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A Multilateral Solution for the Income Tax Treatment of Interest Expenses

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The question of the proper treatment of interest expenses has generally been looked at from the perspective of either inbound or outbound investment and with the view that nations are either debtors or creditors, not both. As a result, the issues of residence countries' limitations on interest deductions on borrowing to finance tax-favoured foreign-source income, on the one hand, and of source countries' restrictions on interest deductions intended to limit companies' ability to strip income from a higher-tax to a lower-tax country, on the other, have generally been treated as separate issues, with no real effort to show how they relate. This article demonstrates their linkage and proposes a multilateral solution that would address both of these problems.

1. Introduction

Although there has been some discussion in recent years of the treatment of borrowing and its attendant interest expenses, the tax treatment of this expense has generally received less analysis than that of business income. Some recent developments, however – including greater taxpayer sophistication in structuring and locating international financing arrangements, increased government concerns with the role of debt in sophisticated tax avoidance techniques, and disruption by decisions of the European Court of Justice (ECJ) of a host of Member States' regimes for limiting interest deductions – have stimulated new laws and policy controversies concerning the international tax treatment of interest expenses. Recent developments make clear the complexity, the incoherence and the futility of countries acting independently to limit interest deductions.[1] They also raise fundamental questions about the proper treatment of interest expenses and whether other expenses, such as for headquarters costs or research and development (R&D), should raise similar concerns.

National rules are in flux regarding the financing of both inbound and outbound transactions. When outbound investments are financed by debt, the question arises whether the fact that the foreign-source income will be deferred or taxed at lower rates justifies the home country limiting the deductibility of interest expenses. In the United States and the United Kingdom, for example, attention has recently focused on whether to allocate and disallow interest deductions connected to foreign-source income under a dividend exemption system.[2] Also in the U.S., House Ways and Means Committee Chairman Charles Rangel (Democrat, New York) has introduced legislation under the U.S. foreign tax credit system that would allocate and postpone interest deductions on outbound investments until dividends are repatriated.[3]

The EU Member States have recently been revising their treatment of interest deductions with special concern for the taxation of inbound investments. As in the outbound context, the critical questions stem from government concerns about the potential for a disappearing corporate tax base. In Europe, the greatest attention has focused on the treatment of "fat" or "thin" capitalization rules (known in the U.S. as "earnings stripping rules"). Reconsideration of Member States' limitations on interest deductions in this context was required by the ECJ in its 2002 decision in the *Lankhorst-Hohorst* case (and subsequent decisions), which struck down Germany's thin capitalization rules as applied to interest paid to companies from other Member States as a violation of the freedom of establishment guarantee of the EC Treaty.[4] These ECJ decisions require equal treatment of

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1. For a useful summary of recent developments, see the excellent General Report authored by Pascal Hinny and the 34 Branch Reports on Subject 2: New tendencies in tax treatment of cross-border interest of corporations, in *Cahiers de droit fiscal international*, Vol. 93b (2008) (62nd Congress of the International Fiscal Association, Brussels, 2008). See also Arnold, Brian, General Report on Subject I: Deductibility of interest and other financing charges in computing income, in *Cahiers de droit fiscal international*, Vol. 79a (1994), at 491 (48th Congress of the International Fiscal Association, Toronto, 1994); and Shaviro, Daniel N., "Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of American Multinationals", 54 *Tax Law Review* 353 (2001).
2. The proposals by the U.S. Joint Committee on Taxation and the President's Advisory Panel on Federal Tax Reform for a dividend exemption system would require the allocation and disallowance of interest expenses incurred to earn foreign-source income. See U.S. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (27 January 2005); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposal to Fix America's Tax System* (Washington, D.C.: U.S. Government Printing Office, 2005). In contrast, the U.S. Department of the Treasury recently issued a report on the competitiveness of U.S. businesses that suggests a dividend exemption system with no allocation of interest. U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (20 December 2007). See also HM Treasury and HM Revenue & Customs, *Taxation of the Foreign Profits of Companies: A Discussion Document* (June 2007).
3. Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Congress, §§ 975-977 (2007). This is one of several proposals designed to help finance a lower corporate income tax rate in the United States. In addition, Congress passed legislation in 2004, effective in 2009, that would shift from water's edge interest allocation to worldwide allocation for purposes of determining the foreign tax credit limitation, but that change has now been postponed until 2011. Housing and Economic Recovery Act of 2008, Public Law 110-289, 122 Stat. 3039. See discussion at notes 19-21, infra.
4. *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, Case C-324/00, 2002 ECR I-11,779. In *Lankhorst-Hohorst*, the ECJ considered a law under which German subsidiaries of non-German parent companies were denied deductions for interest paid to the foreign parent company when the subsidiary had a high debt-to-equity ratio, although such deductions were allowed for

borrowing by domestic and non-domestic companies that are from the EU Member States. In response, Germany now limits interest deductibility to a specified percentage (30%) of "earnings before interest, tax, depreciation and amortization" (EBITDA) without regard to whether the borrowing is from a foreign lender or a related company. Similar rules are being enacted or considered by certain other EU Member States.

