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Commentary (Response to article by H. David Rosenbloom)

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Commentary

REUVEN S. AVI-YONAH*

I. Introduction

David Rosenbloom has delivered an important lecture on an important topic:[1] whether exploiting differences between the tax system of two different jurisdictions to minimize the taxes paid to either or both ("international tax arbitrage") is a problem, and if so, whether anything can be done about it in a world without a "world tax organization." As Rosenbloom states, international tax arbitrage is "the planning focus of the future,"[2] and recently has been the focus of considerable discussion and debate (for example, upon the promulgation and subsequent withdrawal under fire of Notice 98-11).[3] Rosenbloom's lecture is one of the first attempts to address the underlying questions in a systematic manner, and thus represents a major contribution to what will no doubt be a fascinating and important debate.[4]

In general, Rosenbloom's thesis can be summarized briefly as follows: International tax arbitrage is the natural response of taxpayers to the normal differences that occur between any two tax systems. As such, it does not represent a problem, or at least no adequate explanation for why it is a problem has yet been given, other than by invoking an "international tax system" that does not exist. Moreover, even if international tax arbitrage were a problem, in the current and any reasonably likely future state of the world, no solution is likely to be available. Therefore, tax policymakers should not bother to try to combat international tax arbitrage, and should repeal those provisions (such as the dual consolidated loss rules[5]) that are inspired by the desire to prevent it.

While I tend to approach these issues from a different perspective than Rosenbloom, I completely agree that tax policymakers and scholars have not done a good job in articulating what is wrong with international tax arbitrage. This Commentary perhaps may serve its

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1 David Rosenbloom, International Tax Arbitrage, 53 Tax L. Rev. 137 (2000).

2 Id. at 166.

3 Notice 98-11, 1988-6 I.R.B. 13, withdrawn by Notice 98-35, 1998-27 I.R.B. 35.

4 For an earlier contribution, see the excellent discussion of the arbitrage problem in Philip R. West, Foreign Law in U.S. International Taxation: The Search for Standards, 3 Fla. Tax Rev. 147 (1996).

5 IRC § 1503(d).

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purpose if it begins the task of doing so. I would like to address three specific points in Rosenbloom's argument: (1) the existence vel non of an "international tax system," or as I prefer to call it the "international tax regime," (2) whether international tax arbitrage presents a problem from the perspective of broadly accepted policy goals that underlie the international tax regime, and (3) given that in my view, international tax arbitrage is a problem, what can be done about it in a world with many taxing jurisdictions and no world tax organization with powers to enforce its views of the proper interpretation of national tax laws.

II. Is There an International Tax Regime?

Rosenbloom begins his lecture by quoting from the legislative history of the dual consolidated loss rules a statement referring to an "international tax system."[6] He then proceeds to deny the existence of this system or regime ("that system appears to be imaginary"[7]), because in the real world, only the different tax laws of various countries exist, and those laws vary greatly from each other.[8] Of course, this description is true as far as it goes, but is this the whole truth? As Rosenbloom notes, in fact, there has been a remarkable degree of convergence even in the purely domestic tax laws of developed countries.[9] Not only can tax lawyers talk to each other across national boundaries and understand what each is saying (the terminology is the same), but the need to face similar problems in taxing income has led jurisdictions with different starting points to reach quite similar results. For example, countries that started off with global tax systems now have incorporated schedular elements (for example, the capital loss and passive activity loss rules in the United States[10]), whereas countries with a schedular background have largely adopted schedules for "other income" that lead to a global tax base.[11]

Not surprisingly, this convergence is most advanced in international tax matters, because in this case the tax laws of various jurisdictions actually interact with each other, and one can document cases of direct influence. For example, every developed country now tends to tax currently passive income earned by its residents overseas (through controlled foreign corporations and foreign investmeent funds (FIF)

[6] Rosenbloom, note 1, at 137 (quoting S. Rep. No. 99-313, at 422 (1986)).
[7] Id. at 166.
[8] Id. at 140-41.
[9] Id. at 140.
[10] IRC §§ 1211, 469.
[11] This is the case in Japan, which has a schedule for "miscellaneous" income. See generally Comparative Income Taxation: A Structural Analysis 155-57 (Hugh J. Ault ed., 1997).

