



Letter from the Section Chair Bill Elwell

I hope that you enjoy the Summer 2009 issue of the Federal Bar Association's Section on Taxation newsletter, which describes the section's recent and upcoming activities and includes winning research papers from the section's 2009 law student writing competition. James Kroger, an LLM student at the Georgetown University Law Center, wrote the first-place paper, entitled "The New Frontier: Tax Implications of Limited Cooperative Associations." Kroger's paper discusses the Uniform Limited Cooperative Association Act and analyzes how cooperatives organized under the act will be taxed under Subchapter T of the Code. David Schneider, a third-year law student at the George Washington University Law School, wrote the second-place paper. Schneider's paper, entitled "Dividing to Unite: How We Can Reach Common Development Goals When Developed Countries Adopt Different Tax Systems," urges the international community to adopt a globally coordinated tax regime to provide greater tax incentives for investment in emerging economies. Billy Joe Mills, a law student at the University of Illinois College of Law, wrote the honorable mention paper, entitled "Inspiring Green Car Sales: What Deserves the Credit?" Mills' paper, which we hope to publish in an upcoming edition of the newsletter, argues that the plug-in electrical vehicle tax

credit has not been an effective incentive for purchasing electric automobiles.

The section recently hosted two major conferences. On Mar. 6, 2009, the section hosted its 33rd Annual Tax Law Conference. At a special ceremony, the section was pleased to honor Mortimer Caplin as the 2009 Kenneth S. Liles Award winner. The section presents the Liles Award annually to a person who, over the course of his or her career, significantly contributes to Federal tax policy and tax administration. Caplin served as the Commissioner of the IRS from 1961 to 1964 and on President Kennedy's Task Force on Taxation before co-founding the law firm of Caplin & Drysdale Chartered in Washington, D.C.

On May 28 and 29, the section and the IRS co-sponsored the 21st Annual Insurance Tax Seminar, which is the premier insurance company and insurance products tax conference in the country. Mark Kovey, of Scribner, Hall & Thompson, the founder and co-coordinator of the seminar, has organized the Seminar for many years and has been a driving force behind its growth and success. Kovey stepped down as private sector chair after this year's seminar, and while we will miss his great leadership, we are very grateful for his efforts on behalf of the Section on Taxation and look forward to having Lori

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Section of Taxation Recent Events

33rd Annual Tax Law Conference

The 33rd Annual Tax Law Conference was held at the Ronald Reagan Building and International Trade Center on Mar. 6, 2009. Highlights from the conference included remarks by Hon. Douglas Shulman, commissioner of internal revenue; Edward Kleinbard, chief of staff of the Joint Committee on Taxation; and Hon. John Colvin, chief judge of the U.S. Tax Court. Attendees received an update of tax legislation from the chief counsels of five Senate and House committees. Concurrent sessions throughout the day included critical developments in employee benefits and executive compensation, domestic corporate tax, international tax, tax practice and procedure, partnerships and pass-throughs, tax accounting and financial products. Presentation of the 2009 writing competition winners took place near the end of the conference. First place was awarded to James Kroger, an LLM student at Georgetown University Law Center. Second place was awarded to David Schneider, a third-year law student at George Washington University Law School. The honorable mention was awarded to William Joseph Mills, a third-year student at the University of Illinois. Following the conference, a reception was held honoring the 2009 Kenneth H. Liles award winner Mortimer M. Caplin, commissioner of internal revenue 1961-1964.

This year's conference was chaired by Danielle Rolfes of Ivins, Phillips & Barker Chartered and Terri McField of the Internal Revenue Service Office of Chief Counsel. The conference would not have been possible without the generous support of our sponsors. The elite sponsors for the 2009 conference include: Caplin & Drysdale Chartered; Dewey and LeBoeuf LLP; Ivins, Phillips & Barker Chartered; KPMG LLP; Mayer Brown LLP; McKee Nelson LLP; Miller & Chevalier Chartered; Morrison & Foerster LLP; and Paul Hastings. The Section on Taxation would like to thank the sponsors for their

continued support.

21st Annual Insurance Tax Seminar

The 21st Annual Insurance Tax Seminar succeeded in informing and educating its audience on insurance company and insurance product tax issues once again at its one and a half day program on May 28-29, 2009. Held in Washington, D.C., the seminar allowed the tax professionals from the Internal Revenue Service—who administer the specialized federal tax law provisions that apply to these corporations and their products—to have an open dialogue with their counterparts at national and international insurance companies and their attorneys and other tax consultants. It is the only seminar in its field that has large numbers of both government and private sector tax professionals in attendance, which enhances the dialogue that has been a hallmark of this seminar for 21 years. The 2009 seminar featured over 19 separate sessions covering the most significant and timely tax topics, as well as a discussion of evolving regulatory issues arising as a result of the current financial crisis. The 22nd Annual Insurance Tax Seminar will be held next year on June 3-4, 2010, also in Washington, D.C.

Women in Tax Law

On Apr. 30, 2009, the Federal Bar Association Section on Taxation sponsored its sixth event in the continuing Women in Tax Law series. This bi-annual program provides women tax professionals in government and the private sector with opportunities for professional development and networking.

The most recent event, Networking and Building Relationships: Strategies and Practical Advice for Women in Tax Practice, featured a panel presentation comprised of the following accomplished and vibrant women:

- Jean A. Pawlow, partner, McDermott Will & Emery LLP



At the 33rd Annual Tax Law Conference—(left photo, l to r) Bill Elwell, section chair; Danielle Rolfes, conference co-chair; Hon. Douglas Shulman, commissioner of internal revenue; and Terri McField, conference co-chair. At the presentation of the 2009 writing competition awards—(right photo, l to r): Bill Elwell, section chair; David Schneider, second place winner; James Kroger, first place winner; Teresa Dondlinger Trissell, Internal Revenue Service; and Kari Larson, section chair-elect.

- Helen H. Morrison, deputy benefits tax counsel, Office of Tax Policy, Department of Treasury
- Elizabeth (“Libby”) B. Coffin, director–tax affairs, United Technologies Corporation

Each speaker shared her personal story of how she came to be involved in tax law and what led her career to the position she holds today. The panelists then shared their experience and advice on building and maintaining professional relationships, as well as making use of advantages and overcoming unique challenges facing female tax practitioners. Kari Larson of the U.S. Department of Justice—Tax Division, chair-elect of the Section on Taxation, moderated the event, which concluded with a networking reception. Approximately 45 tax professionals attended the event. The section would like to

thank Latham & Watkins LLP for hosting this event.

Careers in Tax Law

On June 24, 2009, the Section on Taxation hosted their annual Careers in Tax brown bag lunch on Capitol Hill for summer associates, law clerks, and younger lawyers considering a career in tax law. Panelists from several agencies and all three branches of government discussed their career paths, provided advice, and gave their perspective on the practice of federal tax law. Panelists included Hon. Mark Holmes, U.S. Tax Court; Deb Meland, chief, Office of Review, Tax Division, Department of Justice; Clarissa Potter, acting chief counsel, Internal Revenue Service; Ginny Chung, attorney-advisor, Office of Tax Policy, Department of Treasury; and



At the 21st Annual Insurance Tax Seminar—(left photo, l to r): Nancy Vozar Knapp, Office of Chief Counsel, IRS; and Mark H. Kovey, Scribner, Hall & Thompson LLP. At the Women in Tax Law event on April 30—(right photo, l to r): Teresa Trissell, IRS Office of Chief Counsel, P&A; Libby Coffin, United Technologies Corporation; Jean Pawlow, McDermott Will & Emery LLP; Helen Morrison, Office of Tax Policy, Department of Treasury; and Kari Larson, USDOJ—Tax Division.

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Jones of Scribner, Hall & Thompson take over his responsibilities on the seminar. The 2009 seminar featured 19 sessions, covering significant and timely insurance tax topics, including regulatory and legislative issues affecting the taxation of insurance companies and insurance products, and foreign tax, financial product, accounting, and securitization issues.

There are also several notable upcoming section events. The section is planning to host an event addressing exempt organization tax issues in September, and a breakfast panel featuring newly-confirmed Tax Court judges in October. The Section on Taxation is also very excited to be involved as co-sponsor in the 22nd Judicial Conference of the Court of Federal Claims, which will be held on Oct. 29, 2009, at Tulane

University in New Orleans, La. Please keep an eye out for updated information on these and other upcoming section programs.

I have very much enjoyed serving as section chair and believe that our successes have been a result of the dedication of volunteers from both the government and private sector. I am privileged to work with our fine steering committee members and am grateful for the help of the staff of the Federal Bar Association here in Washington, D.C. As always, I am happy to hear from you, the section members, about any ideas or suggestions you have to improve the section and fulfill the mission of the section to promote the welfare, interests, education, and professional growth and development of members of the section; to contribute to the formation

of federal tax policy through section events, to promote high standards of professional competence and ethical conduct in the practice of federal tax law; and to provide opportunities for interaction between tax practitioners in public service and the private sector.

I look forward to supporting Kari Larson as she takes over as section chair in October 2009 and continues to work toward these same goals. She has been very involved in the section over the last few years, and I have greatly appreciated all of her support, hard work, and dedication. A typical disclaimer states that past performance is no guarantee of future success—but that clearly doesn't apply to Kari! I feel very confident that she will do a fantastic job and be a great asset to this great organization. ♦

The New Frontier: Tax Implications of Limited Cooperative Associations

Jimmy Kroger

Abstract

There's a new kid on the block. In 2007, the National Conference of Commissioners on Uniform State Laws approved and recommended for enactment in all the states the Uniform Limited Cooperative Association Act. The act is attracting a great deal of attention in the cooperative community because it provides a model for a unique business entity that would enable cooperative associations to have both patron and investor members in order to secure equity capital that is much needed in capital intensive cooperative associations, such as ethanol plants and meat processing facilities. Although the act solves the problem of raising equity capital it also brings in to question whether a cooperative association organized under this act would qualify for preferred tax treatment under Subchapter T of the code.

This paper introduces the history of cooperative association principles, cooperative association taxation, and the Uniform Limited Cooperative Association Act. After providing the necessary historical context, this paper provides an analysis of how New Age cooperative associations formed under the Uniform Limited Cooperative Association Act fit in to the present tax law. Specifically, the act is examined in terms of the "check-the-box" regulations and what it means for a cooperative association to be "operating on a cooperative basis" for purposes of Subchapter T of the code. As will be seen, the act presents both opportunities and challenges for the tax practitioner and cooperative associations formed under the act. Such New Age cooperative associations fit well within the present economic landscape, are often vital to rural economic growth and development, and offer something culturally unique—cooperative principles—to the bevy of business entity choices. However, it remains to be seen whether the service and Congress will embrace New Age cooperative associations.

History of Cooperative Associations

Cooperative Association Principles

No single definition of cooperative associations exists; however, one author has defined them as follows:

A cooperative is an organization established for the purpose of purchasing and marketing the products of its members, i.e., shareholders, and/or procuring supplies for resale to the members, whose profits are distributed to the members (in the form of patronage dividends), not on the basis of the members' equity investment in the cooperative, but in proportion to their patronage of it, i.e., the amount of business that each member transacts with it. In a workers' cooperative, the members jointly manufacture a product and share in the profits of the enterprise

based on the amount of labor they contribute.¹

In order to fully appreciate the unique characteristics that define cooperative associations and separate them from other types of business organizations it is necessary to examine them along their evolutionary path in terms of the principles that define them.

Cooperative associations were born of a time when self-reliance and mutual assistance were the order of the day. They began to gain prominence during the twilight of the agrarian age and the dawn of the industrial age. One of the first cooperative businesses established was the Rochdale Equitable Pioneers' Society, founded in England in 1844. The defining feature that set the Rochdale Society apart from other business organizations were the principles upon which it was founded: (1) that capital should be of their own providing and bear a fixed rate of interest; (2) that only the purest provisions procurable should be supplied to members; (3) that full weight and measure should be given; (4) that market prices should be charged and no credit given or asked; (5) that profits should be divided pro rata upon the amount of purchases made by each member; (6) that the principle of "one-member, one-vote" should obtain in government and the equality of sexes in the membership; (7) that management should be in the hands of the officers and committees elected periodically; (8) that a definite percentage of profits should be allocated to education; and (9) that frequent statements and balance sheets should be presented to members.² While these principles have not been universally accepted they do represent one of the earliest expressions of modern cooperative principles.

The principles of cooperative associations evolved, in large part, from the principles of the Rochdale Society; however, several organizations have advanced cooperative principles in the United States. Following the Civil War, the National Grange (Patrons of Husbandry), the Farmers Union, and the International Cooperative Alliance all served unique rolls in the advancement of cooperative principles.³

As economic realities change cooperative associations must be allowed the flexibility to modify their principles in order to enable them to continue as viable economic entities.

As Abraham Lincoln said, "important principles may and must be flexible." Similarly, in the context of the definition of "cooperative" for statutory purposes, Justice Brandeis, in a frequently quoted passage from a dissent

¹Carla Neeley Freitag, *Taxation of Cooperatives*, 744 BNA Tax Management Portfolio § I, 1 (2d ed. 2008).

²Catherine Webb, *INDUSTRIAL COOPERATION—THE STORY OF A PEACEFUL REVOLUTION* (5th Ed. 1912).

³Donald B. Pedersen & Keith G. Meyer, *AGRICULTURAL LAW IN A NUTSHELL* 274 (1994).

joined by Justice Holmes, stated:

That no one plan of organization is to be labeled as truly co-operative to the exclusion of others was recognized by Congress in connection with co-operative banks and building and loan associations. With the expansion of agricultural cooperation it has been recognized repeatedly And experts in the Department of Agriculture, charged with disseminating information to farmers and Legislatures, have warned against any crystallization of the co-operative plan, so as to exclude any type of co-operation.⁴

In 1995, the International Cooperative Alliance listed the following principles of cooperative associations: “(1) voluntary and open membership; (2) democratic member control; (3) member economic participation; (4) autonomy and independence; (5) education, training, and information for members; (6) cooperation among cooperatives; and, (7) concern for community.”⁵ The four basic principles that now characterize cooperative associations are as follows: “[1)] democratic ownership and control by users; [(2)] limited returns on capital; [(3)] return of benefits or margins to users on the basis of use; [and, (4)] the obligation of user-owner financing.”⁶

Subchapter T of the code has inexorably linked cooperative associations to the corporate income tax regime and provided for a modified version of flow-through taxation, with the exception of most savings banks, mutual insurance companies, and rural electric and telephone cooperatives.⁷ This presents an interesting dichotomy, because cooperative associations are organized around unique principles—principles that are necessary for any cooperative association to qualify as “operating on a cooperative basis” for Subchapter T purposes—that are in stark contrast to the characteristics and operations of pure Subchapter C corporations. Cooperative principles are what, in substance, separate cooperative associations from pure Subchapter C corporations. Therefore, it is instructive to compare cooperative principles to the characteristics of a pure corporation: (1) associates; (2) an objective to carry on a trade or business and divide the profits; (3) continuity of the life of the enterprise, notwithstanding the death, disability, or withdrawal of its members; (4) the opportunity for centralized management by representatives of the owners; (5) the privilege of limited liability for the owners; (6) free transferability of ownership interests; and, (7) holding title to property as an entity.⁸ Congress has linked cooperative associations to

pure Subchapter C corporations by cooperative principles that are radically different than the characteristics and operating practices of pure Subchapter C corporations. This historical dichotomy helps to explain why modern cooperative associations are encountering problems.

