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INTERNATIONAL TAX ARBITRAGE: GROUNDS FOR TAX REFORM, NOT TAX OVERKILL*

The U.S. Treasury approaches international tax issues with several objectives in mind. First, the Treasury does not want foreign governments to capture what it feels should be U.S. tax base and revenue. Second, the Treasury wants to create a tax system in which investment decisions of American companies are not driven by differences in taxation across countries. Treasury fears that relatively low tax rates abroad might result in "runaway plants" or distortion of investment decisions. Consequently, Treasury favors the taxation of global income, imposing tax on the foreign earnings of U.S. taxpayers insofar as the U.S. tax rate exceeds that imposed on the same income by foreign tax authorities. Third, however, the Treasury wants U.S. businesses and individuals to be competitive with foreign businesses and individuals operating abroad. Toward that end, the U.S. allows a tax credit for foreign taxes paid to avoid double taxation of foreign source income that would render dealings by U.S. entities impractical.

Taxation of global income runs afoul of differences among various national tax systems. Numerous types of international transactions allow firms to reduce their U.S. or foreign tax liabilities by taking advantage of discrepancies among national tax systems in the definition of taxable income, the tax rates applied to various types of income, the treatment of subsidiaries as independent entities or partnerships, and other differences. These practices are often referred to as "tax arbitrage".

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by taking advantage of discrepancies among national tax systems in the definition of taxable income, the tax rates applied to various types of income, the treatment of subsidiaries as independent entities or partnerships, and other differences. These practices are often referred to as "tax arbitrage".

Tax arbitrage gives rise to several frequently asked questions. Is it harmful? Should anything be done about it? Can anything be done about it? If so, what steps should be taken? As interesting as these questions are, one should first question the Treasury's basic assumption about the effect of differential tax rates on international investment, and the basic premise that income is the appropriate tax base.

Many "tax arbitrage" opportunities stem from three basic tax policy errors: 1) imposing a broad-based income tax instead of imposing a consumed-income or consumption-based tax; 2) taxing corporate income at both the corporate and shareholder level, with no integration, and 3) applying the income taxes to global income, instead of just to income earned within the country under a "territorial" system.

Many "tax arbitrage" opportunities stem from three basic tax policy errors: 1) imposing a broad-based income tax instead of imposing a consumed-income or consumption-based tax; 2) taxing corporate income at both the corporate and shareholder level, with no integration, and 3) applying the income taxes to global income, instead of just to income earned within the country under a "territorial" system.

The broad-based income tax is biased against saving and investment because it includes in the tax base the income used for saving and investment and also the returns on the saving and investment, thereby taxing income used for saving and investment more heavily than income used for consumption. The double taxation of corporate income adds to the bias. The taxation of foreign source income, offset by a credit, is an extension of domestic taxing authority to jurisdictions over which the United States has no control, resulting in needless complication at best, and incredible confusion and conflict, at worst.

The ultimate cure for these tax enforcement ills is to switch to a territorial tax system with a consumption base. It is possible to construct a territorial broad-based income tax system, but the consumption-based system would result in far simpler tax administration, and, more important, allow for far better economic performance.

The Myth of the Runaway Plant

There is an inherent contradiction between Treasury's goals of equalizing the tax paid by U.S. firms on foreign and domestic investment (to prevent so-called "runaway plants") and letting U.S.

firms be competitive in the global economy (since U.S. tax equalization keeps U.S. taxpayers from taking equal advantage of low tax foreign investment climates available to their foreign competition). The Treasury's effort to equalize global tax rates faced by U.S. investors is misguided, and is based on a serious misunderstanding of the process of capital formation.

The amount of capital that it is profitable to employ in a particular nation depends overwhelmingly on conditions in that nation. These include resources, location, population, education, regulation, and taxation, among others. Other things equal, the lower the tax burden on capital in a nation, the greater will be the equilibrium capital stock in that nation. Investment will occur until the capital stock expands to the point at which the output of an additional unit of capital (the marginal product) is just sufficient to yield a risk-adjusted after-tax return sufficient to attract the saving needed to finance the investment. Saving is in very elastic supply at a real after-tax rate of return of a bit under 3.5%.

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If the tax rate on capital is lowered somewhere in the world, the equilibrium level of capital in that country will rise. Except in the shortest of runs, it will be financed by an increase in world saving, not by a shifting of some existing fixed quantity of saving from somewhere else. If the tax on capital is increased somewhere in the world, there will be disinvestment (or less growth of capital than would otherwise have occurred) in that country. World saving will decline by that amount, in line with the reduced investment opportunities. Saving will not simply "relocate" from the tax increasing jurisdiction to finance additional investment in excess of the equilibrium level in some other nation.