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rules, which were inspired by the U.S. example[12]), and to exempt or defer active business income. Thus, the distinction between countries that assert worldwide taxing jurisdiction and those that only tax territorially has lost much of its force.

The claim that an international tax regime exists, however, rests mainly on the bilateral tax treaty network, which, as Rosenbloom states, is "a triumph of international law."[13] The treaties are of course remarkably similar (even to the order of the articles),[14] being based on the same OECD and UN models.[15] In most countries, the treaties have a higher status than domestic law, and thus constrain domestic tax jurisdiction; and even in the United States, the treaties typically override contrary domestic law.[16] This means that in international tax matters, countries typically are bound by treaty to behave in certain ways (for example, not tax a foreign seller who has no permanent establishment[17]), and cannot enact legislation to the contrary.

I would argue that the network of 1,500 or more bilateral tax treaties that are largely similar in policy, and even in language, constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties. These principles are the single tax principle and the benefits principle, which I have articulated elsewhere.[18] In brief, the single tax principle states that income from cross-border transactions should be subject to tax once (that is, not more but also not less than once), at the rate determined by the benefits principle. The benefits principle allocates the right to tax active business income primarily to the source jurisdiction and the right to tax passive investment income primarily to the residence jurisdiction. I develop the implications of these principles for international tax arbitrage below.

To those who doubt the existence of the international tax regime, let me pose the following question: Suppose you were advising a developing country or transition economy that wanted to adopt an income tax for the first time. How free do you think you would be to write the international tax rules for such a country in any way you wanted, assuming that it wished to attract foreign investment? I

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[12] IRC §§ 957, 1297.

[13] Rosenbloom, note 1, at 164.

[14] John F. Avery Jones, Are Tax Treaties Necessary?, 53 Tax L. Rev. 1, 2 (1999).

[15] OECD, Model Income Tax Convention on Income and Capital, July 23, 1992, 1 Tax Treaties (CCH) ¶ 191 [hereinafter OECD Model Treaty]; U.N., Model Double Taxation Convention Between Developed and Developing Countries, 1980, 1 Tax Treaties (CCH) ¶ 206 [hereinafter UN Model Treaty].

[16] See, e.g., IRC §§ 894(a), 7852(d).

[17] OECD Model Treaty, note 16, art 7(1), 1 Tax Treaties (CCH) ¶ 191.

[18] See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507 (1999).

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would argue that the freedom of most countries to adopt international tax rules is severely constrained, even before entering into any tax treaties, by the need to adapt to generally accepted principles of international taxation. Even if divergent rules have been adopted, the process of integration into the world economy forces change. For example, Mexico recently had to abandon its long tradition of applying formulas in transfer pricing and adopt rules modeled after the OECD guidelines[19] in order to be able to join the OECD.[20] South Korea similarly had to change its broad interpretation of what constitutes a permanent establishment under pressure from the OECD.[21] And Bolivia had to abandon its attempt to adopt a cash flow corporate tax because it was ruled not creditable in the United States.[22] Even the United States is not immune to this type of pressure to conform, as can be seen if one compares the 1993 proposed regulations under § 482,[23] which led to an international uproar,[24] with the final regulations, which reflect the OECD guidelines.[25]

III. Is International Tax Arbitrage a Problem?

Given that the international tax regime exists, in what way can international tax arbitrage be regarded as problematic under its principles? In general, the various examples of international tax arbitrage given by Rosenbloom all have a similar goal, to exploit differences in national tax rules (and despite convergence, such differences remain considerable, although they are shrinking) to minimize taxes paid on cross-border income in either or both jurisdictions. The dual consolidated loss transaction involves using the same economic loss to offset the income of two related taxpayers in two jurisdictions; since only one loss has occurred, by definition, tax is underpaid in one of the two jurisdictions. The transactions covered in Notice 98-11[26] and in Sec-

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[19] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, reprinted in 9 Tax Notes Int'l 55 (July 28, 1994).

[20] See Jaime González-Béndiksen, Mexico Amends Transfer Pricing Rules, 97 TNI 27-24, Feb. 10, 1997, available in LEXIS, Tax Analysts File.

