2006

Tax Arbitrage and the International Tax Regime

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

Available at: https://repository.law.umich.edu/book_chapters/299

Follow this and additional works at: https://repository.law.umich.edu/book_chapters

Part of the Taxation-Transnational Commons, and the Tax Law Commons

Publication Information & Recommended Citation


This Book Chapter is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Book Chapters by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
It is a great pleasure to introduce my student Luca Dell’Anese’s book on tax arbitrage. This is an important book on an important topic, which lies at the heart of the current debate on whether an international tax regime exists in practice. I have argued for many years (see, e.g., Avi-Yonah, 1996, 1997, 2000) that a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based and customary). The practical implication is that countries are not free to adopt any international tax rules they please, but rather operate in the context of the regime, which changes in the same ways international law changes over time. Thus, unilateral action is possible, but is also restricted, and countries are generally reluctant to take unilateral actions that violate the basic norms that underlie the regime. Those norms are the single tax principle (i.e., that income should be taxed once— not more and not less) and the benefits principle (i.e., that active business income should be taxed primarily at source, and passive investment income primarily at residence).

This thesis is quite controversial. Several prominent international tax academics and practitioners in the US (e.g., Michael Graetz, David Rosenbloom, Julie Roin) and elsewhere (e.g., Tsilly Dagan) have advocated the view that there is no international tax regime and that countries are free to adopt any tax rules they believe further their own interests (Graetz, 2001; Rosenbloom, 2000; Roin, 2002; Dagan, 2000). Other prominent tax academics (e.g., Hugh Ault, Paul McDaniel, Richard Vann) and practitioners (e.g., Phil West) have supported the view advocated above (Ault, 2002; McDaniel, 2001; Vann, 2003; West, 1996).

The most important statement denying the existence of the international tax regime was the 1998 Tillinghast Lecture delivered by H. David Rosenbloom at the NYU law school (Rosenbloom, 2000). Rosenbloom began his lecture by quoting from the legislative history of the US dual consolidated loss rules a statement referring to an "international tax system." He then proceeded to deny the existence of this system or regime ("that system appears to be imaginary"), because in the real world, only the different tax laws of various countries exist, and those laws vary greatly from each other.

* Irwin I. Cohn Professor of Law and Director International Tax LL. M. Program, University of Michigan Law School.
Of course, this description is true as far as it goes, but is this the whole truth? As Rosenbloom noted, in fact, there has been a remarkable degree of convergence even in the purely domestic tax laws of developed countries. 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 (i.e., tax "all income from whatever source derived" in the same way) now have incorporated schedular elements (for example, the capital loss and passive activity loss rules in the United States), whereas countries with a schedular background (i.e., tax different types of income differently) have largely adopted schedules for "other income" that lead to a global tax base (for example, the U.K.).

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 investment funds (FIF) rules, which were inspired by the U.S. example), 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. We will develop many other examples of such convergence in the course of the book.

The claim that an international tax regime exists, however, rests mainly on the bilateral tax treaty network, which, as Rosenbloom stated, is "a triumph of international law." The treaties are of course remarkably similar (even to the order of the articles), being based on the same OECD and UN models. 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. 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), and cannot enact legislation to the contrary.

I would argue that the network of 2,000 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 will be articulated further below. 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.

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 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 had to abandon its long tradition of applying formulas in transfer pricing and adopt rules modeled after the OECD guidelines in order to be able to join the OECD. South Korea similarly had to change its broad interpretation of what constitutes a permanent establishment under pressure from the OECD. And Bolivia had to abandon its attempt to adopt a cash flow corporate tax because it was ruled not creditable in the United States. Even the United States is not immune to this type of pressure to conform, as can be seen if one compares the 1993 proposed transfer pricing regulations under IRC section 482, which led to an international uproar, with the final regulations, which reflect the OECD guidelines.

Another illustration can be derived from recent developments in both the US and Germany regarding the application of the principle of non-discrimination, which is embodied in all the tax treaties, to thin capitalization rules that are designed to prevent foreign taxpayers from eliminating the corporate tax base through capitalizing domestic subsidiary corporations principally with debt. When the US first adopted its thin capitalization rule in 1989, it carefully applied it both to foreigners and to domestic tax exempts, so as not to appear to be denying interest deductions only to foreigners. The US did this even though thin capitalization rules are an accepted part of international tax law and even though its constitutional law permits unilateral overrides of tax treaties. The Germans adopted the same rule, but when it was nevertheless struck down as discriminatory by the European Court of Justice in 2002, they responded by applying thin capitalization to all domestic as well as foreign taxpayers. Neither the US nor the German actions are understandable in the absence of an international tax regime embodying the principle of non-discrimination.

If an international tax regime exists, what does it look like? The following sections will define the two basic principles which in my view underlie the international tax regime and why they are normatively justified.


International income taxation involves two basic questions: 1. What is the appropriate level of taxation that should be levied on income from cross-border transactions? 2. How are the resulting revenues to be divided among taxing jurisdictions?

