marriage neutrality and equal treatment of married couples, but it cannot

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[293] *Id*.
[294] *See* Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA), H.R. 1836, 107th Cong. (2001).
[295] *Id*. at §§ 601(a), 611(d).
[296] Brookings Institution, *Marriage Penalty* (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle, eds., 2d ed., Urban Institute Press 2010), *available at* http://www.taxpolicycenter.org/taxtopics/encyclopedia/Marriage-Penalty.cfm. The U.S. General Accounting Office's investigation in 1996 revealed that 59 provisions in the individual income tax code contribute to a marriage penalty or bonus. *Id*
[297] The Working Families Tax Relief Act of 2004, H.R. 1308, 108th Cong. (2004).
[298] Brookings Institution, *Marriage Penalty* (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle, eds., 2d ed., Urban Institute Press 2010), *available at* http://www.taxpolicycenter.org/taxtopics/encyclopedia/Marriage-Penalty.cfm.
[299] *Id*.

attain both at the same time.[300] A progressive tax system comes with an inherent conflict between horizontal and vertical equity.[301]

III. U.S. TAX SYSTEM AND THE FINANCIAL CRISIS

Scholars point to excessive leverage as one of the primary contributors to the 2008 financial crisis.[302] Policy researchers from the International Monetary Fund conducted a stud indicating that tax distortions did not necessarily trigger the crisis but may have exacerbated it.[303] Although non-tax factors encouraged a tendency toward excessive leverage, the tax system should strive to disfavor unwarranted use of debt.[304] Excessive leverage was influenced by a tax preference for corporate debt over equity financing and strong tax preferences for home ownership, which distorted investment patterns.[305]

The global financial crisis originated in the collapse of the housing industry.[306] Stable U.S. real estate markets consistently boosted home values over the past couple of decades.[307] In turn, homeowners leveraged residential real estate through excessive home equity lines and perilous mortgage refinancing, so that home mortgage and home equity debt significantly exceeded homes values.[308] Financial institutions used sophisticated financial instruments to

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[300] *Id.*
[301] Beale, *supra* note 29, at 821.
[302] Daniel Shaviro, *The 2008 Financial Crisis: Implications for Income Tax Reform* 2 (January 31, 2011), *available at* http://ssrn.com/abstract=1442089 (last visited Mar. 20, 2011).
[303] Michael Keen, Alexander Klemm, and Victoria Perry, *Tax and the Crisis, Fiscal Studies*, Institute for Fiscal Studies vol. 31, no. 1, 43-79, 44 (London 2010).
[304] *Id.*
[305] Shaviro, *supra* note 305.
[306] Ventry, *supra* note 112, at 277.
[307] *Id.* at 239, 277. In 2004, the rate of homeownership in the United States reached an all-time of 69 percent. U.S. Census Bureau, *Housing Vacancies and Homeownership (CPS-HVS), Historical Tables, Table 7: Annual Estimates of the Housing Inventory (2009)*, *available at* http://www.census.gov/hhes/www/housing/hvs/historic/index.html (last visited Mar. 20, 2011).
[308] Ventry, *supra* note 112, at 277.

package mortgages with high risk of default into opaque multi-tiered securities.[309] Purchasers of these securities included commercial and investment banks, hedge funds, and insurance companies, all of whom play a critical role in the U.S. economy.[310] Although tax preferences for housing exist and taxation causes distortions, the crisis occurred across countries with very different tax treatment of housing, so taxation does not fully explain excessive mortgage leverage and price increases in the housing market.[311]

A. FEATURES OF THE U.S. TAX SYSTEM THAT EXACERBATED THE FINANCIAL CRISIS: DEBT V. EQUITY FINANCING.

i. Deduction for Home Mortgage Interest

The home mortgage interest deduction contributed to the crisis by encouraging overinvestment in housing: the more housing individuals financed through home mortgages, the bigger of tax breaks they enjoyed.[312] The home mortgage interest deduction comes with multiple hazards.[313] It distorts the cost of owner-occupied housing relative to other investments,[314] causes economy-wide misallocation of capital,[315] artificially elevates housing prices,[316] and results in overconsumption of large, expensive homes.[317] The mortgage interest deduction fueled the crisis by raising the cost of credit for homeowners and for other owners of capital, and distorted risk profiles by rewarding highly leveraged homeowners.[318]