In November 2007, the U.S. Treasury issued a report on earnings stripping in response to a congressional mandate requiring such a study as part of legislation dealing with corporate inversions from U.S.-headquartered to foreign-headquartered companies.[5] In Canada, questions about limitations on interest deductions have arisen in the context of a broad review of international tax policy.[6] And in Belgium, for example, a notional interest deduction based on a company's net assets was enacted in 2006 in an effort to reduce the advantages for debt over equity financing.[7] In addition to the foregoing specific rules, interest deductions may also be disallowed under general anti-abuse rules or transfer pricing regimes.

Some countries levy withholding taxes on cross-border payments of interest, although most do not. Where applicable, the withholding tax rates vary from about 12.5% (Italy) to nearly 42% (Mexico), but are often reduced or eliminated by bilateral tax treaties. (The OECD Model Tax Convention sets a maximum rate of 10%.) These treaty reductions are, in turn, restricted to residents of the treaty country by limitation on benefits clauses in the treaties. Obviously, a sufficiently high withholding tax on payments of interest can substitute for disallowing interest deductions.

As this very brief overview implies, the treatment of cross-border interest payments is now one of the most complex aspects of income tax law. Rules differ among countries and contexts. As a result of the decisions of the ECJ, some uncertainty remains in Europe about what rules are permissible. The subject is further complicated by different countries' varying approaches to distinguishing interest payments from dividends. Moreover, because money is fungible, it is difficult in both theory and practice to know the "purpose" of specific borrowing. Nevertheless, many countries attempt to "trace" borrowed funds to their use, creating opportunities for creative tax planning and inducing inevitable disputes between taxpayers and tax collectors.

These disparities in law and practice create opportunities for either double or zero taxation. Since taxpayers generally have great control over the location of their borrowing, there is considerably greater risk of the latter.

Heretofore, in both the literature and policymaking, the question of the proper treatment of interest expenses has generally been looked at from the perspective of either inbound or outbound investment and with the view that nations are either debtors or creditors, not both. As a result, the issues of residence countries' limitations on interest deductions on borrowing to finance low-taxed, exempt or deferred foreign-source income, on the one hand, and of source countries' restrictions on interest deductions intended to limit companies' ability to strip income from a higher-tax to a lower-tax country, on the other, have generally been treated as separate issues. Each of these issues has been discussed in the literature, but there has been no real effort to show how they relate. A fundamental contribution of this article is to demonstrate their linkage and to call for a multilateral solution that would address both of these problems.

I shall use the following simple and stylized example to illustrate the fundamental issues and to show how they are connected. At the outset, the example assumes that the purpose of the taxpayer's borrowing is known; I shall deal subsequently with this oversimplification.

2. A Simple Example to Illustrate the Issues

Assume three countries: H – with a corporate income tax rate of 35%, M – with a 25% rate, and L – with a 15% rate. H is a high corporate tax rate country, such as the U.S. or Japan; M, like most of western Europe, has a corporate tax rate a bit below the OECD average; and L, like China and Ireland for example, has a low corporate tax rate. For simplicity of exposition, H is assumed to want to tax only the domestic-source income of both its residents and non-residents, and it therefore exempts foreign-source dividends.[8] The policy choice for H is (1) allowing interest deductions in full whenever borrowing occurs in H without regard to where the investment it finances occurs, or (2) disallowing interest deductions when borrowing is determined to be used for investing abroad. Thus, to the policymakers of H, the question is whether to disallow interest deductions when interest is incurred to finance exempt (or low-taxed) income. For reasons that will be made clear subsequently, an interest disallowance regime should disallow interest deductions only when the company's borrowing is disproportionately greater in H than elsewhere based on an allocation of interest expenses that compares the ratio of the company's H borrowing to H assets with the ratio of its worldwide borrowing to worldwide assets.

payments by German subsidiaries to German parent companies. See also *Bosal Holding*, Case C-168/01 (13 October 2003); and *Test Claimants in the Thin Cap Group Litigation*, Case C-524/04 (13 March 2007).

5. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (November 2007).

6. The 19 March 2007 Canadian federal budget included a proposal to eliminate the deductibility of interest on debt incurred by Canadian corporations to finance foreign affiliates. In the face of significant criticism, on 14 May 2007 Minister of Finance Jim Flaherty announced significant changes to the interest deductibility proposals. The 14 May 2007 news release is available on the Department of Finance web site at www.fin.gc.ca/news07/07-041e.html. The 2007 Canadian federal budget is available at www.budget.gc.ca/2007/index_e.html.

