

The crossroads versus the seesaw: getting a 'fix' on recent international tax policy developments

November 2015

WP15/29

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Working paper series | 2015

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THE CROSSROADS VERSUS THE SEESAW:

GETTING A “FIX” ON RECENT INTERNATIONAL TAX POLICY DEVELOPMENTS

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Revised Draft

July 2015

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I. INTRODUCTION

U.S. international tax policy is at a crossroads, say those who urge the United States to adopt what common parlance would call a territorial system.¹ They argue that one of the two ways forward they identify – trying to fortify the current U.S. system – would lead to ever-costlier outlier status for our tax system, and ever-declining competitiveness for U.S. multinationals. They therefore urge U.S. policymakers to embrace what they identify as the other way forward: conforming to global norms by adopting a territorial system.

These proponents ignore or misunderstand two important points. First, the “worldwide versus territorial” distinction greatly oversimplifies a reality in which countries’ international tax systems overlap substantially.² For example, no major country actually has a pure territorial

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¹ See, e.g., Mihir A. Desai, *Securing Jobs or the New Protectionism? Taxing the Overseas Activities of Multinational Firms*, Harvard Business School Working Paper 09-107 (2009) at 19 (“Tax policy towards multinational firms would appear to be approaching a crossroads”); Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger, *The U.S. International Tax System at a Crossroads*, Tax Notes, April 5, 2010.

² See Rosanne Altshuler, Stephen Shay, and Eric Toder, *Lessons the United States Can Learn from Other Countries’ Territorial Systems for Taxing Income of Multinational Corporations*, Tax Policy Center Working Draft (2015) at 33 (“The differences between worldwide and territorial systems, in practice, when exceptions and anti-abuse rules are taken into account, are far less significant than the debate in the US tax policy community would suggest”); Kimberly A. Clausing, *Beyond Territorial and Worldwide Systems of International Taxation* 2-3 (2015) (“In practice, we do not typically observe either type of system in its pure form Often, actual real-world territorial systems tax some types of foreign income, exert tax influences on repatriation decisions, and navigate balancing acts between measures that protect the domestic tax base and those that lighten the burden on foreign income. Often, actual worldwide systems tax many types of foreign income lightly or not at all, exert even larger tax effects on

system. Instead, putatively territorial countries generally tax certain foreign source income (FSI) that is earned by resident companies. The U.S. worldwide system, meanwhile, greatly lowers the effective tax rate for FSI, relative to that on domestic source income, by using foreign tax credits and deferral (under which income earned through foreign subsidiaries generally does not become taxable until realized by the U.S. parent). As we will see in section II, further narrowing of the gap between the two types of systems results from the considerable similarity between controlled foreign corporation (CFC) rules in the United States, where they limit the scope of deferral, and in territorial countries, where they limit the scope of exemption.

Second, if “the current U.S. system is ‘out of step’ with world norms, [whereas] other major OECD nations have figured out what to do [in short, i]f everyone else has gotten it right, and they are now doing so great, why aren't they happy? The whole OECD / BEPS (base erosion and profit-shifting) issue shows that they do not think they have gotten it right”³ either.⁴

Despite this dissatisfaction, it should come as no surprise that, even in newly minted territorial countries such as the United Kingdom, there has been no significant discussion of formally returning to worldwide taxation. This reflects that such restoration is both unnecessary, given the practical overlaps between available tools under the two models, and unappealing, given actual worldwide systems’ poor performance historically.⁵ Yet a sterile comparison between counterfactual textbook “worldwide” and “territorial” systems is neither responsive to the main problems that all leading countries’ international tax systems currently face, nor helpful

repatriation decisions, and face the same balancing act between domestic tax base protection and the business interests of resident multinational firms.”).

³ Daniel Shaviro, *They're Not Happy*, available on-line at <http://danshaviro.blogspot.com/2014/10/theyre-not-happy.html> (October 24, 2014).

⁴ The reference to “OECD / BEPS” refers to the fifteen-point action plan, to address base erosion and profit-shifting (i.e., BEPS), that the OECD announced in July 2013. See OECD, *Action Plan on Base Erosion and Profit Shifting* (July 19, 2013).

⁵ There is, for example, “near-universal consensus that the existing U.S. international tax system is horrendously bad.” Daniel Shaviro, *FIXING U.S. INTERNATIONAL TAXATION 3* (2014).

in identifying the key choices and tradeoffs. Thus, vehement advocates of choosing the territorial fork in the road can rightly be charged with lingering at the wrong intersection, whether or not they have been urging a wrong turn once there.

An alternative metaphor to that of the crossroads, more likely to appeal to proponents of addressing stateless income⁶ than to pro-territorialists, is that of the seesaw.⁷ Under this view, while policymakers in OECD countries may long have deliberately tolerated profit-shifting by multinationals – perhaps as an informal way of lowering effective tax rates for these often highly mobile taxpayers – at some point they became convinced that it had gone too far. Thus, proponents of restricting stateless income want to tip the balance somewhat (but not too far) back in the other direction.

Here the problem is different. Even if one accepts the metaphor, policymakers lack the analytical tools for judging, not just how much the equilibrium should shift back, but also in what dimensions it should be balanced properly. Proponents of tougher rules to address stateless income, no less than pro-territorialists, need better normative frameworks for assessing international tax policy, given that the traditional ones, as Michael Graetz argued more than a decade ago, offer “inadequate principles, outdated concepts, and unsatisfactory policies.”⁸

Proponents of rebalancing the “seesaw” have mainly emphasized the single tax principle,⁹ which holds that each increment of a multinational’s global income should be subject to tax somewhere exactly once, rather than either zero times or twice. Unfortunately, even with higher levels of international cooperation than history gives us reason to expect, this principle

⁶ See Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

⁷ My use of the seesaw metaphor is entirely different from that in Joel Slemrod, Carl Hansen, and Roger Procter, *The Seesaw Principle in International Tax Policy*, National Bureau of Research Working Paper No. 4867 (1994), where it refers to the idea that “the optimal tax on the income from capital exports (imports) is inversely related to the given tax rate on income from capital imports (exports).”

⁸ See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 272 (2001).

⁹ See, e.g., Reuven S. Avi-Yonah, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* 59-65 (2015).

would be hard to implement. Short of countries agreeing to harmonize their distinctive rules (which they appear to have little interest in doing), it is quite challenging to coordinate all of the interactions between distinctive systems across multiple complex dimensions.¹⁰ Yet, even if the single tax principle were easy to operationalize, it would be hard to rationalize. As we will see, it fails to line up consistently with promoting either national welfare in a given country that is acting unilaterally, or global welfare among countries that are cooperating.

In my 2014 book *Fixing U.S. International Taxation*, I tried to take up Graetz’s challenge regarding the inadequacy of existing approaches, and to offer a better analytical framework for international tax policy, which I hoped to develop by “start[ing] again from first principles – albeit, principles that are routinely used elsewhere in public economics.”¹¹ The concepts that I aimed to sideline or even banish included not just the single tax principle,¹² along with the “worldwide versus territorial” framework – which I disparaged as conflating multiple margins,¹³ even leaving aside countries’ hybridity in practice – but also normative reliance on the whole rancid “alphabet soup” of single-margin neutrality benchmarks such as capital export neutrality (CEN), capital import neutrality (CIN), and capital ownership neutrality (CON).¹⁴

Proponents of a “battle of the acronyms” between those three concepts, I argued, overlook the significance of international tax policy’s implicating multiple margins, no one of which should be optimized at the expense of all the rest. They also commonly ignore the potential gap between a national welfare perspective, which is what countries usually follow when making policy choices, and the global welfare framework that CEN, CIN, and CON

¹⁰ See, e.g., Michael L. Schler, *OECD vs. D/NI: Ending Mismatches on Hybrid Instruments, Part 1*, Tax Notes, August 11, 2014, at 485-498 (reviewing difficulties in coordination between countries’ income tax systems that relate to hybrid financial instruments).

¹¹ Shaviro, *FIXING*, supra, at 4.

¹² See id. at 4-7.

¹³ See id. at 10-14.

¹⁴ See id. at 14-16.

adopt.¹⁵ While the prospect of gain from multilateral cooperation can push the national welfare and global welfare perspectives closer together, that requires evaluating strategic interactions between countries, which proponents of CEN, CIN, and CON commonly fail to do.

A number of important things have happened in international tax policy since *Fixing* went to press. For example:

(1) The United States has faced a rising tide of corporate inversions, in which foreign companies acquire U.S. companies, at least partly with the aim of lessening the sting of residence-based U.S. rules.

(2) The OECD's BEPS project has been steaming forward, although its long-term prospects, with respect both to ongoing multilateral cooperation and results on the ground, remain uncertain.

(3) The U.K. government has enacted a diverted profits tax, popularly known as the "Google tax,"¹⁶ which is controversially aimed at profit-shifting by multinationals, and perhaps in particular that by non-U.K. companies.

(4) There has recently been much discussion in the United States regarding the possible adoption of what is often called a "patent box" regime.¹⁷ In such a regime, income that is deemed to be associated with specified types of intangible property, such as that from patents, copyrights, and trademarks, may qualify for a special reduced tax rate. The amount of actual domestic economic activity that must be associated with the low-rate income varies with the

¹⁵ See *id.* at 15-16.

¹⁶ Cite for the UK diverted profits tax.

¹⁷ See, e.g., Martin A. Sullivan, *Can a Patent Box Promote Advanced Manufacturing?*, 147 *Tax Notes* 1347 (June 22, 2015); Martin A. Sullivan, *From Check-the-Box to a Patent Box*, 147 *Tax Notes* 1496 (June 29, 2015); Alex Parker, *How Patent Boxes are Taking Congress By Storm*, Bloomberg BNA, *International Tax Blog*, June 5, 2015, available online at <http://www.bna.com/patent-boxes-taking-b17179927417/>.

particular rule, and has recently been a topic of controversy in the European Union (EU), by reason of concerns about what some may view as “unfair” tax competition.¹⁸

(5) A number of leading U.S. policymakers, both Democratic and Republican, have issued ambitious international tax reform proposals, in several instances offering novel approaches that vary from current practice both in the United States and elsewhere.¹⁹

In this paper, without delving too deeply into the ever-changing details of these and other episodes in the ongoing struggles over international tax policy, I will offer a brief review of how the main principles I advanced in *Fixing*, as proposed substitutes for the standard “worldwide versus territorial” framework, relate to, and may help us in evaluating, these recent developments. To this end, section II discusses four of the main arguments advanced in *Fixing* regarding how we should conceptualize international tax policy issues, section III discusses their relevance to the above five developments, and section IV offers a brief conclusion.

II. FOUR MAIN POINTS FROM *FIXING U.S. INTERNATIONAL TAXATION*

A. The Two Margins That Get Conflated Under the Single Tax Principle: The Tax Rate on Foreign Source Income and the Domestic Tax Treatment of Foreign Taxes

Adherence to the single tax principle does not directly serve either global or national welfare. From a global perspective, when countries have different tax rates, taxing everything exactly once does not yield neutrality, much less optimality. What matters about taxes is the burdens they impose, not how many times they are separately (as a formal matter) levied. Thus, most of us would rather be taxed twice at a 15 percent rate than once at a 40 percent rate.

¹⁸ See, e.g., Germany-UK Joint Statement, Proposals for New Rules for Preferential IP Regimes, November 2014, available online at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/373135/GERMANY_UK_STATEMENT.pdf (describing agreement regarding the design of the U.K. patent box regime).