The size of the capital stock in country A will not depend very much on the taxation of capital and the size of the capital stock in country B. If there is any connection, it is that capital formation and prosperity in country B expand opportunities for useful trade, thereby enhancing the productivity and profitability of capital in country A, leading to more growth there as well.

A lower tax rate on capital abroad does not mean less capital in the United States, it merely means more capital in the low tax foreign country. American savers and investors would be better off if they were as free to take advantage of the favorable investment climates in such countries as are the residents of those countries and the residents of third countries whose people are not burdened by global taxation of their foreign earnings.

Similarly, there is not a fixed amount of capital in the world that will exist regardless of conditions, and that can be forced to locate in one country by making another country unattractive.

A higher tax rate on capital in country B will not encourage capital to migrate to or remain in country A, it will simply mean less capital in country B and in the world as a whole.

For example, Ireland lowered taxes on new corporate investors to encourage expansion of its capital stock, which is raising productivity, wages, and employment. The continental members of the European Union regard the Irish capital formation as capital flight from their countries, and are currently pressing Ireland to raise its corporate taxes to their levels. This is misguided policy. Higher taxes in Ireland would not increase capital formation in France, it would merely discourage capital formation in Ireland. The European criticism has had one good result. The Irish responded by making the corporate tax rate reductions universal.

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The Effect of Tax Arbitrage

Treasury often expresses concern that avoidance of tax by some businesses but not others results in uneven taxation of different types of investment, creating economic distortion that reduces total output. It is likely, however, that arbitrage that lowers the cost of raising money benefits businesses operating in a large number of sectors. Even were there to be readier access to the benefits of arbitrage by businesses in one sector rather than another, it is unlikely that the economic losses due to distortion would outweigh the economic gains from lower taxation of at least some capital.

The impact of arbitrage is unknown, but is not likely to be very large. Treasury is studying the issue, but cannot yet put a dollar value on the tax revenue lost, or on the magnitude of the gross transactions. The tax figures are bound to look small in comparison to total U.S. tax revenue.[1] The investment transactions will surely be tiny compared to total annual private sector U.S. capital

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[1] Two anti-"tax shelter" provisions in the Administration's Budget — "tax income from corporate tax shelters involving tax-indifferent parties" and "preclude taxpayers taking tax positions inconsistent with the form of their transactions" — are projected to net only $1.1 billion over 5 years, but they cover transactions involving domestic tax exempt organizations and Native American tribes as well as foreign entities. On the other hand, not all international arbitrage situations are addressed by these provisions. By comparison, total federal revenue over the period will exceed $10 trillion. (*Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000,* U.S. Government Printing Office, Washington, D.C., 1999, Table 3-3, p.87.)

inflows and outflows (financial investment or direct investment in physical assets abroad by U.S. residents and similar investments by foreigners in the U.S.) These totaled nearly $1.5 trillion in 1998.

How the government responds to the revenue loss has a bearing on the impact of tax arbitrage on the U.S. economy. If the arbitrage reduces U.S. tax revenue, and the government responds by raising taxes on other investment activity, there will be an increase in the tax bias against investment and a general reduction in economic activity. Less distorting tax increases would leave activity about unchanged. If the government responds to the difficulty in raising revenue by cutting spending, however, there would be no reduction in economic activity, and perhaps an increase, as resources were left for the private sector to employ.

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Double Dip Leasing

Expensing, as would be allowed in a consumption-based tax system, permits the full recovery of investment costs before a business is considered to have earned a taxable profit. Under the income tax, however, businesses must depreciate rather than expense investment outlays. Depreciation allowances seldom cover the full present value of an investment outlay, especially when the asset life is long or inflation is high. The write-offs lose value to inflation and the time value of money. Business income is overstated, and the effective tax rate is increased above statutory levels.

If [double dip leasing] is to be "fixed", the United States would find that the leasing arrangements would simply end, and the companies would simply claim U.S. depreciation, with no gain in revenue to the Treasury.

Double dip leasing occurs when the tax laws of the lessor's country treat the lessor as the owner of a capital asset and permit the lessor to depreciate the asset for tax purposes, and the laws of the lessee's country treat the lessee as the owner and permit the lessee to depreciate the asset as well.

Double dip leasing lowers taxes on capital that, in most nations, are probably too high, but a double write-off probably goes further than the neutral treatment that would be afforded by expensing. Still, it is hard to get too concerned about the issue. Either the U.S. or the foreign country could alter its definition of ownership to correct the problem. Either way, it would discourage investment by U.S. based companies, and might better be left alone. If it is to be "fixed", the United States would find that the leasing arrangements would simply end, and the companies would simply claim U.S. depreciation, with no gain in revenue to the Treasury. To call Treasury's bluff, one could demand that the United States take the initiative in changing the definition of ownership, so that it is the country to recover the statically-estimated "lost" tax revenue, on the condition that the estimated "recovered" tax revenue be used to fund an offsetting across-the-board reduction in taxation of capital. Since no revenue would be recovered on a dynamic basis, the trade-off in tax provisions would produce a beneficial reduction in the tax burden on capital.