7. See Martin, Stéphane and Patrick Smet, Branch Report for Belgium on Subject 2: New tendencies in tax treatment of cross-border interest of corporations, in *Cahiers de droit fiscal international*, Vol. 93b, supra note 1, at 127, 139.

8. I use an exemption system for illustrative purposes here both for clarity in the exposition of the issues and because it is the dominant method of relieving double taxation of income on outbound investment within the OECD. Only the Czech Republic, Ireland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom and the United States use foreign tax credits. U.S. Department of the Treasury, supra note 2, at 19, Table 1.5.

Take a simple case where an *H* resident company borrows 100 in *H* to finance an investment of 100 in *L*. Assume that the interest expense is 10 and the income from the *L* investment is 15. If the interest expense were deducted against the *L* income, the net income from the *L* investment would be 5, which at the 15% *L* rate would yield an *L* income tax of 0.75 and after-tax income of 4.25 to the *H* company. There would be no domestic income or deduction in *H* and no *H* tax.

If borrowing could be traced to its use, this seems a plausible answer. But, because money is fungible, such tracing is not feasible in practice (despite the commonplace efforts to do so). So it seems reasonable to conclude that the company borrowed in order to keep all of its worldwide assets (rather than selling one or more assets to make the investment in *L*) and to avoid issuing new equity. This explains why *H* should treat borrowing as occurring proportionately to the *H* company's worldwide assets.[9]

If, however, *H* has no interest disallowance rule and allows the 10 of interest to be deducted in full against other income that would otherwise be taxed by *H* at its 35% rate, this would save the company 3.50 in *H* income taxes. The 15 of income in *L* would result in an *L* income tax of 2.25. The *H* company would have earned 6.25 after tax on an investment yielding just 5 before tax – implying not just zero taxation of the *L* income, but in fact a negative rate of taxation, a subsidy for this investment. From the point of view of *H*, this investment would have cost it 3.50 in foregone revenue, 1.25 of which would go to the *H* company and 2.25 of which would go to the treasury of *L*.[10] Perhaps some argument (presumably on competitiveness grounds) can be made for *H* subsidizing this investment by the *H* company, but what argument is there in a case such as this for transferring revenues from *H's* treasury to the treasury of *L* simply because the company chose to locate its borrowing for this investment in *H*? If *H* is revenue constrained, the 3.50 of revenue lost on this investment must be made up from somewhere else, and important economic and distributional consequences will turn on who and what is taxed.

Moreover, at its 15% tax rate, the government of *L* should get only 0.75 in income taxes on an investment yielding a pre-tax profit of 5, rather than the 2.25 it did receive – an amount equivalent to levying a 45% tax on the company's before-tax profits. Under current arrangements, however, *L* will allow no deduction for interest expenses when the borrowing takes place in *H*, so the government of *L* might get 2.25 in taxes whether *H* allows the interest deduction or not. But the consequences will be very different depending on whether that money comes from the *H* company or from other *H* taxpayers. If *H* disallows the entire interest deduction in this case and *L* does not allow any deduction because the borrowing occurred in *H*, *H* will collect its 35% tax on the company's domestic income and, as indicated above, *L's* income tax of 2.25 would produce a tax rate of 45% on this investment – a rate higher than that in either of these countries. In other words, there would be a significant element of double taxation.

The *H* company, of course, could avoid this double tax by, for example, locating the borrowing in *L* rather than *H*. And if each country is to tax the net domestic income earned there, the interest deduction should be allowed by *L*, not *H*.

Internation equity also supports this result. In this example, the source country is given not only the first bite at taxing the active business income earned there, but the sole claim on taxing such income. Given the priority of source countries on the asset side, why should the residence country also be required to lose revenue on the liability side? The source country, by not allowing deduction of the interest, is the cause of the double tax. Why should it be the residence country's responsibility to undo that result – especially when the residence country is not even making a residual claim to tax the foreign income?

For an important variation on this basic example, assume now that *M*, with its income tax rate of 25%, has no interest disallowance rule. If the *H* company also has income and assets located in *M*, it might choose to borrow in *M* instead of *H* or *L* and deduct the 10 of interest against income that *M* would otherwise tax. In that case, the *H* company would save 2.50 of tax in *M* and pay income tax to *L* of 2.25 for an after-tax return of 5.25 on an investment yielding 5 before tax – again earning a return that is higher after tax than before tax. In this case, however, the 0.25 subsidy to the *H* company and the 2.25 transfer to the treasury of *L* would come from the taxpayers of *M* rather than *H*.

The policymakers of the *M* government would view this transaction as a problem of earnings stripping (or thin capitalization) by the *H* company. Thus, economically similar transactions will fit into different traditional analytic boxes depending on which country is examining the transaction and where the borrowing takes place.

