10 Observations Concerning International Tax Policy

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By Daniel Shaviro

There is an old joke about a comedians’ conference. One of the comedians stands up and shouts “22!” Everyone laughs. Another comedian stands up and shouts “47!” Everyone laughs.

A newcomer asks the person next to him what’s going on. His neighbor explains that all the jokes are so familiar that no one actually needs to tell them anymore. The number is enough. So he stands up and shouts “36!” Dead silence. He can’t understand it, so he asks his neighbor what went wrong.

The thing I like about this joke is that it has three different punch lines.

First: “You didn’t tell it right.”
Second: “Someone told that joke already.”
Third: “They don’t know that one.”

I’m reminded of this joke because I’m going to discuss international tax policy, in a room full of people who already know the punch lines. So for me to give a 20-minute rehash of my general views wouldn’t be much better than standing up here and shouting “36!” Thus, in the hope of making things less predictable, I will offer 10 distinct observations, at least a few of which I hope will be fresh to each audience member.

1. International tax policy is an ongoing N-person game in which no one agrees about the underlying payoff structure.

To think coherently about international tax policy, one needs to combine a unilateral national welfare perspective with thinking about strategic interactions.

What should we do in our own self-interest if no one else is watching? And how might countries that are paying attention choose to respond, be it cooperatively or competitively?

There are lots of game theory models out there that can help one to think about these issues. Consider the prisoner’s dilemma for one. Sometimes it captures key elements of a situation.

a. Carbon tax: Prisoner’s dilemma with clear structure. Consider carbon taxes. Unilaterally, each self-interested country should set them in light of the marginal local harm caused by carbon emissions — not the global effects. But all countries can potentially gain if they all set the tax price at marginal global harm. Still, the best thing for each country would be if all other countries set the tax price at marginal global harm, while it only took account of the local effects. Indeed, this is unilaterally optimal whether the other countries cooperate (by pricing at global harm) or defect (by also considering only local harm).

Suppose we have two players: one’s own country and all other countries. Given the payoff structure that I’ve posited, carbon taxes present a classic prisoner’s dilemma. While they take place continuously and in public (unlike the classic one-shot prisoner’s dilemma), political rigidities in countries’ strategic interactions may nonetheless make the model useful as a tool for analyzing how countries will and should behave. So now let’s consider applying the model to a current hot topic in international tax policy debate.

b. What about CFC rules? What should the United States do with regard to its rules for controlled foreign corporations (CFCs)? What should we expect other countries to do with their CFC rules? How might strategic interactions work, and what should we expect of a multilateral process, like that initiated by OECD-BEPS?

Let’s define a residence country as cooperating if it has tough CFC rules, which may protect source countries against profit shifting, and as defecting if it has weak or no such rules. However, before we can tell whether it’s a prisoner’s dilemma — or indeed, apply any other classic game theory model — we need to figure out the payoff structure in the classic four boxes defined by whether each side cooperates or defects.

So, what does the tax policy literature tell us? There has certainly been a lot written on the subject of whether a given country, such as the United
States, unilaterally benefits from having strong CFC rules, and at the limit taxes either all of its multinationals’ foreign source income (by repealing deferral) or none (by enacting a pure territorial system). There has also been a lot written about whether it’s best for worldwide efficiency to have a pure residence-based tax, in which the home country taxes all foreign source income, or a pure source-based tax.

Unfortunately, however, the literature offers no generally accepted consensus. Some experts believe that worldwide residence-based taxation is both unilaterally best (at least, for a “big” country such as the United States) and collectively best. Other experts believe that pure source-based taxation is both unilaterally and collectively best. So one cannot set the payoff structure for a game-theoretic analysis, without controversially taking sides in an ongoing debate.

2. For residence countries, foreign-to-foreign profit shifting is normatively ambiguous.

The big issue these days in taxing multinationals is what to do about “stateless income.” From a residence country standpoint, the significance of such income reveals that one’s multinationals are not merely reporting a lot of foreign source income — they are reporting a lot of it in tax havens or nowhere. Given how little happens economically in most havens, along with the fact that the people who generate income on a company’s behalf must be physically located somewhere at all times, this means that the companies, whether or not they are avoiding domestic taxes, are certainly avoiding foreign taxes. But is this a problem, from a unilateral domestic standpoint?

a. Foreign taxes, unlike domestic taxes, are just a cost from the domestic standpoint. Assuming the shareholders are domestic, there is simply no direct reason to want the companies to pay higher, rather than lower, foreign taxes. From the domestic standpoint, those taxes are just a cost. Domestic individuals do not get the use of the tax revenues.

