1

Introduction: Is there an international tax regime? Is it part of international law?

This book has a thesis: that a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based and customary). The practical implication is that countries are not free to adopt any international tax rules they please, but rather operate in the context of the regime, which changes in the same ways international law changes over time. Thus, unilateral action is possible, but is also restricted, and countries are generally reluctant to take unilateral actions that violate the basic norms that underlie the regime. Those norms are the single tax principle (i.e., that income should be taxed once – not more and not less) and the benefits principle (i.e., that active business income should be taxed primarily at source, and passive investment income primarily at residence).

This thesis is quite controversial. Several prominent international tax academics and practitioners in the United States (e.g., Michael Graetz, David Rosenbloom, Julie Roin, Mitchell Kane) and elsewhere (e.g., Tsilly Dagan) have advocated the view that there is no international tax regime and that countries are free to adopt any tax rules they believe further their own interests.[1] Other prominent tax academics (e.g., Hugh Ault, Yariv Brauner, Paul McDaniel, Diane Ring, Richard Vann) and practitioners (e.g., Luca dell'Anese, Shay Menuchin, Philip West) have supported the view just advocated.[2] However, there is no coherent exposition of this view in the academic or practical literature. This book is intended to fill this gap, following up on previous articles in which I developed the foregoing thesis.[3]

This chapter introduces the overall thesis of the book by addressing three issues. First, the chapter argues that an international tax regime exists, embodied both in the tax treaty network and in the domestic tax laws of the

[1] Graetz (2001); Rosenbloom (2000, 2006); Roin (2001); Dagan (2000); Kane (2004).
[2] dell'Anese (2006); Ring (2002); Menuchin (2004); Ault (2001); McDaniel (2001); Vann (2000); West (1996).
[3] For example, Avi-Yonah (1996, 1997, 2000a).

major trading nations. Illustrations are provided from recent developments that show countries such as the United States and Germany complying with basic norms of the regime, for example, nondiscrimination. Second, the chapter argues that the international tax regime is an important part of international law, as it evolved in the twentieth century. In particular, the chapter argues that parts of international tax law can be seen as customary international law and therefore as binding even in the absence of treaties. An example would be the arm's-length standard under transfer pricing. Finally, the chapter explains the basic structure of the international tax regime and its underlying norms, the single tax principle (income should be taxed once, no more and no less) and the benefits principle (active business income should be taxed primarily at source, passive investment income primarily at residence). The chapter further sets out the normative rationale for these norms and explains how U.S. tax rules fit in with them.

I. IS THERE AN INTERNATIONAL TAX REGIME?

The most important statement denying the existence of the international tax regime was the 1998 Tillinghast Lecture delivered by H. David Rosenbloom at the NYU law school.[4] Rosenbloom began his lecture by quoting from the legislative history of the U.S. dual consolidated loss rules a statement referring to an "international tax system." He then proceeded to deny the existence of this system or regime ("that system appears to be imaginary"), because in the real world, only the different tax laws of various countries exist, and those laws vary greatly from each other.

Of course, this description is true as far as it goes, but is this the whole truth? As Rosenbloom noted, in fact, there has been a remarkable degree of convergence even in the purely domestic tax laws of developed countries. Not only can tax lawyers talk to each other across national boundaries and understand what each is saying (the terminology is the same), but the need to face similar problems in taxing income has led jurisdictions with different starting points to reach quite similar results. For example, countries that started off with global tax systems (i.e., tax "all income from whatever source derived" in the same way) now have incorporated schedular elements (for example, the capital loss and passive activity loss rules in the United States), whereas countries with a schedular background (i.e., tax different

[4] Rosenbloom (2000).

types of income differently) have largely adopted schedules for "other income" that lead to a global tax base (for example, the United Kingdom).

Not surprisingly, this convergence is most advanced in international tax matters, because in this case the tax laws of various jurisdictions actually interact with each other, and one can document cases of direct influence. For example, every developed country now tends to tax currently passive income earned by its residents overseas (through controlled foreign corporations and foreign investment funds [FIF] rules, which were inspired by the U.S. example), and to exempt or defer active business income. Thus, the distinction between countries that assert worldwide taxing jurisdiction and those that only tax territorially has lost much of its force. We will develop other examples of such convergence in the course of the book.

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

I would argue that the network of two thousand or more bilateral tax treaties that are largely similar in policy, and even in language, constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties. These principles are the single tax principle and the benefits principle, which will be articulated further in later sections. In brief, the single tax principle states that income from cross-border transactions should be subject to tax once (that is, not more but also not less than once), at the rate determined by the benefits principle. The benefits principle allocates the right to tax active business income primarily to the source jurisdiction and the right to tax passive investment income primarily to the residence jurisdiction.