Here again, if the borrowing company were resident in *M*, it is perhaps conceivable that some argument or empirical claim could be advanced for this treatment (as before, no doubt grounded in the competitive advantages to *M's* residents of a resident company making this investment[11]), but it seems impossible to fashion an

9. I ignore here the theoretical difficulty and practical necessity of using the book value rather than the fair market value of assets. Relying on basis, rather than value, does have the advantage of resolving the difficult issue of intangible assets since the costs of self-created intangibles are typically deducted rather than capitalized.

10. In theory, the revenue lost to *H* through the interest deduction might be made up if *H* were to tax the lender on the interest income. While the precise dimensions of this possibility are difficult to get a handle on, as a practical matter, given the large holdings of U.S. corporate debt in tax-exempt retirement accounts, university endowments and other tax-exempt entities and by foreigners, this is quite unlikely – at least in the U.S.

11. See Samuels, John, Vice President & Senior Counsel of Tax Policy and Planning, General Electric, "True North: Charting a Course for U.S. International Tax Policy in the Global Economy", the David R. Tillinghast Lecture on International Taxation, 25 September 2007 (forthcoming in *Tax Law Review*); see also the discussion at notes 35-37, infra.

argument that this transfer from the treasury of *M* to both the *H* company and *L's* treasury makes any sense at all as a deliberate policy choice of *M*. Of course, if *M* is an EU Member State, the decisions of the ECJ in *Lankhorst-Hohorst* and subsequent cases might not allow it to treat an *H* company any differently than an *M* company.[12] And it is also possible that the non-discrimination clause of *M's* bilateral tax treaties might foreclose it from making such a distinction.[13]

To complete the analysis, it is worth noting that an *M* company contemplating a debt-financed investment in *L* would have an incentive to do its borrowing in *H* (if it had assets and income there) so that its interest deduction would offset income that would otherwise be taxed at *H's* higher 35% rate. Thus, *H* will also have earnings stripping (or thin capitalization) problems to deal with.

3. How Interest Expenses Should Be Allocated

3.1. A word about source

It is fundamental that, except in the context of a system of current taxation of worldwide income with an unlimited foreign tax credit – a system that no country now has, ever has had, or is likely ever to have – it is essential for each nation to distinguish between domestic-source income and foreign-source income. The consequences of this distinction vary depending on a country's tax rate and its system for avoiding double taxation. In the U.S. foreign tax credit system, for example, the distinction between foreign-source and domestic-source income is important principally for determining the limitation on foreign tax credits; in an exemption system, it is important for measuring taxable versus exempt income.

But, as is well known, the "source" of income is not well grounded economically, nor is it conceptually straightforward.[14] In many instances (not discussed here), archaic rules and distinctions prevail.[15] Moreover, the current rules often stem from political decisions and compromises made scores of years ago when capital was far less mobile. The sourcing of interest, for example, was a contentious decision made in the 1920s during the initial formulation of international agreements for relieving double taxation.[16] Since both net foreign-source and domestic-source income must be measured, however, it is necessary to source both income and deductions, even if the current sourcing rules seem arbitrary and archaic.

3.2. The effect of different rules in different countries

As the foregoing example illustrates and the empirical economics literature amply demonstrates, different tax rates in different countries create incentives for companies both in choosing where to locate real investments and in shifting income and deductions around the world.[17] And, as the example above illustrates, when countries differ in their rules for determining the source of a particular kind of income, both double taxation and zero (or even negative) taxation can occur. U.S. multinationals frequently complain, for example, about the double taxation that occurs because the U.S. allocates and disallows interest (for foreign tax credit limitation purposes) while other countries do not allow deduction of the interest disallowed by the U.S. They stifle such complaints, however, when in other contexts the lack of harmonization allows them to avoid taxation in any country.[18] In the absence of multilateral agreement, these difficulties, opportunities and issues will persist.

As a result, it is treacherous to evaluate companies' claims of competitive disadvantage based on pairwise distinctions of specific rules. To know whether a company headquartered in one country is advantaged or disadvantaged compared to another company headquartered elsewhere, one would have to compare the totality of consequences of similar investments. In the literature, this typically occurs only through efforts to measure the overall effective tax rates. These exercises typically simply assume a certain proportion of debt and equity finance, and therefore do not address the issues I am addressing here, in particular, the location of borrowing. In any event, piecemeal policy-by-policy comparisons should be taken with a grain of salt; a disadvantage in one aspect of tax policy may be compensated for by an advantage elsewhere. Taxpayers obviously have incentives to highlight their disadvantages rather than their advantages.

