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Follow the Money: Essays on International Taxation – Introduction

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MICHAEL J. GRAETZ

FOLLOW THE MONEY

ESSAYS ON INTERNATIONAL TAXATION

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Introduction

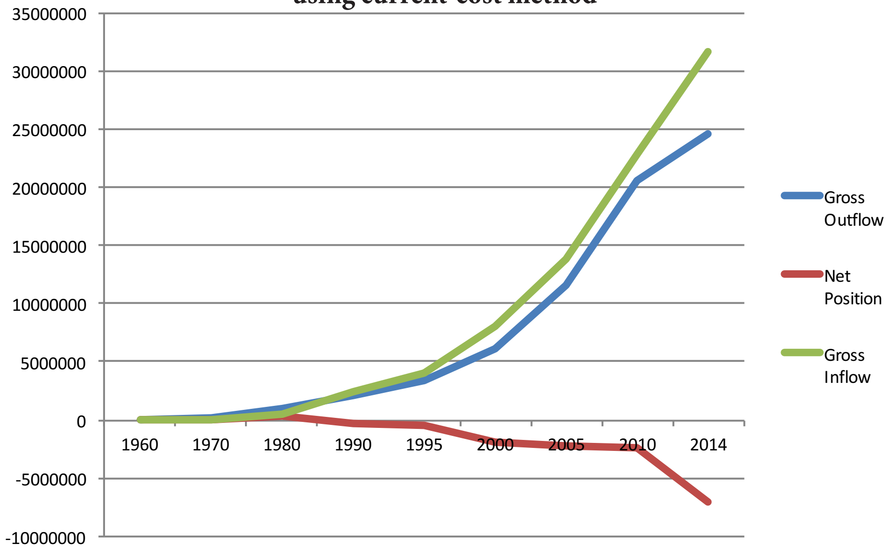
Overview

Since this book begins with history, let me begin with a dollop of my own. As late as 1990, when I returned to the tax policy office of the Treasury, international taxation remained something of a backwater among U.S. tax experts. The subject was outside the ken of virtually all public finance economists and was dominated in the legal community by a relatively small faction of specialists, many of whom had learned international tax at the Treasury in the 1960s.

This has all changed. As Figure 1 shows—beginning in the 1980s and rapidly accelerating by the late 1990s—international capital flows both in and out of the U.S. exploded. The enormous increase in both international direct investments and portfolio flows brought issues of international tax policy and international tax law into the mainstream of tax accountants, lawyers, and economists.

Figure 1

US owned assets abroad, foreign-owned assets, and net position of US using current-cost method



Source: For 1960-1995, Survey of Current Business, July 2000, “The International Investment Position of the United States at Yearend 1999” by Russell B. Scholl, and Survey of Current Business, October 1972, Volume 52, Number 10, “The International Investment Position of the United States: Developments in 1971” by Russell Scholl. For 2000-2014, Bureau of Economic Analysis, U.S. International Investment Position, 2000, 2006, 2010., 2014. http://www.bea.gov/iTable/iTable.cfm?ReqID=62&step=1#reqid=62&step=5&isuri=1&6210=5

The United States, which had long been a large exporter of capital, like other industrialized countries around the world, now both exports and imports large amounts of capital. For the first time—due principally to large inflows of portfolio debt—the U.S. in the 1980s became a net capital importer. The post-World War II worldwide economic dominance of the United States and of U.S. multinational corporations has past—a transformation unforeseen by the 1986 Tax Reform Act, our most recent major tax reform legislation.

Moreover—as will become clear in the pages that follow—the dominant analytical framework used by policymakers to evaluate international tax policy is archaic. Most tax policy experts long insisted that U.S. international tax policy be designed to promote “worldwide economic efficiency” by being neutral about a U.S. resident individual’s or business’s choices between domestic and foreign investments producing the same pre-tax rate of return (a policy known as “capital export neutrality” or CEN). Surprisingly—especially given our long struggle to limit federal budget deficits—this indifference about where investments are made is coupled with unconcern about which country obtains the tax revenues from the income of the investments.