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[309] *See id.*
[310] *Id.*
[311] Keen, *supra* note 306, at 58.
[312] Ventry, *supra* note 112, at 278.
[313] *Id.*
[314] *See* John E. Anderson et al., *Capping the Mortgage Interest Deduction*, 60 NAT'L TAX J. 769, 769 (2007).
[315] *See* Martin Gervais, *Housing Taxation and Capital Accumulation*, 49 J. MONETARY ECON. 1461, 1482 (2002).
[316] *See* William G. Gale et al., *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171, 1171 (2007).
[317] *See* Anderson, *supra* note 317, at 769.
[318] Ventry, *supra* note 112, at 278.

ii. Tax Preferences for Debt Financing

U.S. tax law permits deductions for the cost of debt, in the form of interest expense deductions, but not for the cost of equity.[319] In addition, corporate earnings financed by debt are taxed as interest income only once, at the level of the debt holder.[320] In contrast, corporate earnings financed by equity are taxed twice, once at the corporate level and again at the shareholder level.[321] The higher an individual investor's effective capital gains tax rate is, the less attractive realization of appreciation in stock value becomes.[322] Still, by choosing when to realize capital gains, individual taxpayers have control over the timing of taxation at the shareholder level and could avoid tax permanently if holding the stock until death, and it does not generate capital gain upon transfer once it becomes part of the decedent's estate.[323]

Furthermore, tax-exempt institutions, such as pension plans, charitable organizations, and sovereign wealth funds, prefer debt finance because they can earn tax-free interest from lending to taxable corporations.[324] The growing use of complex financial arrangements involving low-tax jurisdictions, in combination with the debt preference of these tax-exempt institutions, may have led to aggressive exploitation of tax incentives to heighten overall leverage in the U.S. economy.[325] Tax incentives that promote high leverage may undermine the effectiveness of securities regulation and requirements on the banking sector.[326] Recognizing this tax bias, the Basel Accords, which serve as international guidelines for

[319] Keen, *supra* note 306, at 45.
[320] Taxation of interest income at the individual level somewhat offsets the tax advantage of debt financing at the corporate level.
[321] I.R.C. § 1014. Shares of stock held until the taxpayer's death can be redeemed at fair market value without generating capital gains.
[322] Keen, *supra* note 306, at 48. Yet the longer stock is held beyond the taxable year, the lower tax rates on capital gains become. *Id.*
[323] I.R.C. § 1014. Shares of stock held until the taxpayer's death can be redeemed at fair market value without generating capital gains.
[324] Keen, *supra* note 306, at 48.
[325] *Id.* at 48, 50.
[326] *Id.* at 52.

banking regulators, advise that only up to 15 percent of Tier 1 banking capital should consist of hybrid instruments associated with interest deductions.[327]

iii. Hybrid Financial Instruments

Taxpayers can manipulate the tax consequences of their investments by combining the preferred economic characteristics of a financial arrangement to the tax label they favor, be it debt or equity.[328] Financial innovation has focused on developing hybrid financial instruments with multiple features of equity and enough features of debt to attract the interest expense deduction.[329] Sophisticated hybrid financial instruments allow a single financial instrument to be treated as debt in one jurisdiction and equity in another, so that its holder can make the most of tax preferences available on a cross-border basis.[330]

Two examples of hybrid securities are convertible bonds and preferred stock.[331] Convertible bond are bonds that can be converted into predetermined amounts of the company's equity, usually at the discretion of the bondholder.[332] Preferred stock generally is a financial instrument with fixed dividends and unrestrained potential appreciation, and thus combines characteristics of both debt and equity, respectively.[333] Its dividends must be paid out before