3.3. The particular difficulty of tracing interest deductions to the income the borrowing finances

Given the fungibility of money, knowing the purpose of borrowing is an impossible quest. Nevertheless, even for purely domestic investments, the U.S. tax law, for example, distinguishes among categories of personal interest, investment interest and a wide variety of business interest costs. The U.S. has essentially been undaunted by the folly of attempting to trace borrowed money to its use. So have many other countries. This is one reason why the tax provisions governing interest deductions, which frequently condition the deductibility of interest on the

12. *Lankhorst-Hohorst*, supra note 4, and the cases cited there.
13. Such claims were made – but ignored by the United States – in connection with the enactment of the U.S. earnings stripping rules. Graetz, Michael J. and Alvin C. Warren, Jr., "Income Tax Discrimination and the Political and Economic Integration of Europe", 115 *Yale Law Journal* 1186 (2006); Warren, Jr., Alvin C., "Income Tax Discrimination Against International Commerce", 54 *Tax Law Review* 131 (2001).
14. Ault, Hugh J. and David Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises", in Razin, Assaf and Joel Slemrod (eds.), *Taxation in the Global Economy* (1990), at 11.
15. See e.g. Colón, Jeffery M., "Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads", 1999 *University of Illinois Law Review* 775.
16. See Graetz, Michael J. and Michael O'Hear, "The 'Original Intent' of International Taxation", 46 *Duke Law Journal* 1021 (1997).
17. Gordon, Roger H. and James R. Hines, *International Taxation*, National Bureau of Economics Research Working Paper No. 8854-4 (2002); European Commission, Commission Staff Working Paper, *Company Taxation in the International Market*, COM(2001) 582 (2001).
18. Kane, Mitchell, "Strategy and Cooperation in National Responses to International Tax Arbitrage", 53 *Emory Law Journal* 89 (2004); Ring, Diane, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage, 44 *Boston College Law Review* 79 (2002); Rosenbloom, H. David, "International Tax Arbitrage and the 'International Tax System'", 53 *Tax Law Review* 137 (2000).

purpose of the indebtedness, are now among the most complex in the income tax. These complexities, and the controversies about them, often occur, as in the instant context, because of the tax-favoured treatment of assets financed with borrowed funds.

In the context of cross-border investments, beginning with the regulations issued in 1977, the U.S. generally accepted the fact that money is fungible and apportioned the interest expense of U.S. corporate entities for foreign tax credit purposes according either to the (book) value of assets or to gross income.[19] The assets approach was most widely used; thus, interest deductions (for foreign tax credit limitation purposes only) were generally computed using the following (simplified) formula: allowable U.S. interest expense equals worldwide interest expense times the ratio of U.S. assets to worldwide assets. The Tax Reform Act of 1986 refined this concept by looking at interest expenses on a consolidated basis for affiliated corporations rather than on an entity-by-entity basis. The 1986 law, however, unfortunately and erroneously ignored foreign subsidiaries in this calculation,[20] which is why it became known as "water's edge allocation". But that defect was remedied by legislation in 2004, which will treat all members of a worldwide group as a single corporation.[21] (The 2004 corrective legislation, however, was not scheduled to take effect until 2009 and, in 2008, the legislation was delayed until 2011.[22])

A worldwide allocation system, based on the ratio of debt to assets, is the most appropriate method for measuring domestic-source and foreign-source income if interest expense is to be allocated.[23] *Importantly, worldwide allocation based on assets implies that interest deductions will not be treated as allocable to foreign-source income and disallowed except when borrowing in one country is disproportionate to borrowing elsewhere.*

4. What is at Stake in the Treatment of Interest Expenses?

4.1. Location of investment

Some argue that the failure to allocate interest deductions on a worldwide basis will create an inappropriate incentive for companies to invest abroad rather than at home. The example above demonstrates why this might be true. It is important to recognize, however, that the fundamental income tax incentive for a company to invest in a low-tax country, such as *L*, rather than in higher-tax countries, such as *H* (or *M*), is due to the lower tax rate in *L*. Extensive econometric evidence shows that, although business, not tax, considerations often dominate, the location of investments is significantly influenced by tax rate differences, and an important study by the European Commission has concluded that differences in tax rates are the principal income tax factor affecting decisions about the location of investments.[24] The essential point is this: the incentive to invest in *L* rather than in *H* exists even if the investments are financed solely by equity and no interest deductions are at issue. An investment in *H* yielding 5 before tax will produce only 3.25 after tax, compared to the 4.25 available after tax for an investment in *L*. Only by eliminating the tax rate differential – through harmonization of tax rates or a capital-export neutrality policy of current taxation by *H* of the income earned in *L* with a foreign tax credit for *M's* taxes, a policy no country has adopted – will that incentive be eliminated.

