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The Convergence of the Taxation Systems of the Developed Nations

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It is a very great honor to come to your fine country for the first time and to address this august body of lawyers on the occasion of your twentieth annual meeting. American tax lawyers have never successfully formed a separate association, but the annual meetings of the Tax Section of the American Bar Association function, I would guess, much in the same fashion as your annual meetings.

I.

I wish to make a simple but bold claim in this speech. It is simply that the taxation systems of the major developed countries will grow to resemble each other more and more during the remaining years of the twentieth century. I will develop three instances that support my belief as to the growing similarity of these systems. Before I begin, however, I have three points of qualification.

First, my core point assumes that the world is moving and will continue to move in the direction of a worldwide free-trade economy. Although significant protective barriers, some legal, some cultural, will continue to exist, it is my assumption that further liberalization (and resulting growth) of international trade is probable, indeed inevitable. As Sweden has already learned, no nation can remain outside the orbit of international free trade and expect to prosper or to satisfy the demands of its people for the broad array of reasonably priced goods and services that are available in our international market place.[1]

Second, I wish to limit my claim to the developed nations. I suspect that some, perhaps even many, developing nations will retain protective

* Dean and Professor, Cornell Law School. These remarks were prepared and delivered at the annual meeting of the Tax Lawyers Association of Japan on Mar. 11. 1992.

1. *See* Glenn Frankel, *Swedes Face New Course, Uncertainty; Vote Seen as Making Nation European*, WASH. POST, Sept. 17, 1991, at A22; *Sweden; Time for a Change*, ECONOMIST, May 18, 1991, at 52; *A Change of Course; A Less Taxing Time Ahead?*, ECONOMIST, Mar. 3, 1990, at 9; *Swedish Government to Propose Additional Tax Reductions to Attract Investment*, BNA INT'L FIN. DAILY, Feb. 17, 1992, *available in* LEXIS, BNA Library, Bnaitd File.

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barriers that will make the logic of the international market place less compelling for tax harmonization. In addition, the revenue and expense side of government operations in a developing nation typically differs from that of a developed nation, and this can lead to a lower level of taxation than generally prevails in a developed nation.

Third, by taxation system I am not limiting myself to income or even nationwide taxes. I believe the aggregate of taxation schemes, including income, sales, value-added, social security, and local taxes within a single nation, whether a federal or unitary state, will grow to resemble each other from country to country. At the same time, significant variations will remain in the local taxes but I believe the aggregate level of such taxes (when looked at together with the national taxes) will be harmonized.

II.

My first example of the growing similitude of the taxation systems of the developed countries involves Canada, the United States, and the United Kingdom. I am aware that many will immediately question the "internationalness" of an example that involves three leading common law nations in the Northern Hemisphere. Nevertheless, even though these nations are similar, until recently they had very different attitudes towards a major issue of income tax policy. The issue is a familiar one for tax lawyers, particularly those with an interest in international taxation, but it also has major domestic law significance.

Let me briefly describe the issue. Assume that a tax statute is reasonably clear and that it imposes tax on certain kinds of transactions (or it accords nonrecognition to particular forms of transactions). A clever taxpayer or his lawyer or both devise a scheme that is substantially identical in effect to the transaction(s) covered by the statute, but by use of a form(s) or extra step(s) in the transaction, the statute does not literally cover the devised transaction. The issue is: can a court or administrative agency (or the taxpayer, but usually it is the revenue service) disregard the actual form of the transaction and say that it is taxable because its effect is the same as the one specifically covered by the statute? The most famous American case in this regard is, of course, *Gregory v. Helvering*,[2] with which many of you are familiar. In that case the taxpayer contributed appreciated securities to a holding company whose existence was transitory and which disposed of the securities.

It is generally accepted in American tax law that the precise form of a transaction may be disregarded in cases like the one I posit. I cannot say that this principle has been followed in a large number of cases but it is a staple of American tax law. Occasionally, an American court[3] will refuse to apply the principle if the tax statute is very general and there is

2. 293 U.S. 465 (1935).