Cooperative associations have traditionally been mutual self-help organizations in which the owners were also the customers. “Unlike pure for profit organizations, where the objective is to earn profits for those who invest in them, or not for profit organization, whose activities are often focused on providing for third parties, a cooperative’s organizational structure and its activities are focused on its members.”⁹ Cooperative associations have served the purpose of enabling members to improve their individual businesses as opposed to making a profit on their investment. Therefore, it would be impossible for a pure Subchapter C corporation to embody cooperative principles and fulfill the role that cooperative associations play in the economy. That is why Congress chose to carve out a special place for cooperative associations in the Internal Revenue Code. If Congress erred it was in linking cooperative associations to Subchapter C corporations.

Cooperative Association Taxation

Since the inception of the modern U.S. income tax system Congress has recognized the unique nature of cooperative associations and the inherent value in having business organizations based on cooperative principles, which is why cooperative associations have been embodied in U.S. tax law for nearly a century. In order to understand cooperative taxation it is beneficial to trace the genesis of modern cooperative taxation.

The taxation of cooperative associations was first addressed by Congress in the Revenue act of 1916, which exempted from taxation marketing cooperatives that marketed the products of their members.¹⁰ This tax exemption was continued in the Revenue Act of 1918.¹¹ The Revenue Act of 1921 expanded the tax exemption to include cooperative associations that were organized and operated to purchase supplies and equipment for its members.¹² The tax exemption for marketing and purchasing cooperative associations was continued in the Revenue Act of 1924.¹³ The exemption was renumbered and additional statutory rules were provided by the Revenue Act of 1926.¹⁴ The next major development occurred with the

⁹James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 77 (2008).

¹⁰Revenue Act of 1916, ch. 463, § 11(a), 39 Stat. 756 (1916).

¹¹Revenue Act of 1918, ch. 18, § 231(11), 40 Stat. 1057 (1918).

¹²Revenue Act of 1921, ch. 136, § 231(11), 42 Stat. 227 (1921).

¹³Revenue Act of 1924, ch. 234, § 231(11), 43 Stat. 253 (1924).

¹⁴Revenue Act of 1926, ch. 27, § 231(12), 44 Stat. 39 (1926).

⁴James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 68 (2008).

⁵Unif. Ltd. Coop. Assoc. Act, Prefatory Note, 4 (2007).

⁶James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 66 (2008).

⁷See I.R.C. § 1381 (2008).

⁸*Morrissey v. Commissioner*, 296 U.S. 344 (1935); see also Treas. Reg. § 301.7701-2 (2006).

Revenue Act of 1951 wherein Congress addressed exempt farmers' cooperatives and nonexempt cooperatives and provided that patronage income received by a cooperative association would be taxed either to the cooperative or the patron.¹⁵ In succeeding years, a series of judicial decisions thwarted the intent of Congress as embodied in the Revenue Act of 1951.¹⁶ Congress reacted by enacting Subchapter T of the code as part of the Revenue Act of 1962.¹⁷ The Revenue Act of 1962 continued to permit exempt farmers' cooperatives to deduct

Cooperative associations have evolved from purchasing and marketing associations to capital intensive enterprises, such as ethanol plants and food processing facilities, which allow agricultural producers to add value to their agricultural outputs.

distributions from patronage and nonpatronage sources and subjected nonexempt cooperatives to a single level of taxation at either the cooperative or patron level.¹⁸ The structure implemented in 1962 presently applies as sections 1381, 1382, 1383, 1385, and 1388 of the code. Since 1962 there have been few changes to the taxation of cooperative associations. The Consolidated Omnibus Budget Reconciliation Act of 1985 enabled cooperatives to net patronage income and losses between allocation units¹⁹ and the American Jobs Creation Act of 2004 enabled cooperatives to deduct dividends on capital stock

from nonpatronage income.²⁰ Cooperative associations and practitioners now seek to determine whether the new Uniform Limited Cooperative Association Act will be able to embody cooperative principles, in order to justify its existence as a unique business entity choice, and qualify for preferred tax treatment under the code.

The Uniform Limited Cooperative Association Act

In the 1990s numerous New Age cooperative associations were created in several Midwestern states in order to allow agricultural producers to engage in value-added processing of their agricultural outputs.²¹ New Age cooperative associations can be distinguished from traditional cooperative associations in several ways:

- (1) Equity accumulation programs based on substantial up front investments by patron members;
- (2) A tie-in between equity investment and the right and obligation to deliver a specified quantity of product to the cooperative each year; and
- (3) A right of patron-members to transfer their equity to another person eligible to become a patron-member at whatever price is acceptable to both parties.

While traditional cooperatives usually seek to maximize membership, New Generation cooperatives are closed-end with a limited number of members.

....

[A] New Generation farmer cooperative is a value-added cooperative that processes or otherwise converts the raw agricultural products of its members into one or more high-valued products.

....

[The] formation is motivated by the desire to develop new value-added products and to gain access to an increased share of the consumers' food dollar. To the extent that they are successful, therefore, these cooperatives can increase the wealth of their members. They also have the potential for adding wealth to the communities in which they are located by creating new employment opportunities in their facilities. In sum, New Generation cooperatives are commonly viewed as instrumental in rural development.²²

Cooperative associations have evolved from purchasing and marketing associations in to capital intensive enterprises, such as ethanol plants and food processing facilities, which

¹⁵Revenue Act of 1951, ch. 521, § 314, 65 Stat. 452 (1951).

¹⁶*See, e.g., Carpenter v. Commissioner*, 20 T.C. 603 (1953), *aff'd*, 219 F.2d 635 (5th Cir. 1955); *Estate of Caswell v. Commissioner*, 17 T.C. 1190 (1952), *rev'd*, 211 F.2d 693 (9th Cir. 1954); *Long Poultry Farms, Inc. v. Commissioner*, 27 T.C. 985 (1957), *rev'd*, 249 F.2d 726 (4th Cir. 1957).

¹⁷Revenue Act of 1962, Pub. L. No. 87-834, § 17, 76 Stat. 960 (1962).

¹⁸*Id.*; *Gold Kist, Inc. v. Commissioner*, 104 T.C. 696 (1995), *rev'd*, 110 F.3d 769, 772 (11th Cir. 1997).

¹⁹Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13210(a), 100 Stat. 82 (1986).

²⁰American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 312(a), 118 Stat. 1418 (2004).

²¹*See* Michael L. Cook & Constantine Iliopoulos, *Beginning to Inform the Theory of the Cooperative Firm: Emergence of the New Generation Cooperative*, 4 FINNISH J. OF BUS. ECON. 525, 526, 529 (1999).

²²James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 71-72 (2008).

allow agricultural producers to add value to their agricultural outputs. This changing economic dynamic has forced cooperative associations to reach out to non-patron investors in order to secure needed capital throughout all stages of the business enterprise. However, investors have been reluctant to invest in cooperative business enterprises because of how they have traditionally been structured and operated. This has limited the ability of many New Age cooperative associations to start and grow their businesses. As a result, cooperative associations have turned to LLCs, partnerships, joint ventures, and strategic alliances to secure needed capital.²³

Linking cooperative associations to some form of flow-through Subchapter K taxation model may ultimately prove to be a better fit than linking cooperative associations to the Subchapter C taxation model through Subchapter T, especially considering that cooperative associations have little in common with pure Subchapter C corporations. It is instructive to compare corporate and partnership income taxation in order to fully draw the distinction.

The principal difference in the tax treatment of “regular” corporations and partnerships is the “pass-through” characteristic of partnerships. This treatment of partnerships permits each item of income, gain, loss, deduction, or credit of the partnership to retain its character as determined at the partnership level. A corporation is taxed as an entity that exists independently of its shareholders, and thus must report income and take tax credits and deductions as an entity, separate and distinct from its shareholders. Consequently, corporate income is generally taxed twice by the time it reaches the pockets of its participants—once when earned by the corporation and a second time when distributed to the shareholders.²⁴

It seems likely that Congress linked cooperative associations to Subchapter C corporations in order to provide a default for the taxation of income not properly taxable at the cooperative association member level (unallocated reserves); to provide cooperative associations with limited liability, because when Subchapter T was enacted in 1962 Subchapter C corporations were the only entity choice that offered limited liability; and because it was much easier, from a legislative and tax policy standpoint, to piggyback cooperative associations on to Subchapter C than to create a new modified version of Subchapter K that would create an entirely new entity classification for tax purposes.

States began to respond to this type of problem in 1977 when Wyoming enacted the first limited liability company act.²⁵ It is also of interest to note that Wyoming was the first state to enact a New Age cooperative association statute

²³*Id.* at 73.

²⁴A. Willis et al., *PARTNERSHIP TAXATION STUDENT ABRIDGED EDITION* ¶ 1.02[2] (6th ed. 1997).

²⁵Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 *BUS. LAW.* 375, 383-84 (1992) (citing Act of March 4, 1977, ch. 155, 1977 Wyo. Sess. Laws 512).

in 2001.²⁶ As a result of the apparent desire of Congress to quickly and easily “patch” the tax law relating to cooperative associations, we are presently dealing with a system of cooperative taxation that is highly complicated, inefficient, vague, and fraught with pitfalls for unwary cooperative associations and tax practitioners. In short, Subchapter T of the code has succumb to obsolescence, through a process of creative destruction, leaving to cooperative associations and tax practitioners the difficult task of trying to fit round pegs in to square holes. The only point that Congress made abundantly clear when it enacted Subchapter T of the code was that it sought to provide cooperative associations with “a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron.”²⁷

Linking cooperative associations to Subchapter K partnerships and creating a unique default that would provide for the taxation of income at the partnership level for income not properly taxed at the cooperative association member level may have proven to provide for a better fit because, as a practical matter, cooperative associations and cooperative association principles are more closely aligned, in terms of structure and operation, with partnerships. It may be that we will continue to go down a highly complicated road because of the potential error that Congress made when it enacted Subchapter T of the code in 1962.

Several states, including Minnesota,²⁸ Tennessee,²⁹ Wisconsin,³⁰ Iowa,³¹ and Nebraska³² have responded by modifying their existing cooperative association statutes in order to accommodate the needs of New Age cooperative associations, particularly those that engage in value-added processing, to secure capital. It is from these state statutes that the Uniform Limited Cooperative Association Act acquired its genesis.

As a result of the interest expressed by the adoption of the new state cooperative statutes, in those states and elsewhere, the National Conference of Commissioners on Uniform State Laws (NCCUSL) undertook to develop a uniform law to provide a pattern for uniformity among the states desiring to adopt similar statutes. A drafting committee was formed. The members of the committee, with an American Bar Association advisor and observers from the cooperative community providing input, developed a draft law. On August 2, 2007, at

²⁶Unif. Ltd. Coop. Assoc. Act, Prefatory Note, 1 (2007).

²⁷H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 485; S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 821.

²⁸Minnesota Cooperative Associations Act, Minn. Stat. §§ 308B.001-308B.975 (2007).

²⁹Tennessee Processing Cooperative Law, Tenn. Code §§ 43-38-01 to 43-38-1109 (2007).

³⁰Wisconsin Cooperative Associations Act, Wis. Stat. §§ 193.001-193.971 (2007).

³¹Iowa Cooperative Associations Act, Iowa Code §§ 501A-501A.1216 (2008).

³²Nebraska Limited Cooperative Associations Act, Neb. Rev. Stat. §§ 21-2901 to 21-29, 134 (2007).

its annual meeting, Commissioners from fifty states and territories in attendance voted unanimously to recommend the Uniform Limited Cooperative Association Act . . . to the states for adoption.

This Act would not replace any existing state co-op laws. Rather, it would be a free-standing statute to fill a different niche in the cooperative economic ecosystem just as cooperative enterprises fill a niche in the general organizational ecosystem. Thus, some provisions of the Act differ markedly from the more corporate-like framework of existing traditional cooperative statutes. A limited cooperative association formed under this Act is intended to provide an unincorporated cooperative structure with centralized management but democratic member control as an alternative to a limited liability company, which has been a form of business many have turned to when the traditional cooperative form of business entity has not been receptive to outside investments.

The new state cooperative statutes and the Act provide for an unincorporated entity to be formed with both traditional patron members and investor members. In selected ways, “investor members” are similar to limited partners in a limited partnership formed under the Uniform Limited Partnership Act (2001). Nonetheless, the Act seeks to provide an alternative which accounts for cooperative principles to a *greater* extent, with less room for design abuse, and with more transparency to patron members than can be engineered by using a combination of entities to find equity investment. Finally, although some features of the limited cooperative association are very similar to the features of other entities, and descriptive analogies to other entities may be helpful, it is imperative to understand that the limited cooperative association—as are all cooperatives—is a unique entity with important distinctions from other entities to which it may be compared.

. . . .
. . . .

The Act provides an unincorporated and flexible organizational structure buttressed and combined with “cooperative principles and values in order to obtain increased equity investment opportunity for capital intensive and start-up cooperative enterprises.” It is an alternative to other cooperative and unincorporated structures already available under state laws. It is also another statutory option providing a flexible breastwork of mandatory and default rules that are grounded in cooperative values and member governance. The flexibility in this Act necessarily means that much of it is not “hard-wired” to assure that it will be qualified as a cooperative, for example, under various provisions of federal law.³³

While these new state statutes and the Uniform Limited Cooperative Association Act simplified cooperative association business entity problems related to the acquisition of capital they also complicated the system by which cooperative associations are taxed. It remains unclear how these New Age cooperative associations will be taxed at the federal level. One method that would potentially allow for these new unincorporated cooperatives to qualify for either Subchapter K partnership taxation or Subchapter C corporate taxation, as modified for cooperative associations by Subchapter T, would be for the entity to utilize the “check-the-box” regulations to make an election.³⁴ The “check-the-box” regulations may end up serving as a necessary “patch” to a system of cooperative taxation that has become outdated, given the modern economic realities of cooperative associations, and may have been ill conceived from the start.

Taxation of New Age Cooperative Associations

The “Check-The-Box” Regulations

New Age cooperative associations, formed under the Uniform Limited Cooperative Association Act and similar state statutes, are driven by economic and financial needs and concerns.³⁵ In order to fully address those needs and concerns it was intended by the drafters of the Uniform Limited Cooperative Association Act that New Age cooperative associations would be able to utilize the “check-the-box” regulations in order to allow for increased flexibility.³⁶ This would enable New Age cooperative associations to default to partnership taxation under Subchapter K of the code or elect to be treated as corporations under Subchapter C of the code, as modified for cooperative associations by Subchapter T of the code.³⁷

The service has provided very little guidance as to whether New Age cooperative associations will qualify to use the “check-the-box” regulations. The service ruled that an entity formed under a “State Cooperative LLC Act” was an eligible business entity that could utilize the “check-the-box” regulations.³⁸ The service determined that the entity was qualified to use the “check-the-box” regulations because the entity wasn’t organized as a trust or a per se corporation.³⁹ The entity was organized under the act as an unincorporated association, which did not refer to the association as incorporated or as a corporation, body corporate, or body politic.⁴⁰ The service has also ruled that a limited liability company was a qualified business entity that could use the “check-the-box” regulations to

³⁴See generally Treas. Reg. §§ 301.7701-1, -2, -3 (2006).

³⁵See, e.g., Robert R. Keatinge & Anne E. Conaway, KEATING AND CONAWAY ON CHOICE OF BUSINESS ENTITY (2006).

³⁶James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 76 (2008).

³⁷See generally Treas. Reg. §§ 301.7701-1, -2, -3 (2006).

³⁸I.R.S. Priv. Ltr. Rul. 2001-39-020 (Sept. 28, 2001).

