Harnessing the Costs of International Tax Arbitrage

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I. Introduction

The current international tax regime of the United States has become rife with planning opportunities for clever and aggressive taxpayers. In this respect, much attention has been paid to non-economic "tax shelters" and other similar tax avoidance transactions. One planning strategy unique to the cross-border setting (commonly referred to as "international tax arbitrage" or "cross-border tax arbitrage") is different, however. International tax arbitrage generally arises not as an attempt to abuse the tax rules of the United States through the use of non-economic transactions, but rather as a result of taxpayers exploiting conflicting tax rules in different jurisdictions so as to result in a net worldwide reduction in total tax liability.

Under international tax arbitrage, a taxpayer can structure a transaction so as to technically comply with the laws of two or more jurisdictions while at the same time reducing their total worldwide tax liability as compared to what the taxpayer would have paid had only one jurisdiction exercised its taxing authority. In effect, taxpayers can raid the fisc (which fisc is a different question), while fully complying with the law.

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Predictably, the jurisdictions involved tend to view these transactions as inappropriate.[1] The more difficult question is how a jurisdiction, such as the United States, should respond to its taxpayers engaging in such transactions.

This question is difficult precisely because international tax arbitrage arises as a result of the conflict of the tax laws of one jurisdiction with those of another jurisdiction. Each country designs its own internal tax regime so as to promote specific policy goals of that jurisdiction, including the impact on the domestic economy of the country, the distributive impact on the citizens and residents of the country, and the impact of the tax laws on the worldwide economy. When the rules of two jurisdictions conflict, it is because one or more of these policy decisions differ. As a result, any response to international tax arbitrage will necessarily implicate one or more of these policy choices.

Under the current international tax regime, in light of the conflicting policy choices implicit in international tax arbitrage, countries have an incentive not to cooperate with each other to resolve the issue. This incentive structure leads to a long-term equilibrium of mutual non-cooperation and as a result a sub-optimal worldwide tax regime. One solution would be a worldwide taxing authority with the ability to impose harmonized laws on the two jurisdictions. The problem, however, is that no country one has an incentive to agree to surrender its taxing authority to such a body, and respect for the sovereignty of countries to adopt and implement their own tax rules complicates the ability of the international community to create such a body to impose its rules on

[1] For example, in statements to the Tax Section of the American Bar Association, Hal Hicks, IRS associate chief counsel (international), stated that taxpayers "should expect the IRS to focus on international tax arbitrage during 2006, especially on how U.S. tax rules are affected by developments in that area …" *Hicks Updates List of IRS International Guidance*, 2005 TNT 180-4 (Sept. 16, 2005). *See also* Carrick Mollenkamp and Glenn R. Simpson, *Border Crossing: How a U.K. Banker Helps U.S. Clients Trim Their Taxes --- Deals Devised by Roger Jenkins Of Barclays Capital Lift Own Firm's Fortunes, Too --- Paid Once, Credited Twice*, Wall Street Journal, June 30, 2006 at A1.

unwilling countries. In the absence of such a worldwide taxing authority, unilateral responses must be considered.

Any unilateral response to international tax arbitrage necessarily requires a consideration of not only the international tax arbitrage itself, but also the policy choices underlying the law that led to the conflict in the first place. The policies embodied in the United States tax regime are not monolithic, however. The domestic tax rules and the international tax rules of the United States represent different, and at times incompatible, policy choices. By accepting that the United States domestic and international tax regimes adopt differing equity and efficiency policies as their goal, it follows that it may not be possible to maximize the efficiency of both regimes while also minimizing international tax arbitrage transactions. In such circumstances, a decision must be made whether to sacrifice either domestic equity or efficiency considerations or worldwide equity or efficiency considerations to combat international tax arbitrage. Balancing these disparate costs and benefits can prove difficult if not impossible; the experience applying the traditional responses to international tax arbitrage evidences this.

This article attempts to remedy this problem by proposing that there may be a different way to conceptualize the response to international tax arbitrage. Assuming that some cost is inherent in the system (either the arbitrage itself or some policy compromise in response to the arbitrage), the question is whether any particular response could also provide some additional benefit in exchange for bearing such costs. In other words, can the inherent costs of international tax arbitrage be harnessed to further other policy goals? This article proposes that such costs can be so utilized; more particularly, that the costs of international tax arbitrage can be harnessed to benefit those countries which historically have not benefited from the current policies of the worldwide tax regime, i.e., developing countries. Not only would such an approach benefit developing countries at little to no marginal cost to the United States, but more fundamentally it could also serve to change the debate, place the issue of international tax arbitrage on the world stage and potentially realign worldwide incentives and lead to increased worldwide cooperation and perhaps a more harmonized worldwide tax regime.

Part II of this article will summarize the development and rise of international tax arbitrage, and discuss the underlying policy choices of the current domestic and international tax regimes of the United States which have led to the current system. Part III will then discuss the responses to international tax arbitrage, and analyze the criticisms of each in light of the policies discussed in Part II. Part IV will propose a new methodology for harnessing and directing the costs of international tax arbitrage to promote worldwide development, and analyze how such an approach could transform the current worldwide equilibrium into a more cooperative regime in the long run while aiding developing countries in the short run. Part V will then apply this framework to a case study of a particular international tax arbitrage transaction, demonstrating the distributional and cooperative benefits of the approach proposed by this article.

II. International Tax Arbitrage: A Necessary Result of the Current Structure of the United States Tax Regime?

A. Understanding International Tax Arbitrage

What happens when two jurisdictions each assert their right to tax a person, entity or transaction? Barring some other relief, the result is "double taxation" – two taxes imposed on a single economic gain. Double taxation is considered undesirable from a worldwide standpoint for a number of reasons, including that it provides a disincentive for investors to invest capital outside of their jurisdiction and is unfair to taxpayers investing in cross-border transactions.[2] To mitigate the harms of double taxation, a general consensus has arisen in the worldwide taxing community that countries should divide the right to impose a tax in such circumstances.

Although double taxation has been the primary focus of concern in the field of international tax law, the potential for double non-taxation also arises in the international setting. International tax arbitrage is one particular form of double non-taxation, involving the exploitation of the conflict of rules in different jurisdictions as a means to accomplish double non-taxation.[3] More specifically, international tax arbitrage arises when taxpayers subject to tax in multiple jurisdictions exploit differences in the rules of the tax regimes of such jurisdictions (whether it be different international tax regimes, different tax bases, different timing rules, different definitional elements, or otherwise) so as to technically comply with the law of both regimes but incur a lower total net tax liability than if the transaction had been subject solely to the laws of either regime.[4]

[2] *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1046 - 1049 (1997).

[3] The primary reason why this aspect is unique to international tax arbitrage as opposed to other conflicts of laws, such as the overlap of United States federal income tax law with the corporate or tax laws of a particular state, is the lack of a supra-national rulemaking body with the authority to impose harmonization. *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH L. REV. 895, 895 (1992).

[4] Some commentators have questioned this definition by noting that rate differentials and other intentional tax subsidies in a country's tax regime can result in a lower net worldwide tax liability for an investor than

Because the sole necessary condition for an international tax arbitrage to arise is the conflict of tax laws between those of the United States and those of a foreign jurisdiction, such transactions could, and in fact does, arise throughout the Internal Revenue Code. A brief overview of some examples of international tax arbitrage transactions (including those that utilize the laws of corporate residence, entity classification, debt/equity classification and tax ownership) demonstrates the breadth of the issue.

One example of the phenomenon of international tax arbitrage is the "dual resident company" ("DRC"). A DRC is a company that is considered a resident of one jurisdiction (and thus subject to its tax laws) as a result of the DRC's place of incorporation, and a resident of a second jurisdiction (and thus subject to its tax laws) as a result of its place of management. Due to the rules in place to avoid double taxation, both countries effectively divide the right to tax the income of the DRC, ceding the right to tax a portion of the income of the DRC to the other jurisdiction.

The international tax arbitrage arises because the DRC is able to claim beneficial tax attributes in full in both jurisdictions while only being subject to tax on a portion of its income. For example, the DRC could act as a holding company for subsidiaries in both jurisdictions, and then borrow to either acquire or finance these operating

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if the investor had been subject solely to the rules of a single regime, but that these should be distinguished from international tax arbitrage. Under this theory, the presence of intentionality is an additional requirement, i.e., the taxpayer intentionally structured a transaction so to exploit the differences in the tax rules of different regimes. *See* Diane M. Ring, *One Nation Among Many: Policy Implications of Cross Border Arbitrage*, 44 B.C. L. REV. 79, 165 (2002). A further refinement proposes that an aspect unique to international tax arbitrage is "rule indifference", meaning that the taxpayer is indifferent to whether either rule on its face provides a tax subsidy or preference but rather that the combination of two such rules results in net worldwide tax savings. *See* Mitchell Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 109-110 (2004). Regardless, all commentators agree that a necessary precondition for the rise of international tax arbitrage is a conflict between the tax rules in two jurisdictions. *See, e.g.,* Tim Edgar, *Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage*, 51 CAN. TAX J. 1079 (2003). For purposes of this article, therefore, it is sufficient to focus on this element of international tax arbitrage.

subsidiaries. Assuming both jurisdictions have some sort of "fiscal unity" or "consolidated group" treatment, interest deductions resulting from the debt at the DRC would be deductible by the actual operating businesses in each jurisdiction in full. As a result, the DRC has effectively "double counted" the interest deduction, sheltering income in both jurisdictions (and thus reducing its worldwide net effective tax rate) while only incurring as single economic expense.

One unique factor of international tax arbitrage such as the DRC transaction is that the worldwide tax savings occur while fully complying with the law in both jurisdictions. Thus, assuming no other relevant facts, a DRC will have reduced its net worldwide tax liability while: (1) reporting as a taxpayer in each jurisdiction as required by the residence definition in each jurisdiction, (2) reporting as a member of a consolidated group (or fiscal unity) in each jurisdiction as permitted for controlled groups of corporations in each jurisdiction and (3) taking a deduction in full for interest payments made by the DRC, as permitted under the tax laws of each jurisdiction. This feature, i.e., full compliance with the laws of both jurisdictions while achieving a net tax savings, is the trademark of international tax arbitrage. As a result, the only way for a country such as the United States to prevent the use of the DRC arbitrage transaction would be to deny the DRC the benefit of one or more of those otherwise applicable domestic laws by: (1) denying the DRC the benefit of the domestic consolidated group rules, (2) denying the DRC a deduction for interest, or (3) imposing a tax on all rather than a portion of the DRC's worldwide income. Any of these responses would represent a significant departure from the generally applicable tax rules of the United States, each enacted for a particular policy reason or reasons.[5]

A second example involves the use of "hybrid" entities. Under this international tax arbitrage transaction, a United States taxpayer would form a subsidiary in a high-tax foreign country. The taxpayer would directly or indirectly lend money to the subsidiary and the subsidiary would pay interest on the loan. In the subsidiary's country, the interest would be deductible against its income tax, resulting in a net tax savings. However, for United States tax purposes, the taxpayer would make an election under the so-called "check the box" regulations to treat the subsidiary as "disregarded" for United States tax purposes, i.e., the United States would pretend that the subsidiary did not exist.[6] Because the entity was disregarded (and thus the loan did not exist) for United States tax purposes, the offsetting interest income would not be taxed in the United States.[7] Thus, the taxpayer would derive a net tax benefit in the form of the interest deduction in the subsidiary's country while never incurring any offsetting income from the interest payment. As with the case of the DRC, the United States taxpayer had fully complied with the laws of both the United States and the foreign country, but had generated a net worldwide tax benefit solely due to the inconsistent treatment of the subsidiary by the two jurisdictions.

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[5] With respect to the DRC arbitrage transaction, the United States adopted the second alternative, denying an interest deduction to a DRC involved in the arbitrage transaction. *See* IRC § 1503(d). As discussed in more detail below, this response met with only limited success and incurred significant costs. *See infra* note 71 and accompanying text.

[6] The promulgation of the "check-the-box" entity classification rules (except in limited circumstances) permitted taxpayers to affirmatively elect the tax treatment of entities, regardless of their legal classification. The check-the-box regulations and their use in international tax arbitrage are discussed in more detail in Part V, *supra*.

[7] *See* Kane *supra* note 4 at 160; Notice 98-11, 1998-1 C.B. 433.

A related international tax arbitrage transaction is the "hybrid equity" arbitrage transaction. Under this transaction, as in the hybrid entity transaction, a United States taxpayer would establish a subsidiary in a foreign country and lend money to the subsidiary. Unlike the hybrid entity transaction, however, the taxpayer would treat the entity as a corporation for both United States and foreign tax purposes. The arbitrage arises from treating the loan made to the subsidiary as a form of preferred equity for United States tax purposes but as an interest bearing debt instrument for tax purposes of the foreign country. Since the foreign country treated the loan as debt, the subsidiary would be permitted to deduct the interest on the debt as it was accrued. The United States taxpayer, however, would structure the instrument under United States tax rules applicable to preferred equity so the accrued interest would not be taxable in the United States.[8] Again, the taxpayer had fully complied with the laws of both the United States and the foreign country, but had generated a net worldwide tax benefit solely due to the inconsistent treatment of the equity instrument by the two jurisdictions.[9]

A third example involves what are referred to as "double-dip leases" or "cross-border leases." Under this transaction, a United States taxpayer that owned depreciable

[8] *See* IRC § 305. For a general description, *see* Peter H. Blessing, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings: Cross-Border Acquisition Financing*, 635 PLI/TAX 461, 520 – 524 (2004).

[9] A more subtle but similar version of this international arbitrage transaction was marketed under the name of "foreign leveraged investment program" (or FLIPs). Under FLIPs, a foreign bank would lend money to shell foreign corporation, which would use the proceeds to purchase stock in the bank. A related United States taxpayer would buy a small amount of shares in the bank as well. The bank would then repurchase the shell corporation's stock and cancel its debt. For United States tax purposes, the repurchase was intended to be treated as a dividend, which the United States taxpayer claimed resulted in a large deductible loss on the sale of its stock in the bank. For the transaction to work, however, the jurisdiction in which the bank was located had to treat the repurchase as a "redemption" rather than as a dividend so that a withholding tax would not apply. The exploitation of this different treatment in each country is a form of international tax arbitrage. For a comprehensive discussion and criticism of the FLIPs transaction, *see* Calvin H. Johnson, *Tales From the KPMG Skunk Works: The Basis-Shift or Defective-Redemption Shelter*, 108 TAX NOTES 431 (2005).

property would enter into a nominal sale of the property to a foreign taxpayer and would then lease the property back from the taxpayer for a long period of time. For United States tax purposes, the sale and leaseback was considered a loan from the foreign taxpayer secured by the property rather than a sale. Thus, the United States taxpayer was not required to recognize any gain on the sale. For foreign tax purposes, however, the sale was respected and the foreign taxpayer was treated as the owner of the property, entitling the foreign taxpayer to take depreciation deductions on the property for foreign tax purposes.[10] As a result, all parties fully complied with the laws of their respective jurisdictions, but the parties realized a net worldwide tax benefit solely from the inconsistent treatment of the owner of the depreciable property between the two jurisdictions.

Putting aside the technical aspects of these transactions, more fundamentally, why should countries be troubled by the presence of international tax arbitrage as a phenomenon? Countries are concerned because, in effect, international tax arbitrage acts to redistribute a country's tax burden away from owners of internationally mobile capital towards other members of society. This occurs because those taxpayers that engage in international tax arbitrage pay a lower worldwide effective tax rate than they would have absent the international tax arbitrage. For a particular country to raise an intended amount of total tax revenue (absent international tax arbitrage), such country would have to increase the total tax burden on those taxpayers less able to engage in international tax arbitrage transactions, presumably the labor wage base. The arbitrageurs as a class are not the beneficiaries of this distributional effect as a result of an affirmative policy choice

[10] *See* Kane *supra* note 4 at 149 – 150.

of a country to allocate its relative tax burdens, but rather solely as a result of the unanticipated conflicts of its laws with those of another country.[11] In addition to this distributional concern, this shifting of tax burden itself could have adverse efficiency effects on society as a whole, even if any particular international tax arbitrage transaction did not distort specific investment behavior or lead to inefficient resource allocation.[12] This distributional issue unifies international tax arbitrage as a phenomenon, raising concerns over its presence in the international tax regime both as an intuitive and technical matter.

In addition, countries are concerned about international tax arbitrage because, notwithstanding the use of arbitrage in its name, it is not a phenomenon for which the market can be relied upon to correct in whole or in part. This is because, unlike traditional economic arbitrage or tax arbitrage, international tax arbitrage is not really a form of arbitrage at all.[13]

Economic arbitrage occurs when an investor exploits an imperfection in the market, for example, as a result of information disparities or other market failures, to enter into two separate arms-length transactions with unrelated parties that, when held together, result in a riskless position that nonetheless produces a positive economic

[11] *See* Ring *supra* note 4 at 120 – 121.

[12] *See* Edgar *supra* note 4 at 1103 – 1104 ("[I]nstances of "pure" tax avoidance typically involve "purely paper transactions" that attempt to arbitrage differences in tax treatment without altering the desired pattern of cash flows associated with a particular transaction. This type of avoidance does not directly entail any efficiency costs other than transaction costs. It does, however, entail revenue loss for the taxing jurisdiction (and tax savings for the taxpayer), which must be recovered by either increased taxes on other bases or reduced spending on public goods and services. Increased taxes on other bases may entail efficiency losses and can have undesirable distributional consequences.")