However, if that’s the case, then why do so many countries have CFC rules? And why do such rules almost invariably focus on tax haven income, whether directly like Japan, or indirectly via a U.S.-style focus on passive or other highly mobile income that is easily placed in tax havens (or nowhere)?

b. Suppose ‘tagging’ arguments apply to tax haven income or highly mobile items. I think this widespread concern is best captured by a “tagging” analysis. Being in a tax haven (or nowhere) may be thought to correlate with domestic profit shifting or base erosion that one has decided one wants to discourage. Otherwise, it is hard to explain rationally why residence countries should ever, in a unilateral setting, want to target tax haven or “nowhere” income, whether directly or indirectly.

But here’s the thing. The tagging concern does not automatically override the point that paying higher rather than lower foreign taxes is bad for domestic welfare, all else being equal. Instead, what it does is complexify and confuse the analysis. The resulting motivation for ambivalence may help to explain both the lack of consensus about CFC rules, and the way given countries periodically change their policies.

For example, consider the United States. First we enacted subpart F (containing our CFC rules), then we allowed it to be undermined by the adoption of the check-the-box rules, then we enacted section 954(c)(6), which allows check-the-box-style results without even requiring the use of hybrid entities, and then we have repeatedly dithered about whether, and if so when, this provision should be allowed to expire.

3. For source countries, allowing profit shifting for inbound investment is normatively ambiguous.

What prompted OECD-BEPS? Basically, the EU countries decided that they were shocked, shocked, by what United States multinationals were getting away with. But here’s the thing — for years they had seemed to be fine with it.

a. Countries may like informally lowering the effective tax rate for taxpayers that are highly mobile. It’s standard optimal tax theory to tax the mobile and the elastic more lightly than the immobile and the inelastic. By allowing multinationals to engage in profit shifting, source countries got to do this without explicit ring-fencing, or the adoption of avowedly preferential regimes for such taxpayers. Then something apparently changed.

I interpret the change in preferences that led to OECD-BEPS as reflecting the view that profit shifting had simply gone too far. This may partly have reflected post-2008 changes in the political and budgetary environment. However, it also probably reflected advancement over time in the multinationals’ tax planning technologies.

b. How much tax reduction is ‘too much’? While it is perfectly logical to favor some, but not too

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3See Kleinbard, supra note 1.
much, tax reduction through self-help by multinational companies that are making inbound investments, quantifying the analysis is considerably harder. Source countries lack clear guidelines for determining how much profit shifting is “too much,“ and even regarding how best to think about the problem.

4. ‘Worldwide versus territorial’ is a poorly framed choice that conflates two margins.

Here, if you know my academic work, I am in danger of being like the comedian who shouts “36!” Still, since I believe that this point sometimes gets less attention than it deserves, I will ask your indulgence as I repeat a point that I’ve made frequently before. A classic worldwide system with foreign tax credits differs at two margins, not just one, from a standard territorial system.4

a. What is the marginal tax rate (and the effective tax rate) for residents’ foreign source income? A classic worldwide system, without deferral, taxes foreign source income at the full domestic rate. Given foreign tax credits, the effective rate depends on the spread between domestic and foreign rates. By contrast, a pure territorial system, with no CFC rules, taxes all foreign source income at zero.

b. What is the marginal reimbursement rate (MRR) for foreign taxes paid? A classic worldwide system provides 100 percent reimbursement of foreign taxes paid, at least until any foreign tax credit limits apply. Thus, it induces resident companies to maximize before-foreign-tax foreign source income, and to have cost-consciousness with regard to foreign taxes paid.

A pure territorial system provides no reimbursement for foreign taxes paid. However, since the MRR of zero equals the marginal tax rate of zero for foreign source income, territoriality is an implicit deductibility system for foreign taxes. Just like explicit foreign tax deductibility, under a system with a marginal tax rate for foreign source income anywhere between zero and 100 percent, it induces resident companies to maximize after-foreign-tax foreign source income.

c. Why the linkage, and why aren’t intermediate values allowed (other than via the effect of deferral)? Two things are odd about this. The first is its automatically linking two distinct margins. The second is its ruling out intermediate values at each of the margins. Why not at least consider taxing foreign source income at between a zero rate and the full domestic rate? And for that matter, why have the effective rate depend on the domestic-to-foreign tax rate spread? Likewise, given the normative ambiguity of foreign-to-foreign profit shifting, why not consider effective MRRs for at least some foreign taxes paid that lie between the marginal tax rate for foreign source income and 100 percent?

