Harnessing the Costs of International Tax Arbitrage

MARY BUTKUS PHOTO

THE CURRENT INTERNATIONAL TAX REGIME of the United States has become rife with planning opportunities for clever and aggressive taxpayers. In this regard, much attention has been paid to noneconomic "tax shelters" and other, similar tax-avoidance transactions. However, one planning strategy unique to the cross-border setting (commonly referred to as "international tax arbitrage" or "cross-border tax arbitrage") is different.

Under international tax arbitrage, taxpayers 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 taxpayers would have paid if only one jurisdiction had exercised its taxing authority. In effect, taxpayers can raid the fisc (which fisc is a different question), while fully complying with the law. Predictably, the jurisdictions involved tend to view these transactions as undesirable and seek to curtail them.

A more difficult question is how a jurisdiction, such as the United States, should respond to its taxpayers engaging in these types of transactions. This question is difficult precisely because international tax arbitrage arises as a result of the conflict between the tax laws of one jurisdiction with those of another jurisdiction. Each country designs its own internal tax regime to promote specific policy goals, balancing the impact on the domestic economy, the distributive impact on its citizens and residents, and the impact on the worldwide economy in different ways. When the rules of two jurisdictions conflict, it is precisely 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.

In light of the conflicting policy choices implicit in international tax arbitrage, countries have an incentive not to cooperate to resolve the issue under the current international tax regime. This incentive structure leads to a long-term equilibrium of mutual noncooperation and, as a result, a suboptimal worldwide tax regime. An optimal solution might be the establishment of a worldwide taxing authority with the ability to impose harmonized laws on the two jurisdictions. The problem with this approach is that no one country has any incentive to surrender its power over tax matters to such a body. Respect for the sovereignty of countries to adopt and implement their own tax rules also complicates the creation of a body to impose harmonized tax rules on unwilling countries. Therefore, in the absence of a worldwide taxing authority, unilateral responses by individual countries must be considered.

ANY UNILATERAL RESPONSE to international tax arbitrage necessarily requires 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 U.S. tax regime are not, however, monolithic. The domestic tax rules and the international tax rules of the United States represent different, and at times incompatible, policy choices. Accepting that the U.S. domestic and international tax regimes adopt differing equity and efficiency policies, 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 or international equity or efficiency (or both) to combat international tax arbitrage. Traditional responses to international tax arbitrage have attempted to balance these disparate costs and benefits, a task that has proven difficult, if not impossible.

This article addresses the problem by proposing that there may be a different way to conceptualize the response to international tax arbitrage. In particular, analysis of international tax arbitrage must be taken out of isolation and placed within the proper context; international tax arbitrage is not an independent

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phenomenon, but rather one manifestation of the broader issue of international tax relations. 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 provide some additional benefit to the international tax regime in exchange for bearing these 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 specifically, this article contends that the costs of international tax arbitrage can be harnessed to benefit those countries that have not historically benefited from the policies of the worldwide tax regime—i.e., developing countries. Not only would such an approach benefit developing countries at little or no marginal cost to the United States, but, more fundamentally, it could also serve to change the debate: placing the issue of international tax arbitrage on the world stage, realigning worldwide incentives, and leading to increased worldwide cooperation and a more harmonized worldwide tax regime.

PART II OF THIS ARTICLE summarizes the development of international tax arbitrage and discusses the underlying policy choices of the domestic and international tax regimes of the United States that have led to the current system. Part III then discusses responses to international tax arbitrage and analyzes the criticisms of each in light of the policy choices discussed in Part II. Part IV proposes a new methodology for harnessing and directing the costs of international tax arbitrage to promote worldwide development and analyzes how such an approach could ultimately transform the current worldwide equilibrium into a more cooperative regime while aiding developing countries in the short term. Part V then applies 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.

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Despite attention from governments, international organizations, and academics, the issue of international tax arbitrage has proven a difficult and at times intractable one. Rather than try to minimize the costs of such arbitrage or prevent abuse of the laws of a particular regime, the United States should consider affirmatively bearing some of the costs of the international tax arbitrage, both as a means to further exogenous policy choices and to transform the current incentive structure that led to the worldwide equilibrium permitting the rise of international tax arbitrage in the first place, by unilaterally and explicitly permitting the benefits of such transactions to the extent they are undertaken in developing countries.

Harnessing the cost of international tax arbitrage will not always be the appropriate response to every particular international tax arbitrage transaction, but it should be considered when other, more traditional 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, harnessing the costs of international tax arbitrage could place the issue back on the international scene, restart stalled international tax discussions, and move the worldwide tax regime towards greater consensus, not only on the role of international tax arbitrage, but also on the larger issue of international vertical equity in the global tax regime. In a second-best world, unilateral action by the United States to harness the costs of international tax arbitrage may be the first step towards a first-best solution.

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