

ONE NATION AMONG MANY: POLICY IMPLICATIONS OF CROSS-BORDER TAX ARBITRAGE

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Abstract: Cross-border tax arbitrage arises where a transaction is subject to two or more countries' differing tax regimes. Conflicts between the tax rules create unique opportunities for the parties to engage in profitable tax planning—opportunities that would not be available if the transaction occurred entirely domestically in one of the countries. These opportunities have been a growing feature of the multi-jurisdictional business world and have raised issues concerning whether and how countries, such as the United States, should respond. This Article examines cross-border tax arbitrage in the context of both domestic tax policy and of other international tax issues, and considers potential responses. It proposes an analytic framework for cross-border tax arbitrage based on specific case studies. The Article concludes by proposing a balancing test for determining the appropriate treatment of specific instances of cross-border tax arbitrage.

INTRODUCTION

The central challenge in international tax is navigating the relationship between an individual country's tax system and the rest of the world—a question of how nations should balance competing demands of revenue, domestic policy, retaliation, and global goals. The question grows more pressing as the pace of intersections among tax regimes escalates. The difficulty of this exercise manifests itself quite clearly in the emerging questions about cross-border tax arbitrage.¹

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¹ Although a more comprehensive definition of cross-border tax arbitrage is offered elsewhere in the paper, it is worth noting up front that the terminology may be awkward for readers familiar with the financial literature. In that context, arbitrage refers to the process of eliminating price gaps in the market—presumably a desirable function from the perspective of a competitive market. This definition does not carry over into the tax area.

Does cross-border tax arbitrage represent egregious abuse of the tax system? Is it the natural outcome of a multi-jurisdictional world? What is the proper view of cross-border tax arbitrage and how should its analysis be framed?

In its simplest terms, cross-border tax arbitrage refers to a situation in which a taxpayer or taxpayers rely on conflicts or differences between two countries' tax rules to structure a transaction or entity with the goal of obtaining tax benefits (for example, reduced or no taxation) overall. Had the structure or transactions taken place entirely domestically, the net tax benefit (which was created by the conflict between the two countries) would not exist. Thus, taxpayers in the arbitrage transaction or structure exploit the intersection of the two countries' tax systems to eliminate or reduce substantially their income tax. Particular areas of tax law can prove to be especially fertile "breeding ground[s] for arbitrage," either because one country's tax rule is rather unique or because it is difficult to apply predictably.²

The starting point for analysis of cross-border tax arbitrage, as with most other international tax analyses, is recognition of the power of globalization. The international scope of business, along with related changes in communication, cash flow restrictions, and regulatory practices, has increased the ease and volume of cross-border activity. The reality of these changes helps shape international taxation as a topic, and has contributed to the burgeoning growth of arbitrage.

The opportunity for cross-border tax arbitrage arises where transactions are subject to two or more countries' tax regimes. This regula-

Whether advisable or not, the term "arbitrage" has been adopted in the domestic tax context to describe cases in which a taxpayer can benefit from inconsistent tax treatment of a transaction, including both normal arbitrage (which is eliminated by the market) and pure arbitrage (which is not). See *infra* note 8 and accompanying text. Furthermore, "cross-border tax arbitrage" has emerged as the term designating benefits obtained by taxpayers through a conflict in two or more countries' tax rules, even where the transaction or structure does not precisely fit the domestic tax arbitrage definition. See *infra* note 14. Presumably the term was initially adopted in the international context because it conveyed a sense of pitting two independent and inconsistent systems against each other for gain, reminiscent of how financial arbitrage plays on pricing in two different markets. Concern regarding the appropriateness of the phrase cross-border tax "arbitrage," though important for clearly identifying the subject matter and eliminating confusion, is one of terminology. Given the prevalence of the term "cross-border tax arbitrage" in the tax literature, this Article follows that usage.

² H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 137, 153 (2000) ("Whenever any country adopts a rule that is either difficult to replicate or apply (for example, the U.S. rules for distinguishing debt from equity) or markedly out of step with what other countries do or are likely to do, a breeding ground for arbitrage is created.").

tory intersection between two countries presents the potential for conflicting rules. Despite many common features in our trading partners' tax systems, the multitude of factors that produce tax law, including social policy, administrative constraints, and political compromise render conflicting rules a likely possibility.³ Conflict in rules produces one of two results: taxation by both countries (double taxation) or taxation by neither (nontaxation). Domestic tax laws and bilateral treaties include mechanisms for limiting double taxation,⁴ which is generally viewed as a barrier to cross-border activity. Where the conflict in rules leads to nontaxation, taxpayers (and governments, perhaps because of reduced taxpayer advocacy on the issue) have traditionally paid less attention. The internationalization of the economy, however, combined with developments in technology, has fueled taxpayer recognition of these tax-law conflicts as an opportunity for profitable tax planning.⁵ Tax differences exploited by taxpayers to achieve nontaxation produce cross-border tax arbitrage.

³ See, e.g., COMM'N OF THE EUR. CMTYS., REPORT OF THE COMMITTEE ON INDEPENDENT EXPERTS ON COMPANY TAXATION, 1992, reprinted in 4 TAX NOTES INT'L 563 (1992) [hereinafter EC Report] (noting that "[t]he existing tax diversity across Community countries is the outcome of trade-offs" in each country regarding efficiency, equity, feasibility, and social policy); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303-04 (1996); Rosenbloom, *supra* note 2, at 139-41.

⁴ Double taxation in this context refers to situations in which two countries both seek to impose income tax on a taxpayer's item of income. The success in dealing with this conflict derives from the general adoption in treaties, and often in domestic law, of an allocation priority. See, e.g., Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939, 939-41 (2000) (arguing that treaties play a less critical role in reducing double taxation and that the task can be handled adequately by domestic legislation). Under the dominant approach, the taxing of active business income is allocated to the source country and the residual right to tax active income, plus the right to tax passive investment income, is allocated to the country of residence. This basic division, which has been argued to lack a firm economic or analytic basis, has endured to the present, belying its practicality. See Avi-Yonah, *supra* note 3, at 1306-13 (reviewing and justifying historical and current patterns of taxing active and passive income); Michael J. Graetz, *The David Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 TAX L. REV. 261, 324 (2001) (characterizing U.S. international tax policies, with the differing treatment of passive and active business income as "a 'compromise' between CEN [capital export neutrality] and CIN [capital import neutrality]"); Michael J. Graetz & Michael M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L.J. 1021, 1023-25 (1997) (noting the survival of active and passive income distinction).