[13] *See* Daniel Shaviro, *Exploring the Need for International Harmonization: Money on the Table?: Responding to Cross-Border Tax Arbitrage*, 3 CHI. J. INT'L L. 317, 321 (2002) [hereinafter "Shaviro, Exploring"] ("Anyone who is accustomed to the standard economic usage of "arbitrage" may therefore find its application [to international tax arbitrage] metaphorical at best, and misleading at worst...")

return. Once an arbitrage opportunity is identified, demand for the positions comprising the arbitrage will rise so as to take advantage of the riskless profit. As demand increases, the prices of the assets constituting the arbitrage position will increase, and eventually reach equilibrium, i.e., the point where riskless profit is no longer possible. As a result, not only is economic arbitrage generally considered self-correcting, but also a valuable correction for market failures.[14]

Tax arbitrage is generally considered to occur when a taxpayer exploits either the favored tax treatment of a particular type of investment (sometimes referred to as "organizational arbitrage") or the favored tax treatment of a particular type of asset (sometimes referred to as "clientele based arbitrage").[15] Such arbitrages are distinguishable from economic arbitrage in that they involve investments that have real economic risk, i.e., the investment itself may lose money notwithstanding the tax preferred attributes. In a closed economy, as investors move investments to tax preferred assets or investments, the price of such investments should increase (or the return should

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[14] *See* Ephraim Clark & Dilip K. Ghosh, ARBITRAGE HEDGING AND SPECULATION: THE FOREIGN EXCHANGE MARKET 1-2 (2004). In practice, however, it is difficult to find a truly riskless arbitrage position. Instead, economic arbitrage transactions are generally those in which on average the economic return exceeds the expected risk-based return of the position, solely due to arbitrage. *See, e.g.*, Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDH. L. REV. 191, 215 (1988) (discussing "index arbitrage," the arbitrage between prices of index futures and underlying stocks due to differing transaction costs in the futures and stock markets). A variation is "risk arbitrage" in which the offsetting positions of the arbitrage generate a positive return subject to the risk of an intervening event, such as a legal, regulatory or tax event. *See, e.g.,* Mark Mitchell and Todd Pulvino, *Characteristics of Risk and Return in Risk Arbitrage,* 56 J. Fin. 2135 (2001) (discussing "merger arbitrage," the arbitrage between the price of the stock of a target company and an acquiring company following the announcement of a merger, which will produce a positive return unless the merger does not go through) .

[15] *See* Kane, *supra* note 4 at 102-106; Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Maydew & Terry Shevlin, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 134-135 (3rd ed. 2005).

decrease) until the net after-tax return available on such investments is in equilibrium with other non tax preferred assets.[16]

In contrast with both economic and tax arbitrage, under international tax arbitrage there is no particular reason to believe that the price of making investments in an arbitrage jurisdiction would increase, preventing a "self-correcting" mechanism from arising.[17] This is especially true if a taxpayer can subject themselves to the laws of a particular jurisdiction without altering the underlying business purpose or economic fundamentals of the investment, such as by merely forming a "shell" entity in a jurisdiction. Assuming no other costs of international tax arbitrage, investors would theoretically continue to exploit the international tax arbitrage,[18] increasing the adverse efficiency and distributional consequences as a result.

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[16] *See, e.g.*, Myron S. Scholes & Mark A. Wolfson, *The Cost of Capital and Changes in Tax Regimes*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron et al. eds., 1988). Tax arbitrage will not generally be perfectly self-correcting, depending on the size of the tax preference and the ability of markets to price the attribute through trading, since only one taxpayer need face a marginal tax rate higher than the rate priced into the asset for the arbitrage to be present. *See, e.g.*, Merle Erickson, Austan Goolsbee and Edward Maydew, *How Prevalent is Tax Arbitrage? Evidence from the Market for Municipal Bonds*, 56 NAT'L TAX J. 259 (2003) (describing the ability of firms to undertake small amounts of municipal debt tax arbitrage notwithstanding statutory limits and implicit taxes) [hereinafter "How Prevalent is Tax Arbitrage"]; Kane, *supra* note 4 at 107, n. 48; Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX. LAW. 549, 564-74 (1985). In addition, tax benefits for which the market is very small may not have sufficient trades for the market to capitalize taxes into the price efficiently. *See* Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 SMU L. REV. 339 (1999).

[17] If the increased demand is for actual economic investment in the jurisdiction itself, then the market conceivably could correct for the increased demand through increased prices or reduced returns in the same manner as in economic arbitrage. Since international tax arbitrage arises due to the different legal regimes and not the source of economic investment, however, this will not necessarily be the case.

[18] Once this process begins, under the theory of path dependence it is possible that it will continue regardless if it remains as advantageous to taxpayers as it had been at the time the transaction initially arose, especially if (under a public choice model) the arbitrageurs act as a unified interest group. For a debate on the role of path dependence in the tax laws, *see*, Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction*, 80 Texas L. Rev. 859 (2002); David A. Weisbach, *Thinking Outside the Little Boxes: A Response to Professor Schlunk*, 80 Tex. L. Rev. 893 (2002).

If international tax arbitrage provides riskless (or no marginal risk) tax benefits, why do investors not engage in more international tax arbitrage transactions? One answer may be that the occurrences of international tax arbitrage transactions are in fact rising. Another is that, as discussed above, such transactions are only available to taxpayers with internationally mobile capital. As taxpayers grow more sophisticated and as capital becomes increasingly mobile, however, the use of international tax arbitrage could be expected to grow, with the attendant efficiency and distributional concerns increasing as well. The presence of non-tax frictions serves as a limitation on the ability to exploit international tax arbitrage transactions indefinitely,[19] but does not solve the underlying issue of the arbitrage itself or its growth as capital becomes increasingly more mobile internationally.

As a result of this combination of factors, international tax arbitrage transactions can only be addressed by one or both of the applicable jurisdictions changing their laws (unilaterally or through cooperation) so as to remove the conflict and thus the arbitrage. Any change in a country's tax laws in response to international tax arbitrage necessarily implicates a change in the policies underlying such laws as well, however. Thus, to fully appreciate the appropriate costs and benefits, an analysis of these underlying policies is necessary before a proper response to international tax arbitrage can be crafted.

[19] *See, e.g.,* How Prevalent is Tax Arbitrage *supra* note 16 at 267 – 268 (describing non-tax frictions as limiting what theoretically would be an indefinitely available municipal debt tax arbitrage); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001). International tax arbitrage incurs numerous non-tax frictions. For example, forming an entity in a foreign jurisdiction may subject a taxpayer to incremental regulatory or transaction costs (such as legal, accounting and banking fees incurred in forming entities, moving capital, filing tax returns and other transactions), as well as additional legal uncertainty costs regarding issues such as the limited liability of an entity, the ability to enforce contracts, the ability to protect assets or declare bankruptcy. In fact, taxpayers may be more risk-averse to this form of legal uncertainty than to other forms of uncertainty, in which case the benefits of the arbitrage would have to exceed the uncertainty costs to a much larger degree. *See* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 370-371 (2005).

B. International Tax Arbitrage and Underlying Policy Choices

In crafting a tax regime, a country balances policy factors, and (in theory) adopts a regime that reflects the policy choices of the country. However, "[t]he leap from the blackboard to the real world is a large one when it comes to taxation."[20] In applying the factors to take into consideration in designing a tax system, compromises are often made, unintended consequences arise and conflicts between rules develop that serve to undermine these initial policy choices. Choices made within the context of a closed system may have unanticipated consequences when they interact with the rules enacted for an open system.[21]

International tax arbitrage exemplifies this tension. At its fundamental underpinnings, the United States federal income tax laws are structured so as to further specific policy goals.[22] These goals are not monolithic, however. The United States tax laws applicable to domestic income and the laws applicable to income earned outside the United States, while nominally pursuing similar policy goals, focus on differing goals and policies. Domestic tax policy generally assumes that the system for which the tax rules are being designed is closed. In other words, it assumes that all relevant parties are

[20] Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, 4 J. ECON. PERSP. 157, 168 (1990) [hereinafter "Slemrod, Optimal Taxation"].

[21] *See, e.g.*, Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOKLYN J. INT'L L. 1335, 1356 (2001); Joel Slemrod, *Effect of Taxation with International Capital Mobility*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 115 – 116 (Henry J. Aaron et al. eds., 1988) [hereinafter "Slemrod, Effect of Taxation"]; Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1072-1073 (1989).

[22] Solely for purposes of discussing the issue, this paper will assume that the tax laws at issue are supported by one or more demonstrable underlying tax policies. Of course, certain rules may be enacted or maintained for other reasons, including under a public choice theory as payment by legislators to special interest groups. *See, e.g.,* Robert D. Tollison, *Public Choice and Legislation*, 74 Va. L. Rev. 339 (1988).

interacting with each other subject to the same single set of rules and laws. International tax policy assumes an open system in which more than one country could apply different sets of rules and laws to a single taxpayer or transaction at the same time. In other words, it assumes that the relevant parties may not all be subject to a single set of rules and thus must take this into account in applying a single policy to all taxpayers. Because of these differences, laws that would be optimal in the domestic context may not be optimal in the international context.[23]

An important aspect of this dual regime, however, is that both the domestic tax rules and the international tax rules of the United States can apply to a single person, transaction or entity at the same time. It does not necessarily follow, however, that complying with United States domestic tax rules in the international context will necessarily further the policy goals of either regime. For example, it is often the conflict of the domestic rules of the United States, such as the entity classification rules or debt/equity classification rules, with those of other countries that lead to the rise of international tax arbitrage, which works to undermine the policies of the international tax rules of the United States.

As a result, to appreciate the costs of international tax arbitrage, it is necessary to understand the different, and at times conflicting, policy choices inherent in the domestic and international tax laws of the United States. Once these policy choices and costs are

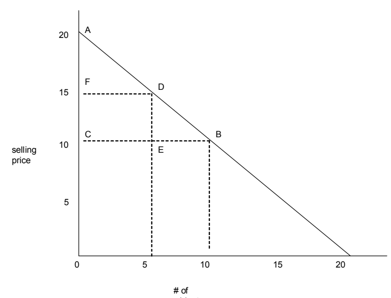
[23] This is not to say that international consequences of domestic tax laws are not considered, or that domestic impact of international tax laws are ignored, but rather that in certain circumstances the rules applicable to the taxation of international income of United States taxpayers seek to achieve different broad policy goals than those applicable to domestic income, and thus such rules will differ in different contexts. *See* Roger Cowie, *Using Tax Incentives to Improve American Competitiveness: A Framework for Normative Analysis*, 31 AM. BUS. L.J. 417 (1993) (explaining how a normative tax in a closed economy may not be normative in an open economy, taking into account the total economic burden imposed by multiple taxing regimes rather than statutory tax rates).

framed, their role in the rise of international tax arbitrage transactions, and the difficulty in addressing them, can be analyzed.

i. Efficiency in an Open v. Closed System

In a closed system, tax laws act to change the behavior of parties by changing the relative prices of goods or services, resulting in a change in behavior of taxpayers, and thus a net loss to society (referred to as the "excess burden" or "deadweight loss").[24] Economic efficiency in the tax laws is thus maximized to the extent that the tax law has little or no effect on behavior, i.e., "neutrality."[25] Neutrality is achieved to the extent higher taxes are imposed on those goods or services for which demand will change very

[24] For example, assume a tax was imposed that raised the price of widgets from $10 to $15. Rather than purchase 10 widgets at $10 apiece, a consumer would now purchase 5 widgets for $15 apiece. A graphical representation would look as follows:



The value represented by the rectangle FDEC represents the tax revenue raised as a result. The triangle DBE, however, represents the deadweight loss, or economic loss to the society resulting solely from the modification of B's behavior in response to the tax. Although a useful representation for the concept of deadweight loss, the actual deadweight loss incurred in a dynamic economy often proves more difficult to quantify. *See* James R. Hines, Jr., *Three Sides of Harberger Triangles*, 13 J. ECON. PERS. 167, 186 (1999) ("Real world economies with inefficient or less than benevolent governments may … find their Harberger triangles becoming trapezoids.").

[25] Assuming a market with perfect information and no transaction costs, voluntary transactions entered into between two parties acting rationally and at arms-length are assumed to maximize economic efficiency (in general, because the parties would not have entered into the transaction unless both the buyer and the seller are better off). The amount and extent of the benefit to society depends on the relative elasticities of the two parties engaged in the transaction. For a general discussion of the efficiency considerations in structuring tax laws, see RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE, Ch. 14 (4th ed. 1984).

little as a result and lower taxes are imposed on goods or services for which demand will change more readily as a result.[26]

In an open system, economic theory similarly provides the tax laws should be neutral, i.e., the laws should minimize their effect on the location of investment capital within the open economy.[27] Because capital investment in an open economy may be subject to the tax rules of different jurisdictions, the tax laws of the United States must take into account the effect of the tax laws of other jurisdictions in addition to its own to make this judgment. As a result, a significant debate has thus arisen as to what "neutral" means in the context of a worldwide economy where multiple jurisdictions assert their sovereign rights to apply their tax laws to a particular taxpayer or transaction.[28]

One type of neutrality proposed for a worldwide economy is "capital export neutrality" (CEN). Under CEN, a country's tax policy should be set so as to minimize the influence the tax law has on the decision of the taxpayers subject to tax in that

[26] This reflects what is referred to as the "substitution effect." Under an optimal tax regime, goods or services that have ready substitutes should face similar levels of taxation so as to minimize the substitution effect and thus the deadweight loss. *See, e.g.*, Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39 (1996). In addition, there is also a substitution effect for individual taxpayers between what is typically referred to as "work" and "leisure." Under an optimal tax regime, tax rates should be set so as to minimize the influence on taxpayer's choice between work and leisure. One theory of optimal tax regime proposes that tax rates generally should rise sharply while incomes increase, but only while such incomes are in the range necessary for sustenance and necessities, because the demand to earn income in this range is highly inelastic. After surpassing this range, however, tax rates should begin to decline steadily so as not to act as a disincentive to taxpayers to continue choosing work over leisure, with tax rates eventually reaching zero for the highest earning taxpayer. *See, e.g.*, Slemrod, Optimal Taxation *supra* note 20. For a more general discussion of optimal tax theory, see MUSGRAVE & MUSGRAVE, *supra* note 25, ch. 5.

[27] For the same reasons as in a closed system, if the tax laws of a jurisdiction are neutral towards the investment of capital, then there would be no (or significantly reduced) deadweight loss incurred on a worldwide basis. *See generally* Slemrod, Effect of Taxation, *supra* note 21.

[28] *See, e.g.,* Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q. J. OF ECON. 793-798 (1980) (concluding that the optimal international tax regime depends on the relative demand and supply for capital among the relevant countries).

jurisdiction as to which jurisdictions to invest their capital.[29] CEN accomplishes this by requiring income in the foreign "host" jurisdiction to be included in the income of the taxpayer in the "home" country, but with an accompanying credit for taxes paid to the host country on such income. Thus, although the investor pays tax to the host country, the tax does not change the investor's after-tax return because the tax system in the investor's home country compensates the investor on a dollar-for-dollar basis for any tax incurred in the host country. In this manner, an investor in the home country would pay the same tax on an investment whether it is made in the home or host country, thus permitting the investor to choose to make the investment based solely on the investment's pre-tax return.[30]

A second type of neutrality proposed for a worldwide economy is "capital import neutrality" (CIN). Under CIN, a country's tax policy is set such that the taxpayers in the

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[29] For example, if an investor in the United States has two investment opportunities, one in the United States and one in the Netherlands, then absent taxes the investor would invest in the jurisdiction that represented the highest risk-adjusted return to the invested capital. Assuming the United States investment returned 10% pre-tax and the Dutch investment returned 11% pre-tax, under an efficient tax system the investor should invest in the Dutch investment. However, if both the United States and the Netherlands impose a tax on the transaction (and no other adjustments are made), then the investment in the United States could return a higher after-tax return than the investment in the Netherlands, solely as a result of the tax laws. For example, if the United States imposed a 20% tax and the Netherlands imposed a 20% tax, the after-tax return on the Netherlands investment for a United States taxpayer would be 6.6%, while the after-tax return on the United States investment would be 8%. As a result, a rational investor would invest in the United States. Thus, solely as a result of the two jurisdictions asserting their sovereignty to tax the cross-border transaction, the investor's decision is influenced by the tax laws and the worldwide economy suffers a deadweight loss.

[30] Returning to the above example, assuming the United States has a CEN policy, the United States investor would face an after-tax return of 8% on the United States investment and would face an after-tax return of 8.8% on the Netherlands investment, because the United States would credit the Dutch taxes paid against the United States taxes owed resulting in no incremental United States tax liability. The after-tax return for the Dutch investment would be 11% - (11% * 20%) – (11% * 20%) + (11% * 20%) = 8.8%. Under a "pure" CEN approach, the home country would refund any credits for foreign taxes paid in excess of domestic taxes owed. Under the current United States CEN policy, the foreign tax credit is not refundable but is rather capped at the amount of domestic tax owed. As a result, host country taxes in excess of home country taxes may still act to distort capital investment decisions. *See* Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 Va. L. Rev. 919 (1989) (referring to this as "defensive neutrality").

home country are not at a comparative disadvantage to investors resident in the host country in making investments in the host country.[31] CIN accomplishes this by exempting the income generated in the host country from tax in the home country (or deferring the home country's tax on host country income indefinitely such that the net present value of the home country tax is close to zero). In this manner, an investor in the home country pays the same tax on an investment in the host country as an investor resident in the host country, i.e., both pay only the host country's tax. Under this theory, by removing the disadvantage of the home country's investor of doing business in the host country, the competitiveness of the home country's investor is maximized on a worldwide basis.

Under both a CEN and CIN model, the home country unilaterally concedes the right to tax all or part of the income from a dual-jurisdiction investment to the host country in exchange for increased worldwide efficiency. There is no particular reason to believe that the increased worldwide efficiency gain will directly benefit the home country, however. In fact, under a CIN model, in most circumstances the economic benefit will not inure to the benefit of the home country, at least in the short run.[32]

[31] For example, if an investment opportunity arises in Japan that returns 10% on a risk-adjusted basis and capital is freely mobile, then an investor based in the United States and an investor based in Japan might both equally wish to make the investment. Assuming Japan asserts the right to tax the investment because the investment is located in Japan, and that the United States asserts its right to tax the income to the United States investor as a United States citizen, then the United States investor could be at a disadvantage on an after-tax basis as compared to the Japanese investor. For example, if Japan imposed a tax of 10% on the transaction and the United States imposed a tax of 20% on the transaction, a Japanese investor (subject only to the Japanese tax) would realize an after-tax return of 9% on the investment while the United States investor would realize an after-tax return of 8% on the investment (assuming the United States gives a tax credit for Japanese tax paid). As a result, the Japanese investor would have an advantage in pricing the investment over the United States investor.