To those who doubt the existence of the international tax regime, let me pose the following question: Suppose you were advising a developing country or transition economy that wanted to adopt an income tax for the first time. How free do you think you would be to write the international tax rules for such a country in any way you wanted, assuming that it wished to attract foreign investment? I would argue that the freedom of most countries to adopt international tax rules is severely constrained, even before entering into any tax treaties, by the need to adapt to generally accepted principles of international taxation. Even if divergent rules have been adopted, the process of integration into the world economy forces change. For example, Mexico had to abandon its long tradition of applying formulas in transfer pricing and adopt rules modeled after the OECD guidelines in order to be able to join the OECD. South Korea similarly had to change its broad interpretation of what constitutes a permanent establishment under pressure from the OECD. And Bolivia had to abandon its attempt to adopt a cash flow corporate tax because it was ruled not creditable in the United States. Even the United States is not immune to this type of pressure to conform, as can be seen if one compares the 1993 proposed transfer pricing regulations under IRC section 482, which led to an international uproar, with the final regulations, which reflect the OECD guidelines.

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

II. IS THE INTERNATIONAL TAX REGIME PART OF INTERNATIONAL LAW?

Few would dispute that the network of bilateral tax treaties forms an important part of international law. Thus, the key issue is whether these treaties and the domestic tax laws of various jurisdictions can be said to form an international tax regime that is part of *customary* international law.

Customary international law is law that "results from a general and consistent practice of states followed by them from a sense of legal obligation."[5] "International agreements create law for states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted."[6]

There clearly are international tax practices that are widely followed, such as avoiding double taxation by granting an exemption for foreign source income or a credit for foreign taxes. Moreover, there are more than two thousand bilateral tax treaties in existence, and they all follow one of two widely accepted models (the OECD and UN model treaties), which themselves are quite similar to each other and are "intended for adherence by states generally." Is this enough to create a customary international tax law?

In the following, I will briefly survey some examples that in my opinion strengthen the view that the international tax regime rises to the level of customary international law. As usual, the hard question is whether countries not only follow a rule, but do so out of a sense of legal obligation (*opinio juris*).

A. Jurisdiction to tax

Can a country simply decide to tax nonresidents who have no connection to it on foreign-source income? The answer is clearly no, both from a practical perspective and, I would argue, from a customary international law perspective. The fact that this rule is followed from a sense of legal obligation is illustrated by the behavior of the United States in adopting the foreign personal holding corporation (FPHC) and controlled foreign corporation (CFC) rules, which will be described in more detail in Chapter 2. In the case of corporations controlled by U.S. residents, the United States does not tax those corporations directly, but rather taxes the U.S. resident shareholders on imaginary (deemed) dividends distributed to the shareholders. This deemed dividend rule was adopted precisely because the United States felt bound by a customary international law rule not to tax nonresidents directly on foreign-source income, even though they are

[5] Rest. 3rd (For. Rel.) sec. 102(2).
[6] Rest. 3rd (For. Rel.) sec. 102(3).

controlled by residents. The United States no longer feels bound by this rule, but that is because enough other countries have adopted CFC legislation that expands the definition of nationality that customary international law has changed. The spread of CFC legislation from 1962 onward is a good example of how rapidly customary international law can in fact change.

B. Nondiscrimination

The nondiscrimination norm (i.e., that nonresidents from a treaty country should not be treated worse than residents) is embodied in all tax treaties. But is it part of customary international law? The behavior of the United States in the earnings stripping episode just described suggests that the United States felt at the time that the nondiscrimination norm was binding even outside the treaty context. Otherwise, even if it did not wish to override treaties, it could have applied a different rule to nontreaty country residents (as it did in the branch profits tax context three years earlier). Thus, I would argue that the nondiscrimination norm may in fact be part of customary international law even in the absence of a treaty.

C. The arm's-length standard

The standard applied in all tax treaties to the transfer pricing problem of determining the proper allocation of profits between related entities is the "arm's-length standard," which means that transactions between related parties may be adjusted by the tax authorities to the terms that would have been negotiated had the parties been unrelated to each other. This standard has been the governing rule since the 1930s.

In the 1980s, the United States realized that in many circumstances it is very difficult to find comparable transactions between unrelated parties on which to base the arm's-length determination. It therefore began the process of revising the regulations that govern transfer pricing. This culminated in 1995 with the adoption of two new methods, the comparable profit method and profit split method, that rely much less on finding comparables (and in the case of profit split sometimes require no comparables at all).

What is remarkable about the process by which these regulations were adopted is the U.S. insistence throughout that what it was doing was consistent with the arm's-length standard. It even initially called profit split the "basic arm's-length return method." But as I have pointed out elsewhere, once you abandon the search for comparables, it is meaningless to call a method "arm's length," because without comparables nobody can know what unrelated parties would have done. [7]

Nevertheless, despite initial objections, the OECD ultimately came to accept the gist of the new methods in its revised transfer pricing guidelines, which were issued a short time after the new U.S. regulations and represent the widely followed consensus view of transfer pricing. The new methods are thus accepted under the rubric of "arm's length."