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[327] *Id*. The Basel Accords are recommendations on banking laws and regulations intended to serve as banking supervision guidelines developed by the Basel Committee on Banking Supervision based at the Bank for International Settlements in Basel, Switzerland. Fadi Zaher, *How Basel 1 Affected Banks*, in INVESTOPEDIA, *available at* http://www.investopedia.com/articles/07/BaselCapitalAccord.asp.
[328] Shaviro, *supra* note 305.
[329] Keen, *supra* note 306, at 51.
[330] Hybrid entities exist where the same business entity gets disparate treatment in two jurisdictions that operate on the same principle. A good example is a reverse hybrid that is treated as a U.S. corporation for U.S. tax purposes and as a partnership for a foreign jurisdiction's tax purposes. Subject to a few exceptions, the U.S. check-the-box regulations allow business entities to elect their tax treatment by choosing whether to be taxed as corporations or disregarded entities. *See* Reg. § 301.7701.
[331] Keen, *supra* note 306, at 51.
[332] Investopedia, *Convertible Bond*, *available at* http://www.investopedia.com/terms/c/convertiblebond.asp (last visited Mar. 20, 2011).
[333] Investopedia, *Preferred Stock*, *available at* http://www.investopedia.com/terms/c/preferredstock.asp (last visited Mar. 20, 2011).

dividends to common stockholders and its shares usually do not have voting rights.[334] Overall, hybrid instruments create tax arbitrage opportunities for taxpayers and allow them to avoid unfavorable tax consequences to their utmost benefit.

B. TAX MECHANISMS ADDRESSING THE FINANCIAL CRISIS.

Some tax reforms that alleviate distortions to the housing markets may improve economic efficiency and help avoid macroeconomic imbalances by reducing preferences to owner-occupied housing.[335] The timing of reform implementation is significant because they may also lead to reduced house prices and a slowdown in construction activity – a macroeconomic outcome that is undesirable in times of recession.[336] Ultimately, sound tax policy demands balancing reforms aiming at short-term recovery with those leading to structural improvement in the taxation of housing.[337]

i. Combating the Home Mortgage Interest Deduction

Deductibility of mortgage interest not only creates arbitrage opportunities, but also urges use of debt to finance housing and discourages investment in non-housing assets.[338] Despite its significant cost in tax revenue, the home mortgage interest deduction in the United States has been immunized from reformist threats to "preserve that part of the American dream which the home mortgage interest deduction symbolizes," as President Reagan once suggested.[339] Critics have pointed out that Congress could promote home ownership through

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[334] Id.
[335] Keen, *supra* note 306, at 64.
[336] *Id.*
[337] *Id.*
[338] *Id.* at 59.
[339] Ventry, *supra* note 112, at 235. In 2010, the tax expenditure associated with subsidizing the deduction amounted to $108 billion. U.S. Office of Mgmt. & Budget, Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2010, at 300 (2009) O.M.B. Report 1996, at 300.

direct subsidies rather than use of this tax expenditure.[340] Furthermore, scholars and policy makers have reiterated the benefits of funding a tax credit rather than a deduction to promote homeownership.[341] To prevent excessive borrowing and dangerously high loan-to-value ratios,[342] which were precisely the problems that fueled the financial crisis, the tax credit for homeowners could be independent of home value or size of mortgage debt.[343] To prevent households in high-priced real estate markets from receiving disproportionately large subsidies, this credit could be indexed and capped.[344] A home tax credit would associate the homeownership tax subsidy with taxpayers' need, rather than marginal tax rates, and would reduce complexity by helping minimize the use of itemized deductions.[345]

ii. Imputed Rental Income

In addition to the deductions for mortgage interest and property taxes, the exclusion of imputed rental income has promoted overinvestment in owner-occupied housing.[346] Fully neutral taxation within a comprehensive tax system would require full taxation of imputed rent and capital gain realized from sale of housing in combination with full deduction of mortgage interest payments.[347] According to the Haig-Simons definition of all-encompassing economic income, the value of imputed rental income from owner-occupied homes should be fully

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[340] Ventry, *supra* note 112, at 258; Melvin I. White, Deductions for Nonbusiness Expenses and an Economic Concept of Net Income, at 359, in Daniel H. Holland & C. Harry Kahn, *Comparison of Personal and Taxable Income*, in JOINT COMMITTEE ON THE ECONOMIC REPORT (JCER), FEDERAL TAX POLICY FOR ECONOMIC GROWTH 313 (ed. U.S. Cong., 1955).
[341] Ventry, *supra* note 112, at 282. *See, e.g.*, William G. Gale et al., *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171 (2007).
[342] Loan-to-Value ratio represents a proportion of the mortgage amount over the appraised market value of the real property and serves as a risk assessment ratio that lenders examine before approving a mortgage. Investopedia, *Loan-to-Value Ratio – LTV Ratio*, *available at* http://www.investopedia.com/terms/c/loantovalue.asp (last visited Mar. 20, 2011).
[343] Ventry, *supra* note 112, at 282.
[344] *Id.* The President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 73, at 73-74, 237-38. (2005).
[345] Ventry, *supra* note 112, at 283.
[346] *Id*. at 258.
[347] Keen, *supra* note 306, at 58.