U.S. multinationals are naturally more attracted by improving their “international competitiveness” throughout the world. This has generally led them to urge policies reflecting “capital import neutrality” (CIN), which insists that income from all investments in a particular country should be taxed the same whether made by a domestic or foreign business or individual.

By 1992, when I left the Treasury and returned to teaching, it had become clear that CEN and CIN can both be met simultaneously only when income is taxed the same in all countries. This requires identical tax systems, including an identical tax base and rates. That has never happened and it never will. But, in its absence, any system for taxing international income can be described as a "compromise" between the two principles of CEN and CIN. This is a recipe for political misbehavior, and it also inevitably produces complaints of disadvantage, accompanied by calls for change. Given the shortcomings of the existing normative framework for evaluating international tax policy, I began my international tax research by trying to find out how and why our nation (and others) had arrived at the extant policy structure—in other words, to begin with history. After that, I turned to policy and implementation.

This book collects nine essays on international income taxation originally published between 1997 and 2015. Many of these have been widely read and have had influence in the evolution of international tax policy analysis and proposals for change. By pulling them together in one volume (and moving the abundant law review footnotes to endnotes), I am hopeful that readers might benefit from the conjoint insights they contain. At a minimum, they offer a roadmap of the most important international tax policy issues on the current reform agenda of the United States and our trading partners. A brief summary follows.

Part I: History

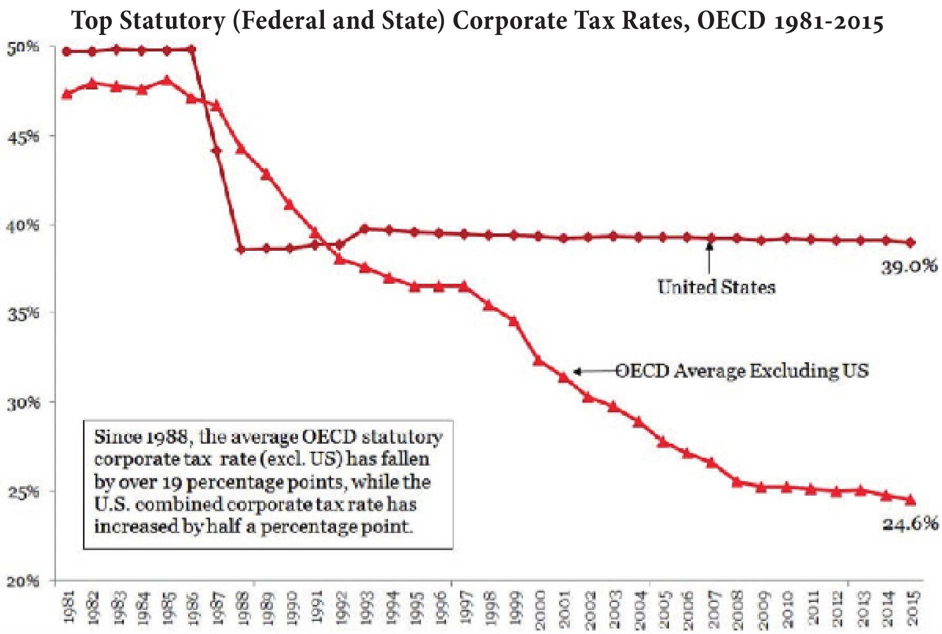
Nearly a century ago, during the decade 1919-1928, the United States regime for taxing international income took shape. While most OECD nations have recently moved away from foreign tax credit provisions of the sort enacted unilaterally by the United States in 1918, these rules, at least for now, remain at the center of the U.S. law taxing income earned abroad by U.S. businesses and individuals. Likewise, despite many changes in the details, the fundamental structure of the model bilateral income tax treaties produced by the League of Nations in 1928 undergirds the thousands of bilateral income tax treaties now in place throughout the world. These developments are the subject of Chapter 1. The major reexamination of international tax policy conducted by more than 80 countries in the "Base Erosion and Profit Shifting" (BEPS) project under the auspices of the OECD between 2013 and 2015 adhered to the basic concepts developed in the 1928 model treaty (see Chapter 7).