The answer to the first question is the Single Tax Principle: Income from cross-border transactions should be subject to tax once (that is, neither more nor less than once). The Single Tax Principle thus incorporates the traditional goal of avoiding double taxation, which was the main motive for setting up the international tax regime in the 1920's and 1930's. Taxing cross-border income once also means, however, that it should not be undertaxed or (at the extreme) be subject to no tax at all.
The appropriate rate of tax for purposes of the Single Tax Principle is determined by the second principle of international taxation, the Benefits Principle. The Benefits Principle, discussed below, assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions. Therefore, the rate of tax for purposes of the Single Tax Principle is generally the source rate for active business income and the residence rate for passive (investment) income. When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible, and may be necessary to prevent undertaxation. Such residual taxation means that all income from cross-border transactions, under the Single Tax Principle, should be taxed at least at the source rate (which tends to be lower than the residence rate), but at no more than the residence rate.

What is the normative basis for the Single Tax Principle? As an initial matter, I assume that most countries would like to maintain both a personal income tax and a corporate income tax. The reasons for having both a personal income tax and a corporate income tax have been discussed extensively elsewhere, and are not repeated here (see, e.g., Avi-Yonah 2002, 2004). For purposes of justifying the Single Tax Principle, it is sufficient that most countries in fact maintain their existing personal and corporate income taxes.

Given a preference for imposing both a personal and a corporate income tax on domestically derived income of individuals and corporations, it becomes relatively easy to establish why the Single Tax Principle is justified as a goal of the international tax regime, on both theoretical and practical grounds. From a theoretical perspective, if income derived from cross-border transactions is taxed more heavily than domestic income, the added tax burden creates an inefficient incentive to invest domestically. This proposition is widely accepted and underlies the effort, which by now is about a century old, to prevent or alleviate international multiple taxation.

The corollary also holds true: if income from cross-border transactions is taxed less heavily than domestic income, this creates an inefficient incentive to invest internationally rather than at home. The deadweight loss from undertaxation is the same as that from overtaxation.

In addition, there is also a strong equity argument against undertaxation of cross-border income, which applies to income earned by individuals. From an equity perspective, undertaxation of cross-border income violates both horizontal and vertical equity when compared to higher tax rates imposed on domestic source income, and in particular on domestic labor income. In this case, the argument that equity violations tend to turn into efficiency issues does not hold, because labor is less mobile than capital and wage earners typically do not have the ability to transform their domestic wages into foreign source income.

On a practical level, the Single Tax Principle can be justified because double taxation leads to tax rates that can be extremely high and tend to stifle international investment. Zero taxation, on the other hand, offers an opportunity to avoid domestic taxation by investing abroad, and therefore threatens to erode the national tax base.
T.S. Adams, the architect of the foreign tax credit and a major influence in shaping the international tax regime, recognized both of these propositions in the 1920's. In justifying the foreign tax credit, Adams wrote "the state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax." Contrary to an exemption system, Adams' credit operated to eliminate double taxation by both source and residence jurisdictions, but preserved residual residence-based jurisdiction to enforce the Single Tax Principle (Graetz and O'Hear, 1997).

The practical justification for the Single Tax Principle can be seen most easily if one imagines a world with only two countries, A and B, and only two companies, X (a resident of A) and Y (a resident of B). If both A and B tax the foreign source income of their residents and domestic source income of foreigners, and neither gives relief from double taxation, then both X and Y would minimize their taxes by only deriving domestic source income (since any foreign tax would by definition be an added burden). The result would be adequate revenues collected by both A and B, but no cross-border trade or investment.

On the other hand, suppose both A and B exempted from tax both foreign source income and domestic source income of foreigners (a not inconceivable proposition in many developing countries, which tax residents territorially and grant tax holidays to foreign investors). In that case, the way for both X and Y to minimize their taxes would be to derive their entire income from cross-border transactions. The result would be adequate cross-border trade, but no revenues for A or B. In a world in which international trade and investment are important, but taxes (unlike tariffs) cannot be reduced to zero, the Single Tax Principle is the best option.

b. Dividing the Tax Base: The Benefits Principle

Having defined one goal of the international tax regime as taxing cross-border income once, the next question is how to divide that base among the various jurisdictions laying claim to it. The Benefits Principle states that the residence jurisdiction has the primary right to tax passive (investment) income, while the source jurisdiction has the primary right to tax active (business) income. As explained above, this division also determines the appropriate rate of tax for purposes of the Single Tax Principle.