[32] This has been referred to as "nationalism" in that individual countries, as the relevant policy-making bodies, tend to adopt policies that maximize their short-term national interests even at the expense of long-term worldwide efficiency. *See* Ring, *supra* note 4 at 137-138. A third type of neutrality, so-called "national neutrality" takes this into account, proposing a system of international tax rules that maximizes

It is often difficult to determine which form of neutrality would be optimal in any given circumstance, given the presence of multiple taxing jurisdictions asserting sovereignty to impose tax on a person, entity or transaction. In addition, competing theories often prove mutually exclusive, requiring choices to be made. For example, pursuing one form of worldwide neutrality, e.g., CIN, necessarily loses the efficiency benefits of the other, e.g., CEN.[33]

In addition, implementing and enforcing a tax regime creates administrative costs. Minimizing these administrative costs to the extent possible, while also maximizing the

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returns to the home country. National neutrality provides for a deduction in the home country for taxes paid to a host country. In essence, national neutrality treats any foreign taxes paid in connection with a foreign investment as a cost of generating the revenues. *See, e.g.,* Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 274 (2001).

[33] This phenomenon has been concisely described as follows:

> It has by now become well-known in the tax policy literature that it is simply not possible to implement both capital import and capital export neutrality simultaneously. Our favorite way of making this point is in terms of an irreconcilable conflict among the following three simple principles:
>
>> Principle 1: People should pay equal taxes on their income regardless of the country that is the source of that income. In particular, U.S. taxpayers should be treated equally regardless of the source of their income.
>> Principle 2: All investments in the United States should face the same burden regardless of whether a U.S. person or a foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.
>> Principle 3: Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.
>
> The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, an identical tax base, and identical choices between source and residence based taxation. That has never happened, and it never will. Even if it ever did, there would be no way to keep such a system in place without violating Principle 3.

Graetz & O'Hear, *supra*, note 2 at 1108-1109; *see also* Michael J. Graetz and Alvin C. Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1216 - 1219 (2006)..

economic efficiencies of a proposed tax regime, is an additional consideration in a total economic analysis. Among the administrative costs to be considered include the cost of processing and enforcement by the government, the cost of preparation and compliance by taxpayers and the need for tax advisors and experts as a result of complexity in the law. Taking administrative costs into account, it is possible that a legal rule should not be adopted even if it would increase total economic efficiency, if such gains would be offset by the administrative costs of implementing and enforcing the rule.[34]

ii. Equity in an Open v. Closed System

Considerations of efficiency are balanced against considerations of equity in adopting the tax laws. There are two generally accepted aspects of equity that are taken into account in implementing a tax law: horizontal equity and vertical equity. Horizontal equity dictates that similarly situated taxpayers should be treated similarly under the law, while vertical equity dictates that the tax laws should make appropriate distinctions between taxpayers that are differently situated.[35] The United States uses income as a measure of ability to pay and indirectly to measure utility, although this is considered far from ideal.[36] Assuming that income is a proper means of measuring utility,[37] under the

[34] *See, e.g.*, David A. Weisbach, *Should a Short Sale against the Box be a Realization Event?,* 50 NAT'L TAX J. 495 (1997).

[35] A significant debate has arisen as to the usefulness of this distinction in making tax policy. *See generally* Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989). For purposes of this article, however, the traditional terminology of "horizontal equity" and "vertical equity" is sufficient to frame the analysis.

[36] In an ideal world, the individual utility of each taxpayer would be measurable and the tax regime would be structured to maximize total utility. Utility is not possible to measure, however, at least not on a scale necessary to use as the basis for developing a national taxing regime. Thus, proxies for utility must be

principles of horizontal equity, taxpayers with the same income should face the same net tax burden while under principles of vertical equity, taxpayers with increasing amounts of income should face a proportionately higher net tax burden as a percentage of their total income. The combination of these principles in a closed system results in a progressive tax, where relative tax rates increase as income increases.[38]

Considerations of equity also inform tax policy in an open system. The primary difference, however, is that in an open system income earned in foreign jurisdictions may be subject to tax in both the home and host jurisdictions. As a result, under the principle of worldwide horizontal equity, in an open system the tax laws of the United States should not necessarily simply apply the same tax rate to two taxpayers with equal incomes. Rather, the law would have to take into account taxes paid to other countries in calculating the amount of United States tax to impose, so that each taxpayer's total worldwide tax liability (both foreign and United States) not exceed that of other similarly situated taxpayers subject only to the laws of the United States.

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used. Income has been considered to be a reasonable proxy for utility, under the theory that if a taxpayer receives money in the form of income, then the taxpayer has a fungible means to obtain goods or services in the economy, and is able to store that value to use at the time and place the taxpayer desires. *See e.g.,* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 162-163 (1998), Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 251 (1946).

[37] For example, one taxpayer may earn $1,000 per week by working at two jobs for 60 hours a week (because the taxpayer is unskilled and works in a high labor supply industry), while another taxpayer may earn the $1,000 per week working 20 hours per week and enjoying leisure for the other 40 hours (because the taxpayer is skilled and works in a low labor supply industry). Using solely income as a measure of utility, these two taxpayers would be considered similarly situated and thus under horizontal equity should be subject to the same tax. Using utility as the measure, however, the first taxpayer is clearly not similarly situated to the second taxpayer, and thus should not be subject to the same tax under horizontal equity. *See, e.g.*, Mark Kelman, *Preference and Tax Equity*, 35 STAN. L. REV. 649, 654-656 (1983).

[38] This contrasts sharply with the tax rate structure under an optimal tax theory, in which rates decrease dramatically at higher incomes. *See* Slemrod, Optimal Taxation *supra* note 20.

Further, in an open system, countries rather than individuals could be considered the relevant unit of measure.[39] Under this approach, the tax laws of the United States would not treat individual taxpayers differently due to any foreign tax paid. Rather, for example, vertical equity would provide that wealthier countries should sacrifice tax revenue (in the form of credits of, offsets for or exemptions related to foreign taxes) to countries that have historically been marginalized worldwide (i.e., developing countries), at the cost of lower domestic tax revenue to the home country.[40] This represents a form of "inter-nation" or "international" (as opposed to individual) equity. Under this theory, the home country's tax regime should be used to accomplish this because it is a more efficient mechanism for promoting development than direct subsidies or transfer payments to the jurisdictions, which are at risk of embezzlement, bribes, theft and other corruption.[41]

iii. International Tax Arbitrage and Conflicting Policies

[39] Under this approach, each country would be entitled to share in the wealth of all of its citizens, and thus should be permitted to tax the worldwide income of its citizens so each dollar of income earned by a citizen would enrich the citizen's home country in the form of tax. *See* Kaufman, *supra* note 36 at 189-195. After maximizing its total revenue in this manner, each country could then adopt its own internal tax laws to maximize the benefit of such wealth for its individual citizens, i.e., provide public goods, redistribution or otherwise, within its own national borders. *See, e.g.*, Reuven Avi-Yonah, *Globalization, Tax Competition, and The Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1614 (2000) [hereinafter "Avi-Yonah, Globalization"].

[40] Similar to critical legal studies, this theory posits that the current world distribution of wealth exists partly as a result of a history of discriminatory practices towards developing countries, and thus even facially neutral international tax laws could result in discriminatory effects for such countries. *See, e.g.*, Karen B. Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?*, 23 U. PA. J. INT'L ECON. L. 45 (2002) [hereinafter "Brown, Missing Africa"].

[41] *See* Paul R. McDaniel, *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 GEO. WASH. INT'L. L. REV. 265 (2003); Brown, Missing Africa *supra* note 40; Graetz *supra* note 32; Karen B. Brown, *Transforming the Unilateralist Into the Internationalist*, *in* TAXING AMERICA 214 (Karen B. Brown & Mary Louise Fellows eds., 1996) [hereinafter "Brown, Transforming"].

Analyzing the rules involved in international tax arbitrage transactions in light of the underlying policies discussed above, the rise of international tax arbitrage and the difficulties in addressing any particular international tax arbitrage transaction becomes more apparent.

For example, the international tax rules of the United States (referred to as the "Subpart F" rules due to the subpart of the Internal Revenue Code in which they are located) adopt a hybrid international tax regime in which passive income earned in a foreign jurisdiction is subject primarily to a CEN current inclusion regime, while active income earned in a foreign jurisdiction is subject (effectively at the election of the taxpayer) to a CIN regime. In general, under Subpart F, passive income earned by a foreign subsidiary controlled by a United States taxpayer is generally subject to a CEN regime, in which the income is included currently in the gross income of the United States taxpayer, while active income of such a subsidiary is generally subject to a CIN policy deferring inclusion of the income until it generates passive returns or is repatriated to the United States. Income earned abroad by a "flow-through" entity, such as a partnership or a branch, owned by a United States taxpayer is subject to a pure CEN regime, in which such income is always included currently in the gross income of the United States taxpayer, regardless of its character as active or passive.[42]

The rules used to implement the Subpart F regime (and thus effectuate its implicit compromises) are generally those applicable to domestic transactions, however, which

[42] Subpart F thus represents a compromise between the policies of CEN and worldwide horizontal equity, on the one hand, and CIN and international vertical equity on the other. The debate at the time Subpart F was enacted reflected this tension, with supporters of worldwide efficiency supporting a pure CEN approach and business arguing that a pure CEN approach would disadvantage them as compared to local competitors in the expansion of United States business worldwide. *See* Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 328 - 331 (2005) [hereinafter "Avi-Yonah, All of a Piece"].

were enacted in the context of a closed system. For example, the rules for measuring the amount of income, the timing of income, entity classification, and other similar issues in applying the anti-deferral rules of Subpart F are for the most part those established for the domestic tax regime. Because of the differences in the underlying policies between domestic and international tax regimes, however, it does not necessarily follow that complying with United States domestic tax rules will necessarily further the policies of Subpart F.

This phenomenon manifested itself in the DRC transaction. Under the international tax rules of the United States, at most only a portion of the income of the DRC earned abroad was taxed in the United States, due to the ability to defer under Subpart F the presence of a foreign tax credit or both. This decision to impose a tax on only a portion of the income of the DRC represented a policy choice of the United States international tax regime, assuming an open system, to further worldwide efficiency considerations (i.e., double taxation relief and a partial CEN-type regime). The international tax arbitrage arose because the DRC, like all domestic companies, was permitted to utilize in full the interest deductions generated at the DRC against all of the income of the DRC (and its related corporations) under the United States domestic consolidated group rules. These rules were enacted as "domestic" tax rules, assuming a closed system in which it was deemed appropriate to permit taxpayers to treat certain related corporations as if they were divisions of a single corporation (to more accurately reflect the economic income of the group), independent of the policies supporting the treatment of the international income of the DRC. By combining these rules, however, the DRC international tax arbitrage opportunity arose.

A similar phenomenon manifested itself in the double-dip lease transaction. Under a double-dip lease, taxpayers exploited the difference between the United States and foreign country in defining the "owner" of property for their respective tax purposes under the domestic tax system, which each adopted by weighing and balancing particular policy considerations.[43] This was important because the "owner" (and only the owner) of such property would be entitled to depreciation deductions with respect to such property, which itself represents a policy choice to more closely match taxable income with economic income within the closed system. The United States adopted a policy that focused primarily on the economic substance of a transactions, treating the taxpayer with the economic rights to property as the owner (to achieve neutrality as among similarly situated investors), while numerous other countries respect the legal title of the property (for administrative costs or other reasons). As a result of each country independently making different policy choices for its domestic tax definitions, however, taxpayers with internationally mobile capital were able to engage in international tax arbitrage.

This can also be seen in the hybrid entity transaction. As discussed in more detail below, in 1998 the United States adopted the "check-the-box" regulations permitting taxpayers (with some exceptions) to elect the tax treatment of legal entities. Although the check-the-box regulations were intended to further underlying policy goals of the closed system of the United States (including efficiency and administrative costs benefits), they also reduced the non-tax frictions (including the uncertainty risk) that prevented taxpayers from manipulating the entity classification rules to minimize taxes prior to their

[43] For a discussion of the factors in defining the owner of property for tax purposes, *see* Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U.L. Rev. 431 (2005)

adoption.[44] This was especially true in the case of foreign entities, where the check-the-box elections provided United States taxpayers the benefit of increased certainty with respect to the United States tax treatment of the foreign entity, regardless of how the entity was treated for purposes of the tax regimes of other jurisdictions. As a result, United States taxpayers could easily treat foreign entities differently under United States tax law than they did under foreign tax law simply by affirmatively electing to do so. The regulations thus made it easier and less costly for taxpayers to exploit different tax treatments of an entity in a foreign jurisdiction, opening the potential for the hybrid entity international tax arbitrage transactions to arise.[45]

As a result, difficult questions arise in light of international tax arbitrage transactions. For example, in the DRC transaction, should the United States abandon individual horizontal equity (by denying some corporations a deduction for the cost of borrowed funds based solely on whether a taxpayer is subject to the taxing authority of

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[44] Almost immediately after the check-the-box regulations were promulgated, their ability to be used for tax planning, and in particular their use in connection with international tax arbitrage, was identified by taxpayers. *See, e.g.,* Lowell D. Yoder, *International Taxation: Re-Thinking Check-the-Box, An Introduction*, 83 TAXES 27 (2005); Philip R. West, *Re-Thinking Check-the-Box: Subpart F*, 83 TAXES 29 (2005); Mary C. Bennett, *Whose Tax is it Anyway? Foreign Tax Credits in a Check-the-Box World*, 83 TAXES 35 (2005); Paul W. Oosterhuis, *Check-the-Box Planning in Cross-Border Transactions* 83 TAXES 43 (2005). For a general discussion, *see* Philip F. Postlewaite, *The Check-the-Box Regulations Turn Ten – Will We Survive Their Teen-Age Years*?, ___ J. Tax. G. Trans. ___ (forthcoming 2006) (manuscript on file with author).

[45] *See* Lee A. Sheppard, *Behind the Eight Ball on Check-the-Box Abuses*, 101 TAX NOTES 437 (2003); David S. Miller, *Snake in the Box: The Hazards of Policymaking With 'Anti-Abuse' Rules*, 89 TAX NOTES 107 (2000). *See also* OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY, 69 (Dec. 2000) [hereinafter "Subpart F Report"] ("Thus, the availability of tax avoidance techniques involving hybrids did not originate with the check-the-box regulations. However, the check-the-box regulations exacerbated the problem in three significant ways. First, they eliminated the uncertainty associated with applying the four factor test. This reduced the costs and risks associated with hybrid arrangements and thus greatly facilitated their use. Second, they focused attention on the use of hybrid arrangements. The result was a considerable increase in design and marketing efforts among tax planners that introduced hybrid planning techniques to mainstream taxpayers. Finally, and perhaps most importantly, the check-the-box regulations facilitated the formation of a new type of entity (or non-entity): an entity "disregarded as an entity separate from its owner" (often referred to as a "disregarded entity"). It is the disregarded entity that features prominently in a number of significant subpart F tax planning techniques").

another jurisdiction) in favor of increased worldwide efficiency? In the double-dip lease, should the United States reduce domestic efficiency (by adopting a legal title definition of "owner" rather than an economic substance based rule) to avoid the international tax arbitrage? In the hybrid entity transaction, should the United States negotiate with the other countries involved to harmonize their entity classification rules, and if so which country's policy should prevail? Should the United States favor worldwide efficient capital allocation (by denying the benefits of the check the box election and thus strengthening the anti-deferral rules of Subpart F) over the efficiency of its own economy (by denying the benefits of the check the box rules to United States taxpayers who engage in cross-border transactions)?[46] An analysis of some of the traditional proposed responses to international tax arbitrage in light of these policy tensions highlights the inherent difficulty in crafting a comprehensive response to international tax arbitrage.

III. Responses to International Tax Arbitrage

As demonstrated above, the international tax rules of Subpart F (adopted assuming an open system) and the domestic tax rules of residency and entity classification (adopted assuming a closed system), when used together, can result in international tax arbitrage. This result reflects not only a conflict between the laws of the United States and the host country, but also a conflict of the domestic and international regimes of the United States. The difficulty in crafting a response to international tax arbitrage transaction is that any response requires making choices between potentially

[46] If the United States unilaterally denied the benefits of a tax rule to its taxpayers in response to international tax arbitrage, there could perhaps be a short-term United States governmental revenue increase as a result. However, any short-term gains would likely only be transitional, and might well be offset by the long-term loss in economic efficiency and retaliation by other jurisdictions.

incompatible policies, both between the laws of the two countries involved and between the domestic and international tax regimes of the United States. Changing domestic tax laws may sacrifice domestic efficiency or equity, changing international tax laws may sacrifice worldwide efficiency or international equity, while doing nothing permits the arbitrage to proliferate.

A. International Tax Arbitrage and the Lack of Cooperation

Since the conflict of rules among countries is what leads to international tax arbitrage, cooperation between the countries involved to harmonize such rules is often proposed as an optimal response.[47] In this context, cooperation would provide for the relevant countries to agree to a single rule, resolving the conflict and the international tax arbitrage. Thus, cooperation necessarily requires one or both countries to compromise or change the initial rule that led to the conflict in the first place.[48] As discussed above, however, any change in the domestic tax rules of the United States in response to their use in international tax arbitrage necessarily sacrifices some or all of the originally intended domestic efficiency or equity benefits of those rules. This definite loss would be made in exchange for the more difficult to quantify benefit of mitigating the international tax arbitrage transactions, i.e., collecting the United States' potential share of the international tax arbitrage surplus. Stated another way, the costs of responding to

[47] *See, e.g.*, William B. Barker, *Optimal International Taxation and Tax Competition: Overcome the Contradictions*, 22 NW. J. INT'L L. & BUS. 161 (2002).

[48] *See* Ring *supra* note 4 at 89 ("Where there are competing judgments about the impact of particular rules, a coordination or harmonization effort may require countries to be persuaded about the likely advantages of the alternative rules.").

international tax arbitrage are immediate and definite, while the benefits are uncertain and indeterminate.

As a result, a country such as the United States has a strong incentive to keep its own domestic rules, even in the face of international tax arbitrage. This incentive acts as a disincentive to bilateral or multilateral cooperation as a means to harmonize international tax rules and thus eliminate international tax arbitrage.[49] In effect, the phenomenon of international tax arbitrage could be thought of as a form of international prisoner's dilemma as between the two countries involved; each country would benefit most from cooperation in the form of harmonized tax rules and increased tax receipts for both countries but, as in any prisoner's dilemma, each individual country (given imperfect information regarding the actions of the other country) has an incentive to not cooperate. For example, as applied to international tax arbitrage, if the United States sacrificed the benefit of its own domestic tax rules as a response to international tax arbitrage, it would be risking the "sucker" payoff, i.e., that the United States would sacrifice for a worldwide gain while other countries would not. Absent a worldwide supra-national taxing authority imposing cooperation or harmonization, the equilibrium in a world regime with such incentives provides for a lack of cooperation.