³⁹*Id.*

⁴⁰*Id.*

³³James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 74-76 (2008).

elect corporate tax status and thus be taxed under Subchapter T of the code provided that it met all of the requirements of that Subchapter.⁴¹

However, the service has not squarely addressed whether cooperative associations organized under the Uniform Limited Cooperative Association Act are business entities for purposes of federal tax law and are therefore eligible to use the “check-the-box” regulations.

Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.⁴²

. . . A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.⁴³

Cooperative associations organized under the Uniform Limited Cooperative Association Act are unincorporated entities that are separate and apart from their members⁴⁴ and divide profits,⁴⁵ although the act does not require a profit motive. However, these provisions are not dispositive because federal tax law governs the definition of a “business entity” regardless of what any cooperative association may provide for in its organic document.

Based on the aforementioned private letter rulings it seems plausible that the service would permit an entity organized under the Uniform Limited Cooperative Association Act and similar state statutes to utilize the “check-the-box” regulations in order to default to partnership tax status or elect corporate tax status. However, it is problematic whether a cooperative association, organized under the Uniform Limited Cooperative Association Act, that elected corporate tax status through the “check-the-box” regulations would qualify for preferred tax treatment under Subchapter T of the code by “operating on a cooperative basis.”

Operating On A Cooperative Basis

In order for a New Age cooperative that elects corporate tax status through the “check-the-box” regulations to qualify for preferred tax treatment under Subchapter T of the code it would have to operate “on a cooperative basis.”⁴⁶ Unfortunately, neither the Internal Revenue Code nor the Income Tax Regulations provide a definition of what it means for a corporation to be “operating on a cooperative basis.” The Income Tax Regulations simply state that section 1381 of the code “applies to any corporation operating on a cooperative

basis and allocating amounts to patrons on the basis of the business done with or for such patrons.”⁴⁷ However, what it means to “operate on a cooperative basis” has been developed in case law and rulings put out by the service.

Historically, cooperative associations have been defined in terms of their principles. The principles of a cooperative association are all that, in many cases, separate it from a pure Subchapter C corporation. The Uniform Limited Cooperative Association Act embraces many traditional cooperative principles and values.

Cooperative values and principles are distributed throughout the Act, though some are varied as a result of permitting investor members with limited governance rights.

. . . .
. . . .

As a matter of general consensus cooperative values and principles include voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; cooperation among cooperatives; and, concern for community.

Section 104 addresses the values of voluntary membership, member economic participation, and autonomy and independence. Voluntary membership is reflected by the term “persons united” in this Section and relationships that are “consensual” in Section 113(a). Open membership has been compromised under this Act and similar existing law in order to allow (but not require) the formation of “closed” cooperatives. Closed cooperative structure is necessary where an association desires for patron members to share fully in any increased value of their equity and to provide member liquidity.

A limited cooperative association is a self-help organization controlled by its members and is a separate entity from its members under Section 105. This principle of autonomy must, however, be placed within the practical context of long-term debt, equity, and contractual relationships both in this Act and in traditional cooperatives.

Section 1004 (“Allocation of Profits and Losses”) expressly provides for the values of member economic participation; education, training and information; and cooperation among cooperatives. One of the key balancing points of the Act concerns “democratic member control.” Sections 405, 511 through 514, 804, and 816(a) (as well as the other voting provisions on fundamental changes) all relate to this balance.

“Concern for community” is directly addressed in Section 820 which varies the law generally applicable to, for

⁴¹I.R.S. Priv. Ltr. Rul. 2001-19-016 (Feb. 6, 2001).
⁴²Treas. Reg. § 301.7701-1(a)(1) (2006).
⁴³Treas. Reg. § 301.7701-1(a)(2) (2006).
⁴⁴Unif. Ltd. Coop. Assoc. Act § 104(a) (2007).
⁴⁵See generally Unif. Ltd. Coop. Assoc. Act §§ 1004, 1005 (2007).
⁴⁶See I.R.C. § 1381 (2008).

⁴⁷Treas. Reg. § 1.1381-1(a) (2006).

example, corporate directors, to allow the directors of a limited cooperative to consider a number of community constituencies in making decisions.

Another frequently articulated cooperative principle is “operation at cost.” This principle is frequently recognized through allocations of profits and losses among members in a traditional cooperative in a manner similar to allocations in partnerships. Section 1004 reflects this approach. “Operation at cost” can also be addressed through pricing of goods and services received from or provided to members in ways that financially benefit the members. This, in turn, will affect profits and losses available for allocation to members. This approach is taken in this Act.

In sum, this Act considers important traditional cooperative values and provides reasoned departures from those values only where necessary for purposes of this Act. Its intention is to encourage the use of entities recognizing cooperative principles by providing greater option for obtaining equity financing, yet is flexible enough to form a limited cooperative association which operates like a traditional cooperative.⁴⁸

By departing from the traditional cooperative model insofar as necessary to provide a measure of flexibility required for cooperatives to adapt to changing economic realities it is intended that the Uniform Limited Cooperative Association Act will expand the use of entities recognizing cooperative principles and values.⁴⁹ However, it is problematic whether the necessary departures from the traditional cooperative model will compromise the eligibility of a cooperative association organized under this act, that elects corporate tax status, to qualify for preferred tax treatment under Subchapter T of the code.

The seminal and often cited Tax Court case that articulated the core principles of cooperative associations was *Puget Sound Plywood, Inc. v. Commissioner*,⁵⁰ which defined core cooperative association principles as follows:

1. The subordination of capital, both as regards control over the cooperative undertaking and the ownership of the pecuniary benefits arising therefrom;
2. Democratic control by the worker-members; and
3. The vesting in and allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues) in proportion to the worker-members’ active participation in the cooperative endeavor.

⁴⁸Unif. Ltd. Coop. Assoc. Act § 104 cmt. (2007).

⁴⁹James B. Dean & Thomas Earl Geu, *The Uniform Limited Cooperative Association Act: An Introduction*, 13 DRAKE J. AGRIC. L. 63, 77 (2008).

⁵⁰44 T.C. 305 (1965).

The three factors enunciated in *Puget Sound* are generally accepted as the framework for analyzing whether an organization is operating on a cooperative basis within the meaning of § 521 and Subchapter T.⁵¹

The first factor, subordination of capital, is satisfied when the amounts that can be distributed with respect to a cooperative’s stock are limited and control over the cooperative is vested in the members—as opposed to the stockholders—by allowing them to elect the trustees and officers.⁵² The subordination of capital requirement is designed to ensure that the net earnings of the cooperative association go to the patrons, who created the profits, as opposed to investors in respect of the amount of their investment.

The Uniform Limited Cooperative Association Act provides that a cooperative association formed under the act must not allocate more than 50 percent of profits to investor members.⁵³ This requirement cannot be modified through the organic rules of the cooperative association. In order to preserve the integrity of this rule for the benefit of both patron members and investor members the act provides that “amounts paid or due on contracts for the delivery to the association by patron members of products, goods, or services are not considered amounts allocated to patron members”⁵⁴ and “amounts paid, due, or allocated to investor members as a stated fixed return on equity are not considered amounts allocated to investor members.”⁵⁵ Together, these two rules prevent the limitation on the allocation of profits to investor members from being compromised and preserve the delicate balance

⁵¹Carla Neeley Freitag, *Taxation of Cooperatives*, 744 BNA Tax Management Portfolio § II, at 4 (2d ed. 2008).

⁵²*Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308 (1965); see, e.g., Rev. Rul. 73-570, 1973-2 C.B. 194 (lumber marketing organization was not “operating on a cooperative basis” because the organization allocated surplus and deficit based on stock ownership rather than the amount of lumber marketed); I.R.S. Priv. Ltr. Rul. 2002-24-017 (Mar. 15, 2002) (cooperative association was “operating on a cooperative basis”, in terms of the subordination of capital requirement, because the cooperative did not have any nonpatron investors, its bylaws required that the cooperative operate on a cooperative basis for the benefit of its members, each member was entitled to one vote with majority rule, and the organic document provided that members would receive cooperative association assets upon dissolution on the basis of their patronage); I.R.S. Priv. Ltr. Rul. 2000-42-013 (July 20, 2000) (cooperative association was “operating on a cooperative basis”, in terms of the subordination of capital requirement, because it did not allow nonpatron investors, its proposed organic and operating documents required operation “on a cooperative basis”, and patrons would receive cooperative assets upon dissolution on the basis of their patronage).

⁵³Unif. Ltd. Coop. Assoc. Act § 1004(c) (2007).

⁵⁴Unif. Ltd. Coop. Assoc. Act § 1004(c)(1) (2007).

⁵⁵Unif. Ltd. Coop. Assoc. Act § 1004(c)(2) (2007).

that exists concerning the allocation of profits between patron members and investor members. This feature of the act would appear to satisfy the requirement that distributions in respect of stock be limited and profits inure to the benefit of those who created them.

We must be mindful of the fact that in a capital intensive New Age cooperative association the profits are created by both the patron members who furnish their products and labors and the investor members who furnish the equity investment without which the cooperative association could not exist. New Age cooperatives present a new cooperative ecosystem in which patron members and investor members are inexorably linked in a symbiotic relationship that benefits them both. To remove one member class for the benefit of the other member class by a fiat of the tax law would be tantamount to cutting off the nose of one member class to spite the face of the other.

Regarding the election of directors and the composition of the board of directors, the Uniform Limited Cooperative Association Act provides that:

- (a) Unless the organic rules require a greater number:
 - (1) the number of directors that must be patron members may not be fewer than:
 - (A) one, if there are two or three directors;
 - (B) two, if there are four or five directors;
 - (C) three, if there are six through eight directors; or
 - (D) one-third of the directors if there are at least nine directors; and
 - (2) a majority of the board of directors must be elected exclusively by patron members.
- (b) Unless the organic rules otherwise provide, if a limited cooperative association has investor members, the directors who are not elected exclusively by patron members are elected by the investor members.⁵⁶

This section of the act clearly satisfies the requirement that control over the cooperative be vested in the patron members, as opposed to the investor members, and at the same time strikes a delicate balance, that must exist in New Age cooperative associations, between patron members and investor members to allow the investor members a voice in respect of their equity investment. Having satisfied the two elements of this factor the Uniform Limited Cooperative Association Act clearly provides for the subordination of capital.

The second factor, democratic control, requires that cooperative associations be organized "according to a model of a widely-based participatory democracy in which all the members are able to exercise a franchise of equal strength"⁵⁷ that

allows the cooperative to be democratically controlled by its members.⁵⁸ Satisfying the democratic control requirement is a fairly straightforward task provided that each member is entitled to no more than one vote regardless of the amount of their investment and patronage.⁵⁹ Voting systems that deviate from this plain vanilla standard become much more problematic. The service determined that a cooperative association, with a tiered voting system whereby matters approved by one-half but less than two-thirds of cooperative association members would only pass if also approved by one-half of the members voting on a patronage basis, would not be "operating on a cooperative basis."⁶⁰ However, the democratic control requirement of Puget Sound may have been relaxed in *Thwaites Terrace House Owners Corp. v. Commissioner* wherein one vote for each share of stock owned was permitted because it was a measure of each member's investment and patronage.⁶¹ The service and the Tax Court have also addressed the manner by which voting takes place. Acceptable voting methods include, of course, the traditional method of voting in person at a stated meeting of the cooperative association, voting by proxy,⁶² voting by absentee ballot,⁶³ and voting by written ballot in lieu of a meeting.⁶⁴

The defining aspect of the democratic control principle is that members, not outside investors, control the cooperative association. To apply this principle the service has created the one-member, one-vote standard. It is not the principle of democratic control that is of concern to cooperative associations, but the rigid standard by which the service has chosen to measure the compliance of cooperative associations with this principle. Cooperative associations, by their very nature, have historically embraced the concept of democratic control and continue to do so.

The Uniform Limited Cooperative Association Act takes a fairly liberal approach to the concept of democratic control. While the act defaults to the conservative standard of one vote per patron member⁶⁵ it also permits a cooperative associa-

⁵⁸*Keystone Auto Club Casualty Co. v. Commissioner*, 122 F.2d 886, 890 (3d Cir. 1941), cert. denied, 315 U.S. 814 (1942) (democratic ownership and control are fundamental characteristics of cooperative associations).

⁵⁹I.R.S. Priv. Ltr. Rul. 98-03-019 (Oct. 17, 1997) (applying the *Puget Sound* democratic control test to a proposed cooperative association in which each member would own an equal amount of stock and would also be entitled to one vote regardless of the amount of stock owned).

⁶⁰Clayton S. Reynolds, *Cooperative Democracy*, 78 *Taxes* 19, 23 (2000) (citing I.R.S. Priv. Ltr. Rul. (unpublished) (Sept. 14, 1992)).

⁶¹72 T.C.M. (CCH) 578 (1996).

⁶²Rev. Rul. 75-97, 1975-1 C.B. 167.

⁶³*Thwaites Terrace House Owners Corp. v. Commissioner*, 72 T.C.M. (CCH) 578 (1996).

⁶⁴I.R.S. Priv. Ltr. Rul. 2002-10-033 (Dec. 4, 2001) (taking note of the technological advancement in modern communi-

⁵⁶Unif. Ltd. Coop. Assoc. Act § 804(a), (b) (2007).

⁵⁷*Etter Grain Co. v. U.S.*, 462 F.2d 259, 263 (5th Cir. 1972), aff'g 331 F. Supp. 283 (N.D. Tex. 1971) (court was referring to an exempt cooperative under section 521 of the Code, but the statement equally applies to nonexempt cooperatives).

Dividing to Unite: How We Can Reach Common Development Goals When Developed Countries and Developing Countries Adopt Different Tax Systems

David Schneider

Abstract

Taxpayers resident in countries with a worldwide tax system have an incentive to invest in high-tax countries,¹ whereas taxpayers resident in countries with a territorial tax system have an incentive to invest in low-tax countries.² Under the global economy's ad hoc patchwork of tax systems, many developing countries are forced to engage in a tax rate race to the bottom to compete for foreign direct investment (FDI) because a low tax rate compensates investors for the country's inability to offer the ideal environment for capital investments. However, even if a low tax rate initially attracts FDI, developing countries do not receive a net benefit because they are unable to collect enough tax revenues to fund government services that promote internal economic development, such as education, healthcare, infrastructure, and security.

Therefore, this article proposes that an international organization should implement a globally coordinated tax regime in which developed countries adopt a worldwide tax system and developing countries adopt a territorial tax system. Under this proposed tax regime, developing countries would no longer face an incentive to engage in a tax rate race to the bottom and would be free to set an appropriate tax rate to fund its economic development without sacrificing FDI inflows. As a result, international organizations would be able to make significant progress towards satisfying their development goals for developing countries.

Background

The International Monetary Fund (IMF) divides the world into two major economic groups: (1) advanced economies, and (2) emerging and developing economies.³ According to the IMF's 2008 World Economic Outlook report, the IMF classifies 31 countries as advanced economies and the rest of the world—141 countries—as emerging and developing economies. This elite group of advanced economies, located mainly in North America and Europe, includes the Group of Seven,⁴ Euro area members, four newly industrialized Asian

economies, and others.⁵ In contrast, emerging and developing economies are concentrated in Africa, Asia, and South America.⁶ Advanced economies enjoy the highest standards of living⁷ and are bolstered by robust, stable economies, whereas emerging and developing economies must endure lower standards of living and are hindered by weak, volatile economies.⁸

The World Economic Outlook report uses three main factors to distinguish advanced economies from emerging and developing economies: “(1) per capita income level, (2) export diversification . . . and (3) degree of integration into the global financial system.”⁹ However, the IMF makes these distinctions based on a “facilitating analysis” rather than “being based on strict criteria, economic or otherwise.”¹⁰ Therefore, the IMF's classifications present a good starting point to distinguish between countries that may need development assistance and countries that should be providing that development assistance.