⁵ Michael Danilack, Associate Chief Counsel International at the Internal Revenue Service (IRS), noted that "technology and globalization have also increased access to arbitrage opportunities" as taxpayers experience borderless business flows but quite real tax borders which produce significant arbitrage possibilities. Sindhu G. Hirani, *Special Counsel Foley Tapped to Head Advance Pricing Agreement Program*, 53 DAILY TAX REP., Mar. 17, 2000, at G-10 (internal quotation marks omitted).

What should be the federal government's response to such arbitrage?⁶ At the end of the 1990s, the U.S. Treasury Department ("Treasury") identified cross-border arbitrage issues as a high priority; the international community is now displaying a growing interest.⁷ When exploring these issues, it is critical to specify precisely what is included in and what is excluded from the concept of cross-border tax arbitrage. As noted above, arbitrage is generally considered the "exploit[ation of] differences between the tax system[s] of two different jurisdictions to minimize the taxes paid to either or both."⁸ What is excluded from the concept here are those transactions that can be characterized as cross-border "shelters."⁹ Such transactions already face scrutiny and examination under the developing shelter rules. The arbitrage question differs because it confronts those transactions that are benefiting from inconsistent treatment across jurisdictions, but presumably have more substance than shelters. The scope of the term "cross-border arbitrage" is reviewed further in Part I and Part IV.

The core tax policy issues for cross-border tax arbitrage can be separated into two discrete sets of questions: (1) why and when is the arbitrage problematic; and (2) whether and how a country, in this case the United States, should respond. Answering these questions demands a comprehensive consideration of tax policy goals, competing values, and practical constraints. Two rather polar responses can be readily imagined. The first, favored by many taxpayers, argues that the United States has no legitimate interest in whether and how much

⁶ See *id.* (quoting Danilack, "Perhaps one of the most fundamental issues facing all of us right now is the extent to which cross-border tax arbitrage is appropriate.").

⁷ See, e.g., Ellen McCleskey, *Panalists' Views Diverge on Benefits, Drawbacks of International Tax Arbitrage*, 42 DAILY TAX REP., Mar. 4, 1999, at G-2 (citing a Treasury official on the high priority Treasury has given to cross-border tax arbitrage). Hybrid financial instruments used in cross-border tax arbitrage was one of two major topics at the International Fiscal Association's (IFA) 2000 Congress. The National and General Reports from the Congress covered a variety of questions including the nature of governments' responses to these transactions. Int'l Fiscal Ass'n, *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, in 85a CAHIERS DE DROIT FISCAL INT'L (2000) (compilation of General and National Reports from the IFA's 2000 Congress) [hereinafter IFA General Report]. In addition, one of the two topics for IFA's 2004 Congress is double nontaxation of income.

⁸ Reuven S. Avi-Yonah, *Commentary on Tillinghast Lecture*, 53 TAX L. REV. 167, 167 (2000). Another definition begins with a wider scope: "inconsistent national treatment of the same entity or transactions that can produce multiple tax benefits or detriments." McCleskey, *supra* note 7, at G-2 (quoting a definition of international tax arbitrage offered by tax practitioner Gregory May). The inclusion of detrimental outcomes as part of the arbitrage definition produces a particularly broad definition. More commonly, arbitrage is considered the taxpayer-favored subset of conflicts, thus excluding double taxation.

⁹ See *infra* notes 17-24 and accompanying text.

tax is paid to a foreign country.¹⁰ If the U.S. tax rules are followed (and the transaction is not otherwise challenged as a shelter), then no further government action or response is appropriate. In fact, the United States should be quite satisfied that domestic taxpayers might be able to reduce their foreign tax burden. The second response, evident in the U.S. government's effort in the late 1990s to eliminate certain arbitrage opportunities,¹¹ reflects a generalized but not fully articulated sense that it can be inappropriate to manipulate the differences between countries' tax rules to reduce or eliminate tax.¹²

The very source of conflict between these positions is the reason that neither constitutes an adequate response. Both positions, at least in their extreme form, grant paramount priority to one of the tax system's goals without adequate acknowledgment of the validity of the others. The view that no action is warranted where U.S. rules have been followed gives dominant weight to national regulatory independence, and perhaps implicitly to administrability, while giving seemingly no weight to the economic distortions and equity harms generated. Conversely, a blanket desire to eradicate cross-border tax arbitrage elevates the elimination of distortions at the expense of other factors, including administrability and domestic policy. A comprehensive policy for cross-border tax arbitrage must integrate and balance all competing goals. As a result, however, any resolution reached here will inevitably have an air of compromise. It will neither seek full elimination nor full acceptance of cross-border tax arbitrage. Steps taken to control arbitrage will reduce domestic autonomy and increase harmonization, but these steps will not fully curb arbitrage. Despite these limitations, the analysis of the arbitrage question should be undertaken in a principled manner and proposals measured against established tax criteria.

¹⁰ See, e.g., Myrna Zelaya-Quesada, *Tax Policy's Talisman Discusses Challenges Created by Globalization*, 238 DAILY TAX REP., Dec. 11, 2000, at G-8 ("Some would argue that arbitrage is not troubling because a transaction is characterized correctly under domestic tax rules.").

¹¹ See, e.g., Treas. Reg. § 1.894-1 (2002) (finalizing regulations limiting a discrete set of treaty-based arbitrage involving domestic reverse hybrid entities); I.R.S. Notice 98-11, 1998-1 C.B. 433 (announcing the intent of Treasury and I.R.S. to limit certain hybrid branch transactions) (opinion withdrawn by I.R.S. Notice 98-35, 1998-2 C.B. 34).

¹² See, e.g., Kevin A. Bell, *IRS Official Addresses Cross-Border Arbitrage Policy*, LEXIS 2002 TNT 59-6 (noting that Matthew Stevens, Special Counsel to the IRS Chief Counsel, observed in an unofficial capacity that "in a macro sense [cross-border tax arbitrage] is not a good thing"); Zelaya-Quesada, *supra* note 10, at G-8 (describing belief that "tax arbitrage creates double nontaxation, distorts economic behavior, and discriminates against taxpayers who do not have access to arbitrage opportunities").

Ultimately, this Article contends that the government can legitimately respond to some instances of arbitrage but that the continued existence of many more will be an ineluctable feature of a multi-jurisdictional business environment. The conclusion is not surprising; it acknowledges the strengths behind the polar positions articulated above. More specification, however, is needed to translate this broad determination into policy guidance. This Article proposes a balancing test that identifies and evaluates the competing goals in each arbitrage case to derive an appropriate response. In addition, this Article offers insights as to the factors that are most likely to be salient and the types of risks that are most likely to arise with particular anti-arbitrage policies.