Careful analyses of situations where assets eligible for favourable tax treatment are acquired with debt, such as where borrowing occurs to finance domestic tax-exempt income or other tax-favoured domestic investments, for example in plant and equipment, have also concluded that it is the tax preference, not the borrowing, that is the fundamental stimulant to the investment.[25] In such instances, it may even be the case that disallowing interest deductions will inhibit the effectiveness of the underlying tax preference.[26] But these analyses focus on cases where both the income taxation on the asset side and the tax treatment of the interest expense are controlled by the same domestic policymaking process. Importantly, with the issue here, the tax preference on the asset side – the low tax rate in *L* – is outside the control of the *H* or *M* government. And, as the example demonstrates, allowing full deduction of the interest on the borrowing in *H* (or *M*) will tend to exacerbate the preference for investments in low-tax countries by producing an overall *negative* rate of income tax on the foreign investment.

19. For a history of interest allocation, see Hufbauer, Gary Clyde and Airel Assa, *U.S. Taxation of Foreign Income* (2007), at 236-240. For an analysis suggesting that worldwide allocation of interest is "more consistent [than water's edge allocation] with the basic objective of the foreign tax credit limit" and details about the formulas that have been used in the United States, see Gravelle, Jane G. and Donald J. Marples, "The Foreign Tax Credit's Allocation Rules", Congressional Research Service (16 May 2008).

20. To my knowledge, no respectable policy argument has been made in support of the U.S. system of water's edge allocation. It is an unprincipled revenue grab enacted in 1986 that has remained in the law far too long, but the U.S. Congress, seeking revenues to finance other tax reductions, seems determined to keep it in place at least for a while longer.

21. American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418, § 401.

22. See note 3, supra.

23. The comparison, for example, is U.S. debt to U.S. assets versus worldwide debt to worldwide assets, with allocation to a foreign source required only when the former ratio is greater than the latter (or, alternatively, the ratio of U.S. borrowing to worldwide borrowing must be the same or less than the ratio of U.S. assets to worldwide assets). There may, however, be an argument for looking at interest on a net basis, i.e. looking only at the excess of interest expense over interest income, but I will put that issue aside here. It is probably most important for financial institutions.

24. European Commission, supra note 17. See Hines, Jr., James R., *Tax Policy and the Activities of Multinational Corporations*, National Bureau of Economics Research Working Paper No. W5589 (1996).

25. See e.g. Warren, Jr., Alvin C. and Alan J. Auerbach, "Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing", 95 *Harvard Law Review* 1752 (1982); see also Pearlman, Ronald A., "A Tax Reform Caveat: In the Real World, There is no Perfect Tax System", in Auerbach, Alan J. and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform* (2005).

26. There is controversy, for example, in the U.S. policy literature over the merits of § 265(a)(2) of the Internal Revenue Code, which disallows interest deductions on indebtedness used to purchase or carry state and local bonds the interest on which is exempt from income tax. 26 U.S.C. § 265(a)(2); see Chirelstein, Marvin A., *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* (10th ed., 2005), § 6.06(a).

4.2. Creating incentives for bad investments

As the example above illustrates, allowing a deduction in a higher-tax country for borrowing to invest in lower-tax countries can produce after-tax returns greater than the investment's pre-tax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments will clearly decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.[27] Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy, as discussed below, would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place.

4.3. Choice of debt over equity finance

Allowing an interest deduction without allocation increases the advantage of debt over equity as a source of corporate finance. However, as with the decision about where to invest, the crux of this problem lies not with the failure to allocate interest, but more fundamentally with the general corporate income tax disparity between the treatment of debt and equity. Much has been written on behalf of a variety of corporate tax integration proposals to eliminate or reduce this disparity.[28] But no country has achieved parity between debt and equity finance by disallowing deductions for interest, nor does that seem likely to occur. Interest deductions will continue to be generally allowed, but whenever debt finance is permitted to produce interest deductions that will offset income otherwise taxed at a higher rate than that on the income resulting from the borrowing, this will exacerbate the advantage of debt finance. Such a regime also affects companies' decisions about the location of debt and equity finance so as to maximize the tax savings from the disparities in their treatment.

4.4. Location of borrowing

Allowing an interest deduction in *H*, even if the borrowing is disproportionately located in *H*, will encourage companies to locate their borrowing in *H* whenever the tax rate in *H* is higher than elsewhere. For example, both companies headquartered in the U.S. and companies headquartered elsewhere will prefer to deduct their interest expense against U.S. income (if they have any) that would be taxed at 35%, rather than to use the interest deduction in a country where it would offset income that would be taxed at a lower rate.[29] Indeed, given the mobile nature of corporations' ability to borrow, borrowing may disproportionately be located in *H* almost as easily for a foreign multinational as for a domestic-headquartered company.[30] *There seems to be no good policy reason for the U.S. to want to encourage borrowing that finances foreign investments to be located in the U.S.*

Interest is not the only expense that companies incur which produces foreign-source income taxed at a low rate. For example, expenditures for R&D may, over time, yield royalty income both domestically and abroad. Under the U.S. foreign tax credit system, the foreign-source royalties may bear little or no corporate income tax anywhere.[31] Likewise, headquarters expenses, often described as general and administrative or stewardship costs, tend to be concentrated in the country where a company locates its headquarters, even though these expenses support the company's production of income throughout the world. In both of these cases, some commentators have argued for a full deduction of these costs in the country where they occur without regard to where the income is earned or whether it is taxed anywhere.[32] These arguments, however, are grounded in the special benefits of these expenditures to the country where they occur – due, for example, to positive externalities from R&D and the high-quality jobs at stake in both R&D and headquarters activities. No similar arguments are available for the location of borrowing transactions.

