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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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Closing the International Tax Gap Via Cooperation, Not Competition

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan.

All three major goals of the Volcker task force — reducing tax evasion and loopholes, simplifying the code, and reducing corporate welfare — can be advanced by focusing on the international aspects of the tax gap. These aspects include both enforcement of existing U.S. law on U.S. residents earning income overseas (the evasion issue) and reforming deferral for U.S.-based multinational enterprises (the avoidance issue). To best advance the task force's three goals, I would propose a change in each of these two major international areas.

The Evasion Issue

The recent revelations involving Swiss bank UBS reveal a fundamental problem in enforcing U.S. tax law on U.S. residents earning income overseas. Beginning with the enactment of the portfolio interest exemption in 1984, the United States has engaged in a race to the bottom designed to encourage residents of other countries to invest their funds in the United States without having to report the income to their home jurisdiction.

Thus, we permit those foreign residents to earn investment income from U.S. sources without meaningful withholding (capital gains, interest, and royalties are exempt, and dividends can be replaced with dividend substitutes) and without the U.S. payer having any information about the real identity of the payee. (Interest can be paid directly to tax haven corporations, while royalties and dividends can be paid to qualified intermediaries, and in both cases the U.S. withholding agent will not know who the real payee is.)

The problem, as the IRS's recent pursuit of UBS for noncompliance revealed, is that these rules enable U.S. residents to also earn U.S.-source investment income without paying any tax on it. The provisions that are designed to prevent this, such as legends on bearer certificates and audits of qualified intermediaries by foreign auditors, do not work.

The currently fashionable solution is exchange of information. If all tax havens automatically gave all their data on U.S. residents to the IRS, the problem would be solved. But that will never happen, because we cannot make all the havens cooperate.

There is a better solution. The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the prosperous and stable economies of the world (which is why some laundered funds that do remain in the tax havens earn a negative interest rate). If the rich countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, imposing a refundable withholding tax (for example, at 35 percent) on payments to noncooperating tax havens, or more broadly, to all nontreaty countries, and by insisting on effective automatic exchange of information with treaty countries. The withholding tax would be refunded after a showing that the income was reported to the country of residence.

The financial services industry would no doubt lobby hard against such a step, on the grounds that it would induce investors to shift funds to other OECD member countries. However, the European Union and Japan both have committed themselves to taxing their residents on foreign-source interest income. The EU savings directive, in particular, requires all EU members to cooperate in the exchange of information or impose a withholding tax on interest paid to EU residents.

Both the EU and Japan would like to extend this treatment to income from the United States. This would seem an appropriate moment for the United States to cooperate with other OECD member countries in imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchanging information, without triggering a flow of capital out of the OECD.

The Avoidance Issue

The debate on subpart F has been going on for almost 50 years. From its enactment in 1962 to 1994, a series of steps were taken to curtail deferral, without significantly altering the original compromise that permitted deferral of most active income. From 1994 to 2006, another series of steps significantly expanded the scope of deferral, and there is now a push to go further and exempt dividends from active income.

Exempting dividends makes sense from an economic efficiency perspective, because the current tax on dividends raises little revenue while inducing significant behavioral changes. But there is an obvious alternative: eliminating deferral altogether. That would result in significant simplification because dividends, interest, and royalties from controlled foreign corporations would not be taxed, and formulas could be used to allocate deductions, just as they now are for interest. Also, outbound transfer pricing would be eliminated, and the foreign tax credit would be greatly simplified (for example, the tricks designed to obtain credits for foreign taxes on deferred income would disappear).

The problem, however, as always, is competitiveness: Like they did in 1961, the U.S.-based MNEs would argue that eliminating deferral would make them noncompetitive, and they would threaten to migrate.

But this problem, too, has a cooperative solution, namely for all OECD members to adopt or strengthen their CFC rules. Because 90 percent or more of MNEs are headquartered in OECD countries, if all OECD jurisdictions abolished deferral, the competitiveness issue would disappear. Inversion transactions could be combated with strict residency definitions based on a properly interpreted managed and controlled standard, because few MNEs would truly want to set up headquarters in tax havens. There may be some growth in MNEs based in developing countries, but economically most MNEs will need to be based in OECD countries for a long time to come.

In my opinion, the solution to both the evasion and the avoidance problem is the same: cooperation with other OECD members, not competition. In a multilateral world, that is the way to preserve the income tax, which cannot be maintained for either individuals or corporations if cross-border income is exempt from taxation. ■