It is important to be quite clear about the value and the limits of this analytical framework. First, it provides a structure for discussion of arbitrage that targets the core issues. Second, it weaves the divergent strands of the arbitrage argument into a single debate by fostering recognition of the multiplicity of national and international goals. Third, it offers an approach for the policymaker attempting to answer, in a coherent and reasonably uniform manner, the question of whether to intervene and, if so, how. The balancing test, however, is not self-applying. There will continue to be very significant questions of policy to debate. That outcome is not a failing of the framework but rather a reflection of the nature of the endeavor, which demands the accommodation of a variety of competing policy goals in a wide range of circumstances. Furthermore, evaluating the examples under the balancing test is not a static exercise; it may change as tax rules, policy goals, or other features of the tax system change. The balancing test, however, should enable comprehensive consideration of arbitrage without reliance on ad hoc case assessments, along with the development of a sophisticated understanding of the arbitrage problem and the responses that can be crafted.

Through the detailed investigation of this major example of an international regulatory clash (cross-border tax arbitrage), the fundamental question of all global regulatory systems can be clarified and distilled: What vision of international regulatory relations should animate government policy? In making regulatory decisions in the absence of full information, countries must determine the nature of the relationship between and among nationally based regulatory regimes. A nationalist-driven perspective emphasizes competition; a more global perspective encourages cooperation. In reality, neither approach likely serves national or international interests because neither nationalism nor globalism constitutes a defensible, definable

goal. The real question is whose interests are to be taken into account in making a policy decision and what outcomes will serve those interests. In tax matters, nations are the dominant actors and can be expected (at least loosely) to promote national interests.¹³ The paths most likely to advance these interests will vary by time and context, and may include a range of more or less cooperative behaviors. It is through the detailed investigation of cross-border tax arbitrage that we can gain more insight into this universal regulatory question.

This Article's discussion is organized into four major parts. Part I reviews the definition of cross-border tax arbitrage and presents four case studies. Part II argues why and how cross-border tax arbitrage can constitute a problem through reference to tax norms articulated on both national and international levels. Part III proposes the framework for analyzing cross-border tax arbitrage cases and applies it to the case studies. Part IV examines the relationship of arbitrage to the other dominant issues in international taxation and considers how to extend the insights from the arbitrage analysis. Finally, the Conclusion contemplates the future of cross-border tax arbitrage and the pervasive subtext of tax harmonization.

I. THE SCOPE OF CROSS-BORDER TAX ARBITRAGE

A. *The Basic Definition*

Before attempting to evaluate cross-border tax arbitrage, it is necessary to establish a working definition. This step is purely a positive decision of how to classify a transaction or structure. Whether and when it should be limited is the central question and is taken up in the remainder of this Article.

Various definitions of cross-border tax arbitrage have been offered by government officials, tax scholars, and practitioners.¹⁴ Generally, these definitions encompass situations in which countries' tax rules governing a particular transaction or structure differ sufficiently that the conflict results in tax benefits that would not exist had the transaction or entity occurred entirely domestically in either country.

¹³ Even at this stage of identifying national interests there is the question of whether nations are likely to pursue short-term as opposed to long-term national interests. See *infra* notes 25-27.

¹⁴ See *supra* notes 1, 8 and accompanying text; see also Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147, 149 (1996) (noting that cross-border arbitrage transactions "involve the favorable and inconsistent tax treatment of any item by two or more jurisdictions.").

In cases of cross-border tax arbitrage, taxpayers avail themselves of conflicting rules and gaps between national tax systems to reduce their tax burden.

Two other problem areas in tax are likely to overlap with arbitrage, but they remain distinct: cross-border tax competition and tax shelters. Unlike tax competition,¹⁵ cross-border tax arbitrage can occur where two countries each operate robust tax systems and aim to tax economic activity comprehensively. The fact that two such tax regimes would still differ (as would be expected in a multi-jurisdictional world) means that the opportunity for conflicting rules, and thus arbitrage, exists. Thriving examples of cross-border tax arbitrage persist independent of any traditional tax competition. Moreover, current proposals for eliminating "harmful" tax competition would not impact most arbitrage opportunities.¹⁶ Of course, important similarities exist, and Part IV investigates the links between arbitrage and tax competition in greater detail.

In contrast to arbitrage transactions, tax shelters typically prompt questions about shams and economic substance, reflecting the nature of corporate tax shelters to test the limits of ambiguities in domestic tax law.¹⁷ The primary concern for shelter regulations is how to identify and stop transactions that generally lack substance without chilling desirable conduct. The challenge lies not in the abstract goal, but in the more concrete task of ascertaining what constitutes a shelter

¹⁵ Tax competition includes cases in which a country enacts a beneficial tax rule or regime to attract certain foreign business investments. See, e.g., ORG. FOR ECON. CO-OPERATION & DEV. (OECD), *HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE* 13-18, 21-35 (1998) (emphasizing risks from certain forms of tax competition); Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575-76 (2000). But see Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 546-49, 554-68 (2001) (offering a more positive characterization of tax competition). See *infra* text accompanying notes 279-294.

¹⁶ See, e.g., OECD, *supra* note 15, at 37-62 (offering a series of suggestions including stronger controlled foreign corporation rules, information exchange, and action against tax havens); Avi-Yonah, *supra* note 15, at 1666-74 (advocating uniform withholding tax on portfolio investments and "consumption-based" taxation of multinationals).

¹⁷ See, e.g., Hirani, *supra* note 5, at G-10-G-11 (quoting Michael Danilack, Associate Chief Counsel International at the IRS, "I don't mean to raise for further consideration whether transactions that can be categorized as abusive cross-border shelters are legitimate. Rather, what I am raising is the somewhat more difficult question of whether arbitraging tax results in a nonshelter transaction, runs afoul of U.S. tax policy interests."); David L. Lupi-Sher, *Corporate Tax Shelters Regain Vitality*, 23 TAX NOTES INT'L 197, 199 (2001) (considering whether the U.S. Court of Appeals for the Eleventh Circuit reversal of the Tax Court finding of a sham transaction in *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), constituted a "victory for tax shelters").

and how that will be determined.¹⁸ Much attention has been devoted to developing shelter gatekeeper-oriented rules that emphasize reporting and documentation.¹⁹ Although it is certainly possible for a cross-border tax arbitrage to be a sham, that is not the core of the arbitrage question.²⁰ Achieving a cross-border benefit is generally more attractive and secure than a shelter benefit because the former derives from the conflict of clearly applied rules in two different countries, not from a stretch of domestic law, which may be subject to domestic anti-abuse rules.²¹ To the extent there is overlap in a case, it makes sense to view the transaction under the rubric for shams because the degree of substance in the activity will be the threshold question.²² Thus, this Article begins with the premise that the transactions under scrutiny would pass the initial test for substance and not merit classification as shams or shelters. The relationship between corporate tax shelters and cross-border tax arbitrage, however, highlights some of the potential challenges in any effort to limit cross-border tax arbi-

¹⁸ See, e.g., Deborah H. Schenk, *Symposium on Corporate Tax Shelters, Part I: Foreword*, 55 TAX L. REV. 125, 127–29 (2002) (much of the challenge with corporate tax shelters is developing a definition to identify which transactions are good planning and which are shelters); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 220–23 (2001) (using *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), to illustrate the difficulty in discerning tax shelters). For a sense of the debate over *Compaq* and the tax shelter questions it raises, compare Daniel N. Shavero & David A. Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 26 TAX NOTES INT'L 191, 195–98 (2002) (criticizing the court's decision to uphold the "tax shelter"), with William A. Klein & Kirk J. Stark, *Compaq v. Commissioner—Where Is the Tax Arbitrage?* 94 TAX NOTES 1335, 1335–36, 1340–42 (2002) (offering a different perspective on the underlying transaction and the Fifth Circuit's analysis).