[21] See J.Y. Lee & R.M. Donaldson, South Korea Moves to Ease Tax Rule Governing Foreign Companies, 94 TNI 233-4, Dec. 5, 1994, available in LEXIS, Tax Analysts File.

[22] Peter D. Byrne, The Business Assets Tax in Latin America—The End of the Beginning or the Beginning of the End?, 15 Tax Notes Int'l 941, 944 n.10 (Sept. 22, 1997).

[23] Intercompany Transfer Pricing Regulations Under § 482, 58 Fed. Reg. 5,310 (Jan. 21, 1993).

[24] Robert G. Clark, Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures From Multinational Cacophony, 42 Am. U.L. Rev. 1155, 1190 (1993).

[25] Reg. § 1.482-6. For Treasury's discussion of the changes made to conform the final regulations to OECD guidelines, see Intercompany Transfer Pricing Regulations Under § 482, 59 Fed. Reg. 34,971, 34,975-34,976 (July 8, 1994).

[26] 1998-6 I.R.B. 13, withdrawn by Notice 98-35, 1998-27 I.R.B. 35.

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tion 894(c) are even better from the taxpayer's perspective, because they result in no current tax being paid in either of the two jurisdictions involved.

These transactions violate the first principle of international taxation mentioned above, the single tax principle, which states that income from cross-border transactions should be subject to tax once, that is, not more than once but also not less than once (at the appropriate residence or source rate, as determined under the benefits principle). The single tax principle is embodied in the typical title of the tax treaties "for the prevention of double taxation" (not more than once) "and fiscal evasion" (not less than once). It also has been articulated by the architects of the international tax regime from T.S. Adams through Stanley Surrey and David Tillinghast.[27]

Rosenbloom's lecture fundamentally challenges us to explain the normative basis of the single tax principle. I would argue that it rests on three normative justifications: efficiency, equity, and preventing revenue loss. First, efficiency: The typical argument against undertaxing income from cross-border transactions is made in the name of capital export neutrality. If taxpayers invest abroad and by using international tax arbitrage earn higher after-tax returns than on domestic investments earning a higher before-tax return, they will prefer the former investments over the latter. Thus, resources will be allocated away from their most productive use, resulting in diminished global welfare.

I would not emphasize this argument too much, in part because it can be countered with arguments in favor of capital import neutrality (involving neutrality in the global allocation of savings rather than investment). Moreover, arguments from global welfare tend to be less than fully persuasive to a noneconomic audience. A different argument can be made, however, regarding the impact of international tax arbitrage on efficiency in the domestic economy. If cross-border investments are taxed at a lower rate than domestic investments, capital will tend to shift from the latter to the former. Such a shift would result in an over-supply of capital for cross-border investments and an under-supply for domestic investments. The resulting efficiency loss is similar to the one Arnold C. Harberger identified in analyzing the effect of the double tax on corporate income in a closed economy.[28] Note that fairness is not an issue in this case, because it is presumed

[27] Thomas S. Adams, International and Interstate Aspects of Double Taxation, 22 Nat'l Tax Ass'n Proc. 193 (1929); The President's Tax Message, H.R. Rep. No. 87-140, at 6-7 (1961) (views of Surrey and Tillinghast proposing to end deferral on all income of CFCs to tax investment in low-tax jurisdictions).

[28] Arnold C. Harberger, The Incidence of the Corporation Income Tax, 70 J. Pol. Econ. 215 (1962).

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than investors can freely shift capital from domestic to foreign investments.

Fairness does enter the picture, however, in making a different comparison, between taxpayers who earn domestic labor income and taxpayers who earn capital income overseas and can benefit from international tax arbitrage. In this case, efficiency is not the issue because the wage earners cannot realistically shift their income overseas (especially given immigration restrictions); in general, labor is less mobile than capital. One of the remarkable trends in recent years has been the rise in the tax burden on labor in OECD member countries (involving not just the income tax but even more so the VAT and payroll taxes) and the concomitant decline in the effective tax rate on capital.[29] A major reason for this trend has been the ability of capital to move overseas where it can avoid taxation through techniques like international tax arbitrage (as well as ordinary tax evasion and taking advantage of tax competition). Recent studies using Treasury data have shown a 15% drop in the effective foreign tax rate of U.S.-based multinationals from 1984 to 1992, and that rate is now significantly lower than the effective U.S. tax rate (which explains why no U.S.-based multinationals are in an excess credit position despite the higher nominal foreign tax rates).[30] International tax arbitrage is a major contributor to these numbers.