As Brian Lepard has suggested, the U.S. insistence that it was following the arm's-length standard indicates that it felt that the standard is part of customary international law.[8] Such a finding has important implications because the U.S. states explicitly follow a non–arm's-length method, formulary apportionment, which has been twice upheld by the U.S. Supreme Court. If the arm's-length method is customary international law, these cases may have been wrongly decided, as customary international law is part of federal law and arguably preempts contrary state law.

D. Foreign tax credits versus deductions

Many economists argue that countries should only give a deduction for foreign taxes rather than a credit. However, countries generally grant either an exemption for foreign source income or a credit for foreign taxes paid. Remarkably, in most cases (following the lead of the United States) this is done even in the absence of a treaty. It is likely that at this point countries consider themselves in practice bound by the credit or exemption norm, and a country would feel highly reluctant to switch to a deduction method instead. Thus, arguably preventing double taxation through a credit or exemption has become part of customary international law.

E. Conclusion

If customary international tax law exists, this has important implications for the United States and other countries. As Justice Gray wrote more than one hundred years ago in the *Paquete Habana* case,

> [I]nternational law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction as often as questions of right depending upon it are duly presented for their determination. For

[7] Avi-Yonah (1995).
[8] Lepard (2000).

> this purpose, where there is no treaty and no controlling executive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations.

To the extent legislation exists, in the United States it can override customary international law as well as treaties. But in the absence of treaties or legislation, resort can be had to customary international law; and I would argue that it can also be used to ascertain the underlying purposes of treaties.

To the extent that customary international tax law exists, this suggests that it is a mistake to deny the existence of an international tax system or regime. Admittedly, even if an international tax regime exists, it does not follow what we should do about it – this has to be investigated in each particular case. But we should not pretend that there are no binding, widely accepted international tax norms that we should flout only when significant national interests are at stake. This view has important implications whenever differences between countries' domestic laws lead to the possibility of tax arbitrage, which will be discussed further in Chapter 10.

III. THE STRUCTURE OF THE INTERNATIONAL TAX REGIME

If an international tax regime exists, what does it look like? The following sections will first define the two basic principles that in my view underlie the international tax regime and why they are normatively justified. I will then illustrate how the U.S. international tax rules are generally consistent with these two principles.

A. Defining the tax base: The single tax principle

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

The answer to the first question is the single tax principle: income from cross-border transactions should be subject to tax once (i.e., neither more nor less than once). The single tax principle thus incorporates the traditional goal of avoiding double taxation, which was the main motive for setting up the international tax regime in the 1920s and 1930s. Taxing cross-border income once also means, however, that it should not be undertaxed or (at the extreme) be subject to no tax at all.

The appropriate rate of tax for purposes of the single tax principle is determined by the second principle of international taxation, the benefits principle. The benefits principle, discussed later, assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions. Therefore, the rate of tax for purposes of the single tax principle is generally the source rate for active business income and the residence rate for passive (investment) income. When the primary jurisdiction refrains from taxation, however, residual taxation by other (residence or source) jurisdictions is possible and may be necessary to prevent undertaxation. Such residual taxation means that all income from cross-border transactions, under the single tax principle, should be taxed at least at the source rate (which tends to be lower than the residence rate), but at no more than the residence rate.

What is the normative basis for the single tax principle? As an initial matter, I assume that most countries would like to maintain both a personal income tax and a corporate income tax. The reasons for having both a personal income tax and a corporate income tax have been discussed extensively elsewhere and are not repeated here.[9] For purposes of justifying the single tax principle, it is sufficient that most countries in fact maintain their existing personal and corporate income taxes.

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

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

In addition, there is also a strong equity argument against undertaxation of cross-border income, which applies to income earned by individuals.

[9] See, for example, Avi-Yonah (2002, 2004b).

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

On a practical level, the single tax principle can be justified because double taxation leads to tax rates that can be extremely high and tend to stifle international investment. Zero taxation, on the other hand, offers an opportunity to avoid domestic taxation by investing abroad, and therefore threatens to erode the national tax base. T. S. Adams, the architect of the foreign tax credit and a major influence in shaping the international tax regime, recognized both of these propositions in the 1920s. In justifying the foreign tax credit, Adams wrote, "The state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax." Contrary to an exemption system, Adams' credit operated to eliminate double taxation by both source and residence jurisdictions, but preserved residual residence-based jurisdiction to enforce the single tax principle.[10]

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

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

[10] Graetz & O'Hear (1997).