Within this category of 141 emerging and developing countries, the United Nations (UN) classifies a subset of 49

ized nations: Canada, France, Germany, Italy, Japan, United Kingdom, and United States of America (the G8 includes Russia). See University of Toronto, G8 Information Centre, <http://www.g7.utoronto.ca/> (last visited Nov. 5, 2008).

¹INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTPUT 254 (Oct. 2008), available at www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf.

²*Id.* at 252.

³There are many indicators of determine a person's standard of living. One good indicator is the Human Development Index which combines the following three factors into an index ranging from zero to one: (1) life expectancy at birth; (2) the adult literacy rate (with two-thirds weighting) and the combined primary, secondary, and tertiary gross enrollment ratio (with one-third weighting); and (3) gross domestic product (GDP) per capita at purchasing power parity (PPP) in United States dollars. See generally UNITED NATIONS DEVELOPMENT PROGRAMME, HUMAN DEVELOPMENT REPORT 2007/2008 (2007), available at hdr.undp.org/en/media/hdr_20072008_en_complete.pdf.

⁴INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTPUT 252 (Oct. 2008), available at www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf.

⁵International Monetary Fund, *Frequently Asked Questions: World Economic Outlook* (Oct. 8, 2008), www.imf.org/external/pubs/ft/weo/faq.htm (last visited Nov. 4, 2008).

⁶INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTPUT 252 (Oct. 2008), available at www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf.

¹See *infra* Part I.A.

²See *infra* Part I.B.

³INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTPUT 252 (Oct. 2008), available at www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf. For the purposes of this article, the term “developing country” means all of the countries that the IMF has classified as “emerging and developing economies” and the term “developed country” means all of the countries that the IMF has classified as “advanced economies.”

⁴The members of the Group of Seven are seven industrial-

countries as least developed countries (LDCs).¹¹ With the exception of Haiti in the Caribbean, all of the other LDCs are located in Africa and Asia—33 in Africa and 15 in Asia.¹² LDCs “represent the poorest and weakest segment of the international community.”¹³ They are “characterized by their exposure to a series of vulnerabilities and constraints such as limited human, institutional and productive capacity; acute susceptibility to external economic shocks, natural and man-made disasters and communicable diseases; limited access to education, health and other social services and to natural resources; poor infrastructure; and lack of access to information and communication technologies.”¹⁴ In sum, for most people living in LDCs, life is harsh, unpredictable, and offers few opportunities for economic advancement.

Since 1968 when the UN adopted the first resolution on LDCs, the UN has made a commitment to improve the living conditions in LDCs.¹⁵ In 2001, the Third United Nations Conference on LDCs reported that the conditions in the world’s LDCs were not improving at the pace set by the Second United Nations Conference on LDCs in 1990 under the Paris Programme of Action.¹⁶ The UN determined that a

¹¹Least developed countries are countries that satisfy the following three criterion: “(1) a low-income criterion, based on a three-year average estimate of the gross national income (GNI) per capita (under \$745 for inclusion, above \$900 for graduation); (2) a human capital status criterion, involving a composite Human Assets Index (HAI) based on indicators of: (a) nutrition: percentage of population undernourished; (b) health: mortality rate for children aged five years or under; (c) education: the gross secondary school enrolment ratio; and (d) adult literacy rate; and (3) an economic vulnerability criterion, involving a composite Economic Vulnerability Index (EVI) based on indicators of: (a) population size; (b) remoteness; (c) merchandise export concentration; (d) share of agriculture, forestry and fisheries in gross domestic product; (e) homelessness owing to natural disasters; (f) instability of agricultural production; and (g) instability of exports of goods and services.” United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and the Small Island Developing States [UN-OHRLLS], *Criteria for the Identification of LDCs*, <http://www.unohrlls.org/en/lcdc/related/59> (last visited Oct. 25, 2008).

¹²UN-OHRLLS, Country Profiles, <http://www.unohrlls.org/en/lcdc/related/62> (last visited October 25, 2008).

¹³Third United Nations Conference on the Least Developed Countries, May 14-20, 2001, Brussels Programme of Action for the Least Developed Countries for the Decade 2001-2010, ¶ 1, U.N. Doc A/CONF.191/11 (June 8, 2001), available at http://www.unohrlls.org/UserFiles/File/G0151734_A_CONF_191_11.pdf [hereinafter Brussels Programme of Action].

¹⁴*Id.*

¹⁵United Nations Conf. on Trade and Dev., *LDC III Background*, www.unctad.org/conference/backgrd.htm (last visited Dec. 9, 2008).

¹⁶Brussels Programme of Action, *supra* note 13, at ¶ 2.

gulf between the have countries (developed countries) and the have-not countries (least developed countries) was continuing to widen and that the UN needed to revise and reaffirm a program of action to reverse the trend.¹⁷ At the conference, the UN’s member countries committed to the Brussels Programme of Action which set objective benchmarks aimed to help LDCs develop.¹⁸ The UN’s plan “provides a framework for a strong global partnership to accelerate sustained economic growth and sustainable development in LDCs, to end marginalization by eradicating poverty, inequality and deprivation in these countries, and to enable them to integrate beneficially into the global economy.”¹⁹

Key to the UN’s Brussels Programme of Action is to satisfy the following eight Millennium Development Goals by 2015: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.²⁰ As of 2008, progress towards achieving these goals has been mixed.²¹

Despite the UN’s long-standing commitment to help LDCs achieve an acceptable standard of living, the UN’s small victories are outweighed by the UN’s failure to make a significant impact in a majority of the world’s LDCs.²²

Introduction

In the case of the economic development of LDCs, the UN typically has adopted a bottom-up development approach.²³ A

¹⁷*Id.*

¹⁸*Id.* at ¶ 3.

¹⁹*Id.* at ¶ 4.

²⁰United Nations, Millennium Development Goals, www.un.org/millenniumgoals/index.shtml (last visited Nov. 5, 2008).

²¹UNITED NATIONS, MILLENNIUM DEVELOPMENT GOALS: 2008 PROGRESS CHART 1 (2008), www.un.org/millenniumgoals/2008highlevel/pdf/newsroom/MDG_Report_2008_Progress_Chart_en_r8.pdf; see also UNITED NATIONS, THE MILLENNIUM DEVELOPMENT GOALS REPORT 1 (2007), www.un.org/millenniumgoals/pdf/mdg2007.pdf.

²²Only three countries have graduated from the LDC list. G.A. Res. 62/97, U.N. Doc. A/RES/62/97 (Feb. 8, 2008) (resolving to graduate Samoa from the LDC list); G.A. Res. 59/210, U.N. Doc. A/RES/59/210 (Feb. 28, 2005) (resolving to graduate Cape Verde and Maldives from the LDC list; Maldives graduation was subsequently delayed due to the tsunami disaster); G.A. Res. 46/206, U.N. Doc. A/RES/46/206 (Dec. 20, 1991) (resolving to graduate Botswana from the LDC list). *But see* Thalif Deen, *Few Graduate from UN Programme for the Poorest*, UNDP (stating the list of LDCs has “virtually doubled” since 1971).

²³Brussels Programme of Action, *supra* note 13; Brussels Declaration, Third United Nations Conference on the Least Developed Countries U.N. Doc. A/CONF.191/12 (2001)

bottom-up development approach means that development work starts on the ground-level within a certain region or LDC (the “bottom”) and is continually monitored, evaluated, and adjusted by an international organization or government entity that oversees and funds the ground-level development work (the “up”). For example, the UN’s approach to economic development in LDCs is to fund and support ground-level development partnerships, who agree to make a commitment to the UN’s development goals, while the UN focuses on monitoring, evaluating, and other large-scale management and coordination issues associated with these development programs.²⁴

Although the UN’s bottom-up development approach has had some successes over the last 50 years and has certainly helped improve the conditions in some LDCs,²⁵ the UN’s bottom-up development approach is flawed for two reasons. First, the UN’s bottom-up development approach uses scarce resources inefficiently because it requires putting into place “mechanisms and arrangements for implementation, follow-up, review and monitoring of these policies.”²⁶ In other words, the UN’s management structure is top-heavy because the UN must expend resources to continually monitor, review, and manage development operations rather than using those resources directly on the country’s development programs.²⁷ Second, because the bottom-up approach usually involves influxes of capital from non-profit organizations, the bottom-up development approach inserts market distortions into the developing country’s economy and can result in the developing country’s reliance on foreign aid, rather than allowing the country to develop a well-diversified economy through private market forces.²⁸

[hereinafter Brussels Declaration]; see also Kyle W. Danish, *International Environmental Law and the “Bottom-Up” Approach: A Review of the Desertification Convention*, 3 IND. J. GLOB. LEG. STUD. 133, 176 (1995) (discussing the UN’s bottom-up approach in the context of combating desertification and promoting sustainable development).

²⁴Brussels Programme of Action, *supra* note 13; Brussels Declaration, *supra* note 23.

²⁵See sources cited *supra* note 22.

²⁶*Id.* at ¶ 3.

²⁷See U.S. GOV’T ACCOUNTABILITY OFFICE, UNITED NATIONS: MANAGEMENT REFORMS PROGRESSING SLOWLY WITH MANY AWAITING GENERAL ASSEMBLY REVIEW 1 (2006) (“Despite the UN’s efforts to improve its management processes, several independent reports, such as the 2005 Independent Inquiry Committee’s investigation of the UN’s Oil for Food program and the Gingrich-Mitchell task force review in June 2005, found that inefficient UN management operations persist.”); see also U.S. INSTITUTE OF PEACE, AMERICAN INTERESTS AND UN REFORM 109 (2005) (“The present UN system tends to proliferate agencies and programs, with inadequate and dispersed accountability. As a result, the UN country teams have great difficulty with serious coordination and strategy development from the independent clusters of agencies”).

²⁸R. OMOTAYO OLANIYAN, FOREIGN AID, SELF-RELIANCE, AND

To avoid the inefficiencies associated with a bottom-up development approach, the UN should adopt a top-down development approach. A top-down development approach means that development work starts with a policy adopted by an international organization or government entity (the “top”) and eventually impacts the ground-level conditions within the developing country (the “down”). For example, the Organisation for Economic Co-operation and Development’s (OECD) approach, in most cases, is for member countries (sometimes in consultation with nonmember countries) to agree to adopt a certain policy.²⁹ Once this policy is universally implemented, such policy would have an impact on the ground-level conditions within the member countries.³⁰ The policies adopted by the OECD often also have an impact on nonmember countries—a common criticism leveled at the OECD because the interests of nonmember countries may not be adequately represented during the policymaking process.³¹

Unlike the bottom-up development approach, the top-down development approach avoids the costly top-heavy management structure and the need for constant monitor-

ECONOMIC DEVELOPMENT IN WEST AFRICA 5 (1996); George Economides et al., *Do Foreign Aid Transfers Distort Incentives and Hurt Growth? Theory and Evidence from 75 Aid-recipient Countries 1-3* (CESifo Working Paper Series, Working Paper No. 1156, 2004).

²⁹The OECD membership currently includes 30 developed economies. The members set the OECD’s development policy—a value-laden activity. The OECD, however, is working towards expanding membership and increasing cooperation with nonmembers. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ANNUAL REPORT (2008), www.oecd.org/dataoecd/39/19/40556222.pdf (“OECD ministers initiated a two-tier process of enlargement and enhanced engagement with ten new countries.”); see generally ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, A STRATEGY FOR ENLARGEMENT AND OUTREACH (2004), www.oecd.org/dataoecd/24/15/37434513.pdf; Organisation for Economic Co-operation and Development, Centre for Co-operation with Non-members, www.oecd.org/pages/0,3417,en_3633598_6_36336523_1_1_1_1_1_1,00.html.

³⁰Robert W. McGee, *Legal Ethics, Business Ethics and International Trade: Some Neglected Issues*, 10 CARDOZO J. INT’L & COMP L. 109, 194-95 (2002) (stating that the OECD “tries to coordinate economic activity using the top-down approach”); see, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, POLICY FRAMEWORK FOR INVESTMENT (2006), www.oecd.org/dataoecd/1/31/36671400.pdf; ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAX POLICY ASSESSMENT & DESIGN IN SUPPORT OF DIRECT INVESTMENT: A STUDY OF COUNTRIES IN SOUTH EAST EUROPE (Apr. 2003), www.oecd.org/dataoecd/46/14/34466352.pdf.

³¹See ORGANISATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 14 (1998) (resolving to discourage harmful tax regimes in some nonmember countries).

ing and evaluation of the ground-level programs.³² Similarly, unlike the bottom-up development approach, the top-down development approach avoids market distortions and aid reliance because the international organization sets the policy, and then the private market operates within that policy-defined framework. In comparison to international organizations and government-run aid programs, the private market is a superior economic development vehicle because the private market functions more efficiently and provides a built-in oversight function.³³

One under-explored approach to carrying out a top-down development approach is adopting a globally-coordinated tax regime. This article contends that if an international organization³⁴ established a globally-coordinated tax regime in which developed countries adopted a pure worldwide tax system³⁵ and developing countries adopted a pure territorial tax system,³⁶

³²Unlike the UN which focuses on strengthening ground-level partnerships to achieve economic development, the OECD places a greater emphasis on formulating policies and principles to achieve economic development. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ANNUAL REPORT (2008), www.oecd.org/dataoecd/39/19/40556222.pdf; see also ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ECONOMIC POLICY REFORMS: GOING FOR GROWTH (2008), www.oecd.org/document/58/0,3343,en_2649_34325_40157242_1_1_1_1,00.html.

³³As a result, the OECD places an emphasis on corporate governance, and the privatization and corporate governance of state-owned enterprises. See generally ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004), www.oecd.org/dataoecd/32/18/31557724.pdf. Unlike many international organizations, however, the private market's motive is profit-maximization, not altruism.

³⁴This article proposes that an organization within the UN umbrella is best-suited to coordinate this new tax regime because of its comprehensive membership. As proposed by Professor Victor Thuronyi, another feasible alternative is a multilateral treaty with "an international organization to administer the treaty and for procedures," such as the World Trade Organization or the World Customs Organization. Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT'L L. 1641, 1667-80 (2001).

³⁵In the context of this article's proposal, the term "worldwide tax system" refers to a pure worldwide tax system. A pure worldwide tax system taxes residents of a country on all of their income regardless of the source of the income. If the foreign tax rate exceeds the domestic tax rate, then such excess would be allowed as a foreign tax credit against domestic taxes. In addition, taxpayers are unable to defer income tax on a foreign subsidiary's earnings. See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* ¶¶ 1085-1100 (3d ed. 2006).

³⁶In the context of this article's proposal, the term "territorial tax system" refers to a pure territorial tax system. A pure territorial tax system taxes residents of a country only on

then developing countries would be able to make significant strides towards the UN's development goals because the proposed tax regime would increase foreign direct investment (FDI) to developing countries. The increase in FDI inflows to developing countries would spur economic development both through private investments in the country and increased tax revenues for government-provided services.³⁷

The underlying premise of this thesis is that a tax system can be used to direct the flow of foreign direct investment to developing countries. When FDI is directed into developing countries, much-needed capital from the private market creates positive spillovers such as (1) employing citizens, providing them with skills, education, healthcare, and causing their wages to increase, (2) building factories and developing the country's infrastructure, and (3) transferring technology.³⁸ Finally, because of increases in employment, production, and services and the elimination of the incentive to engage in tax rate race to the bottom, developing countries would be able to collect more tax revenues which could be used to fund productivity-increasing government services such as healthcare, education, infrastructure, and security. Therefore, adopting a tax regime that increases the flow of FDI to developing countries would promote their economic development.