¹⁹ Refer to Camp, Baucus, and 2016 Obama Administration budget plans.

Turning to the unilateral national welfare perspective, a given country does not necessarily benefit (at least directly) by reason of the scenario where firms that are owned by domestic individuals have to pay foreign taxes, rather than being able to avoid them. Thus, the single tax principle is at best a multilateral coordination device that peer countries, if they have sufficiently similar tax systems and economies, may find convenient in arranging the terms of their rules' potentially overlapping application to particular transactions and taxpayers. The principle's convenience in this respect presumably helps to explain its widespread use in bilateral tax treaties.

Given this point, why emphasize the normative limitations of the single tax principle? Perhaps the core problem with treating it as something more than an often useful coordinating device is that this can result in blindfolding both policymakers and analysts. In particular, unreflective adherence can lead, not just to too-swift narrowing of the design choices for international tax systems that are deemed potentially feasible, but also to a fundamentally confused analysis of existing systems' relevant effects on taxpayer incentives.

If each increment of a given multinational's global income can only be taxed once and source-based taxation is prevalent, then residence countries seemingly have only two choices: to exempt resident companies' FSI or to offer foreign tax credits. No matter, from this perspective, that one could actually impose *lower* tax burdens on FSI if foreign taxes were merely deductible but it was taxed at a sufficiently low rate, than under the classic worldwide approach where it gets foreign tax credits but faces the full domestic rate.²⁰ After all, once has drunk the "tax-it-

²⁰ For example, if the U.S. domestic tax rate is 40 percent and the German tax rate is 25%, a given U.S. company would owe less U.S. tax on its FSI if the U.S. tax rate on FSI was 15 percent and foreign taxes were merely deductible, than if FSI was taxed at the full domestic rate and foreign taxes were fully creditable. For example, \$100 of German FSI would face a residual U.S. tax bill of \$12 (i.e., 15% of \$75) under the former approach, as compared to \$15 under the conventional worldwide approach. Shaviro, *FIXING*, supra, at 6.

exactly-once” Kool Aid, actual tax burdens no longer matter – just the question of whether the same increment of income has literally been taxed twice.

Whether or not territorial and worldwide/foreign tax credit systems are the only feasible choices, a simple distinction between them is not well-posed intellectually. The problem is that they differ at two margins, not just one. Focusing separately on each margin turns out to be indispensable to a coherent analysis of both existing international tax systems and possible reform options.

The first margin concerns the tax burden that a given country’s tax system imposes on resident companies’ FSI, whether one thinks of this in terms of the marginal tax rate (MTR) or the effective rate (both of which matter for particular purposes). Starting with the MTR, it is zero under a pure territorial system, and equal to the domestic tax rate under a classic worldwide system. The effective rate presumably is still zero under a pure territorial system, and is likely to be somewhere between zero and the full domestic effective rate under a classic worldwide system (although this depends on myriad further details, including the relationship between domestic tax rates and those applying in source countries).

The second margin concerns how foreign taxes affect one’s domestic tax liability. If one pays, say, an extra dollar of foreign taxes, how much, if at all, does one’s domestic tax liability decline. If, by reason of paying a dollar of foreign taxes, one’s domestic tax liability declines in present value terms by a dollar, then the marginal reimbursement rate (MRR) for foreign taxes is 100 percent. (As I discuss below, however, it could also in practice be higher than 100 percent). If paying an extra dollar has no effect on one’s domestic tax liability, then the MRR is zero.

A pure territorial system has an MRR of zero, as it ignores foreign taxes along with the associated FSI. By doing so, however, it creates equivalence between the MRR and the MTR for

FSI, which after all is exempt. By reason of this equivalence between the MRR and the MTR, a pure territorial system treats foreign taxes as implicitly deductible. Just like an explicit deductibility system for such taxes that is accompanied by a positive tax rate on FSI, it creates after-tax equivalence between foreign taxes paid and other inputs to net after-foreign tax profitability. It thus induces resident companies to seek to maximize their after-foreign-tax returns, rather than, as in the case of a system that offers unlimited foreign tax credits, their before-foreign tax returns.

One mystery, which I further discuss below, is why it is commonly assumed both (1) that the MTR for FSI should either be the full domestic rate or zero, and (2) that the MRR for foreign taxes should either be 100 percent or the MTR (i.e., zero, in the case of pure territoriality). How can it possibly make sense to rule out intermediate values at either or both margins, other than as an automatic byproduct of mindlessly following the single tax principle? In addition, even if putatively “worldwide” and “territorial” systems are the only legally or politically feasible choices – and I will show below that they are not – it turns out that one cannot coherently analyze existing international tax systems, or potential reforms to such systems that clearly are feasible, without considering each margin separately.

B. The Case for Taxing Resident Companies’ Foreign Source Income at a Rate Between Zero and the Full Domestic Rate

Unhelpful though “alphabet soup” or the battle of the acronyms generally is to the evaluation of international tax policy issues, there is one counter-example in spite of itself (or exception that proves the rule): a particular acronym that helps out, in a sense, by the way in which it facially misdirects attention may end up pointing one in the right direction. This is the norm of national ownership neutrality (NON), which ostensibly motivates exempting resident

companies' FSI, as considered purely from the standpoint of unilateral national welfare. As I explained in *Fixing*, however, what NON actually helps to demonstrate is that countries employing significant distortionary source-based taxes generally *should* tax resident companies' FSI, at some rate greater than zero, if they have significant market power over corporate residence.

NON rests on the premise that “additional outbound foreign investment does not reduce domestic tax revenue, since any reduction in home country investment by domestic firms is offset by greater investment by foreign firms.”²¹ Now, the presumption here that unchanged investment must mean unchanged revenue is erroneous, even as a first-order approximation, given that outbound investment by domestic firms may permit them to engage in increased profit-shifting. Thus, suppose a U.S. firm buys an affiliate in a low-tax country such as Ireland or Singapore, in lieu of simply dealing at arm's length with independent foreign counterparties, so that it can use transfer pricing and intra-group or third party debt to shift reported profits out of the U.S. tax base.²² This may reduce domestic tax revenue (while also inducing inefficiency) even if home country investment remains constant.

Ignoring this point, NON posits that, “[w]ith unchanging domestic tax revenue, home country welfare increases in the after-tax profitability of domestic companies, which is maximized if foreign profits are exempt from taxation.”²³ In short, NON defines the “neutrality” advantage of exempting FSI in terms of imposing no distortion whatsoever at the margin of a resident firm's deciding how much to invest abroad. As I noted in *Fixing*, “[t]his is ‘neutrality’

²¹ Mihir A. Desai and James R. Hines, *Evaluating International Tax Reform*, 56 Nat'l Tax J. 937, 946 (2003).

²² As Kleinbard, *supra*, shows, once profits have been shifted abroad, it may become easier to on-shift them further to tax havens that have no income tax, in lieu of the merely low (by U.S. standards) rates of countries such as Ireland and Singapore.

²³ Desai and Hines, *supra*, at 946.

in the same sense that a lump sum tax, such as a uniform head tax, is neutral with respect to choices such as how much income one earns.”²⁴

In a world that is full of distortionary taxes, “neutrality” is more commonly defined in terms of equalizing the distortions at different margins. For example, CEN, CIN, and CON all involve equalizing the inefficient tax wedges that apply, as the case may be, as between investment choices, taxpayers, or assets.²⁵ When multiple distortions can or must be traded off against each other, this is generally preferable to seeking zero distortion at one particular margin, while that at other margins remains high and unmitigated.

How does this apply to taxing (or not) resident companies’ FSI? Suppose that, whether a country does so or not, it definitely will be imposing a source-based tax on domestically earned business profits. In that case, it would be strange indeed to ignore the possibility of a tradeoff between the distortions associated with taxing FSI, and those associated with the source-based domestic tax. In the United States, for example, as Mihir Desai has argued, it is plausible that U.S. corporate tax reform, including that with respect to U.S. companies’ FSI, “must be roughly revenue-neutral, given fiscal and political realities.”²⁶

This consideration contradicts treating neutrality in the lump-sum tax sense as an appropriate objective with respect to the taxation of resident companies’ FSI. Instead, if one started with a zero tax rate on FSI and a high source-based tax rate, there is a strong implication

²⁴ Shaviro, *FIXING*, supra, at 151.

²⁵ Id. at 150-151. It is true that a key part of the case for taxing consumption instead of income is that it would set the tax wedge with respect to savings decisions at zero. The underlying rationale, however, is that this would equalize the tax wedges faced by present consumption and future consumption. See, e.g., Joseph Bankman and David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 *Stan. L. Rev.* 1413 (2006). Given the labor supply distortions that result from both income and consumption taxation, the desirability of avoiding any tax wedge as between sooner and later consumption rests on the applicability of the so-called “double distortion” argument, derived from A.B. Atkinson and J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 *J. Pub. Econ.* 55 (1976).

²⁶ Mihir A. Desai, *A Better Way to Tax U.S. Businesses*, 90 *Harv. Bus. Rev.* 135 (2012).

that one could reduce overall distortion, while keeping net revenue constant, by simultaneously raising the tax rate on FSI, and lowering that for domestic investment.

Should this process keep going until one has equalized the tax rates at the two margins? This would achieve neutrality in the other standard sense, that of equalizing the distortions at different margins. It is therefore the prescription of national neutrality (NN), which supports taxing FSI at the full domestic rate, while also treating foreign taxes as merely deductible, since they are just a cost, from the standpoint of domestic individuals.

However, if NN is actually preferable in the unilateral national welfare setting, one would have to wonder why countries have been so universally reluctant to follow its dictates. Are they just being nice, or alternatively are they hoping that other countries will reciprocate if they tax outbound investment less aggressively? While this is certainly possible, one need not posit it, in order to explain the lack of discernible support around the world for NN. Rejecting NN's prescription makes sense even in a unilateral national welfare framework.

Suppose, as seems likely, that countries typically have significantly more market power with respect to domestic investment than they have with respect to the use of a resident entity to invest abroad. Then, for example, the revenue-maximizing source-based rate would likely be considerably higher than the revenue-maximizing tax rate on resident companies' FSI. More importantly, if the same tax rate applied at both margins, it is plausible that the source-based tax would yield a significantly better ratio than the tax on FSI as between revenue raised and deadweight loss imposed on resident individuals. This consideration supports applying a lower tax rate to resident companies' FSI than to domestic investment.²⁷

²⁷ More specifically, as I noted in *FIXING*, "something like what economists call the Ramsey rule should apply. That it, '[t]o minimize *overall* excess burden, the *marginal* excess burden of the last dollar of revenue raised from each [instrument] must be the same.'" Shaviro, *FIXING*, *supra*, at 163. Where some of the items potentially subject to tax are more elastic than others, this can support applying Ramsey's inverse elasticity rule, under which optimal tax

While countries appear to recognize this, given the apparent lack of significant inclination anywhere for following NN, do they also recognize that zero is too low a tax rate for FSI, if one has any significant market with respect to corporate residence? If one looks just at the labels that commonly are assigned to countries' tax systems, and observes how many of them are called "territorial," one might think not.²⁸ However, a different picture emerges if one looks at what these tax systems actually do.

A small point here is that dividends received by resident companies from foreign subsidiaries are sometimes only 95 percent exempt.²⁹ Although the marginal tax rate imposed thereby is small, why would countries bother with 5 percent inclusion if the case for exemption is so crystal-clear, and not subject even to concern about profit-shifting?³⁰ Even a 1 or 2 percent effective tax rate on foreign dividends may invite the comment that outright exemption has been rejected, apparently reflecting concern about tradeoffs of some kind. One could add, if one liked, the standard gibe that, once this has been established, all that really remains is haggling over the price.