I think countries actually understand this to a degree, although it’s not generally put this way. For the United States, deferral, while having serious flaws, can indeed create intermediate effective rates for both foreign source income and the effective MRR.5 Likewise, foreign countries with CFC rules that address tax haven income, either directly or indirectly, may get to a version of intermediate effective rates at both margins. However, doing all this more consciously might lead to more informed debates and, ultimately, better rule design.

5. Treaties barring ‘double taxation’ don’t require that one either set the tax rate for foreign source income at zero or else provide a 100 percent MRR for foreign taxes paid.

a. Defining ‘bifurcation.’ Suppose that, as under a recent Senate Finance Committee staff proposal from when Senator Baucus was the chair,6 the United States treated every dollar of its multinationals’ foreign source income as 60 percent subject to immediate worldwide taxation with foreign tax credits and 40 percent exempt with foreign taxes ignored. In effect, the marginal tax rate for foreign source income would be 21 percent, and the MRR for foreign taxes would be 60 percent.

I call this bifurcation. Its defining feature is that the ratio between the marginal tax rates that it applies to domestic and foreign source income, respectively, equals the MRR for foreign taxes. This condition also holds for the two classic non-bifurcated systems. In a pure worldwide-foreign tax credit system, both of these ratios are 100 percent, and in a pure territorial system both are zero percent. So bifurcation’s only distinctive feature is its using an intermediate value (but the same one) at both margins.

There is no inherent economic reason why bifurcation should be considered optimal. However, in addition to its allowing the use of intermediate values at both margins, it does so in a way that I believe is highly likely to be treaty-compliant.

Bilateral tax treaties generally forbid “double taxation” as between the two contracting parties. This often is interpreted as requiring either a zero tax rate for foreign source income or the allowance of 100 percent foreign tax credits. Treaty compliance

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5See id. at 12-13 and 82-87.

matters, given its potential effects on our treaty partners’ behavior and on our reputation for keeping our promises.

b. **Bifurcation complies with tax treaties formally, and is not unreasonable substantively.** Does bifurcation make the use of an intermediate value (but the same one at both margins) treaty-consistent? This is a formal legal question, not an economic one, and I won’t attempt to answer it in full here. However, I believe that the answer is clearly yes. If the same percentage applies at both margins, then one can describe each dollar of foreign source income as being 100 percent either exempt or tax-creditable. One therefore is not diverging asymmetrically from the degree of tax benefit to taxpayers making outbound investments that one can alternatively provide via either full exemption or full foreign tax creditability.

6. **While both residence and source are highly flawed concepts, we don’t face a ‘horse race’ between them.**

a. **Two dull tools are better than just one.** Neither residence nor source works well as a tool for taxing cross-border activity. However, unless the taxation of such activity is transformed away from its current reliance on entity-based corporate income taxation, it is hard to see how one could entirely dispense with either tool. This, I believe, is why territorial countries still generally retain CFC rules of some kind, which means that they are using residence as well as source.

b. **The single-bullet global welfare norms are long past their sell-by dates.** Using both residence and source with respect to cross-border investment rules out any possibility of achieving full capital export neutrality (CEN), capital important neutrality (CIN), or capital ownership neutrality (CON). However, as I have discussed elsewhere, I believe the time has long since passed for taking any of these neutrality benchmarks seriously as policy guides. They are useful, if at all, only as handy devices for thinking about particular margins and incentives.

7. **Lessons of inversion, part 1: U.S. companies’ ‘loan carry’ from deferral has gotten too big.**

One of the two main reasons for the recent wave of inversions by U.S. companies is that some got hoisted on their own petards after engaging in massive profit shifting to tax havens. Now, with continuing deferral being required if they want to keep fending off the repatriation tax, they may find it genuinely inconvenient to run their internal financial flows as they would like.

Inversion, if it permits a formerly U.S. company to access its “trapped” tax haven profits more conveniently without incurring the repatriation tax, is a bit like getting to skip out on a loan (or at least to keep on deferring it, in the hope that future legal change will cause it to disappear in the interim). So U.S. companies now have an incentive to invert, based on their past profits, that is independent of how we tax new activity going forward.