International tax is neither a one-time game nor a bilateral game, however. States react to each other, and change their behavior in light of the actions of other states. It is thus possible to construct a game in which one potential equilibrium is for international

[49] *See* Tsilly Dagan, *National Interests in the International Tax Game*, 18 VA. TAX REV. 363, 379 - 380 (1998) ("countries hold different views regarding the social role of income taxation, such as redistribution of wealth among the population, encouraging different sectors, or promoting certain activities. Coordinating the international rate of taxation might, therefore, prove an impossible task.").

cooperation, both on a limited and an absolute basis.[50] However, if one state acts in accordance with the belief that the game is not infinite, and thus that there can be an ultimate loser, the incentives for cooperation break down and the same result as in the one-time bilateral game, i.e., non-cooperation, returns.[51] Multilateral cooperation in the international tax context also suffers from a substantial commons (or "holdout") problem, i.e., as each additional country agrees to a multilateral solution to preventing international tax arbitrage it becomes increasingly beneficial to the remaining countries to holdout from the agreement.[52] In addition, even if these disincentives could be overcome, they might not justify any particular country expending the significant resources necessary to harmonize their tax laws on an international basis.[53]

Consistent with this theoretical equilibrium, in reality neither bilateral cooperation nor multilateral cooperation has generally proven effective in addressing the problem of international tax arbitrage.[54] Attempts to utilize international agencies to encourage or

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[50] *See* George Norman & Joel P. Trachtman, *The Customary International Law Game*, 99 A.J.I.L. 541, 549 - 551 (2005); Dagan *supra* note 49 at 379 – 382.

[51] In an international prisoner's dilemma game such as this, assuming a non-infinite iterative game with no supra-national body penalizing non-cooperation, the subgame perfect Nash equilibrium provides for non-cooperation. *See, e.g.* Norman & Trachtman, *supra* note 50 at 549 - 551; Paul G. Mahoney & Chris William Sanchirico, *Norms, Repeated Games, and the Role of Law*, 91 CALIF. L. REV. 1281, 1324 - 1326 (2003).

[52] *See, e.g.,* Susan Block-Lieb, *Congress' Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems*, 39 Ariz. L. Rev. 801 (1997).

[53] *See* Shaviro, Exploring *supra* note 13 at 329 ("achieving desirable coordination between countries' responses to cross-border tax arbitrage is not all that easy. The problem may have less to do with ineluctable disagreement between sovereigns, such as concerning the division of joint surplus, than with inattention, competing priorities, and domestic political considerations.").

[54] Although cooperation has not proven effective in general as a means to combat international tax arbitrage, more narrowly focused cooperation in specific contexts has been proposed as one potential response to specific types of international tax arbitrage transactions. *See* Kane, *supra* note 4 at 165 – 169 (advocating advance agreements among countries establishing procedures to address international tax arbitrage); Edgar, *supra* note 4 at 1142 – 1149 (advocating a unified source and classification regime to address hybrid entity and hybrid equity arbitrage transactions);.

promote harmonization or cooperation on issues such as tax residency, tax base, timing, and other similar issues have met with strong resistance given each particular country's strong preference for sovereignty over its own tax matters. Instead, the primary focus of attempts at international tax cooperation has been on information sharing and withholding tax rather than harmonization of domestic tax laws.[55] Along these lines, the United States, a country which should generally benefit from a vibrant harmonization regime as a means of combating international tax arbitrage, has generally opposed efforts by the OECD to harmonize tax rules among countries.[56]

B. Unilateral Responses to International Tax Arbitrage

Assuming the competing policy considerations between the domestic and international tax laws of the United States and those of other countries create a disincentive to international cooperation as a comprehensive solution to international tax arbitrage, unilateral responses must be considered as well. Several different unilateral responses have been proposed to address international tax arbitrage. Each response furthers one or more of the underlying policy considerations of the arbitrage transaction,

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[55] *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998) [hereinafter "OECD Harmful Tax Competition"]. For example, the treaty process between the United States and United Kingdom has proven more useful in certain "tie-breaker" situations involving the right to tax certain dividends, which tend to raise less complexities then other arbitrage situations involving generally applicable domestic rules such as the hybrid entity or hybrid equity transactions. *See* Edgar *supra* note 4 at 1152, n. 170 and accompanying text (discussing the "tie breaker" provision of the recently revised treaty for dividend taxes when both countries assert the jurisdiction to tax the dividend).

[56] *See* Akiko Hishikawa, *Note, The Death of Tax Havens?*, 25 B.C. INT'L & COMP. L. REV. 389, 413 (2002) ("the idea that any country or group of countries should interfere with another country's tax system, and the potential unfair treatment of non-OECD countries were cause for concern. The United States '[did] not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems.'").

but because of the tension in the underlying policy decisions implicit in the tax rules that led to the rise of the international tax arbitrage in the first place, each necessarily compromises one or more of the competing policy considerations. An analysis of the traditional responses to international tax arbitrage demonstrates these costs. [57]

i. No Reaction to International Tax Arbitrage

Under the first traditional response to international tax arbitrage, a jurisdiction should not act in response to its taxpayers engaging in international tax arbitrage transactions. Under this theory, no response is appropriate because taxpayers are complying in full with the laws of each jurisdiction; that the compliance leads to international tax arbitrage is irrelevant. This theory accepts international tax arbitrage as an inherent aspect of cross-border transactions in a world without a supra-national governing body available to impose harmonization of the tax rules among jurisdictions.[58]

[57] This discussion is limited to the responses to international tax arbitrage, as distinguished from tax competition, notwithstanding that at times they can appear similar. International tax arbitrage arises when individual taxpayers exploit conflicting legal rules of different jurisdictions in a manner to reduce the taxpayer's worldwide net tax liability. Tax competition arises from the intentional use of tax rates or special tax regimes by states, such as "ring fencing" and secrecy laws, to attract capital. Because international tax arbitrage and tax competition implicate different policy considerations, responses to tax competition generally will not necessarily be the same as responses to international tax arbitrage. *See, e.g.*, Ring, *supra* note 4 at 163-167 (discussing three primary differences between international tax arbitrage and tax competition); *but see* Edgar *supra* note 4 (advocating targeted cooperation in the corporate tax context as a response to both tax competition and international tax arbitrage).

[58] *See, e.g.*, H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the "International Tax System,"* 53 TAX L.REV. 137, 154-55 (2000) ("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."); *see also* Andriy Krahmal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, 5 Hous. Bus. & Tax. L.J. 98, 127 (2005) ("Finally, what the Treasury should do - and most likely will do - with respect to the proliferation of the tax arbitrage transactions, is nothing. It should do nothing because (1) they are not abusive from the tax point of view despite indications to the contrary, (2) they have positive business efficiency and economic effects, (3) they may not be deemed abusive unless specifically targeted by a legislation or administrative determinations, and (4) over time they came to be relied upon by the taxpayers to seek and obtain higher returns and desired risks characteristics.").

Under this theory, since the laws in place in each jurisdiction reflect the policy choices of each jurisdiction in balancing the efficiency and equity considerations important to that jurisdiction, any response by changing domestic laws to enforce foreign laws would be inappropriate. In particular, no one country has an interest in enforcing the laws of foreign jurisdictions by changing or limiting the scope of its sovereignty in application of its domestic laws, sacrificing tax revenues or foregoing domestic equity or efficiency benefits, to increase those of foreign jurisdictions.[59]

Several criticisms of this approach have been raised. Under one criticism, it has been contended that an international tax law based on a worldwide consensus – that income should be taxed once, no more and no less – should govern the conduct of countries in the tax arena.[60] Assuming that this international consensus rises to the level of international law, failing to react to international tax arbitrage contradicts the underlying premise of the international tax regime in violation of international law. Regardless of the relative merits of the argument that international tax law is binding on states,[61] it is not necessarily clear that the single tax principle in fact represents the consensus of nations.[62] Absent a distinct movement towards an international consensus on the single tax theory, it is difficult to use the single tax theory as a justification for the

[59] This approach implicitly assumes that states are rational actors that have unitary preferences that they seek to maximize when dealing with other states. As discussed below, this assumption has been criticized under a number of theories. *See infra* note 108 and accompanying text.

[60] Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 171 (2000) [hereinafter "Avi-Yonah, Commentary"]. Avi-Yonah proposes three normative justifications for this policy: (1) efficiency, (2) equity and (3) preventing revenue loss.

[61] *See* Norman & Trachtman, *supra* note 50 at 544- 549 (summarizing four separate approaches to the role of international law in the current international order).

[62] The presence of tax havens offering zero tax rates is one example of the failure of consensus, although there has been a movement to limit the ability to utilize tax havens as a means to avoid tax altogether in international transactions. *See* OECD Harmful Tax Competition, *supra* note 55.

United States to unilaterally change its domestic tax rules (and forego their underlying policy choices) in response to every international tax arbitrage transaction, regardless of the benefit (or lack thereof) to the United States.

Further, this approach does not take into account that the lost revenue arising from international tax arbitrage (and the resulting distributional impact) is not necessarily that of the foreign jurisdiction. Because international tax arbitrage can arise only from the overlap and conflict of the laws of two states, the loss of revenue represents a bilateral surplus in which either country could equally claim the lost revenue. The position that no response is appropriate in the context of international tax arbitrage results in the failure of either side to collect any of this surplus.[63]

In addition, commentators have noted that to the extent international tax arbitrage acts as an implicit tax subsidy for investment in a particular jurisdiction, it is inherently inefficient.[64] Under this recognition, countries should prevent the use of international tax arbitrage transactions to avoid such inefficiencies. Instead, if tax incentives or tax expenditures are desired, the country should adopt direct tax subsidies or incentives through changes in tax rates or similar mechanisms. Although a change in differential tax rates could have similar effects on the location of internationally mobile capital as

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[63] *See* Shaviro, Exploring, *supra* note 13 at 328 ("To date, double-dip leases present the opposite scenario. Neither the United States nor the foreign countries that base tax ownership rules exclusively on legal title have thus far sought to claim what is arguably free money on the table by denying duplicative deductions.").

[64] *See* Julie Roin, *Taxation Without Coordination*, 31 J. LEGAL STUD. 61, 75, n 44 (2002) ("No legitimate purpose is served when a U.S. company builds a car assembly plant in Ireland because it has figured out a way to pay taxes at an effective rate of 5 percent (rather than the statutory rate, applicable to Irish companies assembling cars in Ireland, of 15 percent) on its Irish operations by making use of arbitrage opportunities while Irish companies do the same in the United States, taking advantage of their own arbitrage opportunities. It is hard to see the economic or social benefits of maintaining a tax system that encourages cross-investment for its own sake and not because of some underlying economic or political advantage.")

international tax arbitrage, the incentive is open and transparent and thus the costs and benefits of maintaining the subsidy can be internalized by other countries and by taxpayers looking to benefit from such subsidies. The benefit is open to all taxpayers and not just those sophisticated enough to avail themselves of the "hidden" arbitrage opportunity. By removing the information asymmetry from the tax subsidy structure, the administrative costs are reduced and the use of tax subsidies, while inherently inefficient to some degree, becomes more efficient on a worldwide basis.[65] At a minimum, this analysis would suggest that non-response may not be appropriate in all circumstances, especially if the intent of a particular law was to increase worldwide efficiency, since such efficiency is undermined by the use of international tax arbitrage transactions.

ii. International Tax Arbitrage and Anti-Abuse

A second response to international tax arbitrage proposes that such transactions should be considered an abuse of the home jurisdiction's tax laws, and thus the tax benefits being claimed by the taxpayer in the home jurisdiction should be disallowed as a result. Under this theory, although a taxpayer has literally complied with the technical requirements of the home jurisdiction's law, they have done so in a manner that was inconsistent with the initial intent of the law (or at least in a manner not contemplated at the time the law enacted). Since the international tax arbitrage transaction does not

[65] A further benefit of this proposal is that such incentives become part of the broader tax competition debate. *See supra* note 57 and accompanying text.

comply with the purpose of the law, the resulting benefits in the home jurisdiction should be disallowed by the home jurisdiction.[66]

One difficulty in applying this theory is the scope of the national response. In part this difficulty arises because it is not always clear which "purpose" has been contravened such that a change is necessary.[67] The underlying purpose could be particular to a specific provision of domestic tax law, or it could be the "purpose" of the single tax theory of international tax law, or some other purpose. As a reflection of this uncertainty, two potential approaches in response to international tax arbitrage arise under this theory: (1) harmonize the home jurisdiction's underlying tax rule with that of the host jurisdiction that led to the rise of the international tax arbitrage in the first place, or (2) deny the specific tax benefit in the home jurisdiction for taxpayers who engage in transactions which take advantage of the international tax arbitrage.

Under the first approach, the home jurisdiction would unilaterally harmonize its rule with that of the host jurisdiction. This may in fact be the proper response if the home jurisdiction, upon reflection in light of the international tax arbitrage, decides that its domestic rule was wrong. This is not truly international tax arbitrage, however, but rather just poor domestic policy being rectified in light of better information.[68] Assuming

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[66] *See* sources cited *infra* notes 114 – 116; *see also* Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147, 172 (1996) ("The following questions are thus relevant to an analysis of cross-border arbitrage transactions: (1) Are the results in one jurisdiction dependent to any extent on the results in the other jurisdiction? (2) Is the U.S. tax rule that is being applied explicitly or implicitly premised on a particular tax treatment in the foreign jurisdiction?").

[67] *See, e.g.,* Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677, 702 (1996) ("Perhaps the most serious critique of purposivism is the problem of indeterminacy. According to this critique, since a statute may have more than one purpose, purposive analysis is unlikely to provide a definitive resolution to any case.").

[68] It is for these reasons that this article does not discuss criticisms of transactions that are often referred to as international tax arbitrage but in reality reflect poor tax policy of the home jurisdiction. For example, one criticism of international tax arbitrage transactions that exploit the deferral option under Subpart F is

that the home jurisdiction adopted the underlying rule for some particular domestic policy reason and continues to prefer that policy, the first approach would be disproportionate to the problem. A jurisdiction may not wish to adopt the underlying rule of a second jurisdiction, notwithstanding that it perceives the use of the underlying rule as abusive when used to generate tax savings through international tax arbitrage transactions, because the enactment of the rule represented a policy choice of the home jurisdiction. If each jurisdiction believes its rule is most efficient and/or equitable for its domestic transactions, then it would not want to change the rule completely solely because the rule is "abused" in a limited number of international tax arbitrage transactions. Thus, only the second approach would remain as a viable alternative, i.e., keep the general rule but disallow the benefits of the rule if, and to the extent, benefits are also available in a host jurisdiction.

There are several problems with this approach as well. One concern is that, unless the domestic tax benefit is disallowed for all cross-border transactions, it is difficult to make rational distinctions among different international investments. For example, it becomes difficult at the margins to draw the line between international tax arbitrage and other tax savings, such as low tax rates in a host country.[69] Further, any

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that the arbitrage in fact demonstrates a problem with Subpart F itself, which should be repealed and replaced with a flow-through taxation model. *See, e.g.*, Fleming & Peroni, *infra* note 89. This article assumes that international tax arbitrage arises as a result of the conflict between the tax regimes of two jurisdictions which, as a policy choice, each jurisdiction would prefer to maintain, all else being equal. If this is not the case, however, then harmonization or another response may be more appropriate.

[69] This principle has been expressed as follows:

> The task of identifying elements in another country's tax system that are a sufficient source of concern for otherwise available U.S. tax benefits to be limited or denied is difficult, time-consuming, and endless: It is hard to distinguish one form of arbitrage from another, to distinguish arbitrage in general from other tax minimization strategies, to distinguish tax benefits from other benefits that may be enjoyed outside the United States by persons related to the U.S. taxpayer. Moreover, the reasons for concern are murky; it seems

such response would tend to be over-inclusive, and violate horizontal equity, by applying one rule to domestic taxpayers and a different, less beneficial rule, to a large population of taxpayers engaged in cross-border transactions, solely to prevent a smaller subset of this population from engaging in international tax arbitrage.

A second concern is that the unilateral disallowance of a tax benefit in response to international tax arbitrage does not take into account potential responses from other countries. By definition, international tax arbitrage arises as a result of the difference in tax rules between jurisdictions. As a result, either jurisdiction could equally assert the right to collect the resulting foregone revenue. If one jurisdiction unilaterally denies a domestic tax benefit in response to an international tax arbitrage transaction deemed abusive, that jurisdiction is effectively collecting the foregone revenue. While this satisfies the desire to prevent the "abuse" of the international tax regime, it does so by collecting revenue at the expense of potential revenue to the other jurisdiction. Thus, unilateral denials of deductions for cross-border investments could rationally lead to retaliation among the various jurisdictions involved, potentially resulting in a reduction in total worldwide efficiency (due to the resulting double taxation) that could far exceed anything gained from preventing the perceived abuse.[70]

> justifiable only on the basis of a mysterious "international tax system" in which U.S. benefits are withdrawn, on general competitiveness and nondiscrimination grounds, by reason of benefits enjoyed in other jurisdictions with respect to tax (or other) rules having nothing to do with the United States. The attributes of deliberateness, parallelism, elegance, and lack of foreseeability by any one country do not add up to a tax policy.

Rosenbloom, *supra* note 58 at 154 (2000). *See also* Insop Pak, *International Finance and State Sovereignty: Global Governance in the International Tax Regime*, 10 ANN. SURV. INT'L & COMP. L. 165, 187-192 (2004) (summarizing the rise of worldwide mobile capital and interaction with state sovereignty as leading to cross-border arbitrage); Kane *supra* note 4 (distinguishing international tax arbitrage from other tax competition on the basis of "rule indifference").