¹⁹ See, e.g., N.Y. State Bar Ass'n Tax Section, *Report on the Temporary and Proposed Tax Shelter Regulations*, reprinted in 89 TAX NOTES 1447, 1448–50, 1454–79 (2000).

²⁰ For example, during the IFA's congress on hybrid financial instruments and their use in arbitrages, the debate was framed as a choice between viewing arbitrage as "illegal tax evasion" or as "aggressive tax planning." Robert Goulder, *Panelists Debate Tax Aspects of Hybrid Financial Instruments*, 88 TAX NOTES 1311, 1312 (2000). Even advocates of arbitrage as good planning acknowledge that "fraud, deception, or sham transactions" are off limits. *Id.* (citing French panelist Jean Marc Tirard).

²¹ See Rosenbloom, *supra* note 2, at 143. Another feature of corporate tax shelters is the fact that the tax reporting differs from the financial. Where this inconsistency does not exist, the tax upside is often offset by the negative financial reporting implications of the transaction. See Yin, *supra* note 18, at 225 (the Treasury Department has identified this discrepancy as a major corporate tax shelter feature.).

²² For a related example, see IRS Coordinated Issue Paper on Lease-Stripping Transactions, UIL 9226.00-00, Effective Date: July 21, 2000, available at LEXIS 2000 TNT 147-10 [hereinafter IRS Coordinated Issue Paper]. The Issue Paper explores a variety of ways in which a lease stripping transaction may be challenged, including under the sham doctrine or under the transfer pricing rules. *Id.* Whether a transaction should be treated as a sale for federal income tax purposes, or as a financing, is separately evaluated. *Id.*

trage. The U.S. instinct in dealing with corporate tax shelters has not been to advocate or implement a general anti-avoidance rule (with its potential chilling effect) as seen in Australia and Canada.²³ Nonetheless, the recent domestic legislation targeting corporate tax shelters²⁴ and enacting understatement penalties and registration requirements has ignited debate over the breadth of the rules and the ability to discern boundaries. As always, a tension exists between designing broad reforms that may reach too far and designing targeted rules that may encourage taxpayers' participation in a regulatory cat-and-mouse game as they seek the next transaction just beyond "the law."

B. *The Origins of the Arbitrage Problem: Why Countries' Tax Rules Vary*

An initial question that arises from the basic definition of cross-border tax arbitrage, which is significant later in assessing possible responses, is why do countries have different tax rules? Clearly no single reason prevails. In fact we have only to look at the motivations behind domestic tax law to imagine the range of reasons. Rules vary because of: (1) different policy choices—the political consensus about tradeoffs may vary among societies with different values, traditions, and expectations;²⁵ (2) different judgments about the impact of given rules—to the extent that all rule making requires decisions to be made without full knowledge of the potential impact, it is quite plausible for different decision-making groups (countries) to arrive at alternative determinations; (3) politics—here used in the sense that different political systems permit or facilitate different access to rule-makers and allow different forms of power and influence; (4) randomness;²⁶ (5) path dependence;²⁷ and (6) resources—a country

²³ McCleskey, *supra* note 7, at G-2 (citing a Treasury official); see, e.g., STAFF OF THE JOINT COMM. ON TAX'N, 107TH CONG., BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS 4-44 (Comm. Print 2002) (describing statutory and judicial constraints on tax shelters).

²⁴ See, e.g., I.R.C. §§ 6111, 6112, 6662(d)(2)(C) (2002).

²⁵ See, e.g., HUGH J. AULT ET AL., COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (1997) (comparing nine countries' approaches to structural problems of income taxation). Even within a given country, policy choices may change over time but existing regulations are not continually rewritten.

²⁶ See, e.g., Alan O. Sykes, *The (Limited) Role of Regulatory Harmonization in International Goods and Services Markets*, 2 J. INT'L ECON. L. 49, 58 (1999) ("The evolution of regulatory policy across jurisdictions may to a considerable degree result from chance factors") (citing metric adoption as a matter of royal decrees).

²⁷ Whatever combination of factors has led a country to pursue a particular pattern of rules and taxation, once that path is chosen it tends significantly to dictate the direction of further development. See, e.g., Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109

could determine that an otherwise attractive rule is unrealistic due to administrative, resource, and technical skill constraints. The scope of reasons listed here suggests that one could readily anticipate a notable degree of variation among countries' tax regimes, even when they share many fundamental principles and goals. To the extent that cross-border tax arbitrage depends on the existence of conflicting rules, a steady supply seems quite likely.

The enumeration of sources of tax-law variability is important for policy purposes. The reasons that countries' rules vary can play a critical role in thinking about potential responses to arbitrage and what those responses would entail. For example, where tax rules differ because of policy goals, any plan to coordinate rules would require the countries to balance their domestic policy choices against the benefits from coordination with other countries. If path dependence played a major role in establishing conflicting rules, then changing the relevant arbitrage-related rule could have more widespread impact. That is, when the arbitrage-related rule is changed, the country may need to review its other domestic rules that were part of the original regulatory path. National-level policies may need to be re-evaluated once benefits from multilateral coordination (loosely defined for the present) are factored into the equation of creating policy. Whether this process constitutes a threat to "sovereignty" is considered further in Parts II and III.

If administrability motivated a country to select a particular rule, then unless the country's move to a different, internationally coordinated rule offers discernable benefits to the country, the move might be ill advised. Where there are competing judgments about the impact of particular rules,²⁸ a coordination or harmonization effort may require countries to be persuaded about the likely advantages of the alternative rules. Implicit in these tensions are more fundamental questions about the value of regulatory diversity and the benefits that arise from a system that tolerates experimentation.

HARV. L. REV. 641, 643-58 (1996) (describing the role of "path dependence" in explaining why legal and economic institutions have the current form they exhibit, even where it does not seem the most efficient choice today).