More importantly, however, consider the application of CFC rules to resident companies with foreign affiliates. In general, all countries accept the legal fiction that a CFC, even if 100 percent owned by the domestic parent, is a distinct entity, and thus not directly subject to home country taxation if it avoids any inbound activity. This is the doctrinal basis for deferral under

rates and such elasticity are inversely related to each other. *Id.* See Shaviro, *FIXING*, *supra*, at 161-165, for further discussion of why the reasoning that underlies the Ramsey rule, which was developed in the specialized setting of determining optimal commodity tax rates when certain first-best alternatives are assumed to be unavailable, is apt with respect to source-based plus residence-based taxation of business profits.

²⁸ Desai and Hines, *supra*, at 946, take this stance, claiming that the rationale for NON helps one "to understand why so many countries exempt foreign income from taxation."

²⁹ For example, France, Germany, and Japan treat dividends from foreign subsidiaries as only 95 percent exempt. See Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income*, JCX-33-11 (May 30, 2011), at 22, 25, and 28.

³⁰ Germany apparently rationalizes five percent inclusion for foreign dividends on the ground that it is a "proxy for rules that would disallow a deduction for expenses related to exempt foreign income." Joint Committee on Taxation, *Background and Selected Issues*, *supra*, at 25.

the nominally worldwide U.S. international tax system. However, just as the United States applies CFC rules to limit the availability of deferral, by imputing deemed dividends to U.S. parents under specified circumstances, so putatively territorial countries commonly use CFC rules to deny both exemption and deferral. Indeed, according to Brian Arnold, “most of the major capital-exporting countries have adopted CFC rules,” and “it seems only to be a question of time” before more follow suit.³¹ The only significant and apparently stable exceptions to this trend, among capital-exporting countries, are those, such as Belgium, Holland, and Switzerland, that function as tax havens, and thus “are probably concerned that adopting CFC rules ... would detract from their ability to promote themselves” as such.³²

As both Arnold and Kimberly Clausing note, “the point of CFC laws is to distinguish ‘good’ foreign income from ‘bad’ foreign income.”³³ FSI that is assigned to the latter category faces home-country taxation, even though this discourages the use of resident companies to invest abroad. A close examination of various other countries’ CFC rules has led Brian Arnold to conclude that the U.S. rules are “not exceptional,”³⁴ either in the types of FSI that they address, or in their breadth and rigor.³⁵

CFC rules often impose residence-based taxation on FSI that is classified as passive income, such as royalties, interest, and dividends from portfolio stock. They also sometimes apply to FSI that appears to be getting shifted between foreign countries, such as from one in which significant economic activity is occurring to another that merely contains a related party

³¹ Brian J. Arnold, *Comparative Perspective on the U.S. Controlled Foreign Corporation Rules*, 65 Tax L. Rev. 473, 478 (2012).

³² Id. at 478-479.

³³ Clausing, *supra*, at 5; see also Arnold, *supra*, at 479-480.

³⁴ Arnold, *supra*, at 496.

³⁵ See Clausing, *supra*, at 6; Arnold, *supra*, at 479-496. See also Joint Committee on Taxation, *Background and Selected Issues*, *supra*, at 14-46 (discussing in detail the CFC and other pertinent rules applied by nine particular countries with “territorial” systems).

entity.³⁶ In both of these types of cases, the nature of the FSI may support the surmise that it is likely to be reported as arising in a tax haven.

Some CFC rules focus directly on the source country's statutory or effective rate, imposing a residence-based tax if it is too low. For example, Germany excuses CFCs' passive income from facing home-country taxation if it faces at least a 25 percent effective rate.³⁷ Japan taxes passive or apparently shifted CFC income only if it faces an effective tax rate below 20 percent.³⁸ Other countries employ a "designated jurisdiction approach ... under which the CFC rules apply only to CFCs resident in defined or designated low-tax countries."³⁹ Thus, Argentina, Venezuela, and Italy apply tax haven "black lists," while South Korea and Mexico apply broader definitions to identify low-tax countries. The United Kingdom has a rule directing exemption to CFCs resident in specified territories which have broadly similar tax rates and bases to those in the U.K., pursuant to which it publishes what is in effect a "white list" of approved countries.

In sum, "bad" FSI generally is that which might be expected to, and/or actually does, face a relatively low foreign tax rate. Even before we turn, in the next section, to the separate margin of how foreign taxes should affect one's domestic liability, it is worth noting the general similarity between this and the worldwide / foreign tax credit approach to taxing FSI, under which residual domestic tax liability directly depends on how much foreign tax one paid. However, CFC rules are not the only mechanism by which putatively territorial countries impose tax burdens on FSI.

³⁶ See Arnold, *supra*, at 490-492.

³⁷ See Joint Committee on Taxation, *Background and Selected Issues*, *supra*, at 26.

³⁸ See *id.* at 29.

³⁹ Arnold, *supra*, at 483-484.

Another important instrument towards this end is thin capitalization or anti-earnings stripping rules, under which domestic interest deductions may be denied if they are excessive by some measure. For example, in Germany, in measuring domestic income, in general “a company’s excess of interest expense over interest income ... is deductible only up to 30 percent of the company’s taxable income before interest, taxes, and depreciation and amortization.”⁴⁰ This limitation on net interest deductions generally does not apply, however, if the German company either is not part of a broader group of companies, or “if the German resident company that is part of the group is not more thinly capitalized than the overall group under a measure of equity in relation to total balance sheet assets.”⁴¹ To broadly similar effect, the United Kingdom applies a “worldwide debt cap” to medium- and large-sized companies, limiting domestic interest deductions “in cases in which the United Kingdom interest expense is excessive by reference to such expense in the worldwide group.”⁴²

Such rules address expected profit-shifting, in the form of leverage that is tilted disproportionately, within the global group, against locating net taxable income in the resident company. They take advantage of the fact that, at least on the face of things, aggressive debt structuring is easier to identify than aggressive transfer pricing – the other main profit-shifting technique, but one that lacks a convenient counterfactual analogous to symmetric internal debt, unless one is willing to convert it into quasi-formulary apportionment by judging it relative to visible productive factors.

Thin capitalization rules can also, however, and with equal validity, be viewed as indirectly taxing debt-financed FSI. After all, in the case where one borrows domestically and

⁴⁰ Joint Committee on Taxation, *Background and Selected Issues*, at 25.

⁴¹ Id. The rule limiting net interest deductions also does not apply to German companies with less than €3 million of net interest expense. Id.

⁴² Id. at 43.

uses the loan proceeds to invest abroad, the arithmetical effect of disallowing \$X of “excess” interest deductions is identical to that of allowing the full deduction, but taxing FSI in the amount of \$X.⁴³ Indeed, James R. Hines, arguing that “a country that exempts foreign income from taxation nevertheless [should] permit full domestic deductions for expenditures that contribute to foreign profitability,”⁴⁴ makes this very point. He therefore rightly notes that such rules are inconsistent with favoring exemption of all FSI based on NON and/or CON.⁴⁵

In light of Germany’s CFC, thin capitalization, and other rules addressing its multinationals’ tax strategies, at least one tax director of a major Germany company has claimed that “US multinationals are taxed much more favorably on their foreign income” than German ones, placing the latter at a competitive disadvantage.⁴⁶ However, “US MNCs, of course, make the same claim in the opposite direction,”⁴⁷ and the current state of the evidence on this is indeterminate.

In sum, even putatively territorial countries commonly impose some tax on FSI, mainly through CFC rules that can only apply to resident companies with foreign subsidiaries, although also potentially more broadly, insofar as thin capitalization rules involve looking at the entire worldwide group without limitation to foreign subsidiaries. Many countries therefore apparently agree with the view, which I expressed in *Fixing*, that the effective tax rate on FSI should be greater than zero and less than the full domestic rate. [And they take this view despite being “territorial.”

⁴³ Thin capitalization rules have broader potential reach with respect to FSI than CFC rules, in that they can apply even if the foreign affiliates are not subsidiaries of the resident company.

⁴⁴ James R. Hines, *Foreign Income and Domestic Deductions*, 61 Nat’l Tax J. 461, 473 (2008).

⁴⁵ *Id.* at 468-469.

⁴⁶ Altshuler, Shay, and Toder, *supra*, at 30.

⁴⁷ *Id.*

If this is correct, then a pure territorial approach gets things wrong, by taxing FSI at too low a rate (i.e., zero) and thus forgoing the opportunity to reduce deadweight loss by using a positive rate to fund a reduction in the domestic source-based rate. However, this is not to say that a pure worldwide / foreign tax credit system gets it right. Nothing in the above analysis offers grounds for confidence that a pure worldwide / foreign tax credit system will impose the “right” overall domestic tax burden on foreign investment, rather than too much or too little. In addition, the analysis does not address whether one should use foreign tax credits – rather than, say, a lower MTR – to ensure that FSI faces a lower effective tax rate than domestic source income. I next turn to the core question raised by creditability, which is how foreign taxes should affect one’s domestic tax liability.

C. The Case for Creating a Marginal Reimbursement Rate for Foreign Taxes That is Between the Marginal Tax Rate and 100 Percent

In a pure worldwide / foreign tax credit system that did not even have foreign tax credit limits, the MRR for qualifying foreign taxes paid would always be 100 percent. By contrast, as noted above, a pure territorial system would always have an MRR of zero, equaling its MTR and thus making it equivalent to an explicit deductibility system in any case where taxpayers were trading off foreign tax liability against any other input to net profitability.

In real world tax systems, however, not only do we fail to observe a pure system of either type, but the inputs to determining effective MRRs are more complicated than just observing how foreign taxes are formally treated. In a putatively worldwide system, the effect of foreign tax credit limits must be considered, along with that of deferral (which I discuss in the next section). In a putatively territorial system that has CFC rules addressing profit-shifting to tax

havens, one must consider whether those rules effectively make foreign taxes worse than deductible, at least in particular instances.

The potential MRR effect of “territorial” countries’ CFC rules is clearest when these rules expressly address low-taxed foreign income. Thus, consider the German rule imposing home country tax on CFCs’ passive income when such income faces an effective source country tax rate below 25 percent. Suppose a German company responds to this rule by making sure that its CFCs pay tax on such income at exactly a 25 percent rate, rather than at a zero rate that could have been achieved through foreign tax planning. Since this permits the company to avoid German tax on the CFC income that would have been imposed at approximately a 30 percent rate,⁴⁸ one could view the voluntarily paid foreign taxes as enjoying a greater than 100 percent MRR.

There may also, however, be an MRR effect even if a given CFC rule does not expressly look at foreign taxes paid. Thus, consider rules that impose tax on apparently shifted foreign business income, such as that earned by a CFC that does not engage in significant economic activity in its country of residence. Here, even if the CFC rule does not look directly at source country tax rates, its effect may be to ensure that foreign tax planning, typically designed to avoid paying high source taxes abroad, will bear a domestic tax price.

Territorial countries’ CFC rules also commonly provide foreign tax credits for FSI that is being taxed to the domestic parent. This may directly create a 100 percent MRR for income that will be subject to such rules in any event.