Many agree that, if we eliminate deferral, such as by shifting to a territorial system, there should be a one-time tax — in effect, a deemed repatriation. However, maybe we should do this as an interim measure, even if we cannot agree on a new system to replace the existing one.

a. **Wipe the slate clean while deciding what best to do in the long run.** The “loan carry” from U.S. companies’ deferring their repatriation tax liabilities has simply gotten too high. Replacing it with a one-time tax means we are converting their deadweight loss from the ongoing inconvenience into actual tax revenues. So it is potentially optimal for both the companies and the United States government.

b. **Deemed repatriation tax rate still to be decided — but don’t replicate the 2004 ‘dividend holiday’ fiasco; don’t confine attention to the budget window.** I would not cap the deemed repatriation tax rate at the largest amount that companies were willing to pay, in exchange for getting rid of the deadweight loss from dealing with continued deferral. After all, among other points, they may have done “too much” profit shifting in the past that helped to create this ongoing deadweight loss, and what they are willing to pay reflects their expectations regarding future United States tax policy (which they can try to influence), along with other such other factors as the feasibility of inverting. However, if one sets the deemed repatriation tax rate too high, one does, at some point, face retroactivity issues regarding future taxpayer reliance on existing rules.

On the other hand, if one sets the repatriation tax rate too low, it becomes akin to the 2004 dividend tax holiday all over again, and would induce U.S. companies to stash more profits abroad, waiting for the next low-rate deemed repatriation.

One problem with deemed repatriation taxes is that they can create revenue just within a short-term budget window, permitting Congress to define legislation as revenue-neutral even if it loses money in the out years. This is something to watch out for. Conceptually, the cleanest way to address it is through infinite horizon budget forecasting, but there could also be more ad hoc approaches.

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7See, e.g., Shaviro, supra note 4 at 66-75 (discussing corporate residence electivity) and 18-19 (discussing problems with the definition of source).

8See id. at 14-16 and 107-136.
8. Lessons of inversion, part 2: Change the balance (whether or not the level) in the U.S. anti-profit-shifting regime.

CFC rules address profit shifting that one may disfavor on the view that it comes overly at the expense of the domestic tax base and domestic investment. However, such rules only apply to profit shifting by resident companies.

Other types of anti-profit-shifting rules may be residence neutral or may even favor resident companies relative to nonresident companies. An example of a residence-neutral approach is looking at a multinational’s global debt for all group members, without limitation to the balance sheets of the domestic affiliate and its subsidiaries. Interest disallowance based on such a global rule can be equivalent to indirectly taxing foreign source income, in an amount that equals the disallowed interest deductions.

a. Residence-based and non-residence-based approaches have distinct pluses and minuses. Obviously, the downside to using residence-based rules, such as CFC rules, is that they only apply to resident companies. So they create incentives to invert, and they fail to address profit shifting by nonresident companies. However, their upside is that they can more readily be used to target disfavored foreign source income, such as that which is highly mobile or shows up in tax havens. This targeting does not similarly happen under, say, a tough earnings-stripping rule or global interest cap that is equivalent to taxing unspecified foreign source income indirectly.

b. The U.S. currently overuses residence-based, relative to non-residence-based, anti-profit-shifting approaches. We have long been almost exclusively relying on subpart F, along with interest allocation for U.S. companies. A big reason for the recent wave of inversions is that they permit companies to avoid our CFC rules, in particular with regard to related party debt. Some peer countries, such as Germany, have tougher earnings-stripping rules than we do, and they also may look at global debt of the entire group. As it happens, however, the recent proposed Treasury regulations under section 385,9 which classify certain intracompany debt instruments as equity, involve a shift towards a more German-type of approach, in that they apply to foreign companies generally, not just inverted (or recently inverted) ones. Accordingly, in that respect at least, I consider them a step in the right direction.


The Treasury’s anti-inversion rules have given the vapors to various critics. For example, with respect to the recently issued section 385 regulations, they challenge the use of a provision that was enacted more than forty years ago, to address debt versus equity issues generally, in the particular context of recent inversion transactions.

a. The anti-inversion regulations depart from 1980s-style comity — but guess what, it isn’t the 1980s anymore! The view that Treasury should not act unilaterally in this type of setting, rather than seeking legislation, relies on long-time accepted practice. For many years, if something like a wave of inversions started happening, Treasury would look to Congress to respond. Often, the executive and legislative branches would work together on the response. Indeed, this happened as recently as 2004, when the first wave of inversions prompted the enactment of Code section 7874. Typically in such cases, Treasury would defer in the interim, reflecting an informal norm of intra-branch comity, even insofar as it had at hand available tools that would have permitted it to respond unilaterally.

b. For better or worse, changes in tax legislative politics should be expected to lead to changes in informal regulatory norms. In recent years, however, things have changed in Washington. The normal legislative process has badly broken down. It should be no surprise that this has weakened the time-honored norm of Treasury reticence out of comity to the legislature. Whether that is unfortunate or not, it is likely the wave of the future, without regard to which party controls the executive branch at a given moment, and thus I believe that we are going to have to get used to it.

