

Notable International Tax Articles of 2011

By Robert A. Green

Robert A. Green is a professor at Cornell Law School.

In this article, Green highlights several international tax articles of 2011 that might be of interest to a broad audience of tax professionals.

Introduction and Method

This article highlights recent academic international tax scholarship that might be of interest to tax academics, practitioners, policymakers, and others. The list below is by no means comprehensive; many excellent articles are not included. In selecting the articles listed below, I have limited my consideration to those written by tax academics in 2011 for publication in student- or faculty-edited law reviews. One well-known problem with law reviews is that there is often a long lag between the submission of an article and its publication. Academics solve that problem by reading articles when they are posted as working papers on the Social Science Research Network (SSRN).¹ In accordance with that practice, and to create a more timely list, I have considered for inclusion not only articles that were actually published in law reviews in 2011,² but also

¹There are several good ways to keep up with tax scholarship on SSRN (<http://ssrn.com>). One is to subscribe to one or more of its Tax Law & Policy e-Journals (*Int'l & Comp. Tax; Practitioner Series*; and *Tax Law & Pol'y*). Another is to read Paul Caron's "TaxProf Blog" at <http://taxprof.typepad.com>, which will keep you informed about recent tax working papers posted on SSRN, as well as scholarship presented at various tax colloquia and news of interest to tax academics and others.

²I have excluded several international tax articles that were published in law reviews in 2011 because they were mentioned in last year's list of notable international tax articles, based on working paper versions that were posted on SSRN in 2010. See Robert A. Green, "Notable International Tax Articles of 2010," *Tax Notes*, Mar. 7, 2011, p. 1203, *Doc 2011-2754*, or *2011 TNT 46-10*. They include Kimberly A. Clausung and Daniel Shaviro, "A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?" *64 Tax L. Rev.* 431 (2011); Shaviro, "The Case Against Foreign Tax Credits," *3 J. of Legal Analysis* 65 (2011);

(Footnote continued in next column.)

articles that were posted on SSRN as working papers (and accepted for publication in law reviews) in 2011.

Selected Articles

The following articles are arranged alphabetically by the first-listed author's last name, except when articles are paired because one is a response to the other.

Allison Christians, "How Nations Share," *Ind. L.J. (forthcoming)*.³ Professor Allison Christians notes that tax treaties provide only a design for allocating international tax revenues among nations. To understand how those revenues are actually shared in practice, it is necessary to know how tax treaties are applied in specific cases. Tax treaty disputes, however, are generally resolved in non-law ways, in particular through competent authority proceedings that are carried out in secrecy and that produce undisclosed and non-precedential outcomes. Christians notes that the international tax regime uses soft law institutions, particularly the OECD, to aggregate and publicize the experiences of competent authorities in the form of informal guidance, but argues that that provides only an inadequate, filtered substitute for the publication of competent authority agreements themselves. She argues that the system protects taxpayer confidentiality, but at the high social cost of obscuring public observation of how international tax law develops and how international tax revenues are shared among nations in practice. Christians also argues that the system benefits the economically and politically powerful countries that dominate the soft law institutions, because it enables them to allocate international tax revenues according to their preferences, and perhaps in inequitable ways, without public scrutiny and criticism.

Edward D. Kleinbard, "Stateless Income," *11 Fla. Tax Rev.* 699 (2011)⁴; and Kleinbard, "The

Shaviro, "The Rising Tax-Electivity of U.S. Corporate Residence," *64 Tax L. Rev.* 377 (2011); and Edward Zelinsky, "Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile," *96 Iowa L. Rev.* 1289 (2011).

³University of Wisconsin Legal Studies Research Paper No. 1159, available at <http://papers.ssrn.com/abstract=1815305>.

⁴Available at <http://ssrn.com/abstract=1791769>.

Lessons of Stateless Income,” *Tax L. Rev.* (forthcoming).⁵ In these articles, professor Edward Kleinbard argues that the pervasive presence of “stateless income” necessitates a fundamental re-consideration of international tax policy. He defines stateless income as “income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group’s ultimate parent company, but which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group’s parent company.”⁶ Stateless income generally involves the shifting of taxable income within a multinational group from high-tax to low-tax source countries without altering the location of externally supplied capital or activities involving third parties.

In the first article, Kleinbard analyzes the phenomenon of stateless income and its implications for current tax policies. He argues that stateless income is enabled by fundamental and deeply embedded international tax norms, as well as by the fundamental economic ambiguity regarding the geographic source of income from intangible assets. Eradicating stateless income is unrealistic, because it would require unprecedented levels of international cooperation and agreement on new tax norms.

Kleinbard explains that multinational firms can get two bites at the apple of stateless income tax planning. First, they can take advantage of existing norms and sourcing principles to situate in low-tax countries the returns from factors of production that are more plausibly located in high-tax countries. Second, they can use earnings stripping strategies to move income from high-tax to low-tax countries in a separate step, which typically involves intra-group payments of interest, rents, or royalties. Kleinbard illustrates stateless income tax planning using the “Double Irish Dutch Sandwich” structure used by Google (and easily replicated by others).