taxable.[348] Although few countries have included consumption value of housing in the income tax base in the form of imputed rents, Switzerland and the Netherlands have implemented such inclusion to create neutrality between individual taxpayers who rent and those inhabiting owner-occupied housing.[349]

The United States excluded rent imputed from owner-occupied housing from the income tax base in 1913, and imputed rents have not been part of U.S. tax policy and enforcement ever since.[350] One of the reasons is the associated administrative difficulty, especially in regard to valuation. To overcome valuation challenges, tax authorities could use property tax assessments to estimate gross rental value based on neighboring properties and calculate imputed rent.[351] Two other ways to calculate imputed rent even more precisely could involve imputing a rate of return to the homeowner based on net equity or a return on the fair market value of the home and allowing a deduction for mortgage interest.[352] Another alternative could implicitly tax imputed rents by increasing residential real estate taxes collected from homeowners while basing these taxes on market values.[353] A third one would leave imputed rents untaxed while phasing out the mortgage interest deduction.[354] A possibility for EU tax authorities is taxing sales of residences under the value added tax (VAT), which serve as a proxy for taxation of imputed rents and can prevent distortion of consumption

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[348] Ventry, *supra* note 112, at 254.
[349] Keen, *supra* note 306, at 59.
[350] Ventry, *supra* note 112, at 236. In 1916, the Supreme Court ruled that excluding imputed rent did not violate the Constitution. *Id.* at 257. *See Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 23-24 (1916).
[351] Ventry, *supra* note 112, at 257; Joseph A. Pechman, *Erosion of the Individual Income Tax*, 10 Nat'l Tax J. 1, 14 (1957).
[352] Ventry, *supra* note 112, at 257. *See, e.g.*, Melvin I. White, Deductions for Nonbusiness Expenses and an Economic Concept of Net Income, at 359, in Daniel H. Holland & C. Harry Kahn, *Comparison of Personal and Taxable Income*, in JOINT COMMITTEE ON THE ECONOMIC REPORT (JCER), FEDERAL TAX POLICY FOR ECONOMIC GROWTH 313 (U.S. Cong. ed., 1955); WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 19-21 (1947).
[353] Keen, *supra* note 306, at 65.
[354] *Id.*

decisions.[355]

iii. Combating Debt Bias

Scholars caution that creating a tax bias in either direction, toward debt or equity, can exacerbate the agency problem in business decision-making where managers choose to make risky decisions irrespective of increasing bankruptcy risk.[356] Hence, they call for imposing tax neutrality in the debt-equity choice by eliminating tax preferences for debt and avoiding creating the same preferences for equity.[357] One alternative that scholars have continued to support in recent decades is corporate integration where both debt and equity are subject to a single, uniform tax.[358] One possibility that addresses debt bias is a dividend exemption, which allows shareholders to receive tax-free dividends.[359] The United Kingdom, Canada, and Japan have successfully taken steps to implement dividend exemption.[360] Nonetheless, when tax rates of corporations and shareholder differ, exemption of dividends becomes incapable of creating tax neutrality because shareholders with high marginal tax rates would prefer equity while shareholders in low tax brackets will prefer debt if their tax rates are lower than the respective corporate rates.[361]

An approach already used by the United States is to limit the extent of interest deductibility by applying the thin capitalization rules.[362] The thin capitalization doctrine operates to prevent mischaracterization of debt as equity and dividend distributions as

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[355] Michael Keen, Alexander Klemm, and Victoria Perry, *Tax and the Crisis, Fiscal Studies*, vol. 31, no. 1, 43-79, 65 (2010).
[356] *See, e.g.*, Shaviro, *supra* note 305.
[357] *Id*.
[358] *Id*.
[359] *Id*.
[360] *Id*.
[361] Daniel Shaviro, *The 2008 Financial Crisis: Implications for Income Tax Reform* 7 (Jan. 31, 2011), *available at* http://ssrn.com/abstract=1442089 (last visited Mar. 20, 2011).
[362] Keen, *supra* note 306, at 54.