²⁸ The arbitrage problem is not about some countries having the "wrong" rule, just different rules, although in some cases certain rules may seem to achieve specified goals more effectively.

C. Case Studies

To develop the framework for cross-border tax arbitrage, it is useful to specify a few case studies to provide context for the analysis and to serve as illustrations. This section outlines four sample arbitrages in some detail. There is no intention to suggest that these are exclusive categories of arbitrage, nor is the mission here to reach a conclusion about their treatment. The case studies help ground the more abstract discussions of arbitrage. For most of these examples, a detailed discussion is available in the literature. The purpose of this section is to convey enough information about the arbitrage's structure, operation, impact, and incentives to provide a useful hook for the later analysis of cross-border tax arbitrage. (Readers already familiar with these classic cases can briefly review this section and then turn to Part II.) Part II identifies the relevant criteria for reviewing the arbitrages and studies each arbitrage case for its efficiency effects. Part III then outlines a more complete assessment of each arbitrage based on the efficiency observations combined with other critical factors from the balancing test.

1. Original Issue Discount in the United States and Japan

The United States has grappled with the taxation of original issue discount ("OID") for several decades. The question centers on the timing of interest income to the holder of an OID bond.²⁹ Prior to 1969, the United States waited until the maturity of the OID bond to tax the holder on the interest income,³⁰ although the corporate issuer was taking current deductions for the OID.³¹ This "wait and see" rule provided nonparallel treatment and a significant deferral opportunity

²⁹ In the classic (and simple) OID bond, a purchaser pays \$X for a bond that pays no current interest but at the end of its term pays \$X + \$Y. Here, "Y" represents the interest earned and the question is when and how to tax it. The holder of an OID bond is "guaranteed" a certain amount of interest, and in fact could restate the bond as being a bond with a principal amount of \$X and a rate of return of Z% where the interest deemed earned each year was reinvested in the bond at the same Z% rate such that at the end of the specified bond term the holder would have \$X + \$Y. Note that the guarantee of receiving this OID return is more contingent than that for a holder receiving current actual interest payments which are not reinvested in the instrument.

³⁰ See S. REP. NO. 91-552 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2178-79 (explaining the pre-1969 taxation of OID and the reasons for change); Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest, Deferral, and Discount After 1982*, 38 TAX L. REV. 565, 567-68 (1983).

³¹ JOINT COMM. ON TAX'N, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 129 (1970).

because the holder was perceived to have a virtually guaranteed receipt (unlike, for example, with a stock investment). Thus, in 1969, Congress required current annual inclusion in the holder's income of a pro rata amount of the gain to be received at maturity.³²

The ratable inclusion method, however, overstates income in the early years and understates it in the later years.³³ In theory that result favors the borrower who could take larger interest deductions sooner and disadvantages the bond holder who reports a larger portion of income sooner. In practice though, the effect will not be a wash if the taxpayers holding OID bonds are those for whom the timing of income is not significant, such as tax exempts.³⁴ In light of these concerns, Congress made significant changes to the OID rules in 1982 (and 1984), requiring interest to be calculated on a yield-to-maturity basis reflecting the debt instrument's internal rate of return.³⁵ The overall pattern of tax reform in the area of OID demonstrates an attention to the time value of money and the importance of more accurately representing it in taxation (even if in all areas of the Code this principle is not pursued with equal vigor).³⁶

The opportunity for cross-border tax arbitrage with OID bonds occurred where U.S. issuers of OID bonds paired with buyers in a country that did not require current accrual of the holder's interest

³² For example, if the holder paid \$100 for the bond and was entitled to receive \$133.10 at the end of three years, then the "gain" of \$33.10 would be included in income ratably over the three years (\$11.03/year). As a result, the deferral experienced in the wait-and-see method was eliminated. See, e.g., S. Rep. No. 91-552 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2179-80 (explaining the change to a ratable method); Canellos & Kleinbard, *supra* note 30, at 568, 568-69 (discussing Congressional enactment of prorated system). The ratable method, however, did have a negative effect; the reported ratable interest did not reflect the economic accrual of interest income. See *infra* note 33.

³³ If one conceived of the OID bond as having a single internal rate of return which applied to the principal and the previously earned interest that was "re-invested" in the OID bond, then interest income should be increasing each year. In the above example this would mean that an OID bond purchased for \$100 and paying \$133.10 in three years has an effective internal rate of return of 10% and thus the interest is not earned ratably but rather \$10 in year one, \$11 in year two, and \$12.10 in year three.

³⁴ See, e.g., Canellos & Kleinbard, *supra* note 30, at 568 (noting that in the period of high interest rates around 1982, the "distortion was magnified through the issuance of zero coupon . . . bonds, which were generally sold to tax exempt institutions").

³⁵ See I.R.C. §§ 1271-1275 (2000); see also Canellos & Kleinbard, *supra* note 30, at 568-69 (discussing 1982 Congressional tax reforms and resulting changes to the accrual rules for discounts).

³⁶ See, e.g., I.R.C. §§ 1276-1278 (stating that no current inclusion in income is required for market discount bonds which, by definition, do not involve the original issuer in the calculation of discount and thus cannot rely on the issuer to provide discount information to holders).

income. Japan, in particular, was a market into which U.S. issuers sought to sell their bonds. The basic tax picture was rather attractive.³⁷ The U.S. issuer received current annual interest expense deductions, while the Japanese holder paid no tax on the foreign bond interest under Japanese law until the interest income was actually received (for example, at the end of the bond period).³⁸ U.S. income tax also was not imposed on the holder, presumably because the bonds in question qualified for the portfolio interest exemption.³⁹ (In any event there would be no U.S. withholding tax on the OID until the U.S. issuer made payments to the holder.)⁴⁰ Thus, the parties benefited by pairing current U.S. deductions with deferred income recognition in Japan.⁴¹ Had the borrowing been entirely domestic, with either the U.S. issuer selling to U.S. purchasers or Japanese investors buying from Japanese issuers, this timing benefit might not have been available.⁴²

³⁷ This transaction is described in the past tense because the financial literature references suggest it is not a current strategy. That said, Japan did not change its tax rules on foreign OID bonds in a way that substantially affected the mismatching in timing with the U.S. accrual taxation. Thus, in theory the transaction may still be possible. See *infra* note 38.