Thin capitalization rules, by contrast, do not have MRR effects unless their design takes into account foreign taxes paid or a proxy for that (such as the type of FSI that one earns). Thus, suppose a German company is considering incurring domestic interest expense in order to fund

⁴⁸ See Altshuler, Toder, and Shay, *supra*, at 28.

investments that would yield FSI of any type. While disallowing the German interest deduction under the 30 percent rule is equivalent to imposing German tax on an amount of FSI that is equally to the disallowed deductions, this result does not depend on actual foreign taxes paid. Thus, reducing foreign taxes on the FSI by €1 would not affect the German company's domestic liability. The MRR is therefore still zero – as is the MTR if one takes the amount of disallowed interest deductions as given, and the question is how much the German company will earn abroad on the amount it has already decided to invest there.

Let's now consider what MRR for foreign taxes would be unilaterally optimal for a given country. From the domestic standpoint, foreign taxes are just a cost like any other, since home country individuals do not get to spend the revenues.⁴⁹ Thus, unless there is anything more to the story, pure territorial systems seemingly get this margin exactly right – making it seemingly paradoxical that “territorial” countries seem so averse to allowing this result generally.

It is plausible, however, that these countries – along with the United States, which likewise targets suspected tax haven income through its CFC rules – have good reason for disfavoring high levels of actual or suspected foreign tax minimization. Income that is reported as arising in a tax haven may be unlikely to have been earned there economically, given that havens often have limited productive capacity. In addition, as a matter of successful tax planning, shifting reported income so that it arises outside of the domestic tax base, even if it initially shows up in a foreign jurisdiction, with a significant tax rate, in which one has boots (so to speak) on the ground, often is merely a first step towards further on-shifting it to a tax haven.⁵⁰ Thus, it is reasonable for countries to use the fact that income has been reported as arising in a

⁴⁹ [Note second-order effects: may benefit from peer countries being able to raise revenue, not having their tax systems undermined, etc. But don't generally just give them money.]

⁵⁰ See Kleinbard, *supra*.

tax haven – or is of a kind that seems likely to end up in a tax haven – as a “tag” indicating an increased likelihood that it was actually earned at home.

Of course, it is hard to be sure, in any given case or even generally, that avoiding foreign taxes has adverse national welfare effects. After all, only sufficient adverse effects on domestic tax revenues or investment could override the benefit from paying less in taxes that go to people in other countries. Indeed, even where multinationals can avoid paying *both* domestic or foreign taxes, there may be rationales of tax competition for tolerating or even facilitating this end result, at least up to a point. For this reason, it is unsurprising to observe that countries do not consistently seek to prevent foreign tax avoidance, as opposed to acting schizophrenic.⁵¹

The use of actual or suspected tax haven status as a tag for imposing domestic tax liability on FSI can cause foreign taxes paid (if they permit one to escape this designation) to be effectively better than deductible. Even if foreign taxes paid are not literally taken into account, they have this effect if they lead to a reduction in domestic tax liability that exceeds their amount times the MTR for FSI. This can even be so where a proxy is being used, such as via the application of CFC rules to suspected tax haven income, insofar as avoiding the proxy would involve paying higher foreign taxes.

Even where countries benefit from treating foreign tax liabilities as effectively worse than deductible, a 100 percent MRR appears highly unlikely to be unilaterally nationally optimal. After all, it induces zero cost-consciousness by resident companies with respect to their foreign tax liabilities, rather than creating a more nuanced tradeoff between rival distortions. While this may make it at least initially surprising that foreign tax credits have been so widely used for many decades, especially before the widespread shift towards territoriality took hold, there are

⁵¹ An example is the U.S. adoption, first of CFC rules that address foreign tax avoidance, and then of “check-the-box” rules that can make it easy for U.S. companies to avoid the CFC rules.

two explanations at hand. First, it is not necessarily suboptimal for Country A to credit Country B's taxes, if Country B is crediting those of Country A and would play tit-for-tat if A ceased to do so.⁵² Second, as I discuss next, deferral can have the effect of reducing the actual MRR below 100 percent.

Even if one is effectively taxing FSI, one can avoid the worsening of incentives that results from inducing domestic companies to prefer paying a dollar of foreign taxes to bearing any other net cost of a dollar, by not having the domestic tax depend, even indirectly, on foreign taxes paid. Thus, suppose one uses thin capitalization rules to impose effective (albeit indirect) tax burdens on debt-financed FSI. However, while this is superior to relying on foreign taxes paid at the particular margin of foreign tax cost-consciousness, it is not necessarily better overall, given the rationale for tagging.

D. Deferral's Effects on the Effective Tax Rate for FSI and on the Effective MRR

Deferral is the most unique feature of the current U.S. international tax rules, reflecting the shift among other countries that used to rely on it, such as the United Kingdom and Japan, towards "territorial" systems with CFC rules. Three initial points worth making about deferral are as follows. First, its stringency can vary greatly in practice. For example, in both the United Kingdom and Japan, when they had more U.S.-style systems, CFCs could in effect repatriate their earnings tax-free by making loans to their domestic parents, since (unlike under the U.S. rules) this did not count as a repatriation.⁵³ As a result, "UK companies though nominally operating under a deferral regime ... did not have 'trapped' foreign earnings,"⁵⁴ and the fact that

⁵² Note Graetz and O'Hear on U.S.'s initially unilateral move, but note we were somewhat of a global economic hegemon at the time. And note that the UK began with creditability for members of the Commonwealth.

⁵³ See Altshuler, Shay, and Toder, *supra*, at 20, 25.

⁵⁴ *Id.* at 20.

Japanese multinationals apparently were viewed by the Japanese government as having a trapped earnings problem⁵⁵ is something of a mystery.⁵⁶

Second, as I noted in *Fixing*, “[a]lmost everyone recognizes that deferral ... is a terrible rule. In particular, it induces wasteful tax planning behavior by U.S. companies that must jump through hoops to make optimal use of their foreign earnings while avoiding a taxable U.S. repatriation.”⁵⁷ Recent empirical work suggests that the implicit cost to highly profitable U.S. companies of having to avoid taxable repatriations is about 7 percent annually of the amount of the profits that are being kept abroad for tax (or associated accounting) reasons.⁵⁸ Neither a pure worldwide system nor a pure territorial one would retain deferral, and it survives purely as “part of the forced ceasefire-in-place”⁵⁹ between the proponents of raising and lowering the U.S. tax burden on resident companies’ FSI.

Third, as the “new view” of dividend taxation shows, if there is a permanently fixed repatriation tax rate that will be paid at some point, and if in the interim there is convergence of all the after-tax rates of return that one might earn in different jurisdictions (even with varying source-based tax rates), then there *is* no trapped earnings problem, at least directly by reason of

⁵⁵ *Id.* at 25.

⁵⁶ The situation in Japan is hard for outsiders to understand fully. As Altshuler, Shay, and Toder, *supra* at 24-25, note: “A notable feature of the Japanese tax environment is a compliant international tax-planning culture.... Although changes in attitudes are occurring, many Japanese companies consider paying taxes a matter of loyalty, and the amount of taxes paid are considered a measure of the company’s success” (citation omitted). As for the Japanese government’s decision to shift to a “territorial” system, insofar as the aim was to address the trapped earnings problem, it is possible that the government was confused. Acting “at the height of the global financial crisis Japan wanted to encourage companies to repatriate earnings to improve the Japanese economy at a time of economic stress” (citation omitted). *Id.* at 25. In particular, the government wanted to “encourage R&D and capital investment in Japan,” as opposed to abroad. *Id.* Even apart from the question of why the Japanese government thought CFCs’ profits were trapped abroad, given that they could be lent to domestic parents without triggering a repatriation tax, this appears to rest on viewing the stagnation and recession problems of late 2008 as resting on lack of capital to invest, rather than on the demand side.

⁵⁷ Shaviro, *FIXING*, *supra*, at 12.

⁵⁸ See Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Proposals for Reform of International Taxation*, 66 *Nat’l Tax J.* 671 (2013)

⁵⁹ Shaviro, *FIXING*, *supra*, at 12.

deferral under the international tax rules.⁶⁰ Under these conditions, deferring the repatriation tax has no effect on its present value. What the new view actually shows, however, is not the absence of a trapped earnings problem, but rather where (accounting rules aside) to look for its causes.⁶¹ For example, the fact that future repatriation tax rates surely are not fixed helps to explain why U.S. companies may lose economically, in expected value terms, from bringing home earnings today instead of waiting for a lower rate in the future.

Suppose that the expected future repatriation tax rate is indeed lower than the present one – for example, due to the possibility that Congress will enact a “tax holiday” or shift towards territoriality, via the enactment of dividend exemption, without applying a transition tax to past unrepatriated earnings. This reduces the expected effective domestic tax rate on FSI that is getting deferred. Assuming that foreign tax credits for the associated income will be commensurately adjusted, this also reduces the expected MRR below the 100 percent rate that one might have expected from creditability. At the limit, if one never will face the repatriation tax and the associated foreign tax credits will never be used, then they are implicitly deductible, causing both the MTR and the MRR to be zero (conditioned on keeping the funds abroad until the happy time when the repatriation tax disappears).

One reason that this matters relates to the possibility of changes to the international tax rules. For example, committing to enact a transition tax in the event that the repatriation tax is repealed, and not to enact future tax holidays, each would be expected to reduce the degree to

⁶⁰ See David Hartman, *Tax Policy and Foreign Direct Investment*, 26 J. Pub. Econ. 107 (1985). There may still be lock-out of foreign earnings that is motivated by the accounting consequences of having claimed that the earnings were permanently reinvested abroad (permitting the deferred U.S. tax cost of repatriation to be ignored for accounting purposes). See Shavero, *FIXING*, supra, at 86.

⁶¹ In this sense, the new view is like the Coase theorem, which identifies circumstances in which it would make no allocative difference who owned a particular entitlement – for example, the right to pollute, as distinct from the right to stop someone else from polluting. Either way, with zero transaction costs among other preconditions, the entitlement would end up in the hands of the parties that valued it most highly. However, what the Coase theorem actually teaches us is not that it is generally irrelevant, for allocative purposes, who owns a given entitlement, but rather that, in evaluating why it might matter, it is important to analyze transaction costs.

which earnings are trapped abroad by reason of deferral. In addition, however, the relationship between deferral and the effective MRR for foreign taxes should be kept in mind if one is considering changes to deferral.

For example, if the United States shifted to a pure worldwide system with foreign tax credits and without deferral, this not only would raise the effective tax rate on resident companies' FSI, but also would induce those companies to be entirely indifferent to how much foreign tax they paid, except insofar as they would potentially face foreign tax credit limits. On the ground, this would be a major change in how foreign tax credits actually affected incentives, even if the legal rules governing the credits did not change in the slightest.

Now suppose that, instead of repealing deferral outright, the United States adopted a global "minimum tax" under which each U.S. multinational had to pay U.S. or foreign tax equal to at least 20 percent of its FSI for the year, as computed without regard to deferral. One way to do this technically might be to provide for a "deemed repatriation" that, when added to actual repatriations, was great enough to ensure that the U.S. tax would be 20 percent of FSI in the absence of any foreign tax credits.⁶² Even if a different technical means was used, however, a scaleback of deferral would be the substantive effect, given that companies would no longer benefit from keeping enough earnings abroad to avoid paying as much as 20 percent globally (and that deferred tax liabilities on unrepatriated earnings would have to be adjusted, in order to avoid double-counting).