While Chapter 1 has been widely read, cited, and reproduced in various collections, Chapter 2 has been seldom seen. It was written for a volume on international tax policy published in 2001 by the National Foreign Trade Council. This chapter describes President John Kennedy's efforts to tax currently foreign business income of U.S. multinationals and to enact "tax laws which do not favor investment in other industrialized nations or tax havens."[1] Rather than embracing Kennedy's effort to make CEN the linchpin of U.S. international tax policy, however, the Revenue Act of 1962 settled for the narrower anti-abuse rules of Subpart F of the Internal Revenue Code. These rules subsequently became a touchstone elsewhere for taxing controlled foreign corporations (CFCs). Harkening back to the Kennedy proposals, President Obama recently urged enactment of a minimum tax rate applicable to the earnings of foreign subsidiaries of U.S. corporations.[2]

Part II: Business Income

Since the 1990s, there have been a multitude of changes in the international business income tax laws of the United States and of countries around the world, most recently in connection with the OECD efforts to curb income tax avoidance by multinational business entities. (See Chapter 7.) Many changes have been spurred by aggressive competition among nations for investment and innovation (and, in some cases, a slice of revenues from mobile income). The sharp decline in nations' business income tax rates—with the notable exception of the United States—is the most obvious manifestation of this inter-nation competition. Figure 2 depicts the trend over time.

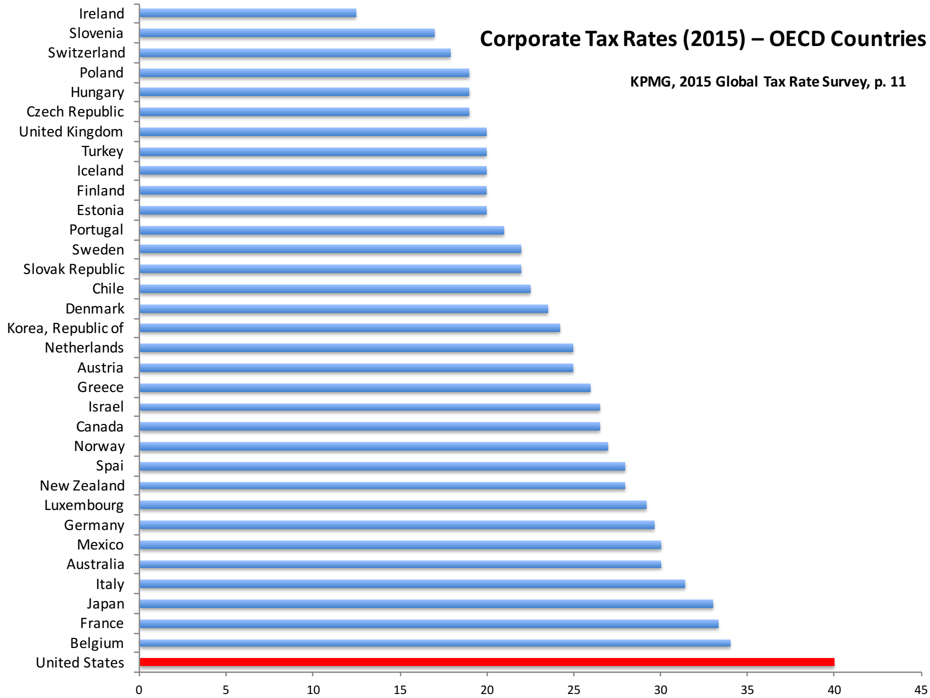
Figure 2



Source: OECD tax database (April 2015)

The United States now has the highest statutory corporate tax rate in the OECD, as Figure 3 shows.