3. *See* Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954).

little linguistic support to narrow the words of the statute (by applying the doctrine), but it is rare that a court will see (or admit) such a state of affairs.

American courts have variously described this rubric of statutory interpretation that allows them to nullify "tax-avoidance" transactions. Sometimes it is referred to as the step transaction doctrine,[4] or the business purpose rule,[5] or even more loosely it is said that the taxpayers must act with bona fides or with an expectation of making a profit.[6] Finally, a transaction is sometimes scrutinized to see whether it is a "sham" and, therefore, to be disregarded.[7]

Until recently, English case law was clearly contrary to American case law. There are few English cases, however, because few English lawyers or the Inland Revenue would traditionally conceive of litigating a case along the lines I am describing.[8] The leading case, known to all tax lawyers, was *Commissioners of Inland Revenue v. Duke of Westminster*.[9] Lord Tomlin spoke the following memorable words:

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[10]

Early in the 1980s the House of Lords decided four cases that moved English jurisprudence considerably in the direction of the American approach. In the *Ramsay* and *Eilbeck*[11] decisions the House of Lords adopted an approach that collapsed multiple steps in a transaction that had an obvious tax avoidance purpose. In *Burmah Oil Company*[12] the House of Lords went a bit further and disregarded a complex internal reorganization, stating that that reorganization had "no commercial purpose."

Finally, in *Furniss v. Dawson*,[13] a case of particular interest to inter-

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4. See the discussion of the doctrine in McDonald's Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520, 524 (7th Cir. 1982), *rev'g* McDonald's of Zion, 432, Ill., Inc. v. Commissioners, 76 T.C. 972 (1981).

5. Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972).

6. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

7. See the discussion of this variant in Knetsch v. United States, 364 U.S. 361 (1960).

8. For an exception see Jones v. Wrotham Park Estates, 1980 App. Cas. 74. The case is discussed very ably in Gordon Woodman, *Dworkin's 'Right Answer' Thesis and the Frustration of Legislative Intent—A Case-Study on the Leasehold Reform Act*, 45 Mod. L. Rev. 121 (1982).

9. 1936 App. Cas. 1 (appeal taken from Eng.).

10. *Id.* at 19-20.

11. W.T. Ramsay, Ltd. v. Inland Revenue Comm'rs, Eilbeck v. Rawlings, 1982 App. Cas. 300 (H.L.).

12. 1981 T.R. 535 (Eng.) (appeal taken from Eng.).

13. [1984] 1 All E.R. 530 (Eng.).

national tax observers, the House of Lords adopted a variant of the step transaction doctrine that allowed it to ignore any step in a transaction that had no business purpose (apart from the avoidance of taxation). In *Furniss*, the pre-sale transfer of appreciated securities to a holding company, formed and operating in a tax haven, was held to be a nullity thus requiring immediate recognition, rather than deferral, on the gain imbedded in the shares transferred, as they were immediately sold in an arm's length purchase.

This development in English case law is truly extraordinary.[14] English statutory interpretation is more attuned to the claims of formality, as opposed to substantive concerns,[15] and it is less willing to range beyond the words of a statute, even one labelled remedial (whatever that may mean).[16] Suffice it to say that some major dynamic must be operating for this change to occur. Note that the change reflected in the four cases occurred pretty quickly, which makes it look like a response to external (and probably economic) forces rather than the gradual judicial reconsideration over a long period that would be more typical of a common law system responding to a change in social attitudes.

The change in Canada was even more violent and abrupt. For many years, Canada also appeared to adhere to Lord Tomlin's view in the *Duke of Westminster's*[17] case. There were hints in some decisions[18] in Canada of the American doctrine but nothing definitive. For instance, in a thoughtful 1984 opinion by Mr. Justice Estey in *Stubart Investments, Ltd.*,[19] the Supreme Court of Canada interpreted section 245(1), a provision of the then Canadian income tax, which limited special capital gains taxation in the case of certain "artificial transactions," to import into Canadian jurisprudence, in a very limited fashion, the "business purpose" doctrine. By contrast, in *Queen v. Melford Developments, Inc.*,[20] Justice Estey led the Supreme Court to adopt a wooden, pro-taxpayer, interpretation of the then applicable Canada-Germany Tax Convention of 1956.[21]

Subsequent to Estey's opinion in *Stubart*, the federal government in Canada moved to amend section 245 to make it a general "anti-avoidance" statute. This was accomplished in the 1986 tax reform of the

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14. *See* Woodman, *supra* note 8.