Enacting such a minimum tax by any technical means, just like directly repealing deferral up to a point, would eliminate foreign tax cost-consciousness for U.S. companies in the range

⁶² For example, with a U.S. corporate tax rate of 35 percent, a U.S. company that paid no foreign taxes but repatriated roughly 57 percent of its FSI would pay U.S. tax equal to 20 percent of FSI. Companies that paid creditable foreign taxes might be allowed to elect deemed repatriations of the related income that triggered allowance of the credits against U.S. tax liability.

where foreign tax liabilities were rising from zero to 20 percent on a global basis. For example, a U.S. company with \$100 million of FSI would pay a total of \$20 million in tax whether its foreign tax liability was zero, \$20 million, or anything in between. Accordingly one downside of such a minimum tax – which, as we will see in section III, the Obama Administration took into account when devising a global minimum tax proposal in its 2016 budget – is that it wholly eliminates U.S. companies’ foreign tax cost-consciousness within this range.

E. Summing Up

The above analysis has clear, though very broad, implications regarding the preferred design of international tax rules for a large country like the United States. (I would not quite call it the “optimal” design, given its resting on so unsatisfying a foundation as realization- and separate-entity-based corporate income taxation, with all the associated horrors of corporate residence determinations, transfer pricing, and so forth.) FSI should probably be taxed at an effective rate between zero and the full domestic rate. The MTR it faces should also probably be between zero and the full domestic rate. The effective MRR for foreign taxes should probably be less than 100 percent, but if a “tagging” rationale applies it should probably be greater than the MTR.

This suggests that both pure worldwide / foreign tax credit and pure territorial systems diverge from the preferred parameters. It may initially seem, however, that devising an international tax system that fits within those parameters would run afoul of bilateral tax treaties that require the signatories to follow the single tax principle with respect to their own cross-investing multinationals. For example, suppose the United States, while still having a 35 percent corporate tax rate, first repealed deferral, creating a pure worldwide system (foreign tax credit

limits aside), and then shifted from this system to one in which, say, U.S. companies' FSI was taxed at a 20 percent rate, and foreign taxes were 50 percent creditable.

For outbound U.S. investment into a treaty partner with, say, a 20 percent corporate tax rate, the first step – clearly treaty-compatible, whether or not wise – would result in a U.S. effective tax rate of 15 percent (i.e., the spread between the U.S. and treaty partner corporate tax rates). The second step, although it would actually lower the U.S. companies' effective tax rate on this FSI to 10 percent (i.e., the U.S. rate minus half of the foreign rate) would apparently violate the treaty. The problem would lie in its causing each particular dollar of the FSI to be taxed “twice,” rather than just once. This reflects that, under the single tax principle, taxing a dollar of income just “once” (at 35 percent, since the foreign tax credit is viewed as negating the source-based 20 percent tax) is permissible, but causing it to be taxed “twice” (at 20 percent and 10 percent) is impermissible.

Even if one finds this a bit silly, might it be a binding legal constraint against the permissibility of implementing the preferred approach, with respect to outbound investment into a treaty partner that does not agree to renegotiate the treaty? To my now regret, I had not fully thought this through when I wrote *Fixing*, but the answer appears to be No. At least some versions of the preferred approach do appear to be legally permissible under typical bilateral tax treaties. This reflects the fact that, when a legal constraint is purely formal – as in the case of taxing a particular dollar of income “twice” rather than once – there is a good chance that one will be able to find formal work-arounds. For example, as we will see, one avenue involves the idea of the “same dollar.” Another relates to the fact that the effective MRR is not purely a function of how one expressly treats foreign tax liabilities.

III. FIVE RECENT DEVELOPMENTS IN INTERNATIONAL TAXATION

A. Recent Wave of U.S. Inversions

Just over ten years ago, the United States faced a wave of actual and proposed corporate inversions. In a typical transaction, a multinational company with a U.S. corporate parent would reorganize itself so as to have a foreign parent at the top of the ownership chain – most likely, incorporated in a tax haven. Since these generally were self-inversions in which little of economic substance actually happened, they were fairly easy to address legislatively.

U.S. Internal Revenue Code section 7874, enacted in 2004 and popularly known as the “anti-inversion” statute, mainly employs a quantitative rules-based approach, rather than a generalized standards-based approach. Nonetheless, it appears to have been based conceptually on notions of economic substance and business purpose. Thus, it focuses on indicia of such substance, such as the degree of ownership change⁶³ and the discernment of “substantial business activity” in the jurisdiction that hosts the new corporate parent.⁶⁴

Since 2014, a new wave of U.S. corporate inversions has been widely noted in the popular press, and by both experts and policymakers. These are not self-inversions, which section 7874 would address, but rather actual acquisitions of U.S. companies by foreign companies. While they therefore generally have some economic significance, they are also often significantly tax-motivated, in either or both of two distinct senses. First, the parties might not have engaged in them but for the U.S. tax advantages attributed to the resulting corporate “expatriation.”⁶⁵ Second, even if the parties would have engaged in them anyway, the decision

⁶³ See U.S. Internal Revenue Code section 7874(a)(2)(B)(ii).

⁶⁴ See U.S. Internal Revenue Code section 7874(a)(2)(B)(iii).

⁶⁵ There may be an “expatriation,” both in terms of common usage and the anticipated U.S. tax advantages, even if the former U.S. parent company remains unchanged, other than its in being owned by a foreign corporate parent rather than directly by largely non-corporate shareholders.

to place the foreign company, rather than the U.S. company, at the top of the chain may strongly reflect the same set of anticipated U.S. tax advantages.

The main anticipated advantages are twofold. First, inversions can make it considerably easier, as a practical matter, to access offshore earnings that have been benefiting from deferral. For example, one can now engage in “hopscotch” between the new non-U.S. parent and continuing CFCs of the U.S. company, without running into the U.S. CFC rules. Second, one can now more easily strip taxable income out of the U.S. domestic tax base without running into the CFC rules, such as through loans from the new foreign parent to U.S. members of the corporate group.⁶⁶

Proponents of a more territorial (or even purely territorial) U.S. international tax system commonly argue that the popularity of inversions supports viewing the U.S. system as the most onerous in the world. This reasoning reflects an important fallacy. Corporate inversions are not a *cri de coeur* by the sorely oppressed responding to the alpha – that is, to the pre-inversion level of U.S. tax burden. Rather, they are a rational response to the delta – that is, to the anticipated change between pre-inversion and post-inversion U.S. tax burden (including, in “tax burden,” the deadweight loss associated with having funds “trapped” abroad by deferral).

Suppose a German firm were to consider being acquired by a foreign parent, or for that matter itself expatriating. In addition to the immediate tax detriment that might potentially be posed under German tax law,⁶⁷ there is the question of how much it would benefit in the before-versus-after. While this question might best be addressed to expert German tax practitioners,

⁶⁶ See, e.g., Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Inversions*, 144 Tax Notes 473 (July 28, 2014); Edward D. Kleinbard, “*Competitiveness*” *Has Nothing to Do With It*, 144 Tax Notes 1055, 1066 (September 1, 2014).

⁶⁷ German corporate residence can be founded either on having a German legal seat or being managed in Germany. “If a German corporation transfers its legal seat or place of effective management outside the EU or European Economic Area (EEA) so as not to be subject to worldwide taxation, it is deemed liquidated, resulting in a deemed disposition of assets and recognition of unrealized built-in gains.” Altshuler, Shay, and Toder, *supra*, at 28.

two points are apparent even based just on a very superficial knowledge of Germany's international tax rules. First, since Germany has effectively eliminated deferral by generally exempting CFC dividends, the first big tax advantage of U.S. corporate tax inversions does not, at least comparably, obtain. Second, since Germany has much tougher thin capitalization rules than does the United States, any advantages in the earnings-stripping realm seem likely to be much smaller.

How does this relate to the analysis in *Fixing*? The obvious point is that the U.S. tax delta associated with engaging in these transactions may be undesirably high. In response, there has been talk of legislatively expanding the scope of section 7874,⁶⁸ although enthusiasm on Capital Hill for this has so far been markedly higher among Democrats than Republicans. In the interim, the U.S. Treasury has announced new regulations aimed at reducing the tax benefits associated with new-wave inversion transactions.⁶⁹ However, whatever the merits of these more granular responses, it is also worth looking more conceptually at the big picture. This requires separating out the two main tax advantages: those associated with deferral, and with avoiding the CFC rules.

Using inversions in response to the deferred repatriation tax – The incentive to create a foreign corporate parent, above the U.S. company that used to be the overall corporate parent, in order to improve access to the earnings of the U.S. company's (typically continuing) CFCs without incurring the U.S. repatriation tax, has a distinctly retrospective, rather than just prospective, character.

⁶⁸ See S. 2360, H.R. 4679 (2014), known as the Stop Corporate Inversions Act of 2014.

⁶⁹ See IRS Notice 2014-52, 2014-14 IRB 1 (September 23, 2014). Treasury officials initially expressed the view that they would need legislative authority to act, but Shay, *supra*, prominently laid out the case for acting based on existing regulatory discretion.

To illustrate this point, suppose that the current U.S. international tax system, rather than employing deferral, were a pure worldwide system in which CFC earnings were currently taxable to the U.S. parent, in practical effect treating the CFCs as if they were part of the same legal entity (and thus, in effect, merely foreign branches). In that scenario, U.S. companies would have far stronger incentives than they do today to expatriate by reason of the CFCs' expected future profitability (including by reason of profit-shifting). What is more, the needed expatriation transactions, unlike those commonly taking place at present, would actually have to get CFCs out from under the U.S. company (potentially triggering additional taxable realization events). It would not be enough if, like the typical new-wave inversion transaction today, they merely added a foreign parent on top, for use in hopscotch and other such transactions that leave the U.S. company off to one side.

In this scenario, however, CFC profits from past taxable years would have no bearing on decisions to invert. After all, they would already have been taxed to the U.S. parent. Thus, expatriation would do nothing to help at this margin.

Now consider the actual U.S. international tax system, with deferral. The prospective incentive to expatriate is weaker than under the pure worldwide scenario, since deferral (with the potential for changing future repatriation tax rates) may serve to reduce or even eliminate the U.S. tax burden on future CFC profits. However, past CFC profits now may strongly induce expatriating (including in the "weak" form where the U.S. company still has CFCs under it).

An imperfect analogy may help to clarify things. Suppose one owed money to a local government – be it for deferred taxes or not – and that the loan was accruing annual interest at a market rate, but that the government's ability to compel repayment would be weakened if one left for another country or state. At the limit, suppose one could wholly escape all repayment

obligations, regarding both interest and principal, by leaving town. If the loan balance was high, this obviously would create a strong incentive to move. And, of course, if we observed that a lot of borrowers were leaving town, this would not tell us that the local government was oppressively over-taxing people, even if the debt obligations reflected deferred taxes.

How does U.S. companies' incentive to engage in inversions, by reason of their CFCs' untaxed past profits, compare to this? In analyzing this, it is useful to distinguish between the "interest" and the "principal" components of the "loan."

The "Interest" on Deferral – U.S. companies with unrepatriated CFC earnings face two kinds of annual interest charge, in an economic sense. First, these earnings presumably are growing at the company's overseas rate of return, commensurately increasing the expected repatriation tax under new view conditions. Second, they are incurring the implicit cost of avoiding repatriations that they would prefer in the absence of the repatriation tax – which, again, was recently estimated at 7 percent annually for certain highly profitable U.S. companies.⁷⁰ Of course, incurring the latter would be senseless if new view conditions otherwise fully held and accounting considerations were irrelevant to the companies' decision-makers.