Figure 3

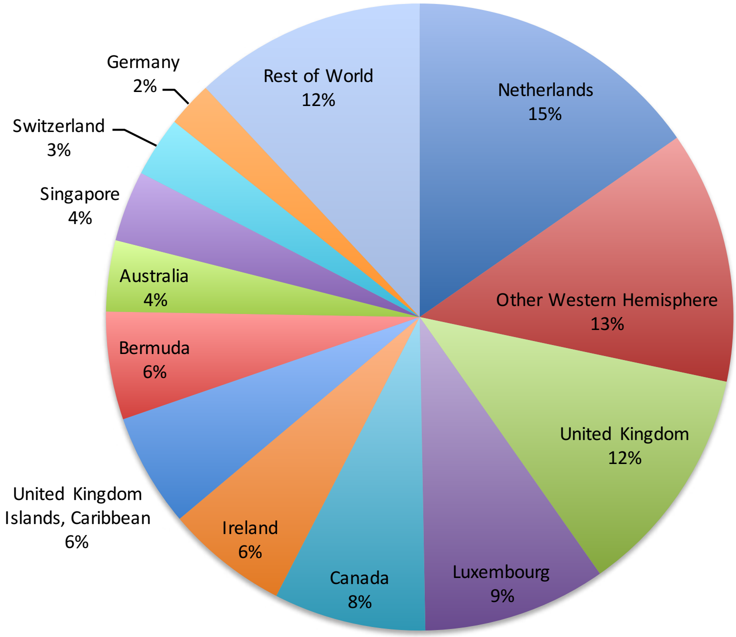


Multinational corporations, to be sure, pay effective rates substantially lower than the statutory rates, but the statutory rates are important. Deductions—principally for interest and royalties—migrate to the high-tax countries, while income—especially mobile income from intellectual property—flows to the low-tax countries. I have elsewhere offered a major tax reform that would get the corporate rate down to 15 percent.[3]

Anyone who doubts the central role of taxes in business investment decisions need only glance at Figures 4 and 5. As Figure 4 shows, there is far more foreign direct investment by U.S. companies in Switzerland, Singapore, Bermuda, Ireland, Luxembourg, and the Netherlands than, for example, in Germany.

Figure 4

Percentage of US Direct Investment Abroad, by selected nations in 2014

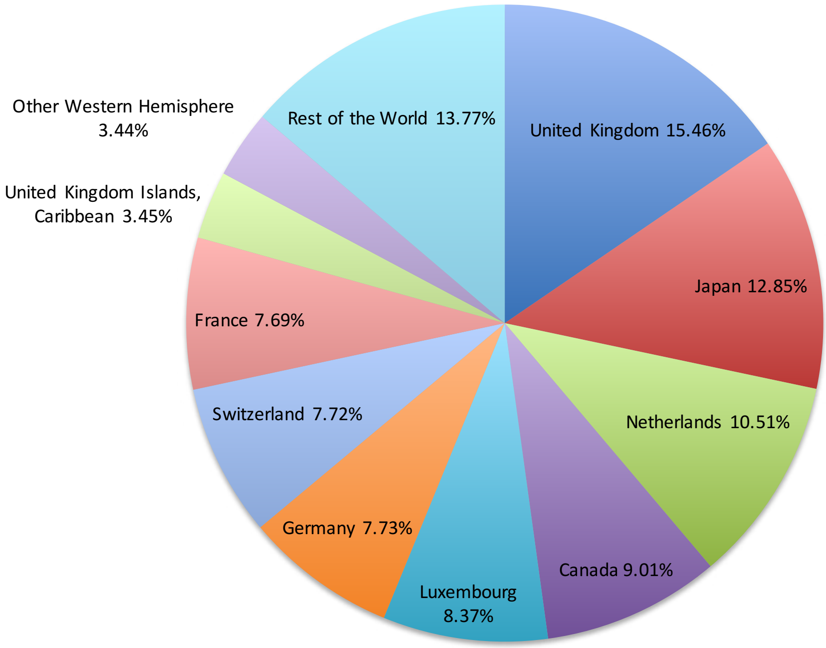


Source: United States Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad.
http://www.bea.gov/international/di1usdbal.htm

Figure 5 makes clear that not just U.S. multinationals engage in tax planning. Foreign direct investment into the U.S. is also disproportionately weighted in favor of tax-advantaged countries, such as Luxembourg and Switzerland.