15. *See generally* P. S. ATIYAH & ROBERT S. SUMMERS, FORM AND SUBSTANCE IN ANGLO-AMERICAN LAW (1987).

16. *Id.* at 100-12.

17. *See* Woodman, *supra* note 8; [Transfer Binder 1986-1991] 1 Can. Tax Rep. (CCH) ¶ 122; Lumbers v. Minister of Nat'l Revenue, 2 D.T.C. 652 (Can. 1943).

18. *See, e.g.*, Minister of Nat'l Revenue v. Leon, 30 D.T.C. 6299 (Can. 1976); Dominion Bridge Co., Ltd. v. The Queen, 29 D.T.C. 5150 (Can. 1975).

19. Stubart Inv., Ltd. v. The Queen, 38 D.T.C. 6305 (Can. 1984).

20. [1982] 2 S.C.R. 504.

21. Convention Between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 14, 1956, Can.-F.R.G., *reprinted in* [1975-1980 Transfer Binder] [8a Treaties & O.E.C.D. Draft-Agreement] Can. Inc. Tax (Butterworth's) 14,301-10.

Canadian Income Tax Act.[22] The current statute reads:

> Where a transaction is an *avoidance transaction*, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.[23]
> An Avoidance Transaction means any transaction (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.[24]

The anti-avoidance provision is called off "where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole."[25] The words "tax benefit," "tax consequences," and "transaction" are elsewhere defined broadly.[26]

Section 245 aligns Canadian tax jurisprudence with that of the United States and also with that of the United Kingdom. It is possible that these three leading common law countries are randomly gravitating in a particular direction or that something intrinsic in their cultures is producing this harmonization. But I doubt either of these explanations and the only alternative explanation that I can generate is the one I began with, namely that the taxation systems of the developed countries are converging, primarily due to economic forces but also due to a better and quicker flow of information across national borders about tax avoidance strategies and about government efforts to limit those strategies.

I do not know what the state of Japanese jurisprudence is on the doctrines spawned by *Gregory v. Helvering*, but my guess is if Japan has not faced this issue it will someday.

III.

My second example is one of grand tax policy in the sense of a major statutory innovation or change. As you all know, in 1988 Japan adopted a modest (three percent), but I understand very unpopular, consumption tax that resembles, but also differs in important respects from, the

22. Income Tax Act, ch. 63, 1970-1972 S.C. 1311, *amended by* ch. 6, 1986 S.C. 221 (Can.).
23. Income Tax Act, ch. 63, § 245(2), 1970-1972 S.C. 1311, *as amended*, ch. 55, 1988 S.C. 1371 (Can.) (emphasis added).
24. *Id.* § 245(3).
25. *Id.* § 245(4).
26. *Id.* § 245(1).

European model of value-added tax (VAT).[27] I am no expert on the Japanese consumption tax and I am not aware of the debate that preceded or has followed the adoption of the tax in Japan, except that I understand that it has been or is about to be substantially amended. I am aware that Japan had considered the adoption of a similar tax from early in the post-war period on several occasions.[28]

I find it unsurprising that Japan adopted a consumption tax in 1988. As many of you know, in 1979 the United Kingdom became the last major developed European nation to adopt a VAT. Its adoption was inevitable given the fact that a VAT is rebated or deductible at the frontier.[29] Any developed nation that does not adopt a VAT eventually must face an export discount set at whatever percentage the exporting country assesses as its VAT. I am aware of the claim by many economists that exchange rates adjust to compensate fully for VAT imposition, but based on the data I have seen, I do not find this claim convincing.[30]