Preferred Stock Repurchase Arrangements

Preferred stock repurchase arrangements give a U.S. company access to relatively low interest rate financing from a foreign lender in whose country the corporate and individual income taxes are integrated to some degree. The foreign lender/"shareholder" gets a tax credit from the foreign tax authorities for the taxes paid by the borrowing corporation to the foreign government on its earnings, offsetting the tax the lender would otherwise pay on the same income received as a "dividend". Because there is no, or reduced, double taxation of corporate income in the foreign country, a foreign lender who is able to structure the loan service as a dividend can afford to accept a lower rate of interest/"dividend" from the "borrower"/share issuer, saving the U.S. borrower some financing costs. This in no way harms the U.S. Treasury, except insofar as it shines a spotlight on the bad treatment of corporate income under U.S. tax law.

Preferred stock repurchase arrangements give a U.S. company access to relatively low interest rate financing in a foreign market in which the corporate and individual income taxes are integrated to some degree.

In a consumption-based tax system, the question of individual/corporate integration does not arise. In an integrated income tax system, there would also be no double taxation of corporate and individual income. Rather than penalize firms for attempting to take advantage of more sensible tax treatment of capital abroad, we should make the issue moot by treating capital more sensibly in the United States.

Timing Issue

Firms lose their net operating loss carry-forwards if they cannot take advantage of them within a set time. The transaction at issue here is a means of rolling the losses forward until there are operating profits to offset (or, better expressed, artificially bringing the presumed future income forward to meet the losses, reducing future tax liabilities). The particular method described (using cross-border asset swaps and up front premium payments) is no longer permitted in the United States, but other timing "arrangements" may emerge. Meanwhile, foreign Treasuries may still have problems in this area. From an economist's perspective, losses should not be lost; they should be carried forward with interest for later use. Alternatively, they should be salable to companies experiencing current earnings. Better yet, the United States would adopt a cash flow tax, under which the losses would automatically be transferred to the lenders helping the company over its rough patch in the year the loan was made. Consequently, the concern over this type of financial arrangement is misplaced.

Hybrid Holding Company

A foreign (e.g. Canadian) corporation may set up a limited liability holding company — LLC) that, in turn, may have a U.S. operating subsidiary (OPCO). The U.S. tax authorities treat the LLC as identical to its foreign parent, but the LLC is treated as a foreign subsidiary by the foreign tax authorities. Income received by the LLC from the OPCO may be accorded favorable tax treaty status by the U.S., including limited withholding, while being regarded by the foreign tax authority as not yet repatriated and not yet taxable. The U.S. Treasury concern in this instance is two-fold.

In a consumption-based tax system, [or] an integrated income tax system, there would ... be no double taxation of corporate and individual income.

First, if the foreign-owned LLC sells the shares in the OPCO, it escapes capital gains tax in either the U.S. or Canada. Since the U.S. taxes capital gains in many other circumstances, why should this company escape the tax? From an economic perspective, however, the tax on capital gains is one of the excess layers of tax on income that is saved compared to income used for consumption. There would be no separate tax on capital gains in a consumption-based tax system. (In a saving-deferred tax setting, the investor would be allowed to expense the investment and would pay tax on the returns, including any future sale of the asset. In a returns-exempt setting, there would be no deduction for the purchase of an asset, but no tax on the returns, including the sale proceeds. The two methods are equivalent.) The hybrid holding company arrangement escapes a tax that should not exist. Rather than impose capital gains tax on these entities, the tax should be scrapped for everyone.

The second Treasury concern is to ensure that income paid by a U.S. corporation to a foreign shareholder is as double-taxed as income paid to a domestic shareholder. The foreign-owned U.S. operating company pays corporate income tax to the U.S. Treasury. The dividend it pays to the foreign-owned LLC is treated by the U.S. Treasury as being paid to the foreign parent, but it is not recorded as income in the foreign country until it is distributed from the LLC to the foreign parent.

Meanwhile, the income enjoys deferral of the second layer of tax it may eventually owe. The U.S. has responded by imposing a higher withholding tax on the dividend (30%) than it would receive under the tax treaty (10%) on the grounds that there is no double taxation, so why grant the offset.