Part I looks at the direction of a country's outward FDI based on whether that country has adopted a worldwide tax system or a territorial tax system. Specifically, Part I looks at the direction of FDI outflows for six advanced economies during the years 2003 to 2008. Three of the six countries have adopted a worldwide tax system;³⁹ the other three countries have adopted a territorial tax system.⁴⁰ Part I then compares the marginal corporate tax rates of each country's top ten

income earned within its borders. Because double taxation is inherently avoided, there is no need to provide a foreign tax credit on income sourced from other countries or worry about foreign subsidiary's deferring income tax earnings. See *id.*

³⁷There is much debate over whether FDI contributes to a country's economic development. See generally DOES FOREIGN DIRECT INVESTMENT PROMOTE DEVELOPMENT? (Theodore H. Moran, Edward M. Graham, & Magnus Blomström eds., 2004); Manuel R. Agosin & Ricardo Mayer, *Foreign Investment in Developing Countries: Does It Crowd in Domestic Investment?* (UNCTAD Discussion Paper No. 146, Feb. 2000); Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work* (Overseas Development Council Policy Essay No. 24, 1999). For the purposes of this article, such link between FDI and economic development is assumed.

³⁸Again, academics have debated whether FDI brings such benefits. Robert E. Lipsey & Fredrik Sjöholm, *The Impact of Inward FDI on Host Countries: Why Such Different Answers?*, in DOES FOREIGN DIRECT INVESTMENT PROMOTE DEVELOPMENT? 23-43 (Theodore H. Moran, Edward M. Graham, & Magnus Blomström eds., 2004) (discussing the wide range of results with little sign of convergence on how inward foreign direct investment affects host countries).

³⁹See *infra* Part I.A.

⁴⁰See *infra* Part I.B.

destination countries for FDI outflows to determine whether worldwide tax countries are more likely than territorial tax countries to invest in countries with a higher tax rate. The data collected for this article suggests that worldwide tax countries are more likely than territorial tax countries to invest in countries with a higher tax rate, but more data is needed to show a statistically significant correlation.

Worldwide tax countries are more likely than territorial tax countries to invest in high-tax countries for two reasons. First, a country with a worldwide tax system creates an incentive to foreign-investing taxpayers (typically multinational corporations) to invest in high-tax countries because such taxpayers can credit all, or a portion if not a pure worldwide tax country, of the percentage of foreign tax that exceeds the domestic rate of taxation. This article assumes a pure worldwide tax system in which a taxpayer can credit all foreign taxes that exceed the domestic rate of taxation and tax-

payers are unable to defer income tax on a foreign subsidiary's earnings.⁴¹ Another incentive is that high-tax countries typi-

⁴¹"No country has adopted a pure worldwide tax system," or pure capital export neutrality. Claire Wade, *The President's Advisory Panel's Recommendation To Move from a Worldwide Tax To a Territorial Tax System*, 12 L. & BUS. REV. AM. 373, 380 (2006) (citing MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 13 (Foundation Press 2003)). For example, the United States' foreign tax credit is limited to the taxpayer's U.S. tax rate. I.R.C. § 904(a). Joseph Isenbergh, *Foundations of U.S. International Taxation*, 900 Tax Mgmt Portfolio: Foreign Income Series (BNA) B-4 (2008) ("The United States, for its part, does not push worldwide taxation to the limit. Besides according a foreign tax credit to offset foreign income taxes, the United States does not tax currently a considerable part of the income of foreign corporations beneficially owned by U.S. persons. One way for a U.S. person to escape current (but not eventual) taxation of foreign income is to conduct foreign business operations through a

cally offer better environments for capital-intensive investments because high-tax countries are able to raise the funds needed to provide an advanced education system, broad healthcare services, developed infrastructure, and internal security.

Second, a nation with a territorial tax system creates an incentive to foreign-investing taxpayers to invest in low-tax countries because such taxpayers' income is subject to the rate of taxation in the low-tax destination country. In addition, low-tax countries typically offer better environments for labor-intensive investments because the cost of labor is cheaper.⁴²

Part II discusses how one of the many challenges that developing countries face is a tax rate race to the bottom to attract FDI from investors looking to maximize returns on capital.⁴³ Because developing countries are unable to offer the most efficient environment for capital, they are forced to lower their taxes to compensate investors and remain competitive in the global economy. Developing countries are pressured to maintain a low tax rate to attract FDI because foreign-investing taxpayers located in a country that uses a territorial tax system have an incentive to seek out countries that offer a low rate of taxation because their income sourced within the low-tax country will be taxed only at the destination country's low tax rate. In addition, some taxpayers in impure worldwide tax countries are able to take advantage of a country's low tax rate using foreign subsidiaries.

Therefore, developing countries are pressured to lower their tax rates to cater to the demands of foreign-investing taxpayers that are seeking the country that can offer the highest returns on their capital. As a result of these external market pressures to set lower tax rates to compete for FDI, developing countries lack the ability to set the domestic tax rate at the level needed to fund the government services that would empower their economic development without sacrificing their attractiveness for FDI inflows.

Because a country's tax system can impact FDI outflow patterns and the current global system either (1) shifts FDI away

foreign corporation. The separate tax identity of corporations, which often entails additional taxation in purely domestic operations, thus mitigates U.S. taxation of foreign income.").

⁴²This article assumes that a government that is unable to provide adequate services such as education, health, infrastructure, and security will have a lower-cost of labor because the costs of doing business are higher and workforce productivity is lower. As a result, to ensure investors receive a competitive return on capital, labor costs are reduced.

⁴³This race to the bottom has not gone unnoticed by the governments of developed countries, who fear such "harmful tax competition" could affect "patterns of trade and investment and reduce global welfare." ORGANISATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 14 (1998) (resolving "that governments must take measures, including intensifying their international co-operation, to protect their tax bases and to avoid the world-wide reduction in welfare caused by tax-induced distortions in capital and financial flows"), available at <http://www.oecd.org/dataoecd/33/1/1904184.pdf>; see also Karen B. Brown, *Harmful Tax Competition: The OECD View*, 32 GEO. WASH. J. INT'L L. & ECON. 311, 314 (1999).

from developing countries, or (2) causes developing countries to engage in a tax rate race to the bottom, the current global framework of ad hoc tax systems undercuts the UN's development goals.⁴⁴ Part III proposes a two-prong solution that aims to increase FDI outflows to developing countries, while preventing the tax rate race to the bottom. First, developed countries should adopt a worldwide tax system to remove the pressures placed on developing nations to reduce their taxes to unsustainable levels. Second, in contrast to developed countries, developing countries should adopt a territorial tax system so they can benefit from low tax rates in other countries.

I. There Is a Positive Relationship Between a Country's Tax System and the Direction of FDI Outflows Based on the Marginal Corporate Tax Rate in an FDI Destination Country.

Worldwide Tax System

Foreign-investing taxpayers resident in a pure worldwide tax system⁴⁵ country have an incentive to invest in high-tax countries because such taxpayers will be paying their domestic rate of taxation regardless of the foreign countries' rate of taxation and the investors will benefit from several externalities that flow from a government with a deep tax base. For example, a well-funded government is more likely than an under-funded government to have the resources to provide education and healthcare services to its citizens, have a developed infrastructure, and ensure security within the country.

A pure worldwide tax system embodies capital export neutrality in which a taxpayer is subject to taxation on worldwide gross income, but may also credit the percentage of foreign taxes that exceed the domestic rate of taxation.⁴⁶ There are two major advantages of a worldwide tax system. First, taxpayers are subject to the same domestic tax rate regardless of where they invest because they are subject to their home country's rate of taxation on both domestic-source and foreign-source income.⁴⁷ The problem of double taxation is eliminated because if the foreign rate of taxation exceeds the domestic rate of taxation, then the taxpayer can take a foreign tax credit in the amount that foreign taxes exceeds domestic taxes. Second, foreign-investing taxpayers will invest in countries where their capital will be used most efficiently.⁴⁸ This benefits the investor because the investor can maximize returns on capital by investing in the most efficient location for the capital. As a result, the tax rate of the host country is

⁴⁴See Background (discussing millennium development goals).

⁴⁵It should be noted, however, that "[n]o country uses a pure system of either worldwide or territorial taxation. Instead, there is a spectrum of taxation that ranges from territorial to worldwide." Wade, *supra* note 41, at 380; see also Isenbergh, *supra* note 41.

⁴⁶See GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶¶ 1085-1100.

⁴⁷*Id.*

⁴⁸*Id.*

not a factor in the taxpayer's investment decision. In addition, because capital is flowing to the most efficient location, global wealth is increased—which may extend to developing countries.⁴⁹

Taxpayers in pure worldwide tax countries will allocate capital to countries where it will be used most efficiently.⁵⁰ As a result, the direction of FDI from worldwide tax countries is more likely to flow to high-tax countries than low-tax countries because high-tax countries are more likely than low-tax countries to offer an investment environment where capital can be put to use in the most efficient manner. In addition, high-tax countries are more likely than low-tax countries to be able to offer the well-educated, healthy workforce, developed infrastructure, security, and other legal protections needed for capital-intensive investments because their governments have the funds necessary to provide these services. For example, suppose a multinational corporation located in a worldwide tax country is looking for a host country for its new biotechnology plant. The multinational corporation would be looking for a country with an educated, productive workforce, the infrastructure to support such an investment, and intellectual property protections for any of its developments. Therefore, high-tax countries are more likely than low-tax countries to be able to provide an investment environment that is conducive to capital-intensive projects because high-tax countries have the funds to provide productivity-increasing services.

Territorial Tax System

In contrast to a pure worldwide tax system, foreign-investing taxpayers resident in a country with a pure territorial tax system have an incentive to invest in low-tax countries because taxpayers are not subject to domestic taxation on any income generated within a foreign country and taxpayers are only required to pay that foreign country's rate of taxation on all income generated within that country.⁵¹ In addition, taxpayers may also benefit from externalities more likely found in low-tax countries such as cheaper labor due to the higher cost of doing business.⁵²

⁴⁹*Id.*

⁵⁰Pamela A. Fuller, *The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?*, 40 INT'L LAW. 773, 777-78 (A pure worldwide tax system "promotes the efficient allocation of capital.")

⁵¹Wade, *supra* note 45 and accompanying text; Isenbergh, *supra* note 45 ("Because it would be too easy to avoid tax by shifting assets abroad, very few countries other than classic tax havens practice the strictest territorial taxation. A common form of predominantly territorial system taxes all passive investment income received by residents, regardless of source, and all business profits from sources within the taxing country. A resident of such a country cannot shift assets to tax-free passive investments abroad, but can engage in foreign business operations without tax in the home country.")

⁵²For example, if a low-tax country lacks infrastructure, then the cost of doing business will likely be higher. To com-

A territorial tax system embodies import neutrality in which a taxpayer is subject to taxation on gross income at the tax rate of the country in which the taxpayer earns that gross income. Income earned in a foreign country is not subject to taxation in that taxpayer's home country. There are two major advantages of a territorial tax system. First, like the worldwide tax system, there is no threat of double taxation in a territorial tax system because income is taxed based on its source. Second, "all competing firms in the same market are subject to the same tax burden . . . [which] encourages the most efficient use of resources within a given capital-importing country."⁵³

Because the territorial tax system creates an incentive for taxpayers to invest in countries that have a lower rate of taxation than their domestic rate of taxation, the territorial tax system has two main disadvantages in the context of international economic development. First, capital is allocated efficiently within a territorial tax country because all taxpayers within a country are subject to the same rate of taxation, but capital is not allocated efficiently on a global scale, which decreases global wealth.⁵⁴ For example, suppose a multinational corporation located in a territorial tax country is looking for a host country for its new biotechnology plant. Even if other countries could offer a more efficient environment for the biotechnology plant, the corporation may find that it would maximize its returns on capital by operating in a low-tax country.

Second—and key to this article—developing countries face a double-bind because developing countries will be worse off, regardless of whether they set a high or low tax. If developing countries compete for FDI by engaging in a tax rate race to the bottom, then developing countries may not be able to raise the tax revenues needed to provide the services for its own economic development, such as health and education services to its citizens. If a developing country maintains a higher tax rate sufficient to raise tax revenues needed for these government services, then it may not be globally competitive for FDI inflows, which in the long-term, may result in earning less revenues from taxes.

Developed countries that use a territorial tax system exploit the double-bind facing developing countries because they benefit from investing in countries with a low tax rate, while the host country is forced to decide between either competing for FDI inflows or setting a sustainable tax rate for internal economic development. This trend could be reversed if devel-

pensate investors, the cost of labor will be lower.

⁵³GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶¶ 1085-1100.

⁵⁴Fuller, *supra* note 50, at 778-779 ("The efficiency norm of [capital export neutrality] has been thought of as superior to the efficiency norm of [capital import neutrality] by both government analysts and tax scholars, many of whom maintain that distortions in the locations of investments are 'more costly than distortions in the allocation of savings.'" (quoting Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX. L. REV. 261, 271 (2001))).

oping countries adopted a territory tax system and developed countries adopted a worldwide tax system because developed countries would no longer have an opportunity to exploit a tax rate race to the bottom. As a result, developing countries would both be able to compete for FDI inflows without sacrificing a sustainable tax rate.

Analysis of the Data

1. Methodology

This article collected data looking at the destination of FDI outflows from three advanced economies that have adopted a worldwide tax system—the United States, the United Kingdom, and Japan.⁵⁵ This article also collected data looking at the destination of FDI outflows from three advanced economies that have adopted a territorial tax system—France, Germany, and the Netherlands.⁵⁶ Specifically, data was collected on these six countries' (1) top ten destination countries for FDI outflows; (2) the total amount of the FDI outflows;⁵⁷ (3) the percentage of their total FDI that flows to each of the top ten destination countries; and (4) the maximum marginal corporate tax rate of each of the top ten destination countries.⁵⁸

The destination countries were labeled either high-tax countries or low-tax countries. Two tax rate thresholds were used to distinguish a high-tax country from a low-tax country. The first set of correlation tests used a 30 percent tax rate threshold. The second set of correlation tests used a 35 percent tax rate threshold. The percentage of total FDI flows to high-tax countries were summed up for each basket of countries and the mean was calculated to run correlation tests. In both cases, the results were similar.

2. Results

The results of the data analysis are mixed. Although the data indicates that there is not a significant correlation between a country's tax system and the direction of FDI outflows, several tests suggest that there is a positive relationship between the two variables. For example, one cross-section of the data indicated that the mean percentage of FDI outflows to high-tax countries was about six percent higher in worldwide tax countries than in territorial tax countries.

However, because the correlation tests were run with a small sample size of six countries, it is difficult to show a statistically significant correlation because the data can be easily skewed by the results of one country. If the data analysis were

⁵⁵See Appendix A.

⁵⁶See Appendix B.

⁵⁷The amount of FDI outflows can be measured by a number of indicators such as the number of jobs created by FDI outflows or the number of investment projects undertaken by the country in a given destination country. This article measures FDI outflows by a country's capital expenditures in a destination country.

⁵⁸For a complete explanation of this article's methodology, see Appendix C.

expanded to include more countries (including advanced economies and developing economies), rather than a small sample size of six countries, and the full list of FDI outflow destination countries were analyzed, rather than the top ten destination countries, perhaps the data would be able to more persuasively conclude that there is a statistically significant correlation.