Figure 5

Percentage of Foreign Direct Investment in the United States by selected nations, 2014



Source: United States Department of Commerce, Bureau of Economic Analysis, "Annual Data,"Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data.
http://www.bea.gov/international/di1fdibal.htm

The essays of Part II address the fundamental principles and concepts undergirding the taxation of international business income and examine a number of the most important current issues. Chapter 3 reproduces my David R. Tillinghast lecture, delivered at New York University Law School in October 2000, in which I urged a fundamental reexamination of international income tax laws and the principles and concepts on which they are based. Tracing the limitations of CEN and CIN as inadequate guides to policy, this chapter argues for a national, rather than worldwide, perspective in international taxation—recognizing both the reality and appropriateness of national governments looking to the effects of international tax laws on the welfare of their citizens and residents. This chapter also looks beyond economic efficiency as the sole basis for international taxation, taking into account, for example, the impact of international income taxation on a fair distribution of taxes among nations and across individuals. Turning to the foundational building blocks of international income taxation—the source of income and corporate residence—the chapter raises important questions about the continuing viability of longstanding rules determining the allocation of income among nations.

Chapters 4, 5, and 6 apply the lessons of Part I and Chapter 3 to three of the most important and vexing issues of international income taxation: the taxation of income from intellectual property, the allowance of deductions for interest expenses, and the appropriate structure of an exemption system for dividends paid out of foreign source business income. After evaluating the economics literature concerning subsidies for developing and exploiting intellectual property, Chapter 4 argues that international taxation of such mobile income should be based substantially on the location of customers rather than where the intellectual property is owned or produced. Given the mobility of borrowing and lending, Chapter 5 provides an analytical frame for the appropriate international taxation of interest expenses. It urges allocation of such expenses based on the location of assets or income. Insights of this chapter have been reflected in reform proposals of the Obama Administration and in the OECD's initial BEPS proposals.[4] Finally, the design of a dividend exemption system described in Chapter 6 has been influential in proposed legislation in the U.S.[5]

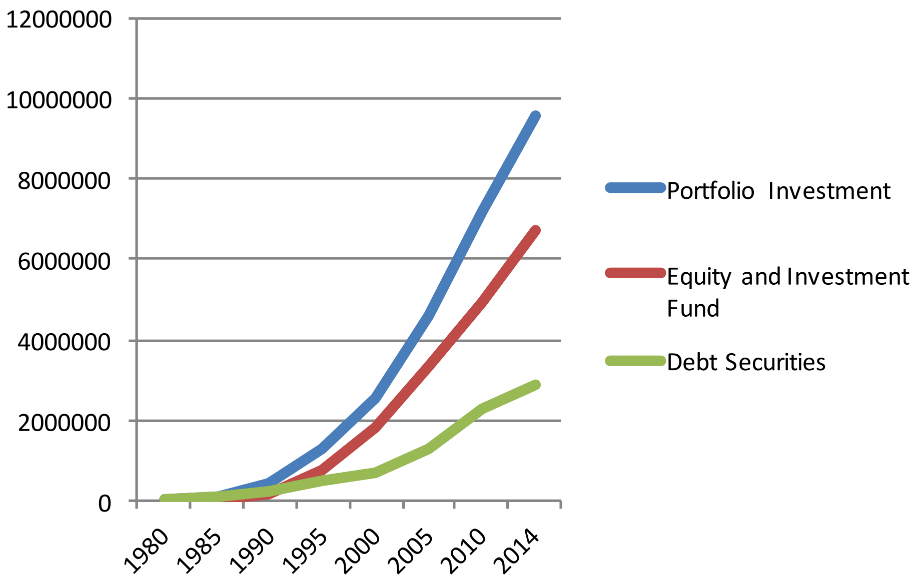
Chapter 7 is the most recently published essay of this collection. It reviews the contemporary challenges of international tax policy, as set forth in my Parsons Lecture, delivered to the University of Sydney Law School in April 2015. After describing the decisionmaking choices and flexibility of multinational corporations and the pressures of inter-nation tax competition, the chapter explains why our 20th Century international tax system is poorly equipped to cope with the 21st Century's technologically driven, integrated global economy. The chapter concludes with a number of predictions about directions international tax policy is likely to take. These include continued inter-nation tax and economic competition; greater application of anti-avoidance rules; greater conflict between taxpayers and tax administrators; broader consumption taxes; and ongoing taxation of capital in the context of retention of politically popular, economically problematic, corporate income taxes.