³⁸ Under Japanese tax law, OID is not classified as interest but rather as "other income." See, e.g., Yoshihiro Masui, *Taxation of Cross-Border Interest Flows: Japanese Responses*, in STAATEN UND STEUERN: Festschrift für Klaus Vogel 863, 865, 867 (Geburstag, hrsg. von Paul Kirchhof et al. eds., 2000) (describing the treatment of OID in Japan); Price Waterhouse, *Japan: An Overview of Japanese Individual and Corporate Income Tax Laws*, in 4 ASIAN PAC. TEXT INVESTMENT BULL. 7, 10 (1986); GRIFFITH WAY ET AL., BUSINESS OPERATIONS IN JAPAN, in TAX MANAGEMENT FOREIGN INCOME PORTFOLIOS A-105-06, C&A-9 (1991). Certain OID bonds issued in Japan are subject to withholding of 16% (pre-April, 1988) or 18% (post-April 1, 1988) at issuance on the difference between the redemption amount and the issue price. GRIFFITH WAY ET AL., *supra*, at 106, C&A-9. Income on OID bonds issued by foreign corporations is taxed at redemption. *Id.* at A-105.

³⁹ I.R.C. §§ 871(h), 881(c).

⁴⁰ I.R.C. §§ 871(a)(1)(C), 881(a)(3).

⁴¹ See, e.g., HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 1034 (8th ed. 2001) (quoting J.P. Morgan, *Swaps: Versatility at Controlled Risk*, WORLD FIN. MARKETS, Apr. 1991, at 17 ("[I]n 1984, when Japan still treated interest 'income' on zero-coupon bonds as nontaxable capital gain, [but] accruing interest 'payments' on zeros were tax deductible by U.S. borrowers," the arbitrage was exploited. "Financing packages utilizing swaps were devised in the market to exploit the discrepancy, enabling a number of U.S. borrowers to procure cheap dollar funding, effectively at the expense of the Japanese taxpayer."). Certainly foreign holders with deferred home country taxation were not the only taxpayers in this timing position. Tax-exempt bond holders, such as U.S. pension funds, often bear no tax on the interest.

⁴² In some cases domestic distortion may remain, such as the purchase of OID bonds from U.S. issuers by U.S. tax-exempt investors.

2. Double-Dip Lease

Perhaps one of the most ubiquitous of cross-border tax arbitrage transactions is the "double-dip lease."⁴³ At the core of this transaction is the ability to have two jurisdictions each treat their taxpayer (either the "lessor" or "lessee") as the "owner" of a leased asset. By virtue of owner status, the taxpayer is entitled to depreciation deductions (typically accelerated) and any investment tax credits. (The key to creating an arbitrage benefit is the availability of *accelerated* deductions and/or credits, *not* the fact that two taxpayers are recovering their respective investments.) For example, imagine that Plane Co., located in France, leases an asset (such as a plane) to Flight Co., located in the United States. Assume that France determines Plane Co. is the owner of the plane (perhaps because France uses a formalistic rule based on legal ownership of an asset). Also assume that the United States considers Flight Co. to be the owner of the plane (because the United States uses a rule based on the economic substance of the lease transaction to determine asset ownership).⁴⁴ Thus, two different taxpayers "own" a single plane and both take accelerated depreciation deductions (plus any available credits). The result derives from the conflict between France's and the United States' rules for asset ownership.⁴⁵

⁴³ Finance leasing (*see infra* note 45) has been a significant commercial activity since the 1960s. *See, e.g.*, IFA General Report, *supra* note 7, at 22; C. Staffan Andersson et al., *Cross-Border Leasing Provides Major Tax (and Other) Benefits*, LEXIS 91 TNI 12-17 (discussing international leasing and its advantages). For discussions of double-dip leases, *see*, for example, Denise L. Blau, *A Guide to Current Structures and Developments in the U.S. Taxation of Cross-Border Financials*, in EQUIPMENT LEASING 1995, at 321-33 (PLI Comm. L. & Practice Course Handbook Series No. A4-4487, 1995); William A. Macan IV & Richard L. Umbrecht, *Cross-Border Leasing Transactions: Pickles, FSCs and Double-Dips*, in EQUIPMENT LEASING—LEVERAGED LEASING 25-107 to 25-112 (PLI Comm. L. & Practice Course Handbook Series No. A4-1404, 1999); William W. Park, *Tax Characterization of International Leases: The Contours of Ownership*, 67 CORNELL L. REV. 103, 148-51 (1981); Michael Downey Rice, *Current Issues in Aircraft Finance*, 56 J. AIR L. & COM. 1027, 1034-40 (1991).

⁴⁴ Flight Co. would be treated as the owner in this case if the leasing transaction were viewed as effectively a sale, with the payments made by Flight Co. under the agreement constituting the purchase price not a rental fee. *See* Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, 1157-59 (providing guidelines for determining whether a transaction constitutes a finance lease or a true lease).

⁴⁵ Conflict can occur in two different ways. First, if a country follows a relatively strict legal title approach, then the party with such legal ownership is deemed the owner with little or no inquiry into whether the terms of the lease contract make the arrangement seem more like a true lease (i.e. an "operating lease," where the lessor is considered the owner for tax purposes) or a sale (i.e. a "finance lease," where the lessee is considered the owner for tax purposes). *See, e.g.*, IFA General Report, *supra* note 7, at 28-31 (outlining distinctions between operating and finance leases); Andersson et al., *supra* note 43 (discussing different countries' standards for deciding ownership under a lease); Park, *supra*

If the leasing transaction had occurred entirely domestically (either in the United States or France), only one owner would be identified and only one taxpayer would be permitted the depreciation deductions. The taxpayer deemed to be the lessee would generally take business deductions for the cost of the lease/rental payments made annually. Those deductions, however, would typically be less advantageous than ones classified as "depreciation" because of the acceleration permitted for depreciation. In addition, investment tax credits may be available for owners but not lessees. Thus, even in the domestic case both taxpayers recover their investments (through depreciation deductions by the owners and through rental deductions by the lessee). It is the availability of the second set of accelerated depreciation deductions (and investment tax credits) in the cross-border scenario that creates cross-border tax arbitrage.⁴⁶ In addition to the double-dip benefits, cross-border leasing can offer financing and withholding tax advantages as well.⁴⁷ It is worth noting that conflicting ownership rules could lead to a case in which neither country recognized their taxpayer as the owner entitled to depreciation deductions. In that case, though, the "burden" borne by the taxpayers is not classic double taxation; it more properly constitutes a "loss" of special tax benefits designed with business incentives in mind.⁴⁸ Specifically, if

note 43, at 115-34, 148-51 (1981) (outlining various jurisdictions' approaches to lease characterization); Ian Shrank, *Legal Issues in Leveraged Leasing*, in EQUIPMENT LEASING 1995, *supra* note 43, at 576-77.

Second, even if a country does not strictly adhere to legal ownership and aims to evaluate the substance of the lease, it might still reach a different conclusion about ownership than another country. See, e.g., IFA General Report, *supra* note 7, at 44 (noting that a lease may be interpreted as an operating lease by one country and a finance lease by another country).