Another weakness of the correlation tests is that they relied heavily on the marginal corporate tax rates of the destination countries, when there are several other ways to manipulate the tax rate on foreign investors. For example, a destination could impose other taxes such as a VAT, or waive taxes such as in a bilateral tax treaty. In addition, some tax systems provide an incentive to invest in both high- and low-tax countries. For example, the U.S. tax system's foreign tax credit allows taxpayers to blend tax rates of high- and low-tax countries.⁵⁹ Finally, it is important to note that China, a high-tax country, tops the list for all three countries. If China is viewed as an exceptional case because of its recent economic boom, then the data may be skewed and show less of a correlation.

In the case of the United States, the United States' top two FDI destination countries are high-tax countries, accounting for about 20% of the United States' FDI total outflows. In the case of the United Kingdom, the United Kingdom's top three FDI destination countries are high-tax countries, accounting for about 28% of the United Kingdom's total FDI outflows. In the case of Japan, Japan's top destination country, the United States, is considered to be a high-tax country and accounts for about 22% of Japan's total FDI outflows.

In the case of France, four of France's top ten destination countries are low-tax countries that account for about 17% of FDI outflows. In the case of Germany, five of Germany's top ten destination countries are low-tax countries that account for about 18% of FDI outflows. In the case of the Netherlands, five of the Netherlands' top ten destination countries are low-tax countries that account for about 33% of FDI outflows.

3. Assumptions

Even though more data is needed to prove a statistically significant correlation, for the purposes of this article, it will be assumed that the home tax system does affect a country's direction of FDI outflows. Although the data did show a positive relationship, because the data population was too small, the results were statistically uncertain.

II. Developed Countries That Use a Territorial Tax System May Impede the Economic Development of Developing Countries

The tax systems of developed countries can impede the economic development of developing countries. Developed countries that use a territorial tax system impede the economic development of developing countries because the territorial tax system both (1) creates an incentive for developed coun-

tries to shift FDI outflows to low-tax countries; and (2) this incentive compels developing countries to decrease their tax rates at the expense of their ability to fund their own internal economic development through tax revenues.

A territorial tax system may impede the economic development of developing countries for the following two reasons. First, developed countries with a territorial tax system have no incentive to invest in high-tax developing countries because investors do not want to pay a higher tax rate when they have the option to invest in another country that offers a similar business environment, but with a lower tax rate. However, developing countries have a need to set taxes at a high level to fund their internal development. For example, developing countries need a large amount of tax revenues to educate its workforce, provide health services to citizens, build an infrastructure to grease the wheels of commerce, and provide security. In turn, developing countries could use these government-funded internal improvements to attract additional FDI. Furthermore, government funds are most likely to provide these services, whereas the private market is not likely to provide them, or at least not universally to all citizens.⁶⁰

Second, the global framework perpetuates a tax rate race to the bottom that forces developing countries to lower their taxes to unsustainable levels. Taxpayers in developed countries with a territorial tax system have an incentive to seek out countries that offer a low rate of taxation. Developing countries that feel pressure to cater to these demands are forced to set a tax rate below the level needed to support their internal economic development.

In contrast to a territorial tax system, a pure worldwide tax system causes a tax rate race to the top.⁶¹ Taxpayers in developed countries have an incentive to seek out countries that offer the best conditions for their businesses including an educated, healthy workforce, a developed infrastructure, and security. High-tax countries more likely have the resources to provide these services. When taxpayers resident in a worldwide tax country are evaluating whether to invest in a foreign country, tax rate is not an issue because taxpayers are subject to the domestic rate of taxation, regardless of the source of the

⁶⁰For example, "[s]ince the mid-1980s, governments around the world have pursued policies to encourage private sector participation in the financing and delivery of infrastructure services. The natural monopoly characteristics of infrastructure utilities mean, however, that the privatization of these industries risks the creation of private-sector monopolies" which has an adverse effect on consumers. Colin Kirkpatrick, David Parker & Yin-Fang Zhang, *Foreign Direct Investment in Infrastructure in Developing Countries: Does Regulation Make a Difference?*, 15 *TRANSNATIONAL CORPORATIONS* 144, 144-45 (2006).

⁶¹However, although taxpayers in worldwide tax countries tend to invest in high-tax foreign countries, some worldwide tax countries can create the same adverse incentives as territorial tax countries by allowing taxpayers to create foreign subsidiaries to escape worldwide taxation and take advantage of the host country's tax rate.

⁵⁹See GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶ 5250.

income.⁶² Therefore, capital will flow to countries in which it will be used most efficiently and developing countries will not be pressured to choose between either setting an unsustainable tax rate to compete for FDI, or setting a sustainable tax rate and sacrificing FDI.

Therefore, developed countries that use a territorial tax system may impede the economic development of developing countries, while developed countries that use a worldwide tax system may support the economic development of developing countries. Whereas the former places pressure on developing countries to set a low tax rate, the latter eliminates it, and may even increase the incentive to increase the tax rate.

III. To Make Progress Towards the UN's Development Goals, Developed Countries Should Adopt a Worldwide Tax System and Developing Countries Should Adopt a Territorial Tax System

Proposal

If developed countries were provided with an incentive to invest in developing countries, then it would spur the economic development of developing countries. Furthermore, economic development would help fuel progress towards the UN's development goals for developing countries. One way to achieve these goals is a globally-coordinated tax regime. Because worldwide tax countries tend to invest in high-tax countries and territorial tax countries tend to invest in low-tax countries, tax policy can be used as an economic development tool by incentivizing investment in developing countries. This article proposes a two prong approach to maximize the benefits to developing countries.

The first prong is that developed countries should adopt a pure worldwide tax system. There are two major benefits derived from developed countries adopting a worldwide tax system. First, it would eliminate the tax rate race to the bottom that pressures developing nations to reduce their taxes below sustainable levels in order to attract FDI from developed countries. Second, capital from capital-rich developed countries will be allocated most efficiently on a global scale which will increase global wealth and potentially benefit developing nations.⁶³

Under the proposed tax regime, the flow of FDI from developed countries to developing countries may increase, but only if developing countries can offer developed countries the most efficient environment for their capital. Developing countries

⁶²Fuller, *supra* note 50, at 777 (“Economists have long believed that worldwide economic welfare is reduced when capital resources cross national borders in response to tax policies and incentives, rather than in response to pure economic fundamentals. A system that taxes residents (or citizens) on their worldwide income is arguably more economically efficient, from a global standpoint, than a territorial system since the decision of where to invest-at home or abroad-is not distorted by tax considerations.”).

⁶³Fuller, *supra* note 54 and accompanying text.

will no longer have the ability to manipulate their tax rate to attract FDI. Although many developing countries already offer low labor costs, other investment factors such as poor governance, weak education, and inadequate health services, undercut developing countries' competitiveness. For example, a developing country's education program, health services, and infrastructure can be improved through increased government expenditures, but only if the government is not mismanaging its funds and is not plagued by government corruption. Thus, there may be a role for international organizations using a bottom-up development approach within this article's proposal.⁶⁴ Using the example above, international organizations could be used to strengthen the accountability and transparency of government bodies in developing countries.⁶⁵

The second prong is that developing nations should adopt a territorial tax system. There are two major benefits derived from developing countries adopting a territorial tax system. First, developing countries that adopt a territorial tax system will be empowered with the ability to allocate capital efficiently within the country because all income earned within that country will be taxed at the same tax rate, except taxpayers in developed countries that have adopted a worldwide tax system. Second, developing countries will be able to take advantage of low tax rates in other countries. As a result, the tables are turned—instead of developing countries experiencing a tax rate race to the bottom, developed countries will have to compete with each other if they want foreign investment from developing countries. A UN Report in 2006 showed that FDI from developing and transitional economies is no insignificant amount, reaching “\$133 billion in 2005, representing about 17% of world outward flows.”⁶⁶

The United Nations is the most capable and best equipped international organization to carry out this proposal because the United Nation's broad member base.⁶⁷ The UN would be able to provide the mechanisms for coordination and enforcement. In addition, the UN's broad member base would add legitimacy to the proposal. In contrast, the OECD and other international organizations have a limited member base which makes it difficult not only to coordinate with nonmember countries, but also sacrifices a great deal of legitimacy because nonmember countries may argue that

⁶⁴See *infra* Part III.B (discussing on how to resolve the second weakness that developing countries may not receive FDI under the proposal because they are not the most efficient location for capital).

⁶⁵See Transparency International, www.transparency.org/ (last visited Dec. 9, 2008).

⁶⁶United Nations Conf. on Trade and Dev., *World Investment Report 2006: FDI from Developing and Transition Economies: Implications for Development*, 18-36, U.N. Doc. UNCTAD/WIR/2006 (Oct. 16, 2006), www.unctad.org/en/docs/wir2006overview_en.pdf (“[A]n examination of different data sources shows a growing and significant international presence of firms . . . from developing and transition economies.”).

⁶⁷See also Thuronyi, *supra* note 34.

their interests are not represented.

Weaknesses of the Proposal

This article's proposal suffers from three main weaknesses. The first weakness is that the premise that countries with a worldwide tax system have an incentive to seek out high-tax countries does not always hold true. For example, in 2003, Ireland adopted a 12.5% corporate tax rate,⁶⁸ yet has still been able to garner significant amounts of FDI from worldwide tax countries like the United States and the United Kingdom.⁶⁹ Even though taxpayers located in worldwide tax countries are still subject to their home country's tax rate on all income earned, such taxpayers continue to invest in Ireland.

The Ireland case study, however, can be explained for three reasons. First, Ireland is still able to offer the same amenities as a developed country with a high corporate tax rate. Ireland did not drop the tax rate until it achieved an educated workforce, responsive healthcare, developed infrastructure, and a robust legal system. In contrast, developing nations are unable to deliver the same amenities as Ireland. Second, taxpayers in worldwide tax countries may be able to avoid domestic taxation by creating foreign subsidiaries in Ireland, despite measures in worldwide tax countries to prevent this shifting of income.⁷⁰ Taxpayers can also manipulate the foreign tax credit to cross-credit income earned from high-tax countries with low-tax countries.⁷¹ Third, there is also speculation that Ireland's corporate tax rate is temporary (or sustainable). Some have discussed the likelihood that Ireland will increase the corporate tax rate after it has received a significant amount of international investment or put pressure on other local taxes such as a value added tax (VAT).⁷²

The case of Ireland and other developed countries that have drastically cut their corporate tax rate to attract FDI may highlight an additional strength in this article's proposal. Under this article's proposal, developed countries may have an incentive to engage in a race to the bottom in corporate tax rates to attract FDI from developing countries using a territo-

⁶⁸IRELAND OFFICE OF THE REVENUE COMMISSIONERS, STATISTICAL REPORT 99 (2003), available at www.revenue.ie/pdf/statreport2003.pdf.

⁶⁹See Appendix A. Note that Ireland is sixth on the United Kingdom's top ten destinations for FDI outflows.

⁷⁰Glenn R. Simpson, *Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe—Tech and Drug Firms Move Key Intellectual Property To Low-Levy Island Haven—Center of Windows Licensing*, WALL ST. J., Nov. 7, 2005, at A1.

⁷¹See GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶ 5250.

⁷²IRELAND OFFICE OF THE REVENUE COMMISSIONERS, BUDGET SUMMARY 2009 2 (Oct. 2008), available at www.revenue.ie/budget/budget2009/summary.pdf (increasing Ireland's VAT from 21% to 21.5% effective Dec. 1, 2008); see generally IRELAND OFFICE OF THE REVENUE COMMISSIONERS, VAT GUIDE (July 2008), available at www.revenue.ie/leaflets/vatguide_2008.pdf.

rial tax system.⁷³ Developing countries may be able to benefit from developed countries engaging in a tax rate race to the bottom because developing countries are subject to the host country's lower tax rates, whereas their developed counterparts are subject to their home country's tax rate.

The second weakness is that this article's proposal does not resolve the issue that developing countries receive a minimal amount of FDI from developed countries. While developing nations with a territorial tax system may benefit from low corporate tax rates in developed countries because they will be subject to the host country's low tax rate, the main benefit is when capital from developed countries flows to developing countries. There are many obstacles that block capital from flowing from developed countries to developing countries. In order to receive capital from developed countries and therefore economically improve their current conditions, developing countries must prove that they are, or can eventually become, the most efficient location to use capital investments. Under this article's proposal, a developing country can no longer become globally competitive by simply lowering its tax rate; the only way to attract FDI would be by becoming an efficient location for capital investments. A developing country can become an efficient location for capital by ensuring its economic development.

To aid developing countries, there is a role for international organizations that engage in bottom-up development work, such as the United Nations. Despite criticisms for their inefficient management structure, these organizations are well-positioned to use their ground-level partnerships to focus their efforts on helping developing nations become desirable locations for capital investments—such as training workers,

⁷³This race to the bottom has already begun. Chris Atkins & Scott A. Hodge, *U.S. Still Lagging Behind OECD Corporate Tax Trends*, FISCAL FACTS 96 (Tax Found., Washington, D.C.), July 24, 2007, tf-live.pjdoland.com/files/ff96.pdf (discussing "the continuing wave of corporate income tax reduction sweeping through many countries in the Organization for Economic Cooperation and Development").

The case of Ireland and other developed countries that have drastically cut their corporate tax rate to attract FDI may highlight an additional strength in this article's proposal.

providing healthcare, building infrastructure, or ensuring security and the rule of law. Therefore, the best solution may be a hybrid approach in which both bottom-up and top-down policies are implemented.

The third weakness is that the proposal's potential costs and coordination problems make the proposal difficult to implement. Both developed and developing countries may need to invest a significant amount of resources into revamping their tax systems. Countries may not support drastic tax policy shifts, especially in light of the current financial crisis. The fact that this proposal may require countries to adopt drastic tax policy changes leads to the problem of global coordination. The proposal's lack of enforceability could lead to a free-rider problem in which some developed countries choose to adopt the policy and other developed countries do not adopt the policy. Developed countries that opt-out of the proposal, assuming they adopt a territorial tax system, could benefit from the tax rate race to the bottom in participating developed countries. Without the participation of the global economy's largest players, especially the United States, the justification and effectiveness of this article's proposal would be seriously undermined. However, even if some developed countries chose not to participate, benefits to developing countries could still be realized.

Alternatives to the Proposal

There are several alternatives to this article's proposal which employ different means, but achieve similar results. The most feasible alternative is for (1) developing countries to issue tax holidays, and (2) developed countries to grant tax-sparing credits. First, developing countries could issue tax holidays which "reduce or eliminate the income tax liability of the foreign investor for a specified period of years."⁷⁴ An additional benefit is that developing countries can use tax holidays to target certain industries or sectors that the developing country believes it can become globally competitive rather than apply a new tax regime to the entire economy.

Second, developed countries could grant tax-sparing credits which "recognize and preserve the benefits of tax incentives provided by developing countries to foreign investors."⁷⁵ Otherwise, the worldwide tax system could undercut or eliminate the purpose of a tax holiday because the taxpayer is still subject to the rate of tax in the investor's country of residence.⁷⁶

The downside to this alternative is that, although the combination of tax holidays and tax-sparing credits may increase the amount of FDI flowing into a developing country,⁷⁷ they

will not immediately increase the developing country's tax revenues to fund its economic development. In addition, not only are tax revenues decreased in the tax holiday country, but also in the country granting tax-sparing credits. Adopting measures that decrease tax revenues may be politically unpopular due to the current financial crisis. Instead the combination which benefits private investors forces developing countries to rely on private market development. On the other hand, if the government is corrupt, then this alternative is a good way to keep the vehicle for economic development in the hands of the private market.