Kleinbard argues that the U.S. tax system, which is commonly viewed as taxing U.S.-based multinational firms on their worldwide income, in fact enables those firms to operate in a quasi-territorial tax environment and to earn stateless income in the same manner as their territorial-based competitors. That vitiates the argument that the U.S. tax system disadvantages U.S. multinational firms by subject-

ing them to higher effective global tax rates than those to which their territorial-based competitors are subject.

Kleinbard argues that stateless income tax planning privileges multinational firms over domestic ones by enabling the former to capture tax rents. If after-tax returns on business income converge on a single worldwide level in economic equilibrium, then pretax returns must be higher in high-tax countries than in low-tax countries. Stateless income tax planning permits multinational firms to earn high pretax returns from activities in high-tax countries and then migrate those returns to low-tax countries for tax purposes, thereby capturing low-risk infra-marginal returns.

Other policy implications of stateless income tax planning include:

the dissolution of any coherence to the concept of geographic source, the systematic bias towards offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the erosion of the U.S. domestic tax base through debt-financed tax arbitrage, many instances of deadweight loss, and — essentially uniquely to the United States — the exacerbation of the lock-out phenomenon, under which the price that U.S. firms pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (roughly \$1.4 trillion, by the most recent estimates) and cash outside the United States.⁷

In his second article, Kleinbard analyzes the implications of stateless income tax planning for the reliability of the economic efficiency benchmarks that are commonly used in evaluating international tax proposals. He also analyzes the implications of stateless income for the design of U.S. international tax policy in the future, focusing on the alternatives of adopting a territorial tax system or a worldwide tax consolidation system.

The principle of capital ownership neutrality has been advanced as the basis for a policy recommendation that the United States adopt a territorial tax system. Kleinbard argues that that policy prescription assumes a world of perfect tax capitalization, and that stateless income tax planning vitiates that assumption. Unless the stateless income phenomenon can be eliminated — a highly unrealistic scenario — the adoption by the United States of a

⁵University of Southern California Center for Law, Economics and Organization Research Paper C11-2 and USC Legal Studies Research Paper No. 11-7, available at <http://ssrn.com/abstract=1791783>.

⁶11 *Fla. Tax Rev.* at 701.

⁷*Id.* at 714 (emphasis in original, note omitted).

territorial tax system will distort corporate investment and ownership decisions and deplete domestic tax revenues.

Kleinbard ultimately recommends that the United States adopt a world tax consolidation system. He acknowledges that such an approach is imperfect, but argues that the imperfections can be mitigated, particularly if the system is combined with a corporate tax rate in the neighborhood of the world median for comparable economies, a thin capitalization regime, and, ideally, adoption of the Business Enterprise Income Tax. Kleinbard argues that, if the United States were to adopt a well-designed worldwide tax consolidation system, a U.S. firm's investment decisions would not be greatly distorted by tax considerations; aggressive transfer pricing strategies, tax arbitrage strategies, and stateless income tax planning would not erode the domestic tax base; and U.S. firms would not be placed at a significant competitive disadvantage relative to comparable foreign firms.

Michael S. Knoll, "Reconsidering International Tax Neutrality," 64 *Tax L. Rev.* 99 (2011); and **Fadi Shaheen, "International Tax Neutrality: Revisited,"** 64 *Tax L. Rev.* 131 (2011). Debates about the form that the international tax system should take are commonly framed in terms of neutrality norms, particularly capital export neutrality (CEN), capital import neutrality (CIN), and capital ownership neutrality (CON). In "Reconsidering International Tax Neutrality," professor Michael Knoll, building on an earlier article by professor Fadi Shaheen,⁸ argues that much confusion has been introduced into the debates because CIN has been used with inconsistent meanings. Professional economists generally adopt the definition given in an influential article by Thomas Horst⁹ and use CIN to mean what Knoll calls "savings neutrality." Many lawyers, policy analysts, and lay readers, however, interpret CIN to mean competitiveness or "ownership neutrality." Knoll argues that to avoid confusion in the future, commentators need to be more careful about terminology, perhaps even abandoning the traditional terms and acronyms and speaking directly about locational distortions, saving distortions, and ownership distortions. Knoll goes on to clarify the conditions required for each neutrality benchmark to be satisfied. In particular, he concludes that global adoption of a worldwide tax system can simultaneously satisfy both locational and ownership neutrality; that global adoption of a

territorial tax system can simultaneously satisfy both ownership and savings neutrality; but that it is not possible for a tax system to satisfy both locational and savings neutrality without harmonizing tax rates.

In his reply to Knoll's article, Shaheen discusses the definitions and efficiency objectives of classic CEN, CIN, and CON; explains his disagreement with Knoll's views of CIN and CON; addresses Knoll's responses to arguments he made in his earlier article; and further develops those arguments.