[70] By unilaterally collecting a portion of the bilateral surplus, an international prisoner's dilemma game such as international tax arbitrage can be transformed into a chicken game, in which both parties have an

An example of this second approach to international tax arbitrage is the "dual consolidated loss" rule of IRC § 1503(d) enacted in response to the DRC arbitrage transaction. In enacting IRC § 1503(d), Congress responded to the use of DRCs as a means to generate deductions in multiple jurisdictions for a single economic cost by providing that a deduction that would otherwise be available to the DRC under the domestic tax rules for a given economic cost would be disallowed if a deduction for the same cost was taken in another jurisdiction. By disallowing the deduction for interest in the United States, but only to the extent a deduction for the interest was available in another jurisdiction, IRC § 1503(d) effectively removes the benefit of engaging in the DRC international tax arbitrage transaction. In exchange, however, United States taxpayers involved in a DRC transaction are denied the equity and efficiency benefits of the domestic consolidated group and interest deduction rules, and are subject to a complex and difficult to administer set of rules.[71]

Further, the enactment of IRC § 1503(d) exemplifies the line drawing problem of the second approach. For example, in general under this provision a United States

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incentive to retaliate even if it would result in a Pareto inferior result. *See, e.g.*, Eyal Benvenisti, *Collective Action in the Utilization of Freshwater: The Challenges of International Water Resources Law*, 90 Am. J. Intl. L. 384, 390 (1996). In the context of international tax arbitrage, this phenomenon has been described as follows:

> In sum, by responding unilaterally with deduction denial, the United States could be viewed as aggressively grabbing nearly all of the available joint surplus from a bilateral monopoly (involving the welfare gain that the countries can reap by coordinating their tax rules). Other countries might rationally expect to benefit from demanding a greater share of the joint surplus, even at the risk of destroying it all. Threats and chicken games are, after all, a common feature of bargaining over the division of surplus.

Shaviro, Exploring *supra* note 13 at 328.

[71] For a discussion of the history, development and administrative concerns of the current dual consolidated loss rules of IRC § 1503(d) and their proposed regulations, *see* Report of the Tax Section of the New York State Bar Association: Proposed Dual Consolidated Loss Regulations (December 21, 2005), available at 2005 TNT 245-14.

taxpayer is disallowed an interest deduction in the United States to the extent a deduction is available in the United Kingdom, but the same taxpayer would not be disallowed an interest deduction in the United States if instead of investing in the United Kingdom the taxpayer had invested in Ireland to take advantage of low corporate tax rates available in Ireland. Assuming a worldwide regime which respects the sovereignty of countries to enact their own internal tax laws, and especially their own tax rates, the United States could not prevent other countries from simply adopting laws similar to those of Ireland to avoid the application of the anti-abuse rule as well.

In addition, as with any provision adopted under the second approach, IRC § 1503(d) does nothing to address the underlying conflict that led to the rise of the arbitrage transaction in the first place. Specifically, the underlying cause of the international tax arbitrage, i.e., the conflict between the United States residency rules and the host country's residency rules, remains, so that the DRC continues to be treated as a resident of both jurisdictions for tax purposes. Since the United States and the host country continue to have differing laws regarding the residency of entities, the potential for future international tax arbitrage transactions not subject to the narrow rules IRC § 1503(d) remains.

iii. Case-by-Case Response to International Tax Arbitrage

A third response to international tax arbitrage contends that, due to the intersecting and conflicting policy considerations and cost/benefits analysis involved in such transactions, the response to each arbitrage transaction should be determined only on a case-by-case basis.[72] Under this approach, the tax benefits deriving from the international tax arbitrage transactions should be disallowed only if, taking into account all of the facts and circumstances of a particular transaction, the transaction is contrary to the purposes of the tax laws and the intent of the parties was to abuse the tax laws. Among the factors that should be considered in making this determination include efficiency, equity, political accountability, revenue effects, administrability, sovereignty, and diversity.[73] Under this theory, due to the breadth and depth of the competing policy issues to consider in an international tax arbitrage transaction, the only appropriate response is a case-by-case analysis taking into account the particular considerations unique to the arbitrage at hand.

In applying the balancing test as opposed to the anti-abuse approach to the case of DRCs, the analysis becomes even more difficult. The response of Congress in enacting IRC § 1503(d) was based on a perceived worldwide efficiency concern that the presence of the international tax arbitrage would unduly influence non-United States entities to invest in the United States because they could receive a greater after-tax return than United States investors. Under the balancing test, however, this was not necessarily the correct approach. For example, Congress had no reason to believe that the subsidy for non-United States investors to invest in the United States was greater than the subsidy to United States investors to invest outside the United States.[74] Similarly, the enactment of IRC § 1503(d) resulted in precisely the type of retaliation that was the concern of

[72] *See generally* Ring, *supra* note 4.

[73] *See id.* at 135.

[74] *See* Kane, *supra* note 4 at 147 – 148 (proposing that the United States intentionally incurred this cost as a signal to other countries to avoid retaliation).

commentators. Soon after the enactment of IRC § 1503(d), the United Kingdom enacted a reciprocal provision. The net result was that it was possible for an investor subject to the rules of both the United States and the United Kingdom to have a loss disallowed in both jurisdictions, resulting in double taxation, contrary to any standard of worldwide efficiency or equity.[75] Were the costs of retaliation and loss of worldwide efficiency worth the benefit of denying the international tax arbitrage transaction?

The case-by-case approach identifies the inherent tension in the cost/benefit analysis and appropriately demonstrates that there may not be any single systematic response to international tax arbitrage as a result. Instead, it balances the costs and benefits of each specific transaction, taking into account a list of relevant, and at times conflicting, policy factors. The case-by-case approach does not propose to prioritize any one particular policy choice, but rather provides that each situation is unique, given the wide scope of the problem of international tax arbitrage throughout the tax laws of the United States and the multiple policy implications that arise as a result.[76]

IV. Harnessing the Costs of International Tax Arbitrage

A. Harnessing versus Traditional Approaches

[75] One striking fact in the IRC § 1503(d) experience is that the worst case scenario, i.e., the inability to cooperatively conform the tax treatment of DRCs and thus double taxation of such entities, occurred with the United Kingdom, a country with which the United States has had a bilateral tax treaty for over thirty years,.

[76] *See* Ring *supra* note 4; Kane, *supra* note 4 at 139 ("If it were the case that international tax arbitrage implicated the violation of some norm, one might rightly demand on the grounds of horizontal equity that government react consistently. But, as I have argued, international tax arbitrage does not implicate the violation, across the board, of any such norm … Thus, one will search in vain for valid generalizations about governmental behavior."). A corollary to the case-by-case approach is a more categorical approach, in which an ad-hoc response is considered appropriate for some categories of international tax arbitrage, while cooperation is more appropriate in others, due to each category's different characteristics. *See* Edgar *supra* note 4.

An inherent limitation in the traditional approaches to international tax arbitrage is that they each attempt to quantify and balance a number of different, and at times competing, policy considerations. Some emphasize sovereignty, some look primarily to worldwide efficiency, while others focus on domestic efficiency and administrative costs. The difficulty in making these judgments arises from attempting to compare costs incurred from changing a domestic tax rule against the costs of permitting the international tax arbitrage (either through explicit approval or through inaction). Because the efficiency and equity considerations involved in the domestic rule context and the international rule context differ from, and are at times inconsistent with, each other, a traditional tax policy analysis comparing, contrasting and balancing these considerations is difficult at best.[77]

Absent a harmonized international tax regime implemented and enforced by a world taxing authority,[78] what response to international tax arbitrage would be a better second-best solution? If international tax arbitrage implicates multiple norms and crosses

[77] In addition, the lack of available information to make such a judgment in the international tax arbitrage context makes the task that much more difficult. *See* Ring, *supra* note 4 at 136.

[78] Given the respect for sovereignty in the international tax area, it is likely that most national governments would oppose the creation of such a regime unless the rewards (in the form of recovered revenue that had been foregone as a result of international tax arbitrage) significantly outweigh these costs. *See* Roin, *supra* note 64 at 80-81 ("But the most important impediment to legislative acquiescence in a harmonization scheme comes from the probability that any such scheme would provide for the establishment of a new, international organization for the consideration of tax legislative proposals. In short, it would remove this area of responsibility--and political opportunity--from the purview of the pre-existing legislatures and entrust it to a newly formed institution."). *See also* Vaughn E. James, *Twenty-First Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen CARICOM Countries of Their Tax and Economic Policy Sovereignty*, 34 U. MIAMI INTER-AM. L. REV. 1 (2002).

all areas of the tax law,[79] perhaps there is no one single second-best solution to international tax arbitrage.[80]

One response, fully denying the international tax arbitrage, sacrifices the underlying policy that the domestic tax rule was initially enacted to promote, and runs the risk of retaliation by host countries. Another response, fully permitting the international tax arbitrage, incurs the entire costs of the arbitrage on a worldwide basis, including loss of domestic tax revenue and distortions to international capital mobility. As a result of this tension, much like the choice between CEN and CIN,[81] there is no costless response to international tax arbitrage.[82]

The case-by-case response recognizes this, and proposes that the law partially permit and partially disallow the international tax arbitrage on a case-by-case basis, so as to limit the number of participants and thus reduce the costs of each particular international tax arbitrage transaction to the extent possible.

The harnessing approach differs, however, by accepting these costs as a necessary result of the conflict of internal and external policies of the United States, absent a worldwide taxing authority imposing harmonization.[83] From this perspective, if the

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[79] *See* sources cited *supra* note 76.

[80] *See* Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189, 1205 (1989) [hereinafter "Shaviro, Selective"] ("The theory of the second best questions the achievement of optimality through piecemeal reform, calling into doubt any approach other than the global removal of distortions. Its prescriptive implications are far less clear. At a minimum, it entails a highly fact-specific analysis. Moreover, especially given limited or imperfectly quantifiable data, it suggests that often there is no single second-best solution, but rather a range of possible approaches.")

[81] *See* Graetz & O'Hear, *supra* note 2.

[82] The case-by-case approach to international tax arbitrage recognizes this tension, but concludes that no systematic response is possible. *See supra* note 76 and accompanying text.

[83] *See* Anthony C. Infanti, *Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the U.S. International Tax Regime*, 35 VAND. J. TRANSNAT'L L. 1105, 1233 (2002) ("by shifting

arbitrage cannot be fixed without the United States incurring costs, can such costs be affirmatively captured and utilized for some other purpose?

Harnessing the costs of the international tax arbitrage does not necessarily seek to minimize or balance costs (although at times that may occur), but instead tries to channel and redirect the costs in a preferred manner so as to accomplish other policy goals. Rather than try to quantify and balance competing and potentially irreconcilable costs and benefits, this approach assumes some minimal level of costs due to international tax arbitrage are inherent, absent a supra-national tax authority imposing worldwide harmonization. Under this assumption, at times a better second-best solution than the traditional approaches could be to harness these costs and direct them to further other policy goals rather than attempt to balance costs (such as domestic efficiency versus worldwide efficiency) that are inconsistent, at best, and conflicting at worst.

What other policy goals not currently addressed in the United States tax regime could be achieved through a response to international tax arbitrage? Because international tax arbitrage is a creature of the current international legal regime, one possibility would be to harness its costs to benefit those countries that have not historically benefited from such regime, i.e., developing countries. In other words, perhaps international tax arbitrage could be harnessed to promote international vertical equity.

How can international tax arbitrage be utilized to promote international vertical equity? International tax arbitrage acts as an implicit tax subsidy. Under the current

from a national to an international perspective, a more holistic approach to reform is fostered, which may allow both the burdens created by the internal and external complexity of the U.S. international tax regime to be addressed and, perhaps, remedied.”).

system, this subsidy is available for investments made in any country with tax rules that conflict with those of the United States, whether accidentally or strategically. The principles of international vertical equity, as applied to international tax arbitrage, would provide that this implicit tax subsidy should be affirmatively used to explicitly subsidize investment only in developing jurisdictions, by permitting the arbitrage in such countries, and disallowing the arbitrage in all other jurisdictions.[84] This is the principle of harnessing the costs of international tax arbitrage; by explicitly permitting international tax arbitrage transactions in certain jurisdictions but not in others, the United States would subsidize its taxpayers to pursue investment in "eligible" jurisdictions.[85]

In the past, proponents of inter-nation or international vertical equity have supported several proposals that target tax benefits directly to developing countries. For example, under one proposal generally referred to as "tax sparing" the United States would exempt income earned in developing countries from United States taxation altogether. Under another proposal, the United States would adopt a CIN-type policy for income earned in developing countries while continuing a CEN-type policy for income earned elsewhere.

These proposals were intended to use the international tax rules of the United States to encourage foreign direct investment (FDI) in developing countries. Proponents

[84] Differentiating on a jurisdictional basis is not novel in the United State tax laws. For example, IRC § 901(j) denies a foreign tax credit to United States taxpayers for income taxes paid to certain "ineligible" countries, including countries that the Secretary of State has designated as supporting acts of international terrorism. IRC § 901(j)(2)(A). *See also* H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 Brook. J. Int'l L. 1525, 1544 (2001) ("tax policy addressing foreign income earned by residents can and should contain means of distinguishing between jurisdictions.").

[85] *See, e.g.,* Joosung Jun, *U.S. Tax Policy and Direct Investment Abroad*, *in* TAXATION IN THE GLOBAL ECONOMY 55, 58-59 (Assaf Razin & Joel Slemrod eds., 1990) ("Tax policy can influence the decision of investment location by affecting the relative net profitability between different countries.").

of this approach contend that FDI stimulates growth not only from the direct benefits of investment, but also from positive "spillover" effects such as infrastructure development, worker training, increased tax base, and other similar benefits.[86]

One method for developing countries to attract FDI would be to dramatically reduce tax rates imposed on businesses operating in their country. The problem with such an approach is that, for investors subject to a CEN regime in their home country, regardless if the tax rate in the host country is lower than that in the home country, the investor would always pay a net worldwide tax equal to the tax rate in the home country.[87] Since CEN-type regimes in developed countries reduce the ability of developing countries to utilize low tax rates as a means to encourage FDI, developed countries could further international vertical equity by adopting CIN-type regimes or exempting such income from tax altogether.[88] Both tax sparing and targeted CIN, however, by definition incur worldwide efficiency costs (as opposed to the current CEN-type policy of the United States and most other developed countries) precisely because they are intended to distort investment behavior in favor of developing countries. As a result, such proposals have been strongly criticized.[89]

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[86] *See* Yoram Margolioth, *Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries*, 23 VA. TAX REV. 161 (2003).

[87] *See supra* note 30 and accompanying text.

[88] For this reason, tax sparing had been adopted by some countries in the past. Due to its significant worldwide efficiency costs and potential for abuse, however, the use of tax sparing has generally fallen into disfavor in the international tax community and its use has dropped significantly. *See, e.g.,* Deborah Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 Can. Tax J. 879 (2001).

[89] *See, e.g.*, J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557, 1576 (2005) ("Some commentators argue that adoption of an exemption system is necessary to allow developing countries to use tax holidays to attract badly needed foreign investment … If the United States desires to provide badly needed financial assistance to those developing countries that are acting responsibly in terms of human rights, the rule of law, nonaggression toward neighbors, and other similar issues (a worthy objective of U.S. foreign policy),

The analysis changes, however, once the costs of responding to international tax arbitrage are taken into account. The equity benefits of promoting or subsidizing investment or growth in developing countries supported by international vertical equity remain.[90] The offsetting costs, usually considered too great to justify the benefits, are no longer incremental, however. Rather, since any response to international tax arbitrage necessarily incurs costs, it may be possible to structure a response to international tax arbitrage that furthers international vertical equity at little marginal cost to either the worldwide tax system or that of the United States.[91]

Returning to the DRC example, the response of Congress to the perceived impermissible use of one economic cost (i.e., interest payment) as a "double" deduction in two jurisdictions was to deny the use of a deduction for interest in the United States to

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bilateral negotiations leading to treaty-based U.S. tax-sparing benefits for those particular countries is a more focused and hence better approach than an exemption system that would indiscriminately benefit all low-tax countries no matter how prosperous, oppressive, or hostile they might be. In the alternative, tax expenditure analysis would support using targeted direct grants in lieu of an indirect and unfocused tax subsidy in the form of an exemption system."); Robert J. Peroni, *Response to Professor McDaniel's Article*, 35 GEO. WASH. INT'L. L. REV. 297 (2003); J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: An Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001).

[90] For a discussion of the benefits of international vertical equity, see Brown, Missing Africa, *supra* note 40; Brown, Transforming, *supra* note 41.

[91] In this respect, the proposal is similar to the traditional debate between equity and efficiency in crafting tax policy, while recognizing that the variables implicated in international tax arbitrage are different from those in the purely international or purely domestic context. Stated another way:

> the concept of inter-nation equity can be given practical meaning in the design of international tax rules if it is interpreted as embodying explicit redistributive goals. More specifically, when a choice is presented between two otherwise comparable alternative rules, one of which has progressive and the other regressive implications for the division of the international tax base between poorer and richer countries, the progressive rule should be explicitly preferred to the regressive one. In the absence of a world taxing authority that can redistribute tax revenues directly, and given the paucity of foreign aid from developed to developing countries, such a concept of inter-nation equity has the best chance of achieving meaningful distributive goals.

Avi-Yonah, Globalization *supra* note 39 at 1650.

members of the DRC's consolidated group of corporations under IRC §§ 1501 – 1504 to the extent a deduction for the same expense was taken in a foreign jurisdiction. Congress effectively sacrificed the domestic efficiency and equity policy benefits of the domestic rule (i.e., treating the group of corporations as if they were divisions of a single corporation) to further worldwide efficiency. In enacting IRC § 1503(d) the United States collected the foregone revenue from the international tax arbitrage by imposing higher taxes on its taxpayers, at the expense of decreased tax revenue for the other jurisdiction. As to be expected, this resulted in retaliation (in this case, by the United Kingdom which enacted a similar law). Although the United States response was effective in preventing the specific international tax arbitrage transaction, it did so at the cost of denying the benefits of a domestically efficient law to United States taxpayers, reducing worldwide efficiency benefits and incurring the costs of retaliation, while failing to remedy the underlying cause of the arbitrage.

Alternatively, under the harnessing approach, IRC § 1503(d) would be amended such that its rules disallowing an interest deduction in the United States would apply only if a deduction for the same expense was taken in a developed country. For such deductions taken in developing countries, however, the international tax arbitrage transaction would remain available. In effect, the implicit subsidy in the international tax arbitrage transaction would remain, but only for investments made in developing countries.

B. Benefits of Harnessing the Costs of International Tax Arbitrage

In many ways, the harnessing proposal is similar to tax sparing or targeted exemption proposals, which have generally been dismissed as incurring too great a cost to justify the benefit.[92] The difference in the international tax arbitrage context, however, is that since costs are already in the system, the cost/benefit analysis changes significantly. Even at little marginal cost, however, it is necessary to analyze the benefits of the harnessing approach so as to undertake such an analysis, and determine if harnessing is the appropriate response in any particular circumstance.[93]

Harnessing the costs of international tax arbitrage provides several benefits. First, it serves to empower the United States to decide which countries should benefit from the costs of international tax arbitrage transactions, placing international vertical equity as a primary policy goal of at least a portion of the United States tax laws. Second, it serves to empower developing countries (relative to the current system) to establish their own policies on the use of tax incentive structures as a means to encourage investment. Third, it could serve to foster international cooperation on issues of international tax arbitrage and perhaps further the first-best solution of international tax cooperation and harmonization.