Canada, among other OECD countries, is one country that has granted tax-sparing provisions in treaties with developing countries.⁷⁸ Although the purpose of the tax-sparing credits was to promote economic development in developing countries, the results have been mixed.⁷⁹

Despite this alternative, and others, this article's proposal is superior because it strikes a balance between incentivizing the private market to invest in developing countries and putting tax revenues in the hands of developing countries to fund internal economic development through government services. Other alternatives, like the one above, tend to favor one factor over the other factor. For example, tax-sparing credits may incentivize the private market to invest in developing countries, but it provides little, if any, tax revenues to developing countries.

Conclusion

Developed countries have pledged their support to the world's developing countries, yet their tax systems may be undercutting their efforts. The global economy's ad hoc patchwork of tax systems divert FDI away from developing countries and do not incentivize investment into developing countries. This article claims that tax policy is one tool for developed countries to aid developing countries. Adopting a globally coordinated tax regime in which developed countries adopt a worldwide tax system and developing countries adopt a territorial tax system would help the economic development of developing countries. ♦

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stimulating FDI").

⁷⁴*Id.* at 880; *see also id.* at 888-893; Karen B. Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?*, 23 U. PA. J. INT'L ECON. L. 45, 51-59 (2002) (proposing that income derived from sub-Saharan nations be free from U.S. income taxation for an experimental period of ten- or fifteen-years).

⁷⁹*See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAX SPARING: A RECONSIDERATION 41-43 (1998) (finding that tax sparing is not necessarily an adequate tool to promote economic development). *But see* Hines, *supra* note 77.

⁷⁴GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶ 5210.

⁷⁵Deborah Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 CANADIAN TAX J. 879, 880 (2001).

⁷⁶*Id.* at 880-81; *see also* GUSTAFSON, PERONI & PUGH, *supra* note 35, at ¶ 5210.

⁷⁷James R. Hines, Jr., "Tax Sparing" and Direct Investment in Developing Countries 3-4 (Nat'l. Bureau of Econ. Research, Working Paper No. 6728, 1998), available at <http://www.nber.org/papers/w6728> (finding that "tax sparing is effective in

APPENDIX A: WORLDWIDE TAX COUNTRIES

TOP 10 DESTINATION COUNTRIES FOR THE UNITED STATES' FDI OUTFLOWS (2003-2008)

Total US FDI Outflows: \$958,805,090,000

US Corporate Tax Rate: 35%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate ¹
1	China	\$130,021,000,000	13.56%	33%
2	India	\$60,045,112,217	6.26%	33%
3	UK	\$49,795,898,716	5.19%	30%
4	Canada	\$42,032,033,333	4.38%	22.1%
5	Russia	\$40,932,490,000	4.27%	24%
6	Germany	\$30,529,716,685	3.18%	26.4%
7	Australia	\$29,731,563,040	3.10%	30%
8	Japan	\$28,291,405,541	2.95%	30%
9	Mexico	\$25,251,070,000	2.63%	28%
10	South Korea	\$23,420,720,151	2.44%	27.5%

TOP 10 DESTINATION COUNTRIES FOR THE UNITED KINGDOM'S FDI OUTFLOWS (2003-2008)

Total UK FDI Outflows: \$370,804,001,008

UK Corporate Tax Rate: 30%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate
1	India	\$42,290,444,915	11.41%	33%
2	USA	\$35,280,138,966	9.51%	35%
3	China	\$25,018,280,000	6.75%	33%
4	Russia	\$23,842,890,000	6.43%	24%
5	Azerbaijan	\$22,036,314,356	5.94%	22%
6	Ireland	\$14,994,200,000	4.04%	12.5%
7	Spain	\$12,514,659,000	3.38%	35%
8	Libya	\$9,977,724,006	2.69%	40%
9	Poland	\$9,147,200,000	2.47%	19%
10	Brazil	\$8,464,938,889	2.28%	34%

TOP 10 DESTINATION COUNTRIES FOR JAPAN'S FDI OUTFLOWS (2003-2008)

Total Japan FDI Outflows: \$376,066,516,547

Japan Corporate Tax Rate: 30%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate
1	USA	\$80,845,173,406.60	21.50%	35%
2	Australia	\$33,395,554,105.70	8.88%	30%
3	Taiwan	\$33,053,170,000.00	8.79%	25%
4	Saudi Arabia	\$32,470,420,000.00	8.63%	85%
5	Vietnam	\$18,120,600,000.00	4.82%	40%
6	India	\$15,870,212,000.00	4.22%	33%
7	Thailand	\$15,868,416,166.70	4.22%	30%
8	South Korea	\$13,020,727,705.60	3.46%	27.5%
9	Russia	\$11,977,750,000.00	3.19%	24%
10	Indonesia	\$10,698,240,000.00	2.84%	30%

¹ THE HERITAGE FOUNDATION, INDEX OF ECONOMIC FREEDOM (2008), available at <http://www.heritage.org/research/features/index/downloads.cfm>.

APPENDIX B: TERRITORY TAX COUNTRIES

TOP 10 DESTINATION COUNTRIES FOR FRANCE'S FDI OUTFLOWS (2003-2008)

Total France FDI Outflows: \$243,560,373,558

France Corporate Tax Rate: 33.8%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate ¹
1	China	\$25,455,740,000	10.45%	33%
2	USA	\$15,065,298,636	6.19%	35%
3	Spain	\$14,285,544,179	5.87%	35%
4	Poland	\$12,484,340,000	5.13%	19%
5	Russia	\$11,623,740,000	4.77%	24%
6	Romania	\$10,352,950,000	4.25%	16%
7	India	\$9,388,096,913	3.85%	33%
8	Indonesia	\$7,287,400,000	2.99%	30%
9	Nigeria	\$6,894,400,000	2.83%	30%
10	Canada	\$6,075,690,000	2.49%	22.1%

TOP 10 DESTINATION COUNTRIES FOR GERMANY'S FDI OUTFLOWS (2003-2008)

Total Germany FDI Outflows: \$362,310,000,000

Germany Corporate Tax Rate: 26.4%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate
1	China	\$59,540,085,246	16.43%	33%
2	USA	\$30,154,178,863	8.32%	35%
3	India	\$25,562,542,262	7.06%	33%
4	Russia	\$23,321,683,636	6.44%	24%
5	UK	\$14,541,096,286	4.01%	30%
6	Spain	\$11,264,904,000	3.11%	35%
7	Hungary	\$11,031,094,241	3.04%	16%
8	Sweden	\$10,541,560,000	2.91%	28%
9	Poland	\$10,107,590,000	2.79%	19%
10	Mexico	\$9,986,480,000	2.76%	28%

TOP 10 DESTINATION COUNTRIES FOR THE NETHERLANDS' FDI OUTFLOWS (2003-2008)

Total Netherlands FDI Outflows: \$216,289,343,943

Netherlands Corporate Tax Rate: 26%

	Destination Country	Capital Investment	% of Total FDI Outflows	Corp. Tax Rate
1	China	\$31,668,460,000	14.64%	33%
2	Russia	\$25,932,200,000	11.99%	24%
3	Canada	\$16,729,122,143	7.73%	22.1%
4	South Korea	\$13,735,500,000	6.35%	27.5%
5	USA	\$12,424,893,878	5.74%	35%
6	India	\$11,139,781,250	5.15%	33%
7	France	\$8,552,400,000	3.95%	33.8%
8	Poland	\$7,838,440,000	3.62%	19%
9	Turkey	\$6,776,300,000	3.13%	20%
10	Saudi Arabia	\$6,739,700,000	3.12%	85%

¹ THE HERITAGE FOUNDATION, INDEX OF ECONOMIC FREEDOM (2008), available at <http://www.heritage.org/research/features/index/downloads.cfm>.

APPENDIX C: METHODOLOGY, DATA ANALYSIS, & CONCLUSIONS

METHODOLOGY

This article collected data looking at the destination of FDI outflows from three advanced economies that have adopted a worldwide system of taxation—the United States, the United Kingdom, and Japan.¹ This article has also collected data looking at the destination of FDI outflows from three advanced economies that have adopted a territory system of taxation—France, Germany, and the Netherlands.² Specifically, data was collected on these countries' (1) top ten destination countries for FDI outflows; (2) the total amount of the FDI outflows; (3) the percentage of their total FDI that flows to each of the top ten destination countries; and (4) the maximum marginal corporate tax rate of each of the top ten destination countries.

First, high-tax countries and low-tax countries must be defined terms. This article designated two threshold amounts. The first threshold amount was set at 30% and was determined by taking the simple average of corporate tax rates of all the countries in both Appendices A and B. The second threshold amount was set at 35% and was determined by taking the United States' corporate tax rate, a country the amounts for a large percentage of worldwide FDI. Second, the six countries were analyzed based on the total percentage of FDI outflows that are flowing to a high-tax country. Third, the total percentage of FDI outflows to high-tax countries was summed up and averaged for each basket of countries.

Finally, three statistical correlation tests were run.³ A Welch two sample t-test was used to test whether the population means are the same. The Wilcoxon rank sum test was used to test

¹ See Appendix A.

² See Appendix B.

³ Thank you to Hiro Hikawa, Ph.D. candidate, The George Washington University, for helping develop these models.

the location of the two population distributions. A bootstrapping the mean difference test was used to test whether the means are the same.

DATA ANALYSIS

A. Percent of Total FDI Outflows into High-tax Countries (30% threshold)

Worldwide Tax Countries

US = 31.06%

UK = 36.02%

Japan = 55.11%

Mean = 40.73

Standard deviation = 12.69798

Territory Tax Countries

France = 32.18%

Germany = 38.93%

Netherlands = 32.60%

Mean = 34.57

Standard deviation = 3.781706

Mean difference = 6.16

1. Results from the Welch Two Sample T-test

data: W and T

t = 0.8053, df = 2.352, **p-value** = 0.494

alternative hypothesis: true difference in means is not equal to 0

95 percent confidence interval: -22.45503 34.77503

sample estimates:

mean of x: 40.73

mean of y: 34.57

2. Results from the Wilcoxon Rank Sum Test

data: W and T

W = 5, **p-value** = 1

alternative hypothesis: true location shift is not equal to 0

3. Results from the Bootstrap Mean Differences Test

Quantiles:

2.5%

-14.0125000

5%

-10.4778333

10%

-8.5300000

15%

-6.7366667

20%	50%	85%	90%
-5.4400000	0.1433333	7.6433333	8.4790000
95%	97.5%		
10.9425000	14.0101667		

P-value = 0.195

B. Percent of Total FDI Outflows into High-tax Countries (35% threshold)

Worldwide Tax Countries

US = 0%

UK = 15.58%

Japan = 34.95%

Mean = 16.84333

Standard deviation = 17.50922

Territory Tax Countries

France = 12.06%

Germany = 11.43%

Netherlands = 8.86%

Mean = 10.78333

Standard deviation = 1.695179

Mean difference = 6.06

1. Results from the Welch Two Sample T-test

data: W and T

t = 0.5967, df = 2.037, **p-value** = 0.6103

alternative hypothesis: true difference in means is not equal to 0

95 percent confidence interval: -36.87712 48.99712

sample estimates:

mean of x: 16.84333

mean of y: 10.78333

2. Results from the Wilcoxon Rank Sum Test

data: W and T

W = 6, **p-value** = 0.7

alternative hypothesis: true location shift is not equal to 0

3. Results from the Bootstrap Mean Differences Test

Quantiles:

2.5%	5%	10%	15%
-17.393333	-10.4778333	-12.623667	-9.584833
20%	50%	85%	90%
-7.840000	0.000000	9.431500	11.470000
95%	97.5%		
15.378667	18.432333		

P-value = 0.2575

CONCLUSIONS

The data shows that worldwide tax countries are more likely to invest in high-tax countries than territory tax countries, but the correlation, although positive, is weak. Regardless of whether the threshold amount is set at 30% or 35%, about 6 percent more FDI flows to high-tax countries from worldwide tax countries than from territory tax countries.

This article acknowledges that the data pool was drawing only from the FDI outflows from six advanced economy countries. Expanding this test to include more countries would allow for a more definitive conclusion on this article's thesis. The sample sizes (3 for each group) are very small to obtain reliable results.

FRONTIER continued from page 11

tion organized under the act to deviate from the default rule in its organic document to provide for patron member voting based on use or patronage; equity; or any combination thereof, which would allow patron members to exercise more than one vote⁶⁶ with no patron member being deprived of a vote.⁶⁷ The act also provides that if a cooperative association has investor members each member is entitled to one vote, unless the organic rules otherwise provide.⁶⁸ These provisions of the act permit a cooperative association organized under this act to go far afield of the rigid one-member, one-vote requirement set forth by the service. However, the act does provide that if a cooperative association organized under this act has both patron and investor members then the patron members must always hold a majority of all voting power and action on any matter can only be approved by a majority vote of all members voting and patron members voting, unless a super majority is required by another provision of the act or the organic rules of the cooperative association.⁶⁹

The Uniform Limited Cooperative Association Act also provides the manner by which votes may be taken. A cooperative association organized under this act, by its organic document, may provide for traditional in person voting, voting by proxy, voting by mail, and tiered voting by delegates who represent districts or classes.⁷⁰ However, if proxy voting is permitted, "a patron member may appoint only another patron member as a proxy and, if investor members are permitted, an investor member may appoint only another investor member as a proxy."⁷¹

It is likely that the service would take issue with the types of voting systems that could potentially be devised under the act. However, although these provisions of the act deviate from the voting standards expounded by the service, the act does continue to ensure that patron members exercise democratic control over the cooperative association, especially when these provisions are considered in conjunction with the provisions relating to the election of the board of directors.

Again, we must be mindful of the fact that patron members and investor members in a New Age cooperative association co-exist in a mutually beneficial symbiotic relationship. It would be folly to think that investor members would contribute equity capital, often large sums of equity capital, to a cooperative association if they are given no voice and are placed in a position analogous to silent partners. Without equity capital New Age cooperative associations, in most cases, would not be able to exist and a unique business entity, often vital to rural economic growth and development, would be relegated to the dustbin of history for no other reason than

that the service chose to apply a rigid requirement, where a general guideline should exist, to implement the concept of democratic control.

If the service approached the principle of democratic control as a concept, as opposed to a rigid requirement, it is likely that any voting system devised under this act would pass muster by ensuring that patron members maintain control over the cooperative association. The principle of democratic control is one that must be viewed with a telescope, not a microscope. It may be that the service and cooperative associations would be best served if the service remained within its area of expertise, tax law, and didn't venture in to the business world equivalent of constitutional law, an area in which its level of expertise is woefully inadequate.

The third factor, proportionate allocation of profits, requires that cooperative associations distribute profits based on patronage rather than investment interests.⁷² Even if the patrons and investors are one in the same it is of concern that earnings be distributed based on patronage. This raised the question of how to classify distributions made to patron-investors. *Union Equity Cooperative Exchange v. Commissioner* determined that a distribution to a patron-investor based on their investment is received in their capacity as an investor and represents a return on investment and a distribution to a patron-investor in their capacity as a patron and based on their patronage represents a "return" on their patronage.⁷³ There are many ways in which a cooperative association can allocate profits on a patronage basis;⁷⁴ however, if a cooperative association fails to

⁷²See, e.g., *Brookings Plywood Corp. v. U.S.*, 78-1 U.S. Tax Cas. (CCH) ¶ 9103 (D. Ore. 1977) (corporation was not operated "on a cooperative basis" because it did not allocate patronage dividends to individual employee-stockholders); Rev. Rul. 73-570, 1973-2 C.B. 194 (corporation was not operated "on a cooperative basis" because it distributed surplus to members based on their stock ownership); Rev. Rul. 70-481, 1970-2 C.B. 170 (proportionate allocation factor satisfied because the corporation made distributions to members based on their patronage); I.R.S. Priv. Ltr. Rul. 2002-09-024 (Nov. 29, 2001) (proportionate allocation factor was satisfied because the cooperative association distributed patronage dividends received from its subsidiary based on each members patronage of the subsidiary's services).