10. There is reason to expect (and, I believe, to regret) declining judicial deference to Treasury regulations.

With Congress often sidelined by gridlock, and with interstitial tax policymaking therefore coming increasingly out of Treasury, the importance of judicial challenges to new regulations is likely to grow. There has also been a shift in (or, at least, a clarification of) the applicable administrative law standards for judicial review of Treasury regulations. To avoid glazing the eyes of all the non-lawyers in the room, let’s just say that there has been a shift away from tax exceptionalism, or the belief that tax is special and requires extra deference to the agency’s judgment.10 In my view, however, that is not the main reason why Treasury regulations have recently shown signs of being under siege.

9See Proposed Regulations under section 385, released on April 4, 2016 (REG-108060-15).

a. Doctrinal changes may matter less here than structural factors. Three structural factors that I consider at least as important as the doctrinal shift are as follows. The first is judicial partisanship, which may affect courts' attitudes towards the Treasury Department and the Internal Revenue Service. However, the significance of this factor is admittedly unclear with respect to international tax cases, especially when they are being decided below the Supreme Court level.

Second, Treasury and the Internal Revenue Service are under-funded and under-staffed. This may affect their ability, during the regulatory process, to dot their i's and cross their t's as well as they might have if more adequately funded and staffed. This can potentially affect the course of subsequent litigation.

Third, the taxpayers in international tax litigation often are not under-funded. What is more, they may follow sophisticated multiyear strategies, which start when Treasury issues proposed regulations under standard notice and comment procedures.

Step 1 is to flood the zone with as much information and argumentation as possible, even if they do not expect Treasury to consider these contributions relevant and pertinent. Step 2, if Treasury fails to respond carefully enough in writing to each point that they have made — such as in the textual preambles to final regulations — is to argue in court that Treasury failed to deliberate properly, and thus should get no deference for its judgments. This may effectively turn the preambles into litigating documents, rather than (as they have generally been to date) efforts to convey information to taxpayers generally. At best, the long-term effect will be to delay time-sensitive regulations, given the litigating stakes.

b. A ludicrous recent illustration: The *Altera* case. *Altera* is a recent transfer pricing case, decided against the government by a unanimous Tax Court, and currently on appeal to the Ninth Circuit. It struck down regulations that slightly limited intelectual property (IP)-intensive firms' ability to create foreign source income that will never be taxed in the U.S., with respect to the use of IP that may have been entirely developed in the United States by employees of U.S. parent companies.

*Altera* arose under the so-called cost-sharing regulations, which can be used to make a tax haven subsidiary effectively the owner of particular IP, for U.S. income tax purposes, with respect to non-U.S. sales based on using the IP. The trick is to have the foreign subsidiary ostensibly pay a proportionate share of the IP's development costs - which can involve using funds that the U.S. parent may have given to the foreign subsidiary specifically to fund the supposed buy-in. The question in *Altera* was whether the subsidiary actually has to "share" one of the main costs, which is that of providing incentive compensation to U.S. employees who work on developing the IP.

Without getting into the details, IP companies and their allies appear to have flooded the zone, during the regulatory comments process, with substantial evidence about true arm's-length cost-sharing deals between unrelated parties — which are completely different from these related-party deals in multiple respects. The evidence suggested that true third parties, when they are making cost-sharing deals, *don't* count incentive compensation among the costs that have to be shared, for reasons that only apply because they are unrelated.

When Treasury failed to explain in its preamble exactly why this evidence is logically irrelevant in the related-party context, the Tax Court criticized it for failing to deliberate properly, and invalidated the regulations. As a result, unless the case is reversed on appeal, a U.S. company that is developing IP can now do supposed "cost-sharing" arrangements with tax haven subsidiaries that do not actually require sharing one of the main costs. This permits the U.S. companies to charge in full, against domestic source income, the tax cost of using incentive compensation to create indefinitely deferred foreign source income.

What makes the decision alarming is less its direct effect on so-called cost-sharing — or even on the rest of the transfer pricing regulations, which it threatens — than its implications for the regulatory process generally. And while I realize that this is a bit in the trenches for the non-lawyers in the audience, it is relevant and worth knowing about, especially if the main action in international tax policy is increasingly moving from Congress to Treasury.

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12 Reg. section 1.482-7(d)(2).

13 For example, if incentive compensation based on the employer's stock price affected the operation of cost-sharing arrangements between unrelated companies, this might cause them to have incentives to seek to affect each other's stock prices. This is not a genuine issue when wholly co-owned parties, such as a U.S. parent and its foreign subsidiary, purport to make cost-sharing arrangements with each other.