⁴⁶ For a hypothetical examining accelerated depreciation deductions, see appendix.

⁴⁷ See, e.g., Andersson et al., *supra* note 43 (leasing can function "as an alternative to buying with borrowed money," thereby keeping the liability "off the books"); Monica Biringer, *Cross-Border Equipment Leasing May Reduce Financing Costs for Canadian Users*, 5 J. INT'L TAX'N 230, 230 (1994) ("[s]tructuring a transaction as an inbound cross-border lease may reduce the cost of financing for Canadian users" and "characterizing the transaction as a lease under the law of the lessor and a sale under Canadian law . . . is often required for withholding tax reasons"); John P. Howitt, *Selected Issues with Respect to Operating Leases*, in EQUIPMENT LEASING 1995, *supra* note 43, at 483-84 (remarking that although tax benefits play an important role in many cross-border leases, "many aircraft lease transactions involve cross-border issues for purely commercial reasons").

⁴⁸ See, e.g., E. John Park, *Cross-Border Equipment Leasing: Recent Developments Related to Section 168(g)*, 16 VA. TAX REV. 299, 302-03 (1996) (reporting Congressional interest in enhancing American competitiveness, and support from some trade economists for tax incentives that favor cross-border equipment leasing to improve international competitiveness).

each country in the cross-border lease considers the other country's taxpayer as the owner, no taxpayer receives accelerated depreciation deductions.⁴⁹ The key loss is the difference in timing. The other likely "loss" from non-owner status is access to investment tax credits—a tax technique to spur investment activity generally, or in targeted sectors. Thus, the "penalty" from tax-law conflict in the cross-border leasing context arguably is not "inappropriate," uneconomic taxation, although it is burdened more heavily than a domestic transaction because no party receives accelerated depreciation deductions or investment tax credits.⁵⁰

3. Dual-Resident Companies

In this arbitrage based on residence rules, corporate groups in two different countries can use a double-dip strategy with a dual-resident company (DRC) to deduct losses twice. Specifically, a corporation resident both in the United States and a foreign jurisdiction (most notably the United Kingdom) serves as a member of a consolidated group of related companies in each jurisdiction. (The dual-resident status is possible if the two countries apply different tests, for example, incorporation⁵¹ versus management and control,⁵² and the facts of the case allow a single corporation to satisfy the relevant test in each country.) If this DRC has losses, then there is an opportunity to use those losses against the income of the U.S. group and the income of the U.K. group.⁵³ For example, the DRC might borrow to fund the acquisition of U.S. subsidiaries. The DRC would have little

⁴⁹ For example, if France views Flight Co. (the U.S. company) as the owner and the United States views Plane Co. (the French company) as the owner, then the following tax treatment would result: Plane Co. would be viewed as selling the plane thereby reporting the "rental" income payment as income from a sale, offset by remaining basis in the plane (or if installment-sale reporting is available, spreading the income and basis recovery over a period of years). Under this scenario, Flight Co. would report the payments as rent, currently deductible on an economic accrual method.

⁵⁰ Certain double taxation problems, however, can develop. For example, if the United States treats a cross-border lease as a sale from the U.S. party to a foreign party, then the payment into the United States is the sale price and might be U.S. source. If the foreign country views the transaction as a lease, and the payment by the foreign party as rent, it might impose withholding tax. In that case, the U.S. party risks economic double taxation if it cannot credit foreign taxes paid. *Park*, *supra* note 43, at 143–44, 151.

⁵¹ The United States applies an incorporation test for residency. See I.R.C. § 7701(a)(4) (2000).

⁵² The United Kingdom, for example, uses a management and control test. See S. REP. No. 99–313, at 419 (1986).

⁵³ For a numerical example, see *infra* note 132.

income but substantial loss due to interest deductions on the debt. The DRC losses would be shared with affiliated groups in both the United States and the United Kingdom. Thus, a single corporation's losses (those of the DRC) reduce two sets of income and ultimately two sets of taxes, creating the double-dip effect.⁵⁴

4. Hybrid Entities

Once we define cross-border tax arbitrage as a situation in which a transaction or structure receives different treatment under two jurisdictions' tax laws, the range of possible arbitrages seems almost infinite. An active (and highly contested) source of arbitrage exists with entity classification. When two countries classify an entity differently—for example, the United States views a business operation as a branch, but the foreign jurisdiction deems it a corporation—substantial arbitrage opportunities result. Although such conflict has always been possible, the adoption of the "check-the-box rules" effective January 1, 1997 provided these results with much greater certainty and much less complexity.⁵⁵ Prior to these new rules, entity classification (in particular the distinction between a partnership and an association taxable as a corporation) turned on an analysis of six factors.⁵⁶ This multi-factor test applied to both domestic and foreign business organizations.

Ultimately, Treasury determined that because classification was virtually elective for a subset of taxpayers, then perhaps it should be elective directly, with a lower cost and broader availability.⁵⁷ The final

⁵⁴ For further discussion of dual-resident corporations, see, for example, S. REP. NO. 99-313, at 420-21 (1986) (example and analysis of DRC transaction); Walter T. Raineri, *The New Dual Consolidated Loss Temporary Regulations*, LEXIS 90 TNI 6-65.

⁵⁵ See Treas. Reg. § 301.7701-2, -3 (as amended in 2001) (the "check-the-box regulations").

⁵⁶ See, e.g., Rev. Rul. 88-8, 1988-1 C.B. 403 (application of the multi-factor test). The six factors were: (1) limited liability; (2) continuity of life; (3) free transferability of interests; (4) centralized management; (5) associates; and (6) objective to carry on business for joint profit. Former Treas. Reg. § 301.7701-2(a). In reality, the last two of the six factors were common to both partnerships and corporations, so the analysis focused on the first four factors. See, e.g., Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 15 TAX NOTES INT'L 53, 54 (1997) (reviewing the application of the pre-1997 classification rules). If an entity had at least three of the remaining four features, it would be classified as a corporation for tax purposes. *Id.*

⁵⁷ Dissatisfaction with the six-factor test grew as it became apparent that in many cases an organization's tax classification was virtually elective with a little tax planning. The well-advised taxpayer had significant control over entity classification. See, e.g., I.R.S. Notice 95-14, 1995-1 C.B. 297 ("[t]he Service and Treasury recognize that there is considerable flexibility under the current rules to effectively change the classification of an organization

check-the-box regulations specify certain domestic and foreign entities as "per se" corporations. No election is possible, and there is no flexibility regarding their taxation. For the remainder of business organizations not subject to the per se classification, however, the taxpayer is generally allowed to elect its tax status either as a corporation or a pass-through (partnership or branch, depending on the facts).⁵⁸

The extension of the election regime to foreign business organizations generated considerable debate. Although both domestic and foreign entities were analyzed under the old six factor test, some tax commentators expressed serious concern about extending any elective classification system to foreign entities due to the risk of inconsistent entity classification between countries and the potential arbitrage it could facilitate.⁵⁹ The Internal Revenue Service (IRS or "Service") itself acknowledged this risk,⁶⁰ but ultimately issued the final check-the-box regulations with treatment for foreign entities that mirrored the regime for domestic entities. In both cases, certain types of enumerated business operations automatically receive corporation status (for foreign entities, the regulations provide a country-by-country list). The remainder may choose their classification. With these new regulations came new opportunities for hybrid entities.