⁷³58 T.C. 397 (1972).

⁷⁴See, e.g., *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 315-16 (1965), *acq.* 1966-1 C.B. 3 (allocation of profits to worker-members based on number of hours worked by each member in proportion to the total hours worked by all members); *Trump Village Section 3, Inc. v. Commissioner*, 69 T.C.M. (CCH) 2985 (1995), *acq.* 1996-1 I.R.B. 5 (allocation of profits to tenant-shareholders based on annual rental payments); Rev. Rul. 66-98, 1966-1 C.B. 200 (allocation of savings to members based on the discount charged to each member in proportion to the discounts charged to all mem-

⁶⁶Unif. Ltd. Coop. Assoc. Act § 512 (2007).

⁶⁷Unif. Ltd. Coop. Assoc. Act § 512 cmt. (2007).

⁶⁸Unif. Ltd. Coop. Assoc. Act § 513 (2007).

⁶⁹Unif. Ltd. Coop. Assoc. Act § 514 (2007).

⁷⁰Unif. Ltd. Coop. Assoc. Act § 515 (2007).

⁷¹*Id.*

distribute profits on an equal basis according to patronage the cooperative association will not be “operating on a cooperative basis” for purposes of Subchapter T of the code.⁷⁵

The Uniform Limited Cooperative Association Act provides that cooperative associations may allocate profits and losses to members, nonmembers who conduct business with the cooperative, an unallocated account, or any combination thereof.⁷⁶ Unless modified by the organic document of a cooperative association formed under the act, all profits and losses must be allocated to patron members “in the ratio of each member’s patronage to the total patronage of all patron members during the period for which allocations are to be made.”⁷⁷ These provisions clearly satisfy the requirement of proportionate allocation of profits; however, the existence of investor members makes the compliance of the act with present tax law much more problematic. The act provides that a cooperative association may have investor members and those members may share in profits “in the ratio of each investor member’s contributions to the total contributions of all investor members.”⁷⁸ However, the act also provides that patron members must receive at least 50 percent of the profits and this requirement cannot be modified by the organic document of a cooperative association.⁷⁹

It is likely that the service will closely examine any allocation scheme that includes investor members. A cooperative

bers); I.R.S. Priv. Ltr. Rul. 98-03-019 (Oct. 17, 1997) (allocation of profits to members based on the claims processing fees charged to each member in proportion to the claims processing fees charged to all members); Rev. Rul. 81-96, 1981-1 C.B. 359 (allocation of profits to members based on the quantity of agricultural products furnished by each member in proportion to the agricultural products furnished by all members); Rev. Rul. 70-481, 1970-2 C.B. 170 (allocation of profits to members based on the value of business done with each member in proportion to the value of business done by all members); *Junita Farmers Cooperative Ass’n. v. Commissioner*, 43 T.C. 836 (1965), *acq.* 1966-1 C.B. 2 (allocation of profits to members based on the amount of grain delivered by each member in proportion to the grain delivered by all members); *id.* (allocation of profits to patrons based on the amount of feed and fertilizer purchased by each patron in proportion to the amount of feed and fertilizer purchased by all patrons); I.R.S. Priv. Ltr. Rul. 2000-42-013 (July 20, 2000) (allocation of profits to patrons based on the value of business conducted with each patron in proportion to the value of business conducted with all patrons); *United Cooperatives, Inc. v. Commissioner*, 4 T.C. 93 (1944), *acq.* 1945 C.B. 6 (allocation of profits to patrons based on the amount of each patrons patronage in proportion to the patronage of all patrons).

⁷⁵*See, e.g.*, I.R.S. Tech. Adv. Mem. 93-03-004 (Oct. 7, 1992) (unequal allocation of profits based on the value of proceeds for services provided by employee-members).

⁷⁶Unif. Ltd. Coop. Assoc. Act § 1004(a) (2007).

⁷⁷Unif. Ltd. Coop. Assoc. Act § 1004 (2007).

⁷⁸*Id.*

⁷⁹*Id.*

association formed under this act that included investor members would quite possibly fail the requirement that profits be allocated based on patronage; however, if the service approaches New Age cooperatives with an open mind and acknowledges present economic realities then the provision of the act which requires that at least 50 percent of profits be allocated to patron members based on patronage may serve as a saving clause that enables New Age cooperative associations to comply with the general principle that the fruits should be had by those who created them.

It will be important for the service to recognize that both patron members and investor members create the fruits of a New Age cooperative association. We have entered a new era in cooperative associations in which patron members are often financially unable to “go it alone” and must enlist investor members who bring equity capital, necessary to the formation and operation of the cooperative association, to the table. This unique relationship naturally requires that the investor members have an opportunity to reap a fair share of the fruits that their equity investment has sown. It would be foolish to believe that anyone would invest in a business enterprise if they had no opportunity to share in the profits were the business successful. However, it is this new delicate relationship between patron members and investor members that strains existing tax law concepts relating to cooperative associations. It is clear that the tax law is behind the ball in this regard. The only question that remains is whether the tax law will be modified or interpreted in such a way as to embrace these new relationships. If not, it is possible that New Age cooperative associations—business entities of significant economic importance—will be found to be unworkable for tax purposes.

The service has generally followed the Puget Sound analysis; however, the service has identified four additional factors significant to qualification as a cooperative, as follows:

- (1) the cooperative must be engaged in some joint effort actively with, for, or on behalf of, its members;
- (2) there must be a minimum number of patrons;
- (3) the amount of business done with nonmembers must be limited; and
- (4) upon liquidation, present and former members must participate on a proportionate basis in any distribution of the cooperative’s assets.⁸⁰

The service has experienced various levels of success in applying these additional factors.

The first factor, joint effort, has been defined by the service as a cooperative association whereby the combined efforts of the members improve their individual circumstances, usually business value, in ways which the individual members could not accomplish on their own.⁸¹ This is the basic concept of several individuals, but one entity, being far stronger and

⁸⁰Carla Neeley Freitag, *Taxation of Cooperatives*, 744 BNA Tax Management Portfolio § II, 54 n.54 (2d ed. 2008) (citing I.R.S. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991)).

⁸¹*Id.*

better off together than they could ever be individually. The whole is greater than the sum of its parts. As one might imagine it is not difficult to satisfy this factor, because this has historically been the basic embodiment of all cooperative associations. One wonders why the service even felt it necessary to create this factor, for it is the sine qua non of cooperative associations and always has been. The Uniform Limited Cooperative Association Act provides that a cooperative association formed under this act is an “autonomous, unincorporated association of persons united to meet their mutual interests through a jointly owned enterprise primarily controlled by those persons”⁸² A cooperative association formed under the act would clearly satisfy the requirement that there be a joint effort of the members, united together for a common mutually beneficial purpose.

The second factor, minimum number of patrons, has been adhered to by the service for decades yet the number of patrons required for a cooperative association to qualify as “operating on a cooperative basis” for purposes of Subchapter T of the code remains unclear.⁸³ However, it appears as though the service has never litigated this issue and no cooperative association has ever been deemed to be not “operating on a cooperative basis” for failing to comply with this requirement. The Uniform Limited Cooperative Association Act provides that there must be at least two patron members for a cooperative association to be formed under this act, unless the sole member is itself a cooperative association.⁸⁴ Under existing tax law this should prove sufficient for purposes of satisfying the requirement that there be a minimum number of patrons.

The third factor, limited nonmember business, was originally applied by the service to require that a cooperative association must “do more than 50 percent in value of its business with members” in order to be “operating on a cooperative basis” for purposes of Subchapter T of the code.⁸⁵ However, after failing to gain judicial acceptance of this view the service conceded that a “cooperative that operates on a for-profit, nonpatronage basis with nonmembers will not be precluded from [the benefits of Subchapter T] simply because it does less than 50 percent in value of its business with members on patronage basis.”⁸⁶ The Uniform Limited Cooperative Association Act doesn’t specify a minimum percentage of business that must be

done with members; however, it does generally provide that a member can transact business with the cooperative association in the same manner as a nonmember.⁸⁷ This factor is presently of little consequence in determining whether a cooperative association is “operating on a cooperative basis.” Therefore, the act satisfies this factor even though it doesn’t provide for a minimum percentage of member business.

The fourth factor, liquidating distributions, is derived from the position of the service that cooperative associations must operate at cost.⁸⁸

As discussed, *infra*, the service believes that operation at cost is an important principle of cooperative associations. However, based on the lackluster success that the service has had in gaining judicial approval for the concept that cooperative associations must operate at cost⁸⁹ it would seem that this factor should be of little concern. Nonetheless, for the careful tax practitioner, it would be prudent to note that in satisfaction of this factor the service requires that “a cooperative’s Articles of Incorporation or Bylaws obligate the cooperative to distribute its remaining assets upon liquidation to both its current and former members in proportion to the value or quantity of business that each did with the cooperative over some reasonable number of years.”⁹⁰

The Uniform Limited Cooperative Association Act provides that after creditor claims have been satisfied the cooperative association shall pay out the remaining assets

The service requires that “a cooperative’s Articles of Incorporation or Bylaws obligate [it] to distribute its remaining assets upon liquidation to both its current and former members in proportion to the value or quantity of business that each did with the cooperative over some reasonable number of years.”

⁸²Unif. Ltd. Coop. Assoc. Act § 104 (2007).

⁸³See Rev. Rul. 72-602, 1972-2 C.B. 510; I.R.S. Priv. Ltr. Rul. 96-23-067 (Mar. 14, 1996); I.R.S. Priv. Ltr. Rul. 95-43-005 (May 8, 1995); I.R.S. Priv. Ltr. Rul. 93-22-028 (Mar. 9, 1993); I.R.S. Priv. Ltr. Rul. 91-41-028 (July 11, 1991); I.R.S. Priv. Ltr. Rul. 92-19-030 (Feb. 7, 1991); I.R.S. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991); I.R.S. Priv. Ltr. Rul. 91-08-042 (Nov. 27, 1990); I.R.S. Priv. Ltr. Rul. 84-02-009 (Sept. 23, 1983); I.R.S. Priv. Ltr. Rul. 82-25-013 (Mar. 18, 1982); I.R.S. Priv. Ltr. Rul. 82-21-111 (Feb. 26, 1982); I.R.S. Priv. Ltr. Rul. 77-46-003 (Aug. 2, 1977); I.R.S. Priv. Ltr. Rul. 77-31-017 (May 4, 1977); G.C.M. 37,750 (Nov. 13, 1978).

⁸⁴Unif. Ltd. Coop. Assoc. Act § 501 (2007).

⁸⁵Rev. Rul. 1972-602, 1972-2 C.B. 510.

⁸⁶Rev. Rul. 1993-21, 1993-1 C.B. 188.

⁸⁷Unif. Ltd. Coop. Assoc. Act § 115 (2007).

⁸⁸I.R.S. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991).

⁸⁹See cases cited *infra* note 96.

⁹⁰I.R.S. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991).

to members in respect of their “financial interests.”⁹¹ For purposes of the act “financial interests” means “amounts recorded in the names of members in the records of a limited cooperative association at the time a distribution is made, including amounts paid to become a member, amounts allocated but not distributed to members, and amounts of distributions authorized but not yet paid to members.”⁹² The distribution of assets is to be made “in the proportion of the member’s financial interests to the total financial interests of the members after all other obligations are satisfied.”⁹³ The act also contemplates that a “look back” period, for the purpose of determining members entitled to liquidating distributions, could be provided for in the organic document of the cooperative association.⁹⁴

Again, the most problematic aspect of the act, the inclusion of investor members brings in to question whether a cooperative association formed under the act would be deemed to be “operating on a cooperative basis.” The service contemplates that liquidating distributions should be made based on a cooperative association member’s historical patronage. However, this traditional and out-dated view fails to take in to consideration the financial interests of investor members who played a key role throughout the life of the cooperative association. If the service continues to hold a traditional view on the subject of liquidating distributions then it is possible that a cooperative association that provided for liquidating distributions in the manner prescribed under the act would not qualify as “operating on a cooperative basis.” However, if the service takes in to consideration present economic realities and general principles of fairness then the scheme for liquidating distributions required under the act will pass muster. Much depends on the willingness of the service to evolve in the same way that cooperative associations have evolved.

As previously discussed, the service has taken the position that a cooperative association is not “operating on a cooperative basis” unless it operates at cost.⁹⁵ However, the service has been largely unsuccessful in gaining judicial approval of this position.⁹⁶ The Uniform Limited Cooperative Association Act

⁹¹Unif. Ltd. Coop. Assoc. Act § 514 (2007).

⁹²*Id.*

⁹³*Id.*

⁹⁴Unif. Ltd. Coop. Assoc. Act § 1207 cmt. (2007).

⁹⁵*See* G.C.M. 38,217 (Dec. 21, 1979); G.C.M. 38,099 (Sept. 18, 1979); G.C.M. 38,061 (Aug. 22, 1979); G.C.M. 37,751 (Nov. 21, 1978); G.C.M. 37,578 (June 16, 1978); G.C.M. 34,935 (July 3, 1972); G.C.M. 34,383 (Nov. 21, 1970); G.C.M. 34,334 (Aug. 17, 1970).

⁹⁶*See, e.g., Lamesa Coop. Gin v. Commissioner*, 78 T.C. 894, 902 (1982) (“We have heretofore rejected the

takes a conservative approach and contemplates that a cooperative association formed under the act will operate at cost.

One of the fundamental principles of cooperative organizations is that they operate “at cost.” . . . Cooperatives are unique in having a principle that, in operation, results in a cooperative having “no profit” and “no loss” at the end of an annual accounting period. Business methods have been developed to reach the “at cost” result while at the same time providing necessary capital to the cooperative.⁹⁷

Therefore, a cooperative association formed under the act, which utilizes business methods that result in the cooperative association operating “at cost,” will satisfy this factor for purposes of “operating on a cooperative basis” under Subchapter T of the code.

It is apparent that whether a cooperative association formed under the act will be deemed to be “operating on a cooperative basis” for purposes of Subchapter T of the code will depend, in large part, on how the service reacts to this new entity structure. The service will surely have to expand its thinking and its view if it is to embrace New Age cooperatives and grant them preferred tax treatment under Subchapter T of the code. If the service continues to adhere to antiquated factors and requirements then it will fall to Congress to recognize the economic and cultural value offered by New Age cooperatives and assign to them tax laws befitting their uniqueness. For now, we wait and watch. ♦

respondent’s concept of the ‘operation-at-cost’ principle”); *Ford-Iroquois FS v. Commissioner*, 74 T.C. 1213, 1222 (1980) (“The ‘operation-at-cost’ principle describes a feature of a cooperative’s relations with its members, not a codified requirement of tax accounting”); *Associated Milk Producers v. Commissioner*, 68 T.C. 729, 739-40 (1977) (citing Rev. Rul. 69-67, 1969-1 C.B. 142) (“The so-called ‘cost’ principle of cooperatives which respondent espouses with unaccountable zeal as the underlying basis for his position in this case appears to have emerged from no greater a source than certain incidental language in a 1969 ruling on an unrelated question of cooperative accounting.”). *But see Buckeye Power v. Commissioner*, 38 Fed. Cl. 154 (1997), *motion to revise denied*, 38 Fed. Cl. 283 (1997) (the operation-at-cost requirement appears to have been accepted).

⁹⁷Unif. Ltd. Coop. Assoc. Act § 1207 (2007).

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