Part III: Portfolio Income

Chapter 8 reproduces a 2003 article on the taxation of international portfolio income—an issue largely neglected in the literature, despite its ever-increasing importance. Figure 6 displays the tremendous increase in portfolio investments into the United States since the 1980s.

Figure 6

U.S. Portfolio Investments into the United States, 1980-2014

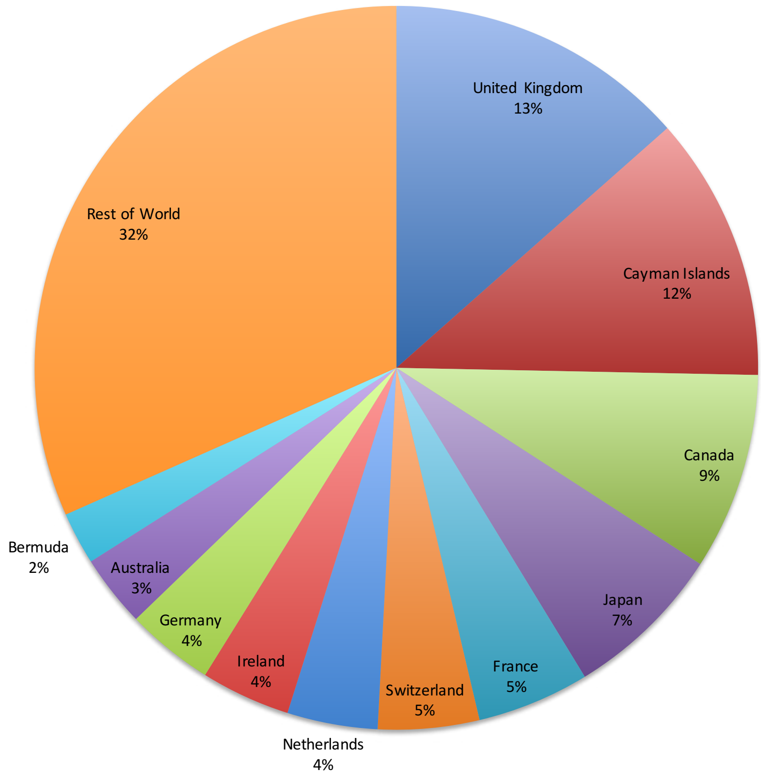


Source: Table 1.2. U.S. Net International Investment Position at the End of the Period, Expanded Detail, Bureau of Economic Analysis.
https://www.bea.gov/scb/pdf/2015/01%20January/0115_international_investment_position_tables.pdf

Figure 7 shows that tax considerations are also very important to the locations of portfolio investments. Once again, places like the Cayman Islands, Bermuda, Ireland, the Netherlands, and Switzerland play an outsized role.

Figure 7

Market Value of U.S. Portfolio Holdings of Foreign Securities, by Country, 2014



Source: Treasury International Capital System (TIC), Securities, (c): Annual Cross-U.S. Border Portfolio Holdings.
https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx

Chapter 8 contends that U.S. tax policy toward foreign portfolio investments of U.S. citizens and residents, which has long been similar to the taxation of foreign direct investment, should be de-linked. Only a deduction, rather than a credit for foreign taxes, may be appropriate.