This, again, is a question of enforcing double taxation, and thwarting a back-door form of corporate integration. In a consumption-based tax system, the question of integration does not arise. In an integrated income tax system, there would also be no double taxation of corporate and individual income. Rather than penalize firms for attempting to take advantage of more sensible tax treatment of capital abroad, we should make the issue moot by treating capital more sensibly in the U.S.

Budget Proposals

These international tax arbitrage issues have become a hot topic. In the President's Fiscal Year 2000 Budget proposals dealing with "corporate tax shelters", the Administration has requested that Congress delegate to the Treasury greatly expanded authority to define and outlaw these and other tax reducing practices. (For example, Treasury would receive broad authority to force taxpayers to stick with the form rather than the substance of tax management transactions, particularly when the other party is a "tax indifferent party" such as a foreign person or a tax exempt organization or group.) The House Ways and Means Committee held a hearing (March 10) on the President's corporate tax shelter proposals. On April 15, Congress completed passage of the First Concurrent Resolution on the Budget for FY 2000. The Senate Budget Committee Chairman's Mark for the resolution assumes adoption of "several of the President's proposed loophole closers" (which ones are unspecified) to offset part of the promised tax reductions.

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The President's budget proposals would cede far too much discretion to the Secretary of the Treasury and to IRS field operatives to set policy in these matters, including defining what is and is not a tax shelter, without specific Congressional consideration and legislation regarding the various types of practices under review. The proposals are significant overkill with the potential to interfere with normal business practices. Furthermore, the Administration budget proposals, including those affecting international tax arbitrage, are the antithesis of fundamental tax reform. They would add complexity and uncertainty to the tax system and its enforcement, chasing after perfect compliance with a tax system based on a misguided concept of economic income. Instead of attempting to achieve perfect compliance with a bad tax system by closing every escape hatch, the Treasury and the Congress should do an immediate about-face and work to enact a territorial, consumption-based tax system.

An Integrated Territorial Cash Flow Tax

Shortly before his death, Norman B. Ture, IRET's president and former Under Secretary of the Treasury, wrote a description of an integrated territorial cash flow (consumption-based) tax, which he called the inflow-outflow (I-O) tax. (A pre-publication summary of that paper is available on request.)

Rather than penalize firms for attempting to take advantage of more sensible tax treatment of capital abroad, we should make the issue moot by treating capital more sensibly in the U.S.

The I-O tax would be paid by individuals, would be neutral as between consumption and saving/investment uses of income, would impose no double taxation of corporate income, and would be imposed only on income earned within the United States. Individuals would be taxed on labor income (cash and fringe benefits) plus any net withdrawals from saving (including borrowing) or less any net additions to saving (including debt service and repayment). Transfers received would be taxable. Transfers paid (state and local taxes, gifts, alimony, etc.) would be tax deductible.

There would be no business level tax. An individual's purchases of stocks and bonds would be treated in the same manner as contributions to deductible IRAs. The businesses would take the capital raised by issuing debt and equity, and invest it tax-deferred. The individual would owe tax only on distributions or asset sales not reinvested or rolled over into other assets.

International tax arbitrage problems are minor from the standpoint of revenue... Many tax arbitrage practices simply allow U.S. firms to compete more effectively abroad, or to offset instances of anti-saving, anti-investment bias in the U.S. tax code... [T]he tax system should be radically overhauled, not to outlaw the practices, but to render them moot via through fundamental tax reform that would provide more sensible tax treatment of saving, investment and foreign source income.

To make the tax territorial, saving or investment abroad would not be tax-deferred, and returns on foreign saving and investment, or labor income earned abroad, would not be taxed. A business would alert the shareholder that a portion of the dividend reflecting foreign source income would be tax exempt, and would inform the shareholder that a pro-rated share of the company's net foreign investment would be a taxable addition to the reported dividend.

Most of the commonly discussed tax arbitrage problems would not exist in a territorial, consumption-based, integrated tax system. There would still be the need to determine what income was domestic, and what was foreign. Transfer pricing issues would still exist. Overall, however, the system would be conceptually cleaner and simpler to administer and comply with than current law, and would do a great deal to improve the efficiency of the economy and the level of GDP.

Conclusion

International tax arbitrage problems are minor from the standpoint of revenue. They arise from bad choices concerning the basic structure of the tax system — taxation of income instead of consumption, lack of individual/corporate tax integration, and the taxation of global income instead of adoption of a territorial tax system. Many tax arbitrage practices simply allow U.S. firms to compete more effectively abroad, or to offset instances of anti-saving, anti-investment bias in the U.S. tax code. Tax arbitrage opportunities probably increase GDP. They certainly indicate that the tax system should be radically overhauled, not to outlaw the practices, but to render them moot through fundamental tax reform that would provide more sensible tax treatment of saving, investment and foreign source income.

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