Corporate inversions, by making it easier to use the CFC earnings however the company likes without incurring the U.S. repatriation tax, may reduce or even eliminate the implicit annual "interest" charge. Of course, since this annual charge represents deadweight loss, rather than expected U.S. repatriation tax revenues, the company's newfound ability to reduce or avoid it does not directly harm the U.S. revenue interest. It may, however, do so indirectly, through its effect on the costliness of keeping both past and expected future CFC profits abroad. So far as past CFC profits are concerned, this relates to the loan "principal."

⁷⁰ Grubert and Altshuler, *supra*.

“Loan Principal” Under Deferral – The clearest reason why the new view generally does not hold in practice, with respect to deferral, is that the repatriation tax rate is not necessarily fixed. Keeping CFC earnings abroad has option value, since one can wait for Congress to lower or eliminate the repatriation tax, whether permanently or just temporarily. However, the deadweight loss associated with keeping the funds abroad is akin to an annual charge for holding the option. The ability to reduce or eliminate this implicit charge by reason of an inversion increases the option’s value, and reduces the expected repatriation tax rate by making it cheaper to wait for the tax-favored time. So it is like getting to reduce the loan “principal,”⁷¹ which one can think of as the product of (1) amount that is waiting to be repatriated and (2) the expected repatriation tax rate.

The potential significance of making it cheaper to wait is evidenced by the fact that U.S. companies sometimes find waiting prohibitively costly. In April 2015, for example, General Electric, long noted for its effectiveness at tax minimization, took a \$6 billion U.S. repatriation tax hit by reason of its apparent need to repatriate \$36 billion in foreign earnings in connection with the sale of G.E. Capital.⁷² G.E. presumably needed the cash at home both because the sale of G.E. Capital reduced its capacity to make continuing productive use of foreign earnings, and because it decided to accompany the sale with a \$50 billion stock buyback from shareholders.⁷³ Conceivably, an inverted G.E. with a foreign parent might have found it easier to “wait for tax reform,” as its top executive at G.E. Capital explained that the company had decided against doing,⁷⁴ so far as a taxable repatriation was concerned.

⁷¹ Past years’ “interest,” in the form of increases to the expected repatriation tax by reason of CFC profits’ further accrual, effectively get added to the loan “principal.”

⁷² See David Gelles and Michael J. de la Merced, *G.E.’s Retrieval of Overseas Cash Highlights Tax Debate*, New York Times, April 10, 2015, available on-line at <http://www.nytimes.com/2015/04/11/business/dealbook/general-electrics-move-on-overseas-cash-highlights-tax-debate.html>.

⁷³ See id.

⁷⁴ Id.

Even if deferral remains a feature of U.S. international tax law, a logical way to address its effect on incentives for engaging in corporate inversions would be to accelerate the effective loans of deferred repatriation tax liability, via rules creating deemed repatriations. Such rules could apply just to U.S. companies that invert, or more generally those whose foreign earnings (either in general, or just counting those classified for accounting purposes as permanently reinvested abroad) grew sufficiently high by some relative or absolute measure.

Using inversions to avoid the U.S. CFC rules – The fact that corporate inversions may make it easier for U.S. companies to avoid the CFC rules is less of an unforced error – albeit, still one to some degree. Imposing *any* tax on FSI in a manner that applies distinctively to resident companies gives those companies some motivation to throw off, or at least loosen, the shackles imposed by domestic residence. After all, countries generally cannot, at least directly and explicitly, make nonresident companies pay tax on their foreign CFCs’ income. Yet despite this consideration, as noted above, putatively territorial companies generally impose tax on what they deem resident companies’ “bad” FSI, such as that which is reported in tax havens or is of a type that one might expect to end up in a haven.

Given the at least partial electivity of domestic corporate residence,⁷⁵ just how much of this to do is a fine balance. The alternatives include not just throwing up one’s hands with regard to profit-shifting at the expense of the domestic tax base, but also aggressively using source rules that apply similarly to domestic and foreign companies. These, in turn, include thin capitalization rules⁷⁶ that may be viewed as indirectly taxing both resident and foreign

⁷⁵ See Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 Tax L. Rev. 377 (2011).

⁷⁶ While, as a formal matter, thin capitalization rules do not so much address source as simply deny certain domestic interest deductions, their effect on domestic source income can be substantively similar to that of rules which reclassify domestically incurred interest deductions as related to FSI.

multinationals' FSI, albeit without the feature of particularly targeting actual or suspected tax haven income.

From this perspective, the new wave of corporate inversions suggests that the United States may have gotten the balance wrong in its relative use of CFC rules and thin capitalization rules. This does not necessarily mean that the U.S.'s CFC rules are too tough. After all, while in principle it could suggest that, the fact that these rules generally are "not exceptional"⁷⁷ leans the other way. So a major takeaway from the inversion story might be that the United States, like Germany and the United Kingdom, should consider addressing profit-shifting in ways that would apply not just to resident multinationals, but also nonresident ones. The most obvious way to do this is through tougher interest deduction disallowance rules that involve looking at the global capital structures even of multinational groups with foreign parents. As I discuss below, however, the U.K.'s diverted profits tax suggests the possible availability of other means to the same end.

B. The OECD / BEPS Action Plan

In keeping with the metaphor of the seesaw, the OECD has undertaken ambitious efforts to coordinate multilateral responses to the rise of stateless income through multinationals' increasingly effective tax planning. To this end, in July 2013, the OECD announced a fifteen-point action plan to address base erosion and profit-shifting (BEPS).⁷⁸ Its aim was to "ensure the coherence of corporate income taxation at the international level, by addressing "loopholes ... gaps, frictions, or mismatches in the interactions of countries' domestic tax laws."⁷⁹ The issues to be addressed included transfer pricing,⁸⁰ the use of interest and other financial payments,⁸¹ and

⁷⁷ Arnold, *supra*, at 496.

⁷⁸ OECD, *Action Plan on Base Erosion and Profit Shifting* (July 19, 2013).

⁷⁹ *Id.* at 13.

⁸⁰ See *id.* at 20-21 and 23 (discussing Actions 8, 9, 10, and 13).

hybrid mismatch arrangements,⁸² or those in which multinationals may achieve double non-taxation, double deductibility, or long-term deferral via inconsistencies in how countries apply common tax law concepts (such as the classification of a financial instrument or a legal entity).⁸³

In two senses, the OECD BEPS project is somewhat off to the side of the main focus of my analysis in *Fixing*. First, it addresses multilateral cooperation between countries, whereas I mainly addressed how a given country, in particular a large one such as the United States, should approach international tax policy questions unilaterally.

Second, the OECD BEPS project largely (though not exclusively) focuses on countries' source rules. These I did address in *Fixing*, but I had less to offer on the subject that was different than what many other writers have said before. I did, however, note the issue of "cheaper versus costlier electivity."⁸⁴ Even sourcing methods that are to some extent arbitrary, such as formulary apportionment – and a degree of arbitrariness is unavoidable, given that the source of income is not a fully coherent economic idea – may be desirable on balance if they make it economically costlier for taxpayers to achieve desired sourcing outcomes.⁸⁵ I therefore am concerned that the OECD's willingness (albeit, perhaps rooted in political necessity) to retain transfer pricing and separate entity accounting within commonly owned groups will limit the overall success of the project, even if the still-emerging recommendations are widely adopted.

⁸¹ See *id.* at 16-17 (discussing Actions 3 and 4).

⁸² See *id.* at 15-16 (discussing Action 2).

⁸³ See *id.* Action 3, which called for strengthening CFC rules, also expressly addressed effective mismatches between countries' rules, via the allowance of interest deductions in one country without offsetting inclusion in another country. See *id.* at 16-17.

⁸⁴ Shaviro, *FIXING*, *supra*, at 20.

⁸⁵ See *id.* Making the tax planning costlier induces greater waste per instance of tax planning, although perhaps less instances thereof. One's normative assessment should depend on the overall effect on wasteful tax planning along with the relevant effects at other margins, such as from reducing the amount of profit-shifting that occurs.

One BEPS initiative that does, however, raise issues of particular interest here is Action 2, which aims at “neutralising the effects of hybrid mismatch arrangements.”⁸⁶ These are arrangements that “exploit[] a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes” that reduces the parties’ aggregate burdens.⁸⁷ The word “hybrid” in the name for this category of arrangements tips one off that what the OECD mainly has in mind here is what I have elsewhere called “semantic arbitrage.”⁸⁸ Classic examples include issuing a “hybrid financial instrument” that Country 1 calls debt while Country 2 calls it equity, or creating a “hybrid entity” that Country 1 regards as legally separate from its owner, while Country 2 regards it as a mere branch of that entity. A common upshot, in cases that Action 2 seeks to address, is that the same cash flow triggers either deductions in both Country 1 and Country 2, or a deduction in one country without an offsetting inclusion in the other country.

Action 2 clearly has some relationship to the single tax principle. After all, the direct consequence of double deductibility, or deductibility without offsetting includability, is that the amount thus inconsistently treated effectively ends up being taxed nowhere. Thus, it is worth asking why countries might find such an approach worth pursuing, given that it may at times require meticulous coordination and/or be difficult to implement in practice.⁸⁹

⁸⁶ See OECD/G20 Base Erosion and Profit-Shifting Project, *Neutralizing the Effects of Hybrid Mismatch Arrangements* (September 16, 2014). This final “deliverable” followed close on the heels of two earlier discussion drafts: OECD Public Discussion Draft, *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (March 19, 2014); and OECD Public Discussion Draft, *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (March 19, 2014).

⁸⁷ OECD/G20 Base Erosion and Profit-Shifting Project, *supra*, at 29.

⁸⁸ See Daniel Shaviro, *Money on the Table?: Responding to Cross-Border Tax Arbitrage*, 3 Chi. J. Int’l Law 317, 322 (2002) (noting that similar transactions, which back then were typically described as involving “cross-border tax arbitrage,” while not literally arbitrages in either a finance or a tax sense, relied on “semantic inconsistency” between countries’ rules in such a way that they metaphorically seemed arbitrage-like).

⁸⁹ For a thorough and generally sympathetic discussion of some of the problems that may arise in practice, see Michael L. Schler, *OECD vs. D/Ni: Ending Mismatches on Hybrid Instruments, Part 1*, 144 Tax Notes 485 (August 11, 2014). Schler addresses the OECD Discussion Drafts, as the final version of Action 2 had not yet been released at the time of publication.

The answer may have a lot in common with the widespread consensus, extending to territorial countries, that, when FSI is reported as arising in a tax haven, this may be a tag indicating profit-shifting at the expense of the domestic tax base. In the case of double deductibility, or deductibility in one country without offsetting includability in another country, there is no direct reason for a given country to mind the favorable result abroad – just as there is no direct benefit from having resident multinationals, owned by resident shareholders, pay higher rather than lower taxes abroad by reason of *not* reporting FSI in tax havens. However, if multinationals can arrange transactions in which they get double benefits (including via semantic arbitrage), this may operate to the detriment of the revenue interest in both of the affected countries. Accordingly, it is plausible that either country, acting unilaterally, might benefit from targeting hybrid mismatch arrangements. And indeed, some existing tax rules did this, long before the OECD announced its BEPS project.⁹⁰ This unilateral incentive may make multilateral cooperation easier to achieve than it would be in the scenario where each country would unilaterally benefit from defecting.