Finally, if cross-border income can escape taxation and capital can move freely across borders, this poses a significant threat to the revenues of developed countries, which traditionally have relied on taxing income from capital to finance government expenditures. This is presumably why both the EU and the OECD recently have launched major efforts to combat harmful tax competition, which include proposals (such as expanding CFC regimes) aimed squarely at opportunities for tax arbitrage.[31]

None of the above reasons to enforce the single tax rule is limited to tax arbitrage; as Rosenbloom points out, the effect of tax arbitrage is similar to simply having different tax rates in different countries.[32] Whether such international tax competition should be curbed is a broader issue that I leave for another day. International tax arbitrage is a natural primary target of attempts to enforce the single tax rule,

[29] See, e.g., Dani Rodrik, Has Globalization Gone Too Far 65 fig. 4.4 (1997).

[30] See Rosanne Altshuler, Harry Grubert & T. Scott Newlon, Has U.S. Investment Overseas Become More Sensitive to Tax Rates (paper presented at NBER Int'l Tax'n Conf., 1997).

[31] OECD, Comm. on Fiscal Affairs, Harmful Tax Competition: As Emerging Global Issue (1998); Council of the European Union, A Package to Tackle Harmful Tax Competition in the European Union, 1998 O.J. C102.

[32] Rosenbloom, note 1, at 149.

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because unlike differences in rates, it results from exploiting interactions between the laws of two countries that clearly were not intended by either. Thus, it is far easier to reach a consensus on curbing international tax arbitrage (since both countries will agree that the effect was unintended) than it is to agree on curbing tax competition in general.

IV. What Can Be Done About International Tax Arbitrage?

Given that the international tax regime exists and that international tax arbitrage violates one of its fundamental principles, what can be done about it? It is hard to suggest a generally applicable solution because the forms of international tax arbitrage are as varied as the vagaries of national tax laws and the ingenuity of international tax planners. Let me make one suggestion, however: Perhaps more attention should be paid to the principle of matching in international taxation.

Matching is an underlying characteristic of the value added tax. Under the VAT, no deduction is allowed (in a subtraction method VAT) and no credit is given (in a credit method VAT) unless it can be shown that the party on the other side of the transaction has paid its VAT liability on the relevant supply of goods or services. Matching is natural to the VAT because it is a transactionally-based tax and because the tax is supposed to be shifted forward and therefore the identity of the taxpayer matters less than in the income tax. But matching (or "substitute taxation") is not unknown in the income tax area, as indicated by provisions like § 83(h) and § 404(a)(5). In the U.S. international tax area, the prime example of matching is the earnings stripping rule, although it only applies in the related party context.[33]

Income tax treaties generally are based on the matching principle. That is, withholding taxes are reduced because the income is subject to tax on a residence basis, and the exchange of information provisions ensure that it is in fact taxed. Tax havens are not proper treaty partners precisely because matching would be violated by reducing withholding taxes for income earned by their residents, since there is no residence-based taxation. That is why § 894(c) is a proper interpretation of the Canada-U.S. treaty[34]: The reduction in withholding tax on interest assumed that it would be taxed by Canada and not treated

[33] IRC § 163(j); see Deborah Geier, The Myth of the Matching Principle as a Tax Value, 15 Am. J. Tax Pol'y 17 (1998); Julie Roin, Unmasking the Matching Principle in Tax Law, 79 Va. L. Rev. 813 (1993).

[34] Income Tax Convention, Aug. 16, 1984, Can.-U.S., 1 Tax Treaties (CCH) ¶ 1901.