Britain's adoption of a VAT, in self-defense against the rest of Europe and also to help fund continuing government deficits, led to serious debate about the same type of tax in Canada with a modified proposal to adopt a national VAT by the Progressive Conservative Government. In 1990, Canada imposed a seven percent VAT.[31]

Much is made of the fact that many Japanese people seem reluctant to discuss embarrassing or offensive matters in public. But no Japanese politician's squeamishness can match the reluctance of American politicians to discuss impending tax increases and impositions. I predict that the United States will be driven to impose a VAT, perhaps along Japanese lines, after the next presidential election. Perhaps at that time there will also be some reform of the financing of Social Security through our regressive payroll tax mechanism, which functions as a third income tax after the federal income tax as well as income taxes commonly enacted by state governments. I also predict that if the United States adopts a VAT of more than three percent, Japan may well raise the rate on its consumption tax.[32]

IV.

My third example is more difficult. It is not a matter of how taxation statutes are interpreted or a grand issue of tax policy like the adoption

27. See Alan Schenk, *Japanese Consumption Tax: The Japanese Brand VAT*, 42 TAX NOTES 1625-27 (1989); Barry N. Freiman, Comment, *The Japanese Consumption Tax: Value-added Model or Administrative Nightmare*, 40 AM. U. L. REV. 1265 (1991).

28. *See* Freiman, *supra* note 27, at 1271-78.

29. Nick Morris, *United Kingdom*, *in* COMPARATIVE TAX SYSTEMS: EUROPE, CANADA, AND JAPAN 314 (Joseph Pechman ed., 1987).

30. JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 302-05 (1991).

31. *Id* at 329, 333.

32. It is possible that Japan will not have to raise its rates because the major exporters to Japan may be developing nations which do not have a VAT; thus, the economic logic may not be so compelling for Japan.

of an entirely new tax, like the VAT. Rather, it is a more discrete question of national taxation policy and is an issue on which Japanese policy currently stands out.[33]

As you know, the Netherlands, Britain, and most other European countries have historically imposed income tax on individuals and businesses based primarily on either permanent residence or a heavy nexus of business activities. Thus, an individual whose residence was not in Britain but who earned income on a deposit in a British bank generally did not pay tax to Britain. The United States historically took a different position and taxed interest earned by its citizens anywhere and by nonresidents on their American bank accounts. American tax policy was eventually reversed to mirror the British and general European treatment. This was accomplished by withdrawing portfolio, including bank account, interest[34] from the thirty percent, in the absence of a treaty, tax on "fixed or determinable annual or periodical gains, profits, and income."[35]

The United States' quick, complete, and recent reversal seems to support my general theme of the convergence of the taxation systems of the developed nations. But it may also illustrate that as a tremendous importer of capital the United States, starting in the 1960s, desperately needed to reduce the cost (and increase the amount) of governmental and bank borrowing. One way to do that was to reduce the tax burden on those who made deposits in American banks or bought American governmental securities.

V.

My overall theme has migrated or changed a bit. Initially, I suggested that the tax systems of the developed nations were converging, largely because the increasing degree of economic integration within a world committed to free trade.

I still generally subscribe to this view but differences remain, even differences with respect to key features of the system. How can those differences be explained? In my view, they reflect indigenous economic conditions that are resistant, for one reason or another, to the internationalization of the world market place. Japan is not a net importer of capital so its tax system may continue to treat foreign passive income disadvantageously without serious harm to Japan. Conversely, the

33. It is my understanding that interest earned by a nonresident of Japan with no permanent establishment in Japan is subject to a 20% withholding tax except in the case of interest earned on certain corporate debentures. Toshio Miyatake & Kozo Toyama, *Taxation: An Overview* § 11.02[6], *in* 1 DOING BUSINESS IN JAPAN, (Zentaro Kitagawa ed., 1991). The 20% rate can, of course, be lowered by a bilateral treaty. *Id.*

There may, in the end, be economic reasons why it will not need to conform its policy in the way that the United States does and I will return to this in a minute.