Under the current system, sophisticated taxpayers have an incentive to engage in international tax arbitrage transactions, but in which jurisdiction a taxpayer does so is left entirely to the taxpayer's discretion. Taxpayers are able to strategically choose in which country to invest so as to maximize the benefits of the arbitrage. As a general matter,

[92] *See* Brown, Missing Africa *supra* note 40; McDaniel *supra* note 41 at 292 – 293.

[93] As with any subsidy, the harnessing approach will not necessarily be appropriate in all cases; depending on the circumstances, the traditional responses may be sufficient, a fundamental change to the underlying United States domestic tax law may be appropriate or cooperation or harmonization in a particular area may arise. *See* sources cited *supra* note 4.

developing jurisdictions in which the arbitrage transaction would be available have higher non-tax frictions (in the form of less developed infrastructure and legal regimes, resulting in administrative and uncertainty costs) than developed countries in which the arbitrage is also available. These higher costs limit the attractiveness of making the international tax arbitrage transaction in developing countries as opposed to developed countries. As a result, the benefits of international tax arbitrage are generally disproportionately derived by developed countries.

Further, under the current system, whether a particular jurisdiction benefits from the tax subsidy implicit in the international tax arbitrage depends solely on whether a jurisdiction adopts a tax rule that conflicts with those of the United States. Any individual country could thus strategically adopt tax policies conflicting with those of the United States solely to take advantage of this, to make the country more attractive to foreign investment from the United States, as retaliation for other policies or otherwise.[94]

Unlike the current system in which a foreign country could strategically adopt the arbitrage, the harnessing approach provides the United States with the authority to determine whether and to whom the benefits of the international tax arbitrage should be available as a matter of domestic policy. Further, targeting international tax arbitrage to developing countries changes the incentives to United States taxpayers by granting certainty of the benefits of the international tax arbitrage transaction only for investments in developing countries, partially offsetting the comparative disadvantage that developing countries face in attracting foreign capital investment. Conversely, international tax

[94] It has been proposed that this is in fact what countries do in response to international tax arbitrage because the use of international tax arbitrage as a subsidy is less transparent than direct tax competition and thus less likely to incur retaliation. *See* Kane, *supra* note 4 at 143-144.

arbitrage transactions in developed countries would increase in uncertainty (if the law was silent or adopted a subjective or case-by-case approach with respect to such jurisdictions) or would be disallowed altogether (if the law adopted a blanket disallowance of the benefits with respect to such jurisdictions). Which approach should be taken would depend on the particular efficiency, equity and administrative costs considerations of the particular arbitrage transaction. Regardless, either approach would increase the relative attractiveness of the developing countries as the location of foreign capital investment. International vertical equity would thus play a primary role in the United States tax law, potentially acting to reshape worldwide norms regarding the benefits of international vertical equity in the international tax regime.[95]

Harnessing would also help minimize the administrative and other costs incurred by the United States in policing international tax arbitrage transactions. The majority of perceived "abusive" international tax arbitrage transactions have tended to be made primarily in developed countries, presumably because developed countries reduce the non-tax costs of regulatory and uncertainty costs. These transactions seem abusive primarily because taxpayers seek out the most beneficial jurisdiction in which to make such investments, solely to take advantage of the international tax arbitrage. In other words, such transactions (including the location of the investment) are solely tax motivated. Targeting the international tax arbitrage transactions to developing countries

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[95] *See, e.g.*, James Salzman, *Creating Markets for Ecosystem Services: Notes From the Field*, 80 N.Y.U.L. Rev. 870, 947 (2005) ("Laws clearly can influence norm formation. As Carol Rose has explained, 'our laws are not just our controllers, but our teachers. For better or worse, normative or hortatory lessons are embedded in our laws, and we need to think about the education they impart when we adopt legal institutions to manage resources' … ") (citing Carol M. Rose, *Rethinking Environmental Controls: Management Strategies for Common Resources*, 1991 DUKE L.J. 1, 38); Peter H. Huang & Ho-Mou Wu, *More Order without More Law: A Theory of Social Norms and Organizational Cultures,* 10 J. L. Econ. & Org. 390 (1994).

specifically to act as a tax subsidy for investment in such jurisdictions removes this concept of abuse, without having to divine the subjective intent of a taxpayer or incur the substantial attendant administrative costs of doing so, because the subsidy would be affirmatively embraced for developing countries and disallowed for developed countries.

Finally, targeting international tax arbitrage transactions provides the one thing that is missing in most responses to international tax arbitrage: certainty. United States investors already undertake international tax arbitrage transactions under current law, but must accept the uncertainty of the benefits of the arbitrage (either under an anti-abuse or case-by-case approach) to do so. The harnessing approach directly benefits United States investors by providing certainty of the benefits of international tax arbitrage, but only in exchange for investing in certain jurisdictions. Thus, the net present value of the tax benefits from international tax arbitrage would be increased by the certainty of the availability of such benefits, at least in the initial years. Although United States investors would no longer have the opportunity to undertake international tax arbitrage in preferred developed jurisdictions, and thus would incur some transaction costs by investing in less stable developing countries, the net present value of this detriment could be offset by the net present value benefits provided by the certainty of the availability of the tax benefits provided for investments made in eligible jurisdictions. Further, to the extent risk aversion serves to prevent investment that would have been made in developing countries in an ideal market, harnessing could serve to increase worldwide efficiency to the extent it serves to offset this distortion in economic behavior.

Second, harnessing the international tax arbitrage serves to empower developing countries to determine their own tax policy, at least relative to the current worldwide tax regime. By permitting United States investors to undertake arbitrage transactions in developing countries, such countries could strategically decide whether to adopt rules that create the arbitrage (and thus the subsidy) or alternatively to harmonize with the United States based on their own policy and political preferences. Under the current United States tax regime, such countries generally do not have the power to unilaterally implement such policies with respect to United States taxpayers because, even if they do strategically enact a conflicting rule to create an international tax arbitrage opportunity, the non-tax frictions prevalent in developing countries as opposed to developed countries act as a strong limit on the benefit of the arbitrage to potential investors.

Under the current United States tax regime, it is difficult for developing countries to attract FDI from the United States solely through the use of tax incentives or low or zero tax rates.[96] For example, a developing country wishing to attract foreign investment through tax incentives[97] (such as low or zero corporate tax rates) will have limited success in attracting investors from countries such as the United States because any tax

[96] This does not necessarily hold true in two circumstances: first, this is generally less true for foreign portfolio investment than for foreign direct investment, especially for investors such as hedge funds which pool capital from multiple jurisdictions and thus are less sensitive to any particular tax regime, second, this is generally less true for foreign direct investment that would have been made for non-tax reasons in the jurisdiction anyway, such as FDI made in the European Union, which will often be held through tax preferential jurisdictions in the EU such as Ireland or the Netherlands.

[97] Not all jurisdictions may wish to do so. A debate exists over whether and how developing countries could or should use tax rules to attract foreign investment. One position argues that all foreign investment, both direct and portfolio, generates growth and revenue for the host jurisdiction, and thus developing countries should try to attract any foreign investment. Under this theory, even minimal tax revenue, infrastructure improvements, jobs or economic growth resulting from foreign investment of any kind is marginally beneficial to the host jurisdiction. A second position argues that only FDI, as opposed to foreign portfolio investment, is beneficial for a host country because of the positive spillover effect of direct investment. A third approach is that foreign capital investment is not necessarily beneficial to developing countries at all, arguing that foreign investment only exploits the resources of such countries and extracts economic rents solely for the benefit of the owners of the capital. *See, e.g.,* Avi Nov, *The "Bidding War" to Attract Foreign Direct Investment: The Need for a Global Solution*, 25 VA. TAX REV. 835, 867-871 (2006); Margolioth *supra* note 86. Developing countries currently are not able to choose any of these alternatives with respect to taxpayers subject to a CEN-type regime in their home country, however.

savings achieved by investing in the host jurisdiction that adopted a tax preference would immediately be offset by the current taxation of that income in the United States under the partial CEN regime embodied in Subpart F.[98]

Contrast this to a regime in which the United States unilaterally targets an international tax arbitrage transaction to a particular host jurisdiction as a means to subsidize and stimulate investment in such jurisdiction. The host jurisdiction would now have the power to choose whether to adopt policies to encourage or discourage foreign investment. If the host jurisdiction wanted to maintain the implicit investment incentive, it could simply do nothing and continue to permit the international tax arbitrage investment to be made. If the host jurisdiction did not wish to provide incentives to foreign investment in such jurisdiction (or at least not through the means of international tax arbitrage), it could respond by unilaterally conforming its tax rules to those of the United States, thus removing the arbitrage and the foreign investment incentive. Alternatively, if the host jurisdiction did not wish to change its domestic law for domestic policy reasons, it could approach the United States to negotiate on a bilateral basis to remove the arbitrage through other means, including by having the United States remove the jurisdiction from the eligible list of arbitrage jurisdictions, or by entering into a bilateral treaty between the jurisdictions to provide for a negotiated consistent rule. Under any of these approaches, the unilateral act of targeting the international tax arbitrage to a specific country would empower that country to make its own policy decisions on whether and how to attract foreign investment through its domestic tax rules.

[98] *See supra* note 30 and accompanying text. Numerous commentators have noted this phenomenon and suggested different responses to empower developing jurisdictions, including tax sparing, targeted CIN and others. *See* sources cited *supra* note 41.

Another benefit of unilaterally harnessing and targeting the costs of international tax arbitrage is that it could serve to change the current incentives in the worldwide tax regime from those that further the rise of arbitrage transactions and non-cooperation, to one that furthers worldwide cooperation and harmonization, potentially leading to a long-term first best solution. Currently, particular countries may, and some have argued in fact do, strategically adopt tax policies that conflict with those of the United States solely to take advantage of the international tax arbitrage (to make the country more attractive to foreign investment from the United States, as retaliation for other policies or otherwise).[99] Further, as discussed above, the United States has an incentive to keep its own tax rules rather than cooperate with other countries to eliminate the arbitrage through harmonization. The combination of these incentives under the current worldwide regime is not only contrary to promoting the first-best solution of a harmonized worldwide tax regime, but serves to further a long-term equilibrium of non-cooperation.[100]

Harnessing the costs of international tax arbitrage could serve to change these incentives, and thus potentially alter the long-term equilibrium to one of mutual cooperation and harmonization. Under the current system, countries have little incentive to engage in bilateral or multilateral cooperation, resulting in equilibrium of non-cooperation. Under a harnessing approach, however, if a particular jurisdiction or jurisdictions desired to be included or excluded from the eligible list of the United States, they would have to approach the United States to discuss and negotiate the issue. The opportunity costs of not broadening the discussion to other tax issues among the countries

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[99] *See* Kane, *supra* note 4 at 143-144.

[100] *See supra* note 51.

increases significantly after negotiations between two or more countries on international tax issues has already begun. Thus, at a minimum, such discussions would at least begin a larger dialogue of the proper taxation of internationally mobile capital among the individual countries.[101]

More specifically, this approach could begin a discussion with developing countries on the role of the international tax regime to promote development, countries with which the United States historically has not had tax treaties,[102] in part due to the unwillingness of the United States to consider the use of "tax sparing" or other provisions to benefit such countries. Although not a tax sparing provision, harnessing international tax arbitrage could serve to further similar interests and thus potentially break this historic impasse that has prevented even discussions regarding tax treaties between the United States and developing countries.

For countries on the non-eligible list, which would no longer be eligible to engage in the international tax arbitrage, the possibility of retaliation rather than cooperation might appear to remain relevant for such countries.[103] This is not necessarily the case,

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[101] *See* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 306 (2003). The development of a new international tax paradigm through discussion and negotiation on a worldwide basis, and potentially through organizations such as the OECD, would likely be more attractive to individual countries and effective than the prospect of a single worldwide body imposing uniform tax rules. *See* OECD Harmful Tax Competition, *supra* note 55; *see also* Arthur J. Cockfield, *The Rise of the OECD as Informal 'World Tax Organization' Through National Responses to E-Commerce Tax Challenges*, 8 Yale J. L. & Tech. 136 (2006).

[102] *See* Brown, Transforming*, supra* note 41, at 225 ("The failure of the United States to accept the tax sparing credit has derailed many developing country treaty negotiations.").

[103] Retaliation by a host country through the tax laws is intended to impose marginal costs on citizens of the home country so as to encourage them to petition their government to change the offending provision. *See* Derek Devgun, *International Fiscal Wars for the Twenty-First Century: An Assessment of Tax Based Trade Retaliation*, 27 LAW & POLICY INT'L BUS. 353, 386 (1996) ("the retaliating jurisdictions use of [tax based retaliation] is directed essentially at pressuring the target jurisdiction's government to change its behavior, by using the taxpayers in question, whether domestic or foreign, as unwilling intermediaries to achieve its end.").

however. In a multi-party infinite game such as international tax, unilateral actions that are not purely one-sided, but rather promote some worldwide benefit, could serve to transform the incentives and lead to a more cooperative equilibrium.[104] For example, by the United States foregoing from collecting a portion of the bilateral surplus at stake in international tax arbitrage, other developed countries would no longer have an incentive to retaliate solely to prevent the United States from achieving a relative gain at their expense; rather, such countries could instead focus on maximizing absolute worldwide gain, which at times could be achieved through harmonization.[105] Further, changing the United States tax law in this manner could serve an expressive function, potentially overcoming the collective action problem inherent in the current international tax regime which obstructs the rise of mutual cooperation.[106]

Traditionally, retaliation has been considered a rational reaction to perceived one-sided state actions (such as the unilateral collection of a bilateral surplus). Conversely, retaliation is generally expected to be lower in response to actions that are perceived to be

[104] For example, it might be possible for the United States to utilize harnessing to create a perception of fairness in the issue of international tax arbitrage that could positively influence the behavior of other countries in response, changing the subgame perfect Nash equilibrium from mutual non-cooperation to mutual cooperation. *See* Matthew Rabin, *Incorporating Fairness into Game Theory and Economics,* 83 Am. Econ. Rev. 1281 (1993) (describing how a first-mover in an iterative game may be able to cause a second player to regard the first-mover positively); William Robert Nelson, Jr., *Incorporating Fairness into Game Theory and Economics: Comment*, 91 Am. Econ. Rev. 1180 (2001) (noting that perceived fairness may have a greater impact on games involving very large stakes).

[105] *See, e.g.*, Joseph Grieco, Robert Powell and Duncan Snidal, *The Relative-Gains Problem for International Cooperation,* 87 Am. Poli. Sci. Rev. 729 (1993); Duncan Snidal, *Relative Gains and the Pattern of International Cooperation*, 85 Am. Poli. Sci. Rev. 3 (1991).

[106] *See, e.g.,* Mahoney & Sanchirico, supra note 51; Cass R. Sunstein, *Law, Economics & Norms: On the Expressive Function of Law*, 144 U. Pa. L. Rev. 2021, 2029 (1996) ("Many social norms solve collective action problems. Some of these problems involve coordination; others involve prisoner's dilemmas. Norms solve such problems by imposing social sanctions on defectors."); Huang & Wu *supra* note 95 at 404 ("The route by which laws create and maintain order is through the creation or alteration of social norms … decentralized order is accomplished by internalizing as social norms those laws that are just and perceived to be fair.").

for a common good (such as international vertical equity) than for what is perceived as purely one-sided strategic or economic gain.[107] As a result, in general, retaliation by other developed countries should be less likely in response to a harnessing approach to international tax arbitrage than other unilateral approaches. In addition, states react differently to different incentives depending on their appeal to different interest groups within the state, not all of which will support retaliation.[108] For example, by adopting the harnessing approach, the non-eligible country would provide its citizens with the same certainty benefits as the United States. Depending on the preferences of the dominant interest groups at issue, this benefit may result in further cooperation, rather than retaliation, by such countries.

Under either theory, rather than retaliate in response to the harnessing of the international tax arbitrage, non-eligible jurisdictions might have an incentive to further the perceived beneficial underlying purpose of promoting international vertical equity, either by joining in adopting policies that benefit eligible jurisdictions, or alternatively by approaching the United States to discuss the proper treatment of the international tax arbitrage on a worldwide basis.[109] Under this new paradigm, even if explicit

[107] *See, e.g.*, Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 103 (2003) ("[countries] can be counted on to contribute to collective goods … so long as they perceive that others are included to do the same.").

[108] Under this theory, a state in fact reflects no more than the sum of its constituent interest groups, each seeking to maximize its own interests, and using the state as a means to accomplish this in the international arena. *See, e.g.*, Enrico Colombatto & Jonathan R. Macey, *The Decline of the Nation State and its Effects on Consitutional and International Economic Law: A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 Cardozo L. Rev. 925 (1996).

[109] Although in a different context, the United States has in the past targeted the disallowance of certain tax provisions to United States investors investing in certain countries to further other policy objectives without incurring substantial international retaliation. *See* IRC § 901(j) (disallowing foreign tax credits for foreign taxes paid to countries with which the United States does not have diplomatic relations); IRC § 952(a)(5) (denying the deferral benefit under Subpart F for income earned in such jurisdictions).

harmonization did not arise, potentially a type of spontaneous harmonization could arise, in which jurisdictions, merely by reacting to the unilateral action of the United States, would begin to coalesce around a single worldwide tax policy.[110]

Even if countries did engage in retaliation, the retaliation would not necessarily lead to the same "race to the bottom" concerns that arise under the traditional responses to international tax arbitrage. First, any retaliation to the United States harnessing international tax arbitrage that was disproportionate would likely not be attractive to other jurisdictions; considering that the international tax regime is dynamic,[111] there would be nothing preventing the United States from counter-retaliating in response. The risk of such counter-retaliation could act as a significant deterrent to any disproportionate retaliation.[112]

Second, proportionate retaliation by developed countries (such as disallowing the same benefits under their tax rules for investments made in developed countries) may not be as problematic as retaliation under the current system. Rather, it could actually further the policy choice underlying the harnessing approach. To implement a proportionate response, the retaliating country would effectively adopt the policy of the United States by itself selectively disallowing the benefits of international tax arbitrage to developed

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[110] *See, e.g.*, Infanti, *supra* note 83; Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939 (2000) (supporting unilateral action by states as preferable to negotiated treaties as a means towards developing a worldwide consensus). Some have argued that this is in part may be what led to the current worldwide equilibrium in international tax. *See* Avi-Yonah, Commentary, *supra* note 60 at 169-170; Avi-Yonah, All of a Piece, *supra* note 42.