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as tax-free dividends. That is also why treaty shopping is properly curbed by limitations on benefits articles.[35]

I would argue that the matching principle should be extended beyond the treaty context. This would imply that no reductions in withholding taxes should be made outside the treaty context; for example, the portfolio interest exemption[36] should be repealed. Moreover, deferral should be conditioned explicitly on the deferred income being subject to a reasonable level of tax overseas (that is, there should be a low tax kick-in as well as a high tax kick-out). This latter rule would take care of the transactions targeted in Notice 98-11. More generally, consideration should be given to denying deductions for interest or royalties paid to nonresidents unless it can be documented that they are subject to tax abroad.[37]

The application of the matching principle to international income taxation would go a long way toward reducing the opportunities for international tax arbitrage and enforcing the single tax principle. Presumably, the international tax bar can think up tax arbitrage techniques that do not depend on the absence of matching, but this is true of every move to enhance tax collections, and is not a sufficient reason to refrain from even trying. Moreover, to the extent that other U.S. rules such as check-the-box[38] enhance arbitrage possibilities (because, as Rosenbloom says, they depart from the international norm[39]), they represent bad tax policy and should be reconsidered.

One important feature of matching is that it does not require a world tax organization or international coordination. Each country, like the United States, can apply the matching principle unilaterally. Arguably, as shown by the enactment of § 894(c), and before it, the qualified resident rule in § 884,[40] it does not violate treaties to apply the matching principle in the treaty context because treaties are based on matching.

It may be argued, however, that a country that applies the matching principle unilaterally will hurt itself because it will drive away investors who rely on not being taxed anywhere. That was presumably why the portfolio interest exemption was enacted. The recent coordinated actions by the EU (which proposed a uniform withholding rate on

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[35] U.S. Model Income Tax Convention, Sept. 20, 1996, art. 22, 1 Tax Treaties (CCH) ¶ 214.

[36] IRC §§ 871(c), 1441(c)(9).

[37] Determining the effective foreign tax rate may not be easy, but it is not impossible either. Many OECD member countries explicitly condition their deferral regimes on foreign tax rates. See Stephen E. Shay, Revisiting U.S. Anti-Deferral Rules, 74 Taxes 1042 (1996).

[38] Reg. § 301.7701-3.

[39] Rosenbloom, note 1, at 153.

[40] IRC § 884(e).

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interest from member countries) and the OECD (which favors expanding CFC and FIF rules[41]), however, promise that developed countries can act in tandem to curtail any harm from imposing limitations on international tax arbitrage.

V. Conclusion

Rosenbloom argues that "there does not appear to be any clear reason why U.S. tax policy should take account of the fact that the taxpayer or a related party enjoys benefits under the tax laws of another country with respect to income or activities not subject to U.S. taxation. The treatment of that income or those activities is not obviously our business, and there is no clear reason why we should make it our business—any more than the rules of that other country applicable to its own citizens and residents on its own soil with respect to anticompetitive behavior, corrupt practices, or the price of water."[42]

Those examples are illuminating, because, in fact, the United States made all three of them its business, as indicated by recent developments in the international application of antitrust laws, the foreign corrupt practices act and its OECD corollary, and international environmental laws.[43] Moreover, as the recent crisis in Asia and its ramifications show, developments in one area can spread rapidly to other areas, and this sometime makes what happens in other countries our business. The rise of international tax arbitrage is merely one example of a much broader phenomenon: The purposes of an increasing number of national laws can be completely defeated if they are not applied extraterritorially or coordinated with the laws of other countries. We live in an integrating world, and perhaps in the long run, worldwide institutions like the WTO are the only possible solutions. But in the meantime, it is not an adequate answer to the problem of international tax arbitrage to say that it is just a normal feature of the world we live in and nothing can be done about it. If the "triumph" that is the international tax regime is to be preserved, something must.

[41] See note 12.

[42] Rosenbloom, note 1, at 155.

[43] On the extraterritorial application of U.S. antitrust law, see, e.g., Philip Areeda & Louis Kaplow, Antitrust Analysis: Problems, Text, Cases 153-66 (4th ed. 1988); on the Foreign Corrupt Practices Act, see Pub. L. 95-213, 91 Stat. 1494 (1977); on international application of U.S. environmental law see, e.g., Peter Obstler, Toward a Working Solution to Global Pollution: Importing CERCLA to Regulate the Export of Hazardous Waste, 16 Yale J. Int'l L. 73 (1991).

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