repayments of principal on putative debt.[363] In the United States, the doctrine has been used to characterize debt and equity properly through a set a factors the IRS and the courts have applied.[364] Because the thin capitalization rules are applied on an ad hoc basis, they may fail to capture all tax-avoidance transactions involving use of excessive debt.[365]

The allowance for corporate equity (ACE) is yet another possibility that would allow interest deductibility to remain in tact.[366] By having tax authorities levy tax only on corporate profits in excess of the notional risk-free return on equity required by shareholders, the ACE regime would effectively permit corporations to deduct the notional cost of equity financing.[367] In its fully neutral form, this regime would restrict deductions to the same notional rate for both debt and equity and would thus eliminate problems associated with hybrid financial instruments.[368] Practical difficulties arise with ACE because it requires commitment to a risk-free notional rate of return of a particular percentage, and the possibility that a corporation may go out of business would call for adjustments to that risk-free rate.[369] Moreover, ACE narrows the tax base and leads to cutbacks in revenue.[370] Still, Belgium and Latvia have implemented this regime in its original form while Italy and Austria have applied a modified form of ACE.[371]

Another alternative is dividend imputation, which gets close to tax neutrality, by taxing dividends at the shareholder level but allowing shareholders a tax credit in the amount of corporate tax gross-up payment attributed to the dividend distribution.[372] However, issues of

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[363] Gustafson, *supra* note 34, at ¶ 4265.
[364] *Id*. *See* I.R.C. § 385.
[365] Keen, *supra* note 306, at 54.
[366] *Id*.
[367] *Id*.
[368] *Id*. at 55.
[369] Keen, *supra* note 306, at 55.
[370] *Id*.
[371] *Id*. at 54.
[372] Shaviro, *supra* note 305.

complexity caused France, Germany, and the United Kingdom to abolish this option.[373] The Comprehensive Business Income Tax (CBIT), yet another alternative, denies interest deductions while exempting from tax interest income and retaining depreciation allowances.[374] CBIT proposals come with difficulties of transitioning pre-existing debt because interest deductibility is required for a foreign tax to be viewed as creditable when claiming foreign tax credits.[375]

C. MECHANISMS ADDRESSING FLIGHT OF CAPITAL

From a cross-border perspective, any time the tax burden on investment income becomes more onerous on domestic or foreign investors, either group can exit and turn to investments in other jurisdictions that assure higher returns on an after-tax basis. On the other hand, the lock-in effect creates an incentive to defer realization of capital gains and to accelerate realization of capital losses.[376] The lock-in effect also affects the mobility of capital by keeping capital invested, rather than allowing it to move freely across markets domestically and abroad.[377]

Proponents of worldwide efficiency take a stand that taxes should not stand in the way of investors to distort their decisions.[378] The principles of capital export neutrality support this view of having investors taxed in the same manner regardless whether they choose to invest at home or abroad.[379] Capital export neutrality postulates that to continue to attract investment inflows, tax jurisdictions should abstain from taxing investment income realized within their

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[373] *Id.*
[374] Keen, *supra* note 306, at 54.
[375] *Id.* at 55.
[376] *Id.*
[377] Edrey, *supra* note 60, at 172, 177.
[378] GARY CLYDE HUFBAUER & ARIEL ASSA, U.S. TAXATION OF FOREIGN INCOME 81 (Peterson Inst. for Int'l Econ., 2007).
[379] *Id.*

boundaries and should allow the investor's home country to tax.[380] The U.S. tax system relies on capital-export neutrality to prevent flight of domestic capital. By its design, the U.S. system taxation creates a default advantage for nonresident aliens who are not taxed on their incomes from foreign sources unlike U.S. citizens and resident aliens who are taxed on their worldwide income. U.S. citizens and resident aliens who derive substantial portions of their total income may have strong incentives to engage in tax-motivated expatriation even if weighing a costly exit tax and ten-year after-expatriation tax consequences.[381] Sadly, investors' choice to let their capital earn investment income abroad ultimately results in a decrease in domestic capital investment.