This chapter's special concern with widespread underreporting and evasion of income taxes from portfolio assets abroad, especially in locations with bank secrecy, has been ratified by recent revelations.[6] The 2010 enactment of the Foreign Account Tax Compliance Act (FATCA) and the many bilateral and multilateral agreements that it has spawned, along with major inroads into bank secrecy and arrangements for automatic sharing of financial information, are making headway in redressing these problems. But the fundamental policy issues raised in Chapter 8 remain unaddressed.

Part IV: Europe

Chapter 9 reproduces the first—and most widely read and cited—of three co-authored articles concerning the impact on European income tax laws and policies of the European treaty guarantees of freedoms of movement of goods, services, persons, and capital. The treaty-based institutional and decisionmaking arrangements now governing income taxation in Europe have cut a broad swath through the income tax rules of the member states of the European Union. This chapter demonstrates that the jurisprudence of the Court of Justice of the European Union is ultimately incoherent because it quests for an unattainable goal in the absence of harmonized income tax bases and rates: to eliminate discrimination based on both the origin and destination of economic activity. The chapter also compares the ECJ's jurisprudence with the resolution of related issues of international taxation elsewhere and to the U.S. taxation of interstate commerce. Chapter 9 describes important shortcomings of the European Union in its fiscal powers and democratic decisionmaking. As the recent financial crisis has demonstrated, these deficiencies extend far beyond international tax policy, especially in the Eurozone where currency realignments in response to changing economic and fiscal circumstances are impossible.

Conclusion

Mihir Desai, in his very generous forward to this volume, correctly answers for readers the question why I have published this volume of essays rather than a monograph on international income taxation. As Chapter 7—borrowing from Sting—says, shaping international tax policy is like trying to write on the surface of a lake: too many constantly moving pieces. So having no ending, only the beginning and middle of a monograph, I have settled for pulling together this book of essays.

Desai's main criticism is that I have offered no "polestar" to guide international tax policymaking. As he puts it, "How can we find our way to the Holy Land without a polestar?" This is hardly surprising. Mihir Desai himself has offered such a polestar: "capital ownership neutrality" (CON) which "promotes global efficiency whenever the productivity of an investment differs based on its ownership" and, as an alternative, "national ownership neutrality" (NON), which promotes "the profitability of domestic firms."[7] CON can be satisfied, he claims, if all countries either exempt foreign income from tax or tax foreign income while providing foreign tax credits. NON requires that foreign income be exempted from tax.

CON and NON were advanced by Desai and his co-author James Hines in an article published in 2003, subsequent to the publication of Chapter 3, which discusses the limitations of CEN and CIN as policy polestars. As Desai knows, had CON then been on the table, I would have expressed similar doubts about that norm as a sole guide to international tax policy. NON, as a national rather than global guide to policy (grounded in an economic efficiency claim) is more consonant with my emphasis in Chapter 3 on national governments looking to the effects of their international tax laws on the wellbeing of their citizens, but I remain unconvinced that the "profitability of domestic firms" should be the sole criterion for enhancing that welfare.

The problem, as it turns out, is that rather than having no polestar, international tax policy has too many. With each nation focused on improving its own welfare, it is hardly surprising that various nations' interests are pulling international tax policy in many different directions. So far, as Chapter 7 laments, international tax competition dominates international tax lawmaking. The recent BEPS effort endeavored to substitute multilateral cooperation for such competition, but with only limited success. There are, to be sure, gains to be had from more multilateral cooperation, but disparities in different countries' circumstances and interests make ongoing inter-nation competition far more likely than substantially more robust international cooperation—at least for the foreseeable future. Ultimately, as Chapter 4 suggests, this may well push (at least large market countries) in the direction of greater international income taxation based on the location of consumers. That, for now, is as close to an ending as I have to offer—unsatisfying as it may be.

Michael J. Graetz
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