While this consideration may add to the usefulness of the single tax principle in some settings, it has no bearing on the separate question of whether one's only choices should be to exempt FSI or else provide foreign tax credits. For example, just because it may be of interest to both the United States and the United Kingdom that the same cash flow is being deducted in both countries does not mean that either has reason to demand, with respect to inbound investment from the other country, that such country choose between imposing on the income from such

⁹⁰ For example, U.S. Internal Revenue Code section 1503(d), enacted in 1986, generally denies “dual consolidated losses,” or the use within consolidated returns of the net operating loss of a domestic corporation that is also treated as a resident of a foreign country under such country's income tax laws. The United Kingdom likewise has rules denying domestic losses to certain dual resident companies.

investment either (1) an MTR and MRR of zero or (2) some positive MTR and a 100 percent MRR.

C. U.K. Diverted Profits Tax

Under recent U.K. legislation, with an effective date of April 1, 2015, the U.K. imposes a 25 percent diverted profits tax (as compared to its 20 percent corporate income tax) on “[l]arge multinational enterprises with business activities in the UK who enter into contrived arrangements to divert profits from the UK by avoiding a UK taxable presence and/or by other contrived arrangements between connected entities.”⁹¹ The first part of this, addressing contrived arrangements to avoid a U.K. permanent establishment (PE), is evidently directed at foreign multinationals. The second half, addressing “contrived arrangements between connected entities,” appears mainly to address the aggressive use of transfer pricing, by either U.K. or nonresident companies, to shift profits out of the U.K.

Given that the tax rate under the diverted profits tax exceeds that under the U.K. corporate income tax, the gyrations that it seeks to discourage may in effect face a tax penalty, even if the two taxes do not apply duplicatively.⁹² Thus, it may increase the U.K.’s corporate tax revenues, rather than just raising revenue under its own aegis. This may help to account for its anticipated revenue yield of more than £1.35 billion pounds over the first five years, despite a slow start of only £25 million in the first year.⁹³

The diverted profits tax is controversial on a number of grounds. For example, some question its reliance on broad economic substance-type principles. The lack of clear guidelines

⁹¹ HM Revenue and Customs, *Diverted Profits Tax 1* (2014), available online at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385741/Diverted_Profits_Tax.pdf.

⁹² Where a company pays both U.K. corporate tax and diverted profits tax on the same profits, the U.K. tax authorities announced their intention to allow “[s]uch credit as is just and reasonable” against the diverted profits tax. See *id.* at 18.

⁹³ See *id.* at 2.

might end up either impeding effective implementation, or promote uncertainty if it does indeed end up being a key feature of U.K. tax law on the ground. Critics have also questioned its compatibility with tax treaties, with the ongoing BEPS process, and with the U.K. government's asserted "open for business" message to overseas investors.⁹⁴

Yet, however one views these issues, two aspects of the diverted profits tax clearly weigh in its favor – at least as guidance to other countries that they might choose, if they like, to implement quite differently. The first is that, by addressing profit-shifting outside the CFC rules, and also by backstopping the PE rules,⁹⁵ it avoids creating tax incentives to expatriate, or more generally to invest in the United Kingdom via foreign rather than domestic multinationals. In this regard, the diverted profits tax may reinforce the U.K.'s worldwide debt cap as a counter-measure to profit-shifting by all large multinationals. Second, if viewed as mainly a response to aggressive transfer pricing (at least for companies that have an acknowledged U.K. PE), it may cleverly make up, through its use of an effective penalty along with less than crystal-clear boundaries, for the fact that such transfer pricing may be harder to second-guess directly than the aggressive use of debt. Again, transfer pricing lacks a convenient counterfactual analogous to symmetric internal debt, unless one is willing to convert it into quasi-formulary apportionment by judging it relative to visible productive factors.

D. Patent Box Regimes and Proposals

A number of EU countries employ patent box regimes that offer special tax rates, typically between 5 and 15 percent, to income that is associated with particular types of

⁹⁴ See, e.g., Kristen Parillo, *The Diverted Profits Tax: Is the U.K. Still Open for Business?*, 146 Tax Notes 165 (January 12, 2015). Parillo quotes a number of tax experts (myself included) who take the view that offering a favorable environment for companies is compatible with seeking to address aggressive tax avoidance.

⁹⁵ PE rules' rising avoidability in a digital age is also a major focus of the OECD's BEPS project – addressed in particular by Action 1 ("Address the tax challenges of the digital economy"), Action 6 ("Recent treaty abuse," described with expressed reference to the avoidance of PE rules), and Action 7 ("Prevent the artificial avoidance of PE status"). See OECD, *Action Plan on Base Erosion and Profit Shifting*, supra.

intellectual property, not necessarily limited to patents.⁹⁶ The United Kingdom, for example, adopted such a regime when it shifted towards territoriality in 2009. In November 2014, after negotiations with Germany in response to complaints that the U.K. patent box regime was being used to siphon off taxable income from peer EU countries, the U.K. tax authorities agreed to augment the measure of actual domestic economic activity that it would require as a precondition for allowing income that was booked domestically to qualify for the special rate.⁹⁷

Proponents of patent box regimes emphasize two main rationales, one of them more plausible and the other more pretextual. The rationale that proponents like to emphasize points to the positive externalities that research activity, aimed at developing intellectual property such as patents, can potentially generate. These may either be the global knowledge spillovers that basic research in particular may generate, lying outside the scope of intellectual property protections, or it may be more local in incidence, as in the case where local knowledge hubs end up generating national wealth and jobs.⁹⁸

While this line of argument is widely accepted in principle, countries such as the United States already commonly have better-targeted tax benefits, such as research and development credits, that aim directly at encouraging such activity. Moreover, patent box rules often seem to be aimed mainly at encouraging companies simply to report particular income as domestic source rather than as FSI, with little regard for how much positive-spillover activity occurs domestically, or indeed anywhere.⁹⁹ Thus, the common focus on, say, “want[ing] our jobs to

⁹⁶ EU countries with patent box regimes include at least Belgium, France, Luxembourg, Hungary, Ireland, Italy, Spain, and the United Kingdom. See Peter R. Merrill et al, *Is It Time for the United States to Consider the Patent Box?*, 146 *Tax Notes* 1665, 1667 (March 26, 2012); Paul Rutherford, Adam Cooke, and Claire Bennett, *EU Patent Box Regimes: The Way Ahead*, available online at <https://www.dlapiper.com/en/czech/insights/publications/2015/02/eu-patent-box-regimes/>.

⁹⁷ See Germany-UK Joint Statement, *supra*.

⁹⁸ See Sullivan, *Can a Patent Box Promote Advanced Manufacturing?*, *supra*, at 1348-1350.

⁹⁹ See *id.*

remain red, white and blue – not [in] the EU!”¹⁰⁰ is probably best viewed as somewhat pretextual. It combines appealing to domestic voters with delicately minimizing any direct reference to what policymakers in other countries might regard as “unfair” tax competition.

The more plausible motivation is precisely that of engaging in tax competition with peer countries. If the taxable income that a multinational taxpayer can place in a given patent box is relatively mobile, the country that offers the benefit may raise revenue by offering it a special rate. This comes, of course, at the expense of peer countries, but the same is true for universally accepted forms of tax competition, such as lowering one’s corporate rate, and the lines between what peer countries will accept versus complain about is hard to draw clearly. “One country’s blatant cash grab is another’s aggressive but legitimate business-friendly tax policy.”¹⁰¹

In the purely unilateral case, where a country’s decision to adopt a patent box not only raises revenue, but also induces no strategic response from other countries, it clearly can advance national welfare. However, even apart from the possible strategic interactions, which may matter more in the OECD BEPS era than they appeared to when I wrote *Fixing*, it may be hard to get the balance right. Companies may prove adept at cramming less-mobile income into the patent box contours that end up being adopted, especially if their lobbyists are working closely with key policymakers. And in addition, what with all the rhetoric about innovation and jobs, not to mention the political realities of the U.S. legislative process, Congress might deliberately adopt a revenue-losing patent box regime, without substantially restricting its reach to the contours that an academic economist’s focus on relative tax elasticities might suggest. My own bottom line about U.S. adoption of a patent box is therefore quite skeptical, despite the argument from tax competition that might, at least in a sufficiently unilateral context, have significant merit.

¹⁰⁰ See Parker, *supra*, quoting Senator Chuck Schumer at a March 2015 Senate Finance Committee hearing.

¹⁰¹ See Parker, *supra*.

E. Recent U.S. International Tax Reform Proposals

The last post-*Fixing* trend that I will discuss here concerns recent U.S. international tax reform proposals. In brief, there is some evidence that ideas discussed in my book are beginning to influence the range of reform options that are understood to exist. This may enrich both academic and public debate, whether or not it ends up influencing enacted law any time soon.

The most prominent U.S. international tax reform proposal to be disseminated in the period shortly before *Fixing* appeared was the U.S. House Ways and Means Committee Discussion Draft of a proposed “territorial” system (albeit with some taxation of FSI), released by the Committee under then-Chairman Dave Camp in October 2011.¹⁰² This proposal aimed at paralleling the changes made in countries such as the United Kingdom and Japan, while addressing concerns not just about revenue loss but also about profit-shifting at the expense of the domestic U.S. tax base. Thus, in addition to providing only 95 percent foreign dividend exemption, the Camp discussion draft proposed using CFC rules to impose current tax on passive and highly mobile FSI, and using strengthened thin capitalization rules to address the disproportionate use of U.S. debt by the U.S. members of global affiliated groups. It also laid out multiple options for further addressing profit-shifting by U.S. multinationals, such as through a Japan-style rule focusing on low-taxed FSI. More novelly, and unlike the United Kingdom and Japan when they changed their international tax systems, the Camp discussion draft proposed enacting a one-time transition tax (at a 5.25 percent rate) on pre-enactment foreign earnings.

The Camp discussion draft was a serious effort. Its proposals merit continued consideration, in the event that significant U.S. international tax reform efforts should actually get off the ground – a prospect that I regard as fairly low-probability, given both our broader

¹⁰² See U.S. Committee on Ways and Means, *Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System* (October 26, 2011), available online at http://waysandmeans.house.gov/uploadedfiles/summary_of_ways_and_means_draft_option.pdf.

political and legislative dysfunction, and the inherent difficulty of enacting budgetarily responsible tax reform legislation with losers as well as winners.¹⁰³ Since its issuance, however, two more recent, and comparably serious, efforts have broadened the palette of prominent international tax reform choices, in ways that are consistent with the analysis that I offered in *Fixing*.

The first is the U.S. Senate Finance Committee Staff Discussion Draft of international tax reform options, released by the Committee under then-Chairman Max Baucus in September 2013.¹⁰⁴ This discussion draft offered two distinct proposals, both eliminating deferral and seeking to address profit-shifting incentives without going all the way to a classic worldwide system. The first, known as Option Y, is a global minimum tax proposal with full foreign tax credits, making it subject to the critique that it would eliminate U.S. companies' incentives to minimize foreign taxes until the point within the relevant range. However, the second proposal, known as Option Z, actually implements my suggestion in *Fixing* that the tax rate on FSI should be between zero and the full domestic rate, while the MRR for foreign taxes should be between the MTR and 100 percent. Moreover, it does so in a way that addresses treaty-based concerns about the formalistic bar on "double taxation" of FSI.

¹⁰³ In my view, the least unlikely path to major U.S. international tax law changes would be Republican capture of the presidency in 2016, accompanied by continued Republican majorities in both houses of Congress. This might conceivably lead to the enactment of a "territorial" system that did far less than that suggested by the Camp discussion draft to address concerns either about revenue neutrality or about profit-shifting. In such a setting, one would hope that resulting revenue loss would be candidly acknowledged – as opposed to being obscured through an overly short-term budgetary focus or even through the misuse of "dynamic scoring." On the latter, see James W. Wetzler, *Dynamic Scoring: Some Unanswered Questions*, 147 Tax Notes 171, 177 (April 13, 2015) ("Depending on how it is implemented, dynamic scoring can have a wide range of impacts on the tax legislative process," ranging from "pressure[] to present rosy scenarios" that leads to lesser accuracy and lost credibility, to the creation of "more accurate budget estimates" that increase available public information).