34. I.R.C. § 871(i) (1988).

35. I.R.C. § 871(a)(1) (1988).

United States, as the world's biggest importer of capital, is motivated to keep it inexpensive in terms of taxes for foreigners to invest passively in American banks and other financial instruments. Similarly, Japan's low VAT may reflect the fact that the major exporters to Japan are developing nations without VATs whereas the United States and Europe import a substantially greater portion of their GNP from nations with VATS.

Why, then, did Japan adopt a consumption tax/VAT at all? Japan is a heavy world exporter that competes with other exporters. If the other exporters are willing to discount goods, by the net imbedded VAT at the frontier (but otherwise impose it on wholly domestic and importation transactions), then it would disadvantage Japan not to impose a tax at least on fabricated goods that it imports.

VI.

There remains one great conundrum with the thesis I am advancing. If the developed countries' taxation systems are converging because they are now operating (more or less) in a single worldwide economy, then neoclassical economics would tell us that they should converge on, as the case may be, (i) the lower or lowest rate of any member of the system, (ii) the system with the lowest aggregate level of taxation, and (iii) the more or most lenient rule of interpretation among the systems. Indeed, I would argue that this is generally happening. Witness the reduction in maximum rates beginning in the United States in 1981, followed by Britain and others, including most recently Sweden.

In two of the examples I cite, however, the movement to a VAT and the movement towards the more aggressive American doctrines that attack tax avoidance transactions, the movement has been to the stricter rule and, so to speak, to the higher rate. Can this be explained? Frankly I find it easier to explain the movement towards the American doctrines limiting or attacking tax avoidance. Two phenomena may explain it. First, the United States is such an attractive investment opportunity, for non-purely economic reasons (political and military stability), that if it adopts a stricter rule or higher tax, particularly if it is not with respect to a key feature of the system, then the rest of the developed world may well follow suit. Second, the American tax avoidance doctrines do not *simply* raise rates. In the long run their economic consequences are hard to gauge but to the extent that they discourage purely tax-motivated transactions they may promote efficiency. A third explanation may be that some features of a complex tax system, like the treatment of non-profit institutions, may have only a modest or hard-to-measure impact on national expenditure and frequently involve activities that are hard to transfer abroad.

The spread of the VAT is harder to explain. My guess is, again, that it has spread because it is a more efficient[36] tax and because, as we all

36. I believe it is at least more efficient in the sense that the administrative costs associated with a VAT will, in the long run, be lower than those associated with a

know, it is rebated at the frontier, at least in the European model. Whatever cost or inefficiency the tax entails disappears or is at least lessened at the moment of exportation; thus, it is to be expected that it would spread across the world *at the same time as income and general excise taxes seem to be going down*. Indeed, the nearly simultaneous reduction in income taxes among developed nations adopting a VAT probably distorts any simple view of the VAT as an additive tax whose addition is hard to explain in terms of a neoclassical economic analysis of international competition among taxation systems.

There may be a further explanation that is much more complicated and that would require some revision of my thesis. It may be that the state in a developed industrial society is actually better able to render certain services more efficiently than the private sector. Thus, the imposition of a VAT by one nation will not necessarily render it at a competitive disadvantage with another nation if that other nation continues to rely on private initiative (which is in this instance less efficient) to handle the matter being handled by the revenues generated by the VAT in the first nation.

In sum, taxes are one feature of national cost or expenditure that affect a nation's ability to compete in world trade. To the extent that all nations are engaging more actively in international trade, taxation systems will be subject to competitive pressures. Neoclassical economics tells us that when subjected to competitive pressures, these taxation systems will be driven towards a point of equilibrium. Thus, as I said at the beginning, national taxation systems in the developed nations will inevitably converge during the remainder of this century.

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corporate income tax. *See* JOINT COMMITTEE ON TAXATION, *supra* note 30, at 334-41. I also believe that it may be more efficient in a larger sense that it is a tax that appertains to value enhancement rather than profitability and, thus, more accurately measures social costs associated with production and taxes them proportionately. This is a much more controversial point. The main economic argument for a VAT is that it is a species of a consumption tax and that it will encourage savings and investment unlike income taxes. *Id.* at 289-92.