D. LEGISLATIVE OUTLOOK

xii. Consumption Tax Solution: VAT.

The increasingly global economy and a tax base consisting of mobile capital make it more difficult to rely on traditional sources of revenue.[382] The global financial crisis has resulted in decreased tax revenues and economic stimulus measures that brought significant government deficits.[383] While lowering tax expenditures will reduce deficits, most countries will need to raise taxes and generate additional revenues to effectively offset the deficits' impact.[384] The Organisation for Economic Cooperation and Development (OECD) has

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[380] *Id*.
[381] *See generally* Nancy H. Kaufman, *Fairness and the Taxation of International Income,* 29 LAW & POL'Y INT'L BUS. 145 (1998). See *infra* Part II.A.ix for a discussion of tax-motivated expatriation.
[382] Justin Lowe and Stafford Smiley, *A Shift Toward Consumption Taxes: The Tax Policy Prescription for the Fiscal Ills of the Global Financial Crisis?*, J. CORP. TAX'N, 42-48, 42 (July/August, 2010).
[383] *Id*.
[384] *Id.* at 44.

supported the increased use of consumption taxes as they have a significantly less adverse effect on gross domestic product (GDP) than income taxes.[385]

One prevalent form of consumption tax is the value added tax (VAT), which is a multi-stage sales tax collected at each point in the production and distribution process.[386] Although the VAT is a major source of revenue in many industrialized countries, its adoption in the United States has been suggested as a supplement to the federal income tax, rather than its replacement, in the form of an income-based consumption tax known as cash-flow tax.[387] A cash flow tax transforms the income base into a consumption base by deducting net savings or adding net borrowing.[388]

Although significant fiscal demands call for raising tax revenues and evidence shows a tendency of greater worldwide reliance on consumption taxes as stimulants of GDP growth and global competitiveness, the introduction of the VAT in the United States is challenged by significant political stumbling blocks.[389] While the VAT is tied to consumption and is relatively easy to collect and enforce, the institution of a completely new tax typically faces resistance.[390] Critics also suggest that the potential VAT revenue stream will not reduce other tax burdens but will be used to increase government spending over the long term and would create additional burdens for businesses, especially for small businesses.[391]

States would likely object strongly to the introduction of a VAT because their sales taxes, another form of consumption tax, are a primary source of state governments' revenues.[392]

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[385] *Id*. *See* Organisation for Economic Cooperation and Development, Tax and Economic Growth, Economics Department Working Paper No. 620 (2008).
[386] Kurtz, *supra* note 4, at 160.
[387] *Id.* at 161.
[388] *Id.* A cash flow tax levies tax only on the consumption element of Haig-Simons income.
[389] Lowe, *supra* note 384, at 46.
[390] *Id*.
[391] *Id*.
[392] *Id.* at 46-47.

The United States could follow the model of other countries that have dealt with raising VAT revenue in a federal system.[393] In Germany, national government collects VAT revenues, which are apportioned to the various provinces, but the method of apportionment has caused controversy.[394] Canada effectively integrated its national goods and services tax with provincial taxes although the provinces resisted the infringement on their autonomy.[395]

Taxpayers with lower incomes will end up paying a larger percentage of their income in VAT than ones with higher incomes because the former tend to spend a larger portion of their income, and taxpayers with higher incomes are able to save a larger percentage of their income. Commentators have concluded that using the money raised by the VAT for progressive social programs is the best way to reduce the VAT's regressive nature.[396]

xiii. Tax Rates 2010-2013.

Beginning in 2013, Medicare tax will be imposed on unearned income, which includes capital gains, dividends, royalties, and interest income.[397]

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[393] *Id.* at 46.
[394] *Id.* at 46-47.
[395] *Id.* at 42-48, 47.
[396] *Id.* at 48.
[397] Stefan F. Tucker and Tammara F. Langlieb, *Recent Developments Affecting Real Estate and Pass Through Entities*, American Law Institute - American Bar Association Continuing Legal Education, Creative Tax Planning for Real Estate Transactions, Legislative Development (Nov. 4 - 6, 2010).