¹⁰⁴ See U.S. Senate Finance Committee, *Summary of Staff Discussion Draft: International Business Tax Reform* (November 19, 2013), available online at <http://www.finance.senate.gov/imo/media/doc/Chairman%27s%20Staff%20International%20Discussion%20Draft%20Summary.pdf>. While this preceded *Fixing*'s publication date, the manuscript had already gone final.

Under Option Z, the CFC rules, in addition to reaching FSI other than foreign active business income, would tax a percentage of such income – say, 60 percent. The remaining 40 percent would be exempt. Foreign tax credits would be allowed as to the 60 percent portion, but not the 40 percent portion. Accordingly, the net effect would be to tax U.S. companies' foreign active business income at 60 percent of the U.S. corporate rate (i.e., 21 percent, if the U.S. corporate rate remains at 35 percent), while providing a foreign tax MRR of 60 percent.¹⁰⁵

In illustration, suppose that the U.S. corporate tax rate remains 35 percent, and that a U.S. multinational earns \$100 of active business income in the United Kingdom, on which it pays \$20 of U.K. corporate tax. This would cause the U.S. parent to have \$60 of currently taxable FSI, leading to a pre-credit U.S. tax liability of \$21, reduced by \$12 of allowable foreign tax credits, to a final U.S. tax liability of \$9.¹⁰⁶

Obviously, the inclusion percentage under Option Z could be adjusted upwards or downwards from the tentatively indicated 60 percent. The key design constraint that Option Z proposes is its requiring equivalence between (1) the ratio between the MTR for FSI and domestic source income and (2) the MRR for foreign taxes. There is no particular reason to think that this equivalence is generally optimal. However, as a matter of formal legal argumentation, it permits one to defend Option Z's consistency with bilateral tax treaties that rule out double taxation, on the ground that no increment of a U.S. company's FSI is actually being taxed twice. Part of it is taxed at the full U.S. rate but subject to foreign tax credits, while the rest is exempt.

¹⁰⁵ See Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft on Provisions to Reform International Business Taxation*, JCX-15-13 (November 19, 2013), at 39-41 and 53.

¹⁰⁶ Paying, say an additional \$10 of foreign taxes (for a total of \$30) would have increased the allowable foreign tax credits to \$18, thus reducing the final U.S. tax liability to \$3. This helps to illustrate the 60 percent MRR that Option Z would create up to the point when all residual U.S. tax liability on FSI was eliminated.

In my view, the formalistic character of the underlying norm against double taxation should weigh heavily against criticizing this workaround for its formalistic character. It is not as if the provision permits the substantive undermining of U.S. treaty partners' interests that the treaties appear to have been designed to prevent. After all, a 60 percent MRR reduces U.S. companies' cost-consciousness with respect to foreign tax liabilities, compared to the clearly permissible case of a 0 percent MRR from outright exemption. And setting the U.S. tax rate for FSI at 60 percent of the full domestic rate preserves some net worldwide tax incentive to earn (or report) profits within the territory of a U.S. treaty partner that charges a lower tax rate than does the U.S., as compared to the clearly permissible case of having a pure worldwide system with foreign tax credits.

Second, in February 2015, the Obama Administration issued a new international tax reform proposal as part of its proposed 2016 budget.¹⁰⁷ This proposal, in addition to featuring a transition tax like that in the Camp proposal (albeit with a 14 percent rate), described a 19 percent global minimum tax under which foreign taxes, in effect, would only be 85 percent creditable, rather than fully creditable. The minimum tax would generally apply on a per-country basis, rather than for all FSI as a whole.¹⁰⁸ Accordingly, for FSI in any given country, the MRR would effectively be 85 percent, up to the point where residual U.S. tax liability was wholly eliminated (i.e., when the relevant foreign tax rate for that country had risen to approximately 22.35 percent), at which point the MRR would decline to zero.¹⁰⁹ The

¹⁰⁷ See U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (February 2015), available online at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf>.

¹⁰⁸ More specifically, the tax rate of 19 percent for FSI would be reduced by "85 percent of the per-country effective tax rate," which would be computed over a 60-month period. *Id.* at 20.

¹⁰⁹ Among other distinctive features of the Obama Administration's proposal, it would allow FSI that was subject to the modified minimum tax to be reduced by an allowance for corporate equity, effectively providing U.S. exemption for a risk-free return on foreign equity that was invested in active business assets. See *id.* at 21.

Administration has not as yet publicly addressed the question of whether this proposal is compatible with existing U.S. bilateral tax treaties.

At a broad structural level – leaving aside the particular numbers used in Option Z and in the Obama Administration proposal, which could easily be changed – how should one think about the difference between these two approaches? The key distinctions are twofold. First, the Obama Administration proposal severs the link in Option Z between the ratio of domestic to FSI tax rates, on the one hand, and the generally applicable MRR on the other hand.¹¹⁰ This has the advantage of permitting greater design flexibility, although it may come at the cost of raising greater concerns about treaty compatibility.

Second, the Obama Administration proposal, unlike Option Z, requires per-country computations. While this increases administrative complexity – clearly a disadvantage – it permits further differentiating the U.S. tax treatment of FSI arising in high-tax as opposed to low-tax countries. Under Option Z, neither the pre-credit U.S. MTR nor the MRR depend on where a given dollar of FSI arises. By contrast, under the Obama Administration proposal, suppose that Country A is determined to have a 25 percent foreign effective tax rate, while that for Country B is 15 percent.¹¹¹ In effect, this causes the U.S. international tax system, at the margin, to operate like a territorial system in Country A, while still imposing a positive residual tax and providing an MRR that exceeds the U.S. MTR in Country B. The question of whether this greater targeting flexibility, in how the U.S. rules apply with respect to income earned in higher-tax versus lower-tax countries, is worth the associated administrative complexity would require analysis going beyond anything that I offered in *Fixing* or will try to offer here.

¹¹⁰ In addition, under the Obama Administration plan, the tax rate for FSI (resulting from the minimum tax) apparently would not automatically adjust if the domestic corporate tax were altered. However, policymakers would be free to alter the minimum tax rate for FSI if they were altering the domestic corporate rate.

¹¹¹ Again, as noted above, these computations are made over 60-month periods. *Id.*

While Option Z and the Obama Administration's 2016 budget proposal offer welcome expansions of the preexisting menu of international tax reform options, I do not view them as necessarily being central to the contribution that I would like to believe *Fixing* made to the debate. I place more stock in the general conceptual points that we should think distinctively about the tax rate on FSI on the one hand, and the MRR on other hand, and about how deferral can affect each, while also moving beyond such artifacts of the past as (1) the use of acronyms-based alphabet soup in lieu of coherent analysis, (2) the single tax principle treated as an end in itself, and (3) the simplistic invocation of "worldwide versus territorial" as a fundamental design choice.

IV. CONCLUSION

While this article emphasizes how the analysis in *Fixing U.S. International Taxation* may help one to think about recent international tax developments, perhaps one could just as well reverse the arrow. Reflecting on recent developments has increased my understanding of various issues that I discussed in *Fixing*. In particular, for each of the recent developments in section III, the points that, at a minimum, are clearer to me now than when I wrote *Fixing* include the following:

Recent wave of U.S. inversions – While inversions' return to the headlines does not indicate that the U.S. rules must be too "tough" in the aggregate, they do indicate the sheer magnitude of the "trapped earnings" problem that U.S. companies have created for themselves, in part due to their great success in creating stateless income. This increases the urgency that one might ascribe to wiping the slate clean through deemed repatriations that avoid systematically

rewarding profit-shifting in the manner of periodic tax holidays. More modestly, one also might consider treating inversions as triggering deemed repatriations.

Inversions' return to the headlines also demonstrates the downside of over-relying on CFC rules, as opposed to thin capitalization or worldwide debt cap rules that also apply to foreign multinationals, in one's overall response to profit-shifting. One could think of the tradeoff between these two types of approaches as follows. CFC rules have the advantage of permitting one to distinguish between low-taxed and high-taxed FSI, which may be desirable if low foreign taxes are a "tag" for domestically earned profits that have been shifted through the use of tax planning games. This comes, however, at the disadvantage of discouraging the use of a resident company to invest either at home or abroad. It is plausible that some combination of these two approaches is superior to relying exclusively on either of them.

OECD / BEPS action plan – Reflecting on the OECD's focus, through BEPS Action Plan 2, on hybrid mismatch arrangements has encouraged me to combine the analysis in *Fixing* with that I offered in earlier work addressing semantic arbitrage,¹¹² in relation to evaluating the single tax principle. While I had earlier noted that the duplicative tax benefits which companies can achieve through hybrid arrangements seem unlikely to have been intended by either country, making it seem natural to at least consider addressing them, *Fixing* suggests the supplementary point that countries may reasonably view such benefits, like the creation of tax haven FSI, as likely to come at the expense of protecting the domestic tax base. Thus, even if the taxpayer's reducing foreign as well as domestic taxes is not directly objectionable, it may similarly function as a kind of tag that is likely to be associated with something objectionable.

This in turn may support a more nuanced account of the single tax principle's strengths and weaknesses. Beyond just being a useful coordinating device that similar peer countries may

¹¹² See Shaviro, *Money on the Table?: Responding to Cross-Border Tax Arbitrage*, supra.

choose to employ, the single tax principle can help to identify instances of suspected profit-shifting at the expense of the domestic tax base, where it is violated either by locating profits in tax havens or by using hybrid arrangements to prevent particular profits from appearing to have been earned anywhere. However, this in no way rebuts the single tax principle's lack of substantive merit insofar as it seems to require either exempting FSI or taxing it with full foreign tax credits.

U.K. diverted profits tax – Whatever one thinks of the U.K.'s new "Google tax" in particular, it offers a new perspective on how one might address aggressive transfer pricing, not just by resident multinationals but also foreign ones that may have especial profit-shifting advantages if they can avoid the domestic PE rules. The new tax's focus on a general standard, in lieu of specific black-letter rules, to create the potential for imposing an effective penalty on overly "contrived" tax planning, may help the U.K. tax authorities to address profit-shifting without overly relying either on domestic residence or on the direct application of PE rules.

Patent box – Given that positive externalities from developing intellectual property are probably best advanced through other means, the case for U.S. adoption of a patent box or similar proposal is best rationalized in terms of tax competition, which can motivate offering lower rates to highly mobile income. The case for adoption would be especially strong if the proposal genuinely raised revenue, relative not just to present law but to other feasible alternatives, at least in the absence of significant strategic responses by other countries. However, there is good reason to be skeptical about actual revenue-losing patent box proposals that may emerge from the U.S. legislative process.

Recent U.S. international tax reform proposals – When I wrote *Fixing*, I was more concerned than I am now about the practical availability of approaches that, without relying on

poison pill of deferral, would create, not just (1) MTRs for FSI that were between zero and the full domestic rate, but also (2) MRRs for foreign taxes that were between the MTR and 100 percent. Both Option Z in the Senate Finance Committee Discussion Draft and the Obama Administration's 2016 budget proposal suggest that there may be greater practical flexibility here than I had realized. They also offer food for future thought regarding how such approaches might best be designed.

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