4.5. Internation equity between source and residence countries

Under current international income tax arrangements, the source country is generally given not only the first bite at taxing the active business income earned there, but in many cases, through the domestic exemption of foreign-source dividends, the sole claim on taxing such income.[33] This source-country priority has been established either unilaterally, such as by the United States when it first enacted a foreign tax credit, or bilaterally through income tax treaties. Today, this priority is a fundamental element of more than 2,000 bilateral income tax treaties.[34] But these treaties do not require countries to allow interest deductions wherever the borrowing occurs.[35] Since source countries have the first claim to

27. The argument for repealing § 265 of the U.S. Internal Revenue Code is not applicable here; there is a great difference between transferring U.S. federal revenues to U.S. state and local governments to help them save interest costs and transferring such revenues to low-tax foreign countries. Moreover, although the advantages of repealing § 265 have long been known, this denial of interest deductions remains untouched.

28. See e.g. Graetz, Michael J. and Alvin C. Warren, Jr. (eds.), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (1998).

29. While corporations may have considerable control over where they locate their borrowing, that control may not be absolute: *L*, for example, may not have well-developed capital markets for corporate borrowing. And there may be economies of scale from concentrating borrowing in one or a few places. Moreover, a corporation will have to have assets in *L* to deduct interest there given *L's* likely earnings stripping rules. But the *government* of *H* should prefer *L* as the place for corporate borrowing to finance investments in *L*.

30. The foreign company would need to have adequate assets or income in *H* in order not to run afoul of *H's* earnings stripping rules.

31. This is because royalties are permitted to be deducted abroad, may bear little or no withholding tax, and can be sheltered from U.S. tax through cross-crediting.

32. See e.g. Hufbauer and Assa, supra note 19, at 133-143.

33. Graetz and O'Hear, supra note 16; Avi-Yonah, Reuven S., "The Structure of International Taxation: A Proposal for Simplification", 74 *Texas Law Review* 1301 (1996).

34. OECD Model Tax Convention on Income and on Capital, 15 July 2005, Arts. 23 A and 23 B.

35. They do, however, require countries not to discriminate against foreigners.

the tax revenues from income on business assets, it seems incongruous that the residence country should also be required to forego additional revenue due to the location of liabilities there. This is not required by tax treaties. Source countries contribute to causing the double tax by not allowing the deduction of interest expenses. Why should residence countries be responsible for eliminating that double tax by allowing interest deductions for borrowing used to finance assets abroad – especially when most residence countries do not even make a residual claim to tax the foreign-source income?

4.6. The potential for competitive disadvantage

The recent debate in the United States over the treatment of interest expenses has focused on outbound investments and the proper scope for the allocation (and disallowance) of interest expenses. In a turn away from its previous view, the U.S. Treasury Department, in its December 2007 report, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, called for the U.S. to allow interest deductions in full without regard to the location of the investments attributable to the borrowing.[36] The University of Michigan economist James Hines in a recent article[37] and General Electric's top tax officer John Samuels in his New York University Law School Tillinghast Lecture[38] have also recently advocated this policy. The Treasury report emphasizes the complexity of interest allocation. Prof. Hines focuses on its potential to result in advantages for foreign over domestic ownership of businesses. And Mr Samuels claims that the U.S. disallowance of interest expense will put U.S.-based multinationals at a competitive disadvantage compared to companies headquartered in nations that allow interest deductions without any such limitations.

I cannot address these views in any detail in this article. Nor is such discussion necessary here since my main purpose here is to point the way to a *multilateral* solution to this issue. But the breadth of the claims that the benefits to the U.S. from having U.S. multinationals make foreign investments justify full U.S. deduction of interest under all circumstances is troubling. There is an extraordinary "race to the bottom" quality to these arguments. In essence, they claim that the U.S. makes a mistake by disadvantaging U.S.-based companies in *any* aspect of the tax law where the consensus treatment among the U.S.'s trading partners reaches a more advantageous result. Such claims are particularly hard to credit in a context where U.S. multinationals have ready access to worldwide capital markets. They are likely to respond to a U.S. rule disallowing interest deductions when borrowing is disproportionately located in the U.S. simply by relocating their borrowing to a more favourable jurisdiction.