This distinction, which stems from the work of the League of Nations in the 1920s, also can be justified on both theoretical and pragmatic grounds. On a theoretical level, the Benefits Principle makes sense because it is primarily individuals who earn investment income, whereas it is primarily corporations that earn business income. In the case of individuals, residence-based taxation makes sense. First, residence is relatively easy to define in the case of individuals. Second, because most individuals are part of only one society, distributive concerns can be addressed most effectively in the country of residence. Third, residence overlaps with political allegiance, and in democratic countries, residence taxation is a proxy for taxation with representation. In the case of multinational corporations, source-based taxation seems generally preferable. First, the grounds for taxing individuals on a residence basis do not apply.
to corporations. The residence of corporations is difficult to establish and relatively meaningless. Residence based on place of incorporation is formalistic and subject to the control of the taxpayer, while residence based on management and control also can be manipulated. Moreover, multinationals are not part of a single society and their income does not belong to any particular society for distributive purposes. Finally, multinationals can exert significant political influence in jurisdictions other than the residence jurisdiction of their parent company, and therefore the concern about taxing foreigners who lack the ability to vote is less applicable to them.

Second, source-based taxation is consistent with a benefits perspective on justifying tax jurisdiction. Source jurisdictions provide significant benefits to corporations that carry on business activities within them. Such benefits include the provision of infrastructure or education, as well as more specific government policies such as keeping the exchange rate stable or interest rates low. These benefits justify source-based corporate taxation in the sense that the host country's government bears some of the costs of providing the benefits that are necessary for earning the income. As T.S. Adams wrote in 1917, "A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment." These costs justify imposing a tax as compensation to the government bearing them.

On a more pragmatic level, as Adams also observed, since the source jurisdiction has by definition the "first bite at the apple," that is, it has the first opportunity to collect the tax on payments derived from within its borders, it would be extremely difficult to prevent source jurisdictions from imposing the tax. "Every state insists upon taxing the non-resident alien who derives income from source [sic] within that country, and rightly so, at least inevitably so." Thus, as Michael Graetz and Michael O'Hear observe, even if economists tend to prefer pure residence-based taxation, this recommendation is unlikely to be followed in practice (Graetz and O'Hear, 1997). This is particularly the case for business income derived from large markets, in which case there is little fear that the foreign investor will abandon the market because of source-based taxation. For portfolio investment, however, even large source countries like the United States have tended to abandon it for fear of driving away mobile capital. Thus, business income is a better candidate for source-based taxation than investment income.

The division between active (mostly corporate) and passive (mostly individual) income also makes sense because it is congruent with the Single Tax Principle, since most of the rate divergence among taxing jurisdictions arises in the individual income tax, while corporate tax rates have tended to converge. The top marginal personal income tax rate among OECD member countries varied in 2003 from 11.5% (Switzerland) to 62.7% (Denmark). This variability is acceptable for purposes of the Single Tax Principle, because under the Benefits Principle most income earned by individuals in cross-border transactions is investment income that generally is subject only to residence country tax. Therefore, the residence country rate typically determines the single tax rate for investment income.
Corporate tax rates, on the other hand, do not vary so widely (and also tend to be flat, rather than progressive). Among OECD member countries, in 2003 the corporate tax rate ranged from 12.5% (Ireland) to 52.2% (Italy), but 23 out of 29 member countries had rates in the 29% to 40% range. Thus, for purposes of the Single Tax Principle, the rate applied is generally the residence rate for individual (mostly investment) income and a rate in the 30-40% range for corporate (mostly business) income. It is congruent with both the Single Tax and Benefits Principles, however, to have residual taxation by residence or source jurisdictions in cases where the jurisdiction that has the primary right to tax under the Benefits Principle refrains from doing so. Thus, under the Single Tax and Benefits Principles, all income from cross-border taxation under current rate structures should be taxed at a rate between approximately 30% (the lower end of the source rates) and approximately 60% (the higher end of the residence rates).

Neither the Single Tax Principle nor the Benefits Principle provides a clear answer to the question of how to divide the corporate income tax base among the various jurisdictions providing benefits. Market prices can provide an answer when transactions are at arm’s length, but not when they are between related parties (and there are no comparable arm’s length transactions). In addition, the Single Tax Principle requires that taxation be imposed even on income derived from a jurisdiction that chooses not to levy a tax in return for the benefits it provides. These issues will be addressed further below.

It is useful to summarize the resulting structure of international taxation in the following table, which divides the world into two categories of taxpayers, resident and non-resident. For each category, there is a further division between active (business) and passive (investment) income. Active income is taxed primarily at source, while passive income is taxed primarily at residence:

<table>
<thead>
<tr>
<th>WORLD</th>
<th>Residents</th>
<th>Non-residents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active</td>
<td>Passive</td>
<td>Active</td>
</tr>
<tr>
<td>Low tax</td>
<td>High tax</td>
<td>High Tax</td>
</tr>
</tbody>
</table>

As noted by Rosenbloom (2000), tax arbitrage forms the most crucial test for the existence of an international tax regime. As Luca Dell’Anese explains, tax arbitrage uses the differences between countries’ tax law to violate the single tax principle, and thus attitudes toward it depend crucially on the view one takes of the international tax regime. The following book shows that in fact most countries do not tolerate tax arbitrage and try to combat it. Thus, it is a very important contribution to the international tax literature, and should be studied carefully by anyone who cares about this subject.