[111] *See* sources cited *supra* notes 50 – 51.

[112] For examples of counter-retaliation as a policy of the United States, see IRC § 896 (permitting the President to impose counter-retaliatory taxes on residents or corporations of a host country if such country applies discriminatory taxes against United States investors); IRC § 902(c) (permitting the President to allow foreign tax credits for certain taxes to citizens or subjects of a host country only and to the extent such country permits a foreign tax credit for similar United States taxes). *See also* Norman & Trachtman, *supra* note 50.

countries. Even if the overlap is not identical (for example, because the retaliating country has a different list of eligible countries), at a minimum the issues of international tax arbitrage and tax subsidies to developing countries would now be a part of the worldwide tax policy debate. Since the United States would have already affirmatively chosen to bear such costs to assist developing countries, any such retaliation could actually serve to increase the benefit of this policy choice to the extent the tax policy of other countries furthers such investment and development.

Harnessing the costs of international tax arbitrage provides immediate short-term benefits: it reduces the administrative costs of the policing the arbitrage, it furthers the policy of international vertical equity and it changes the incentives of other countries to strategically adopt laws to exploit the arbitrage. Perhaps even more importantly, however, it could serve to fundamentally reshape the debate. The affirmative use of international tax arbitrage by the United States would remove the issue from the shadows, changing the incentives from dividing a bilateral surplus to aiding developing countries. By placing the issue on the worldwide agenda, an even better response, such as harmonization, could arise.[113]

V. Harnessing International Tax Arbitrage: A Case Study

To more fully appreciate the implementation and analysis of harnessing the costs of international tax arbitrage, it is helpful to look to a case study. Due to its well developed history, one of the most useful case studies is the “check the box” entity

[113] *See, e.g.*, Kahan, *supra* note 107 at 103 (“the law can instead enlist … cooperation by furnishing us with grounds to trust one another to contribute our fair share to society’s needs.”); Norman & Trachtman, *supra* note 50.

classification regime in the realm of international transactions. The history of the check the box regime, its use in international tax arbitrage transactions and the rise and failure of governmental responses provides a useful lesson of the difficulties of addressing international tax arbitrage, and the benefits of the harnessing approach as an alternative.

As discussed above, the check-the-box regulations fundamentally altered the opportunities for international tax arbitrage under the present United States international tax regime. The ability to elect the United States tax treatment of businesses conducted through foreign entities undermined the implicit compromises in Subpart F. Because Subpart F applied a CEN regime to income earned through a branch or "flow through" entity and a CIN regime (except for certain passive income) to income earned through a foreign subsidiary, taxpayers were effectively able to choose which regime would apply simply by electing to treat their foreign subsidiaries as a corporation or a flow-through entity for United States tax purposes.[114]

Regardless whether United States taxpayers had any intent to evade any United States taxes (which they often did, but at times did not), by 1998 the IRS and Treasury believed that the underlying policy benefits of the check-the-box rules in such a circumstance should not be available to taxpayers because they violated the "spirit" of Subpart F by minimizing foreign taxes without paying an offsetting United States tax.[115]

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[114] In its study on Subpart F, the Office of Tax Policy recognized that the check-the-box regulations had fundamentally altered the underlying assumptions of Subpart F and, in connection with several other fundamental changes in the tax and business environments, required a fundamental re-thinking of the Subpart F regime. *See* Subpart F Report *supra* note 45. This approach reflects the possibility that such transactions were not international tax arbitrage at all, but rather a symptom that Subpart F represented the wrong policy choice for the United States international tax regime as an initial matter and thus should be changed. *See* Fleming & Peroni, *supra* note 89.

[115] Notice 98-11 announced that new regulations would be issued disallowing a check-the-box election in certain circumstances. According to the Notice:

What was unique was that the perceived abuse was the minimization of *non-United States* taxes without paying a corresponding tax *in the United States*, even though the United States taxpayer had fully complied with the check-the-box rules and all other domestic tax rules of the United States.

From 1998 – 2003, IRS and Treasury attempted several different approaches to address this perceived problem of the application of the check-the-box entity classification rules to Subpart F.[116] As to be expected, there was a significant uproar from the business community and from Congress regarding these proposals, partially on the basis that United States taxpayers would lose the benefits of the check-the-box rules in the international context.[117] As a result, Treasury and the IRS eventually withdrew their attempts to combat the check the box international tax arbitrage.[118] What was left

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> Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. Treasury and the Service will issue regulations to prevent the use of these types of hybrid branch arrangements. Regulations will provide that, when such arrangements are undertaken, the branch and the CFC will be treated as separate corporations for purposes of subpart F.

Notice 98-11, 1998-1 C.B. 433. Thus, under Notice 98-11, the IRS withdrew the right to make a check-the-box election for certain taxpayers who were considered to be abusing the check-the-box regulations.

[116] For example, in 1999, the Treasury Department issued Prop. Regs. § 301.7701-3(h), permitting the Service to disregard a foreign entity's check-the-box election if: (1) ten percent or more of the interests in the entity are transferred in one or more transactions during the period beginning one day before the election's effective date and ending 12 months after that date and (2) the entity was classified as an association at any time within 12 months before the date of the transfer of the interests. Under these regulations, the disregarded would be treated as a foreign corporation for U.S. tax purposes. Notwithstanding the narrower focus and significant transition relief of these rules, however, the business community and Congress again vehemently objected. This time, Treasury waited until 2003 to withdraw the proposed regulations. Notice 2003-46, 2003-2 C.B. 53.

[117] *See e.g.*, NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, PART ONE: A RECONSIDERATION OF SUBPART F (1999), *reprinted in NFTC Releases Subpart F Report*, 1999 TAX NOTES TODAY 58-17.

[118] In Notice 2003-46, the IRS and Treasury announced that transactions that utilized the entity classification rules in connection with the sale of the stock of foreign entities and other transactions contrary to the intent of certain United States income tax treaties, and that such transactions would be analyzed on case-by-case basis. *See* Notice 2003-46, 2003-2 C.B. 53.

after the foray of Treasury and the IRS into the perceived abuse of the domestic entity classification rules as used in international tax arbitrage was (effectively) a statement of intent from the IRS that it would watch for abusive cases on case-by-case basis. The IRS and Treasury no longer indicated exactly what "abuses" they were concerned about, however, except in very limited circumstances such as "check and sell" transactions.[119]

During the same time period, the Joint Committee on Taxation recommended that the ability to make a check-the-box election be revoked for any wholly-owned foreign entity with limited liability as a means to combat this potential erosion of Subpart F.[120] According to the Joint Committee, adopting this proposal would prevent the specific abuse contemplated, i.e., elective deferral of income and acceleration of losses through the use of check-the-box entities. Taxpayers who value the elective deferral would be forced to invest in foreign jurisdictions in traditional branch form rather than in through a limited liability entity treated as a disregarded branch under the check-the-box rules. In effect, the proposal of the Joint Committee identified limited liability as the primary non-tax friction limiting the ability to utilize the international tax arbitrage. Thus, if a taxpayer desired flexibility under Subpart F through the use of disregarded entities, they

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[119] A "check and sell" transaction is one in which a controlled foreign corporation intends to sell a subsidiary controlled foreign corporation. Under the current Subpart F rules, the sale of the subsidiary by a controlled foreign corporation would result in current tax to the United States shareholder of the controlled foreign corporation. A liquidation of the target followed by a sale of the assets would not result in current taxation to the United States shareholder, however. Under a check and sell transaction, the taxpayer checks the box on the target corporation, resulting in a deemed liquidation of the entity, and then sells the entity. For a general discussion of "check and sell" and other perceived abuses of the check-the-box regulations in the international context, *see* Douglas Holland, *Check-the-Box Rules in the Cross-Border Context*, 108 TAX NOTES 1151 (2005). Not long after the issuance of Notice 2003-46, however, the Tax Court held that even a "check and sell" transaction that the IRS and Treasury had specifically identified in the Notice as abusive was valid, ruling that the resulting tax benefits would not be denied. *See Dover v. Commissioner*, 122 T.C. 324 (2004).

[120] Staff of J. Comm. on Taxation, 111th Cong., *Options to Improve Tax Compliance and Reform Tax Expenditures* at 182 - 185 (Comm. Print 2005).

would have to invest through a branch, sacrificing limited liability. This proposal went even further than that of Treasury and the IRS, not only denying the benefits of the check-the-box rules in perceived "abusive" situations, but in all foreign single-member entity situations.

As evidenced by its history, the attempts by the IRS, Treasury and the Joint Committee to deny taxpayers the benefits of the check-the-box rules to engage in international tax arbitrage, proved difficult to apply and subject to substantial legal and political pressure. The anti-abuse approach of Treasury and the IRS demonstrated some of the identification, line-drawing and administrative cost limitations of this approach. The approach of the Joint Committee, i.e., to deny the benefits of the check-the-box rules to United States taxpayers owning single member entities with limited liability in foreign jurisdictions, demonstrated some of the line drawing problems of this approach, in particular the sacrifice of the benefits of the check-the-box rules for all single member foreign entities in exchange for a more robust Subpart F regime. Because of each proposal's significant costs, none received much support. As a result, under the current system, the ability to use the check-the-box entity classification rules to engage in international tax arbitrage transactions remains unabated.

Under the principles of the proposals in this article, with respect to the check-the-box regulations, a United States taxpayer would be permitted to make a check-the-box election for a foreign entity only in a specified list of developing jurisdictions. For those jurisdictions in which a check the box election would not be permitted, entity classification could be determined under on a case-by-case basis, applying *Kintner*-style factors, or under a bright line rule such as that proposed by the Joint Committee.

Under this approach, the cost to United States taxpayers of losing the underlying policy benefits of the check-the-box regulations would be limited to entities formed in those jurisdictions not on the eligible list. For entities formed in eligible jurisdictions, United States taxpayers would maintain all of the benefits of the check-the-box regime. Taxpayers seeking the benefits of the check-the-box rules could thus form entities in these jurisdictions. Consequently, the international tax arbitrage transaction made possible through the use of a hybrid entity would be explicitly permitted in eligible jurisdictions. This certainty benefit to United States taxpayers, not present in either the Treasury and IRS or the Joint Committee's proposals, could serve to reduce the domestic opposition those proposals received.

A. Check-the-Box and Limited CIN as an incentive for FDI

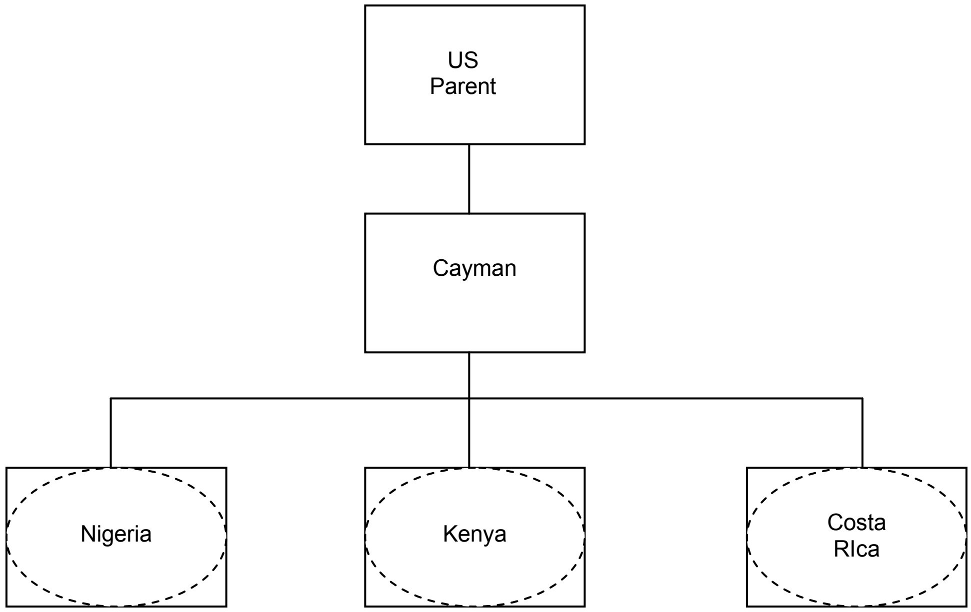
The proposal permits United States taxpayers to make a check-the-box election for entities formed under the laws of certain eligible jurisdictions. As a result, taxpayers making investments through entities formed in such jurisdictions would be permitted to engage in planning strategies to minimize their worldwide effective tax rate, subsidizing the location of foreign capital investment in general, and FDI in particular, in developing countries.[121]

For example, a United States corporation interested in conducting its business overseas could establish a holding company to be used to make or manage all of the

[121] *See, e.g.,* Mihir A. Desai, James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 Nat'l Tax J. 937 (2004) (analyzing impact of effective tax rates on FDI); Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 Nat'l Tax J. 825 (2000) (empirical analysis concluding that for each one percent reduction in effective tax rate a country attracts three percent foreign investment and that nineteen percent of United States foreign invested capital would be invested in different foreign locations absent taxes).

corporation's investments in those countries on the list of eligible jurisdictions. The holding company would be formed in any jurisdiction that the United States corporation considered efficient for the purposes (including traditional tax haven jurisdictions such as the Cayman Islands). The United States corporation would then make a check the box election to treat the holding company as a corporation for United States income tax purposes (or if in an ineligible jurisdiction, would use a per se corporation or other entity clearly satisfying the standards for corporate treatment). The holding company would then form wholly-owned legal entities with limited liability in any of the eligible jurisdictions in which it desired to operate, for example (assuming each would be an eligible jurisdiction) in Nigeria, Kenya and Costa Rica. The holding company would then make a check the box election with respect to each such subsidiary to be disregarded for United States income tax purposes. The resulting structure would appear as follows:[122]

[122] Solid-line boxes represent legal entities with limited liability. Solid boxes without a circle represent entities treated as a corporation for United States federal income tax purposes. Solid boxes with a dotted circle inside represent entities with limited liability treated as a flow-through or disregarded entity for United States federal income tax purposes.

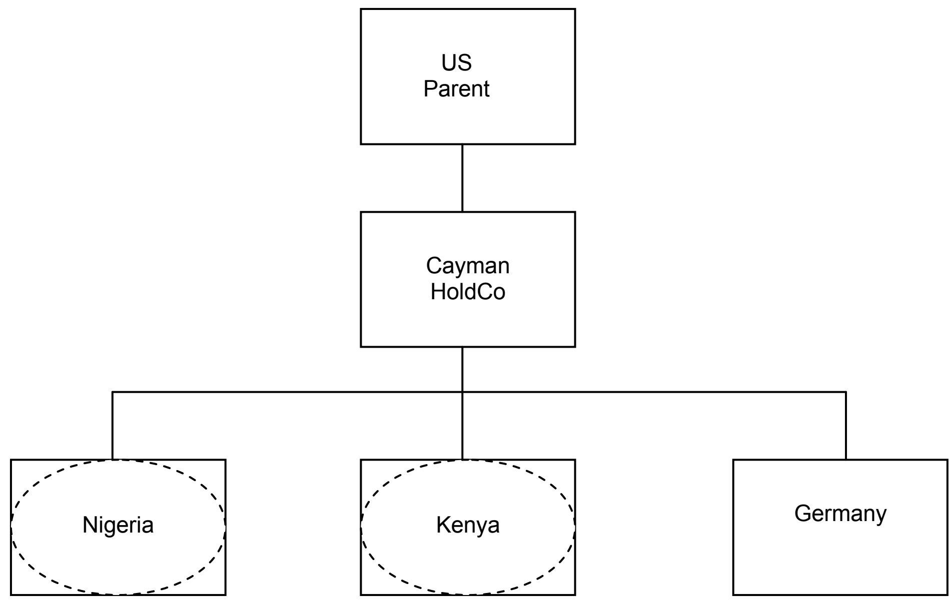


Under this structure, any active income of the subsidiaries would be treated as active income of the holding company, and thus eligible for deferral under the current Subpart F regime. Any passive income earned in such jurisdictions would be subject to the anti-deferral rules of Subpart F. The primary difference, however, would be that any transactions among the entities, including any movement of cash or other assets among the jurisdictions, could be accomplished without any current United States income tax consequences, because all such movements are treated as occurring within the holding company itself. By way of comparison, if each entity were treated as a corporation for United States tax purposes, then either direct transfers of assets among the entities or intercompany loans between the entities would result in current tax to the United States corporation (under certain deemed dividend rules, the anti-deferral rules of Subpart F or otherwise).

Deferral of home country tax on reinvested earnings can provide a significant incentive to reinvest retained earnings.[123] The proposal would expand this incentive by permitting deferral for reinvestment not only in the same jurisdiction but also within any of the eligible countries. Thus, in the above example, the United States corporation would be able to achieve indefinite deferral of inclusion of the income generated in all three jurisdictions so long as cash or assets is reinvested in any one of them, regardless of where it was earned. Thus, United States taxpayers would have a strong incentive to reinvest retained earnings, not just in the same country as it was earned (which may have limited growth or reinvestment potential) but in any country on the eligible list.

Similarly, United States taxpayers would have an incentive to retain cash or assets in developing countries rather than move them to developed countries, making the investment stickier within the developing world. For example, assume the holding company formed in the Cayman Islands owns wholly-owned subsidiaries in Nigeria and Kenya (assuming each is an eligible jurisdiction) which are disregarded for United States income tax purposes. The third wholly-owned subsidiary is located in Germany (which for these purposes is assumed not to be an eligible jurisdiction) rather than Costa Rica. The resulting structure would look like the following:

[123] Assuming that the present value of deferred taxes is capitalized into the price of contributed capital to a subsidiary, then deferral of home country income taxes should have its strongest impact on reinvestment of retained host country earnings. *See* Jun, *supra* note 85 at 57-58 ("Since in [the retained earnings] case the marginal cost or the equilibrium shadow value of capital is smaller than in the parent-transfer case … retained earnings must be the optimal marginal source of funds."). If the cost of the deferred taxes is not perfectly capitalized, because of information asymmetries or otherwise, then the incentive might apply to newly contributed capital as well.