Highest Marginal Tax Rates (2010-2013):[398]

Types of Investment Income	**2010-12**	**2013**[399]	**2013** (plus 3.8%)[400]
Ordinary Unearned Income (Interest, Non-qualified Dividends, Rents, and Royalties)	35%	39.6%	43.4%
Qualified Dividends	15%	39.6%	43.4%
Long-Term Capital Gains	15%	20%	23.8%

Ordinary Income Tax Brackets (for taxable year 2011).[401]

2011 Tax Brackets	**Single**	**Married Filing Jointly**
10% Bracket	$0 – $8,500	$0 – $17,000
15% Bracket	$8,500 – $34,500	$17,000 – $69,000
25% Bracket	$34,500 – $83,600	$69,000 – $139,500
28% Bracket	$83,600 – $174,400	$139,500 – $212,3000
33% Bracket	$174,400 – $379,150	$212,300 – $379,150
35% Bracket	$379,150+	$379,150+

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[398] Martindale.com, Curtis, Mallet-Prevost, Colt & Mosle LLP, *Update on U.S. Long-Term Capital Gain, Interest and Dividend Tax Rates* (Sep. 6, 2010), *available at* http://www.martindale.com/government-law/article_Curtis-Mallet-Prevost-Colt-Mosle-LLP_1143322.htm (last visited Mar. 20, 2011).
[399] Tax rate does not include 3.8 percent tax on Unearned Income.
[400] Tax rate including 3.8 percent tax on Unearned Income.
[401] Smart On Money, *What Changes Will Happen To My Taxes On January 1st, 2011?*, *available at* http://www.smartonmoney.com/what-changes-will-happen-to-my-taxes-on-january-1st-2011/ (last visited Mar. 20, 2011).

CONCLUSION

While *ex post* studies and investigation indicate that taxation was not the direct cause of the financial crisis, tax preferences certainly helped fuel it. Debt bias encouraged excessive leverage. U.S. citizens and resident aliens drowned in home mortgage debt as they sought to maximize their investments in residential equity. In addition, despite tax fines through FIRPTA when unloading real estate, nonresident aliens had opportunities to participate on an equal footing with U.S. taxpayers to leverage residential and commercial real estate by obtaining USTB tax treatment and deducting interest and other business expenses.

A tax system has a delicate balance of mechanisms that seek to induce behavior and is closely intertwined with a nation-state's domestic economy and the global financial landscape. Policy makers have set their sights on implementing solutions that eliminate, or at least mitigate, debt bias to equalize the after-tax cost of debt to that of equity finance. Arriving at optimal tax policy requires careful consideration of not only the benefits of tax neutrality and reducing mounting budget deficits, but also the potential drawbacks and their impact on that landscape.

Appendix: Tax Treaties between the United States and EUCOTAX countries.

EUCOTAX Countries	**Dividends** (%)	**Interest** (%)	**Royalties** (%)
Austria	15	0	0
Belgium	0/15[402]	0	0
Czech Republic	15	0	0
France	15	0	0/5[403]
Germany	15	0	0
Hungary	15	0	0
Italy	15	0	0
Netherlands	15	0	0
Poland	15	0	0
Spain	15	0/10[404]	5/8[405]
Sweden	15	0	0
United Kingdom	15	0	0[406]

402 The zero percent tax rate generally applies to: (1) dividends paid by a Belgian resident company to a U.S. resident company, provided the U.S. shareholder has owned 10% or more of the capital of the Belgian company for at least 12 months before the date the dividends are declared. The rate is 15 percent in all other cases.

403 Payments for the use or the right to use a copyright of literary, artistic or scientific work (including reproduction rights and performing rights), any cinematographic film, any sound or picture recording, or any software are exempt; otherwise, the rate is 5 percent.

404 Interest is exempt if paid on a long-term loan (five or more years) granted by a financial institution or paid in connection with the sale on credit of any industrial, commercial or scientific equipment; otherwise, the rate is 10 percent.

405 The 5 percent rate applies to the use /right to use any copyrights of literary, dramatic, musical, or artistic work. The 8 percent rate applies to the use/right to use films, tapes, and other means of transmission or reproduction of image or sound and the use/right to use industrial, commercial, or scientific equipment, and for any copyright of scientific work.

406 The domestic rate applies in respect of any royalty paid under, or as part of, a conduit arrangement.