Ruth Mason and Michael S. Knoll, "What Is Tax Discrimination?" *Yale L.J.* (forthcoming)¹⁰; and **Michael J. Graetz and Alvin C. Warren Jr., "Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility,"** *Yale L.J.* (forthcoming).¹¹ In their article, professors Ruth Mason and Michael Knoll argue that in common markets like the EU and United States, the income tax nondiscrimination principle can best be interpreted as promoting what they call "competitive neutrality." They focus on situations involving the taxation of labor income. In that context, a tax system is competitively neutral when it is not possible to increase productivity by shifting jobs among people. On the other hand, if the tax system induces workers to take jobs at which they are at a comparative disadvantage, then the tax system violates competitive neutrality.

In arguing that nondiscrimination is best understood as promoting competitive neutrality, Mason and Knoll primarily make an interpretive argument based on the goals of the EU common market, the language and structure of the EU treaties, and the European Court of Justice's case law. They also consider normative arguments, however, and conclude that a competitive neutrality interpretation of nondiscrimination would promote economic efficiency, decrease legal uncertainty, promote representation reinforcement and political unity among residents of different EU member states, and allow the ECJ to avoid making legislative decisions.

Mason and Knoll conclude that in the absence of global tax harmonization, there are two principal ways to achieve full competitive neutrality. First, all states could adopt worldwide taxation with unlimited credits for source taxes. Second, all states could adopt what the authors call the "ideal deduction method" of double tax relief. Under that method, states would tax cross-border income in two stages.

⁸"International Tax Neutrality: Reconsiderations," 27 *Va. Tax Rev.* 203 (2007).

⁹"A Note on the Optimal Taxation of International Investment Income," 94 *Q. J. Econ.* 793 (1980).

¹⁰Available at <http://ssrn.com/abstract=1647014>.

¹¹Columbia Public Law Research Paper No. 11-282 and Harvard Public Law Working Paper 11-24, available at <http://ssrn.com/abstract=1923809>.

In the first stage, each state would impose source-based taxes on the same basis on both residents and nonresidents. In the second stage, each state would tax its residents on their worldwide income, with a deduction for the first-stage (source-based) taxes imposed both at home and abroad. In the special case when the second-stage tax is set at zero, the “ideal deduction method” reduces to an exemption system.

Mason and Knoll acknowledge that courts cannot compel all states to agree on one of the two methods of taxation described above, and therefore cannot implement the requirements for full competitive neutrality. They argue, however, that courts can advance competitive neutrality by interpreting the nondiscrimination principle to require both uniform source taxes and uniform residence taxes. That means that a state must apply its source-based tax regime uniformly to all workers within its jurisdiction (no matter where they reside), and must apply its residence-based tax regime uniformly to all its residents (no matter where they earn their income). Each state, however, may set its own tax rates.

Although Mason and Knoll primarily use ECJ tax cases as examples to illustrate their arguments about the meaning of tax discrimination, they also discuss the implications of their arguments for the U.S. Supreme Court’s tax nondiscrimination jurisprudence.

Mason and Knoll’s article is in part a response to a 2006 article by professors Michael Graetz and Alvin Warren.¹² In that article, Graetz and Warren criticized the ECJ’s approach to tax discrimination cases, arguing in particular that the court’s approach is incoherent because it imposes nondiscrimination obligations on states taxing in both a source capacity and a residence capacity. That corresponds to requiring states to implement both capital import neutrality and capital export neutrality. But it is impossible to implement both neutrality norms simultaneously unless states harmonize their income tax bases and rates. The ECJ has repeatedly held that EU law does not require tax harmonization, because that would violate the member states’ retained tax autonomy. Therefore, by imposing nondiscrimination obligations at both source and residence, the ECJ has entered what Graetz and Warren called a “labyrinth of impossibility.” Mason and Knoll argue that the competitive neutrality interpretation of nondiscrimination provides a way out of

the labyrinth, because it is consistent with imposing nondiscrimination obligations on both source and residence states.

In their reply article, “Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility,” Graetz and Warren argue that Mason and Knoll have failed to make a persuasive case — as either a positive matter or as a normative matter — that tax nondiscrimination is best understood as promoting competitive neutrality. They also argue that implementation of the full version of competitive neutrality would be impractical because it would require all states to adopt the same one of two unrealistic tax systems. Graetz and Warren view what they term the “partial competitive neutrality” standard that Mason and Knoll advocate (that is, requiring uniform source and residence taxes) as being too attenuated from the full requirements for competitive neutrality to be compelling as a constitutional standard. Graetz and Warren also argue that competitive neutrality fails to provide a way out of the labyrinth of impossibility, as they described it in their 2006 article. In particular, they argue that full competitive neutrality involves either harmonization, locational distortions, or effective elimination of either source or residence country taxation. And the partial competitive neutrality standard restricts the court’s analysis to the law of only a single country, which is contrary to the ECJ’s decisions and fails to reflect the total tax burdens or benefits imposed on cross-border income. Finally, Graetz and Warren argue that neither version of competitive neutrality provides courts with clear answers in difficult cases.

¹²“Income Tax Discrimination and the Political and Economic Integration of Europe,” 115 *Yale L.J.* 1186 (2006).