Moreover, such claims do not respond to any of the concerns expressed above. Nor have they been supported by any compelling empirical evidence that either worldwide economic efficiency would be improved by such a policy or, more narrowly, that the benefits to U.S. workers and investors from such a policy would exceed their costs. (Indeed, if the U.S. is worried about the international competitiveness of its workers and businesses, a far stronger argument exists for lowering the U.S. corporate tax rates, but that issue is well beyond the scope of this endeavour.) To be revenue neutral, allowing interest deductions without any limit or allocation requires higher tax rates than would a U.S. policy which requires worldwide allocation of interest expenses. And, for the reasons discussed above, it is difficult to see why allowing interest deductions without allocation should be a policy priority.

5. A Multilateral Solution

5.1. Worldwide allocation

The problems I have described here – the mismeasurement of income, potential distortions in the location of investment, an increased incentive for debt over equity finance, distortions in the location of borrowing, and unjustified revenue transfers among countries – would all disappear if all countries allocated interest deductions to assets on a uniform worldwide basis and allowed a proportionate amount of interest expense to be deducted against income earned domestically *without regard to where the borrowing occurs*.[39] Such a system would deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world.

For outbound investment, the advantages of such a regime should by now be apparent. Incentives to locate borrowing in high-tax countries would disappear, as would incentives to make debt-financed investments because their after-tax returns exceed their pre-tax returns. Debt would be located wherever it is most economical. The revenue transfer from countries where borrowing is located to those where investments are made would stop. And the advantages of debt over equity finance would be reduced somewhat.

In the case of inbound investment, where the problem is typically described as earnings stripping or thin capitalization, there is also much to commend worldwide allocation as a mechanism for determining allowable interest. No country would have to fear that it was bearing a disproportionate portion of a company's interest expense. Indeed, some EU Member States now allow worldwide allocation as a safe-harbour method to protect companies against interest expense disallowance.

The practical difficulty with such an allocation rule for inbound investments is that, without international

36. U.S. Department of the Treasury, supra note 2, at 60.
37. Hines, James R., "Reconsidering the Taxation of Foreign Income", paper delivered at New York University Law School on 14 November 2007 (forthcoming in *Tax Law Review*), available at taxprof.typepad.com/taxprof_blog/files/hines_reconsidering_nov_07.pdf.
38. Samuels, supra note 11.
39. Another possibility would be to allocate interest expense proportionately to income rather than assets. This would also be a major improvement over current laws and practices, but an allocation based on assets seems conceptually more sound and is probably easier to implement.

cooperation, the information about a company's total amount of borrowing and assets necessary to calculate a worldwide allocation may not be readily available to the source country. This explains why source countries have separately devised thin capitalization rules, often relying on fixed allowable debt-to-equity ratios or fixed limits on interest expense deductions as a percentage of income (EBITDA) to limit interest deductions. However, as with interest allocation for outbound investments, disallowing interest deductions through earnings stripping or thin capitalization rules – when, as is generally the case, the interest disallowed by the source country will not be allowed by the residence country – may lead to double taxation of the inbound income. On the other hand, allowing the interest deductions in full may produce negative tax rates and threatens the domestic tax base. Thus, worldwide allocation is desirable for both source and residence countries.

5.2. The benefits of a multilateral response

Rarely does a difficult international income tax issue produce such a clear solution. Worldwide allocation of interest expense by both source and resident countries would eliminate a host of problems now bedevilling nations throughout the world – problems that have produced varying, complex and inconsistent responses among different countries, responses that frequently may result in zero or double taxation. Given the flexibility of multinational corporations to choose where to locate their borrowing and the difficulties nations have in maintaining their domestic income tax bases in the face of such flexibility, achieving a multilateral agreement for the treatment of interest expense based on a worldwide allocation should become a priority project for both source and residence countries. The OECD and the European Commission might lead the way. The European Commission should begin by incorporating such a rule into its common consolidated corporate tax base project.[40] For the OECD, making worldwide allocation a commonplace feature of bilateral income tax treaties throughout the world, along with attendant requirements for information sharing adequate for source countries to be confident about their ability to enforce such a rule, would be fair to all nations and substantially improve economic efficiency and internation equity throughout the world. As has so often been the case, a common multilateral solution may be accomplished piecemeal through bilateral income tax treaties.[41]

Solving the problem of interest expense deductions on a multilateral basis would offer great benefits to virtually all nations. Unlike some other areas of international income tax law where a nation may see substantial advantages from pursuing a beggar-thy-neighbour tax policy, there is no important national competitive advantage available in departing from the solution I have offered here. That alone does not make achieving a multinational solution easy, but it might make it possible.

40. For an overview, see Weiner, Joann M., "Approaching an EU Common Consolidated Tax Base", 46 *Tax Notes International* 647 (14 May 2007).
41. One cannot help but note the irony that the most promising path to a multilateral solution to an income tax issue is through revisions of bilateral treaties.