If the German subsidiary needed access to capital currently at the Kenyan subsidiary, the Kenyan subsidiary could either directly transfer the capital to the German subsidiary or loan the capital to the Netherlands. A loan from the Kenya subsidiary to the German subsidiary would be treated as a loan from the Cayman Islands holding company to its German subsidiary, resulting in current inclusion of the interest income to the United States parent corporation under Subpart F. A direct transfer of the assets from the Kenyan subsidiary to the German subsidiary would be treated as a contribution to the capital of the German subsidiary by Cayman, which would have no current United States tax consequence to the United States corporation. However, once the capital was in Germany, it would be fully subject to the anti-deferral regime of Subpart F (i.e., passive income earned by Germany and non-previously taxed dividends paid by Germany would incur United States tax, subject to foreign tax credits).

By harnessing the international tax arbitrage, United States taxpayers for the first time would have an incentive not only to invest initially in developing countries, but to reinvest capital in developing jurisdictions rather than repatriate it to the United States or transfer it to other developed countries, potentially further multiplying the positive externalities of such investments.

Although this proposal would effectively apply a partial CIN-type policy to investments made in developing jurisdictions, this proposal differs from previous targeted CIN proposals[124] in that it would not alter the underlying mechanics of the United States international tax laws; the policy choices embodied in the current Subpart F regime would remain unchanged. Rather, an existing arbitrage already being used to manipulate the CEN rules of Subpart F would be harnessed. The efficiency and administrative benefits of the check-the-box election would be maintained for investments made in developing countries, while a less efficient entity classification system would be in place for developed countries. The loss in efficiency and increased administrative costs in the entity classification system for developed countries would be offset by the increased worldwide efficiency and worldwide horizontal equity benefits of a more robust and more difficult to avoid CEN regime for income earned in such jurisdictions.

The proposal also empowers developing countries to use low or zero corporate tax levels to attract foreign investment. Developing countries have pursued using low or zero corporate tax rates to attract foreign investment on the theory that such investment attracted by low rates would generate positive spillover effects to the economy of the developing jurisdiction. For United States taxpayers, any such attempts to attract foreign taxpayers would have little impact as a result of the strong CEN policy of the current

[124] *See* sources cited *supra* note 41. *See also* Samuel C. Thompson, Jr., *The Case for Tax Sparing Along With Expanding and Limiting the Subpart F Regime*, 35 Geo. Wash. Int'l L. Rev. 303 (2003) (supporting a limit to the application of Subpart F for certain foreign-to-foreign transactions).

Subpart F regime.[125] Thus, even if utilizing low tax rates could be effective for developing countries to attract FDI and such countries desired to adopt them, it would not be effective with respect to United States investors because of the effect of the United States tax law. Under the proposal, however, a United States taxpayer could maximize the deferral of taxation of income earned in such a jurisdiction by reinvesting such income in any eligible jurisdiction (and effectively apply a CIN regime to such income). As a result, United States capital would be much more sensitive to host country tax rates in such countries. Each developing country would thus be free to adopt its own welfare maximizing tax rate, balancing the desire to attract foreign investment against the foregone revenue of lowered tax rates and the impact of any reduction in worldwide efficiency.

One criticism of this approach would be similar to criticisms of previous targeted CIN proposals: the worldwide inefficiency costs as a whole outweigh any international vertical equity benefits to developing countries in particular. As an initial response, it must be analyzed whether this worldwide inefficiency might in fact arise. For example, an international tax regime based on CIN may actually be optimal in a two country regime of a high-tax jurisdiction and a low-tax jurisdiction, but only if the high-tax jurisdiction imposes the high-tax rate on relatively inelastic inframarginal rents not available in the low-tax jurisdiction. In such circumstance, from a worldwide efficiency standpoint, the increased revenue from the tax on inframarginal rents in the high-tax

[125] *See* sources cited *supra* notes 29 - 31 and accompanying text.

jurisdiction may offset the inefficiency arising from the shift of mobile capital investment to the low-tax jurisdiction.[126]

This precise situation would tend to be the case between the United States on the one hand and eligible jurisdictions, i.e., developing jurisdictions, on the other. Inframarginal returns tend to be made on investments in countries with developed infrastructure, educated workforces, stable currencies and other similar benefits, i.e., developed countries. Thus, so long as the jurisdictions on the eligible list are those jurisdictions compared to which investments in the United States generate inframarginal returns, adopting a limited CIN-type regime for such jurisdictions (through harnessing international tax arbitrage) may in fact be optimal rather than inefficient from a worldwide capital allocation perspective.

Another criticism of a targeted CIN regime is the so-called "runaway plant" problem. Under this theory, rather than promote new direct investment in a particular jurisdiction, CIN only provides an incentive to United States taxpayers to move the location of currently existing businesses from the United States to the CIN jurisdiction, which would not be efficient absent the tax preference and which would not necessarily provide the same beneficial spillover benefits from local hiring, training and other externalities.[127] Unlike prior proposals, however, harnessing the costs of international tax arbitrage does not change the incentives in the current international tax regime; rather, it

[126] *See* Clemens Fuest, Bernd Huber & Jack Mintz, *Capital Mobility and Tax Competition: A Survey*, 1 FOUND. & TRENDS IN MICROECON. 1, 31 (2005); *see also* Johannes Becker & Clemens Fuest, *Optimal Tax Policy When Firms are Internationally Mobile*, CESIFO Working Paper No. 1592 (2005), *available at* http://www.cesifo-group.de/~DocCIDL/cesifo1_wp1592.pdf.

[127] *See, e.g.*, Ellen P. Aprill, *Caution: Enterprise Zones*, 66 S. CAL. L. REV. 1341, 1347-49 (1993) (discussing the runaway plant phenomenon in the context of the former IRC § 936 Puerto Rico tax credit); Peter Merrill & Carol Dunahoo, *"Runaway Plant" Legislation: Rhetoric and Reality*, 72 TAX NOTES 221 (1996).

limits those incentives to specific jurisdictions. There is no particular reason to believe that assets or capital would move disproportionately from the United States, on the one hand, to foreign jurisdictions, on the other, to an extent different than under current law in which the tax incentive (as between the United States and foreign jurisdictions) is already present; rather, the impact would be expected to largely be on relative investment allocation among foreign jurisdictions.[128]

Targeted CIN is often criticized as not necessarily promoting FDI in developing jurisdictions, but rather only creating a tax haven for less beneficial portfolio investments or "drop-box" entities for intellectual property. These criticisms are significant and must be taken into account. One response is the same as that for runaway plants, i.e., that the proposal actually limits the ability to utilize these tax avoidance methodologies which are already being exploited under current law. Although the proposal does limit the problem, it does not address the underlying concern that unilateral policy of the United States does not in fact promote development in developing countries, but rather only promotes tax avoidance through the use of drop-boxes and portfolio investment which do not generate the positive spillover effect in the host jurisdiction that FDI does. This criticism has two responses: (i) under the proposal, developing jurisdictions are empowered to make their own decision on this issue, and can take into account the risk that reduced tax rates may not encourage FDI, and (ii) any developing jurisdiction that did not wish to be used in such a manner could negotiate with the United States to be removed from the list of

[128] *See, e.g.,* Michael P. Devereux and Harold Freeman, *The Impact of Tax on Foreign Direct Investment: Empirical Evidence and the Implications for Tax Integration Schemes*, 2 International Tax and Public Finance 85 (1995) (empirical analysis concluding that the choice between domestic investment and FDI is not significantly affected by effective tax rates, but that effective tax rates do impact the relative location of FDI among foreign countries).

eligible jurisdictions or otherwise harmonize their tax laws. As discussed above, in this manner the proposal places the power to decide whether to attract foreign investment, with its attendant risks, in the hands of the developing jurisdictions themselves rather than the United States.[129] By so empowering these jurisdictions, harnessing can serve a powerful and important expressive function, even if it does not result in any substantial economic development in such jurisdictions.

This argument does not take into account that the costs of being a tax haven tend to be external to the developing countries making such decisions, i.e., it is the United States that will lose tax revenue as a result of domestic taxpayers moving intellectual property or portfolio investment to such jurisdictions. Because there is little to no positive spillover and little to no tax revenue raised by such investments, the benefit to the host jurisdiction would be limited to certain user fees collected, such as a fee for the right to incorporate and operate in such jurisdiction. For the poorest of countries in the world, however, even this minimal revenue could be sufficient to begin to build infrastructure improvements or other minimal quality of life improvements. In other words, under an international vertical equity analysis the marginal utility of the revenue collected in such a jurisdiction is disproportionately greater than the marginal utility of the lost revenue to the United States. To the extent the costs of international tax arbitrage are inherent in the system, the United States tax policy should use such costs to support these jurisdictions in the early stages of their development, even if it solely to aid in the development of an efficient infrastructure, legal or banking network. If tax havens were

[129] This contrasts to incentives under current law, which promote United States investors to make only portfolio investments in developing countries as a means to generate foreign-source income and utilize excess foreign tax credits generated in developed countries. *See* Brown, Transforming *supra* note 41.

of particular concern,[130] however, one possibility under the proposal would be for the United States to periodically review the list of eligible jurisdictions and remove those countries that have been identified as tax havens from the eligible list.[131]

B. Ease of Implementation

A significant benefit of the proposal, as opposed to traditional responses to international tax arbitrage, is the relative ease of implementation. From a purely procedural standpoint, the proposal could be implemented by creating a list of eligible jurisdictions in which a check-the-box election would be permitted. Under current law, this could be adopted by regulation by the Treasury Department.[132] The check-the-box regulations already differentiate the ability to make an election on a jurisdiction-by-jurisdiction basis; the regulations prohibit an election to be made with respect to "per se" corporations listed by jurisdiction. Creating a separate list of eligible jurisdictions would

[130] Simply adopting low or zero tax rates does not necessarily make a jurisdiction a tax haven. Rather, other factors such as secrecy laws or other similar criteria are necessary to indicate tax haven status. *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TOWARDS GLOBAL TAX CO-OPERATION 10, ¶ 7 (2000) ("The fact that a jurisdiction may impose no or nominal tax on the relevant income is a necessary but not sufficient condition for the jurisdiction to be considered a tax haven. Whether a jurisdiction meets the tax haven criteria is determined based upon all the facts and circumstances, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.") As a result, the OECD has shifted its focus from tax rates to such compliance mechanisms as information sharing and bank secrecy cooperation as a means to prevent tax haven abuses, which could also avoid some of these concerns in the harnessing context. *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAX CO-OPERATION: TOWARDS A LEVEL PLAYING FIELD (2006).

[131] As an alternative, the United States could use the OECD process to define the list of non-cooperative tax haven jurisdictions rather than independently make such judgments on a periodic basis. *See id*; *see also* Cockfield *supra* note 101.

[132] Although procedurally the implementation of the harnessing approach in the check-the-box context could be accomplished solely by the Treasury Department, as a substantive matter it should be Congress (either by enacting legislation or delegating the power to the Treasury Department) that adopts the harnessing approach as an initial matter.

not fundamentally change the current structure or application of the current check-the-box regime.

With respect to non-eligible jurisdictions, two alternatives would be available. By removing such jurisdictions form the list of eligible jurisdictions to make a check the box election, entities in such jurisdictions would return to the case-by-case analysis of the *Kintner* regulations. If, however, the per se approach of the Joint Committee proposal was preferred, the Treasury Department could adopt a new list of "per se" corporations including single-member entities with limited liability in non-eligible jurisdictions, identified by name. For example, Treasury could amend Treas. Reg. § 301.7701-2 to add a list of entities that would be treated as per se corporations, such as the Dutch BV, French SARL, German GmbH, Japanese KK or others. To the extent such entities had multiple members, the regulations could provide that the traditional *Kintner* factors would be taken into account in determining the classification of the entity for Unites States income tax purposes, or could provide another rule (such as a default rule). One alternative could even be that the United States unilaterally harmonize its entity classification rules with those of the non-eligible jurisdiction by adopting a rule that automatically treated an entity for United States tax purposes the same as it was treated for purposes of its home country's tax rules.[133]

C. Certainty and Risk Aversion

[133] This is not a novel approach in the United States tax laws, and was utilized at times prior to the adoption of the check-the-box regulations. *See* Rev. Rul. 73-254, 1973-1 CB 613 (pre-check the box ruling looking to the law of the foreign jurisdiction in determining entity classification).

By targeting the ability to make a check-the-box election, any uncertainty inherent in the entity classification regime would be removed in eligible jurisdictions. Under current law, the ability to make a check-the-box election in foreign jurisdictions is subject to the uncertainty of the case-by-case anti-abuse analysis of the Treasury Department and the IRS. Permitting the check-the-box election and its use in international tax arbitrage in eligible jurisdictions, this uncertainty is removed. Assuming the replacement regime for non-eligible jurisdictions is a return to the *Kintner* regulations, the uncertainty of entity classification would also return to act as a friction on the ability to undertake international tax arbitrage transactions in such jurisdictions.[134]

By removing the uncertainty of entity classification for eligible jurisdictions, the full efficiency benefits of the check-the-box regime are maintained for those jurisdictions. For non-eligible jurisdictions, uncertainty would return as a friction, reducing the benefit of undertaking such transactions. These jurisdictions of course would retain all the other stability and certainty benefits inherent in developed jurisdictions for investments made in such jurisdictions, including legal and political stability and efficient infrastructure such as roads, mail and banking systems. Thus, the benefit of entity classification certainty in the eligible jurisdictions could serve less as a subsidy to invest in such jurisdictions than as a means to offset the non-market inherent benefits of developed countries and thus even the playing field among such countries in the competition for internationally mobile capital investment. In this manner, to the extent the proposal

[134] In analyzing the issue, the Treasury Department's Office of Tax Policy was of the opinion that the uncertainty of entity classification and the lack of "disregarded entity" status under the pre-check the box Kintner regulations acted as a significant limitation on the use of foreign entities to maximize deferral under Subpart F. *See* Subpart F Report *supra* note 45.

served only to offset current distortions in the location of foreign investment, it could actually serve to increase worldwide capital efficiency.

D. Administration and Enforcement

The underlying premise of harnessing the costs of international tax arbitrage is that such arbitrage transactions should be explicitly permitted in such jurisdictions. As a result, the need for the IRS to analyze check-the-box elections in such jurisdictions on a case-by-case basis for an amorphous abuse is removed. This could be further supported by adding the making of the check-the-box election in an eligible jurisdiction to an "angels list" in the "reportable transactions" tax shelter rules.[135] However, if an angels list is considered going too far, the converse could be adopted.[136] Specifically, the making a check-the-box election or treating a single-member limited liability entity as a disregarded entity in a non-eligible jurisdiction could be defined as a "listed transaction" for United States federal income tax purposes. The accompanying increased risk of detection, along with the increased risk of penalties, would provide a disincentive to taxpayers from engaging in such transactions.

E. From Unilateral to Multilateral

[135] The reportable transaction regulations require taxpayers and certain tax advisors to report to the IRS anytime they engage in a transaction that bears certain indicia of a tax shelter, regardless whether the transaction is itself appropriate. Transactions on the "angels list" are not requires to comply with this reporting requirement. *See* Treas. Reg. § 1.6011-1.

[136] As a listed transaction, taxpayers would automatically be required to disclose such transactions to the IRS under IRC §§ 6011 and 6111 regardless of any particular indicia, and tax advisors involved in such transactions would be required to comply with the list maintenance requirements under IRC § 6112.

One of the primary benefits of the proposal is that it can be adopted unilaterally; under the proposal, the United States would specifically incorporate the check-the-box arbitrage into its tax policy (costs already borne by the United States) to encourage investment in eligible jurisdictions. However, it is possible the host country may prefer to maximize its tax revenues (through the elimination of arbitrage) rather than maximize incentives for foreign investment. In such a case, the host country would have an incentive to approach the United States on a bilateral basis to divide the surplus, by being added to the per se list or agreeing to a common entity classification rule in place for that country. The United States could do so, but in return request reciprocal provisions (such as information sharing). The incentives to defect decrease in each subgame, while the opportunity costs of not cooperating increase, once such discussions between two countries begin. Thus, in this manner, not only would a particular international tax arbitrage transaction be prevented, but the incentives for international cooperation could be furthered.

Another possibility, independently or in response to the rise of bilateral negotiations, could be negotiations on a multilateral basis to harmonize the tax classification of entities on a cross-border basis.[137] Any discussions on a worldwide basis to harmonize entity classification, especially through worldwide organizations such as the OECD, could also lead to greater worldwide cooperation on tax issues impacting the relevant regimes, leading to a more unified international tax regime.[138] At a minimum, such discussions could lead to the creation of a common "language" regarding entity

[137] *See* sources cited *supra* note 101.

[138] *See* Cockfield *supra* note 101.

classification issues and their use in international tax arbitrage transactions, a discussion that is not currently being undertaken.[139]

VI. Conclusion

The issue of international tax arbitrage has proven a difficult and at times intractable one. Rather than try to minimize costs of the arbitrage or prevent "abuse" of the laws of a particular regime, the United States should also consider affirmatively bearing some of the costs of international tax arbitrage to further the policy of international vertical equity and transform the incentives that led to the current worldwide non-cooperative equilibrium, and thus the rise of international tax arbitrage, in the first place.

Harnessing the costs of international tax arbitrage transactions will not always be the appropriate response to each particular arbitrage transaction. Depending on the circumstances, the traditional responses may be sufficient, a change to the underlying United States domestic tax law may be appropriate or a worldwide consensus on harmonization in a particular area may arise. Harnessing the costs of the international tax arbitrage should be considered, however, when such responses prove inadequate. At a minimum, in adopting such an approach the United States would provide some level of subsidy for investment in developing countries at little to no cost to the current international tax regime. At best, however, harnessing the costs of international tax arbitrage could place of the issue of international tax arbitrage back on the international scene, restart stalled international tax discussions and potentially move towards a greater

[139] *See* Brauner *supra* note 101 at 306 (describing "the most valuable and wondrous achievement of the treaty practice - the creation of one "language" and a common, though mostly virtual, meeting place for most countries of the world in the international tax field.").

worldwide consensus, not only on the international tax arbitrage itself but on the larger issue of the role of international vertical equity in the worldwide tax regime. In a second-best world, United States unilateral action in harnessing the costs of international tax arbitrage may be the first step towards a first-best solution.