As an arbitrage category, "hybrid entities" is much larger and more varied in its content than the other examples offered in this Article. Nonetheless, it is helpful to have at least one or two versions in

at will"); Walser & Culbertson, *supra* note 56, at 54 ("The pointlessness [of the effort to apply the six factor test] was underlined by the general conviction that, with enough high-priced tweaking of the organizing documents, most taxpayers were able to achieve the classification they desired most of the time."); N.Y. State Bar Ass'n Tax Section, *Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14* (Aug. 30, 1995), LEXIS 95 TNI 172-13.

In addition, the rise of limited liability companies (LLCs) under state law, which enabled taxpayers to create a business organization with limited liability but partnership tax treatment, further weakened the role of the multi-factor test. See, e.g., Susan Pace Hamill, *A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L. Q. 565, 566-71 (1995) (describing the development of LLCs); Walser & Culbertson, *supra* note 56, at 54 (LLCs enabled taxpayers to achieve both limited liability and pass-through taxation).

⁵⁸ See Treas. Reg. § 301.7701-2, -3 (as amended in 2001).

⁵⁹ See, e.g., Albertina Fernandez, *Eighth Annual GWU Int'l Tax Conference*, LEXIS 96 TNI 1-3; Kathleen Matthews, *IRS Official Discusses Check-the-Box Proposal for Foreign Entities*, LEXIS 96 TNI 34-6; N.Y. State Bar Ass'n Tax Section, *supra* note 57, LEXIS 95 TNI 172-13.

⁶⁰ I.R.S. Notice 95-14, 1995-1 C.B. 297 ("consideration in the foreign area is the possibility of inconsistent, or hybrid, entity classification"); see also 64 Fed. Reg. 37727, 37727 (proposed July 13, 1999) (to be codified at 26 C.F.R. Pts. 1, 301) (the preamble notes that "[t]he use of hybrid arrangements . . . is greatly facilitated by the 'check-the-box' entity classification regulations").

mind to support the later discussion of a framework for cross-border tax arbitrage. Two examples are described below.

a. *Subpart F⁶¹ and Entity Classification*

One common use of hybrids is to avoid some of the limitations and restrictions of the subpart F regime.⁶² For example, imagine a U.S. person⁶³ has a wholly owned operating entity in Country X, a high-tax jurisdiction.⁶⁴ This entity constitutes a controlled foreign corporation (CFC),⁶⁵ thereby subjecting the U.S. person to subpart F's antideferral rules.⁶⁶ Despite the fact that the CFC is a separate legal entity and is not a U.S. corporation, some or all of its income might be taxable currently to its U.S. shareholder, even in the absence of a distribution from the CFC.⁶⁷ If the CFC earned passive income, that income would likely be included on the U.S. shareholder's U.S. income tax return immediately, eliminating the deferral benefit from operating offshore. In contrast, most active income earned by the CFC would not be captured by the subpart F rules and, therefore, would not be subject to U.S. tax until the CFC made a distribution to the U.S. shareholder.⁶⁸ Under the facts of the proposed hypothetical here, however, the active income earned by the CFC still faces unattractive taxation because the CFC itself is located in a high-tax jurisdiction. Even though current U.S. tax is avoided, high Country X tax is not. This is where a hybrid structure could be useful.

The U.S. person directs the CFC to set up an entity (Entity Y) in Country Y (a low-tax jurisdiction). Entity Y is treated as a corporation by Country X but is disregarded under U.S. tax law. Entity Y makes a loan to the CFC, and the CFC deducts the interest payments because Country X views the payments as made to a separate corporation.

⁶¹ The subpart F rules limit a U.S. resident's or corporation's ability to defer current U.S. tax on foreign-source income earned through controlled foreign subsidiaries.

⁶² See, e.g., OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY*, DEC. 2000, reprinted in 2001 DAILY TAX REP. S-34-36 (Supp. 1 Jan. 3, 2001) [hereinafter *Treasury Deferral Study*] (discussing use of hybrid entities to avoid subpart F rules).

⁶³ The term "U.S. persons" includes domestic corporations, U.S. citizens, and U.S. residents. I.R.C. §§ 957(c), 7701(a)(30) (2000).

⁶⁴ See *Treasury Deferral Study*, *supra* note 62, at S-34.

⁶⁵ I.R.C. § 957(a).

⁶⁶ *Id.* §§ 951-962.

⁶⁷ *Id.* § 951(a).

⁶⁸ For a description of the types of income covered by the subpart F rules, see I.R.C. §§ 951, 952, 956.

These interest deductions reduce the CFC's operating income subject to Country X's high tax rate (assuming no Country X thin capitalization rules apply). The interest payments received by Entity Y bear little or no tax because Country Y is a low-tax jurisdiction. The remaining question is the U.S. tax treatment. Generally, interest income would be passive income covered by subpart F. It must, however, be earned by a CFC for the rules to apply. Here, the taxpayer would argue that because the United States disregards the existence of Entity Y, the "interest" payment is really an internal cash flow and should be disregarded for tax purposes (producing no subpart F income). Thus, Country X tax on the CFC's operating income is reduced, no significant Country Y tax is due, and no U.S. subpart F income is created in the process. The success of this structure turns on the use of hybrids and the discrepancies in entity classification.

b. *Domestic Reverse Hybrids*

Another type of hybrid, a "domestic reverse hybrid," produces a different benefit.⁶⁹ Consider a foreign corporation with a U.S. operating subsidiary. When the U.S. subsidiary pays a dividend to the foreign parent, there is no deduction and the payment is likely subject to U.S. withholding tax under the applicable treaty. On the other side, the dividend will probably benefit from a foreign tax credit or exemption in the foreign parent's jurisdiction. If instead of owning the operating subsidiary directly, the foreign parent establishes a U.S. hybrid holding company to own the U.S. operating subsidiary, a tax benefit results. The key to obtaining this benefit is that the U.S. holding company is a hybrid—that is, the U.S. holding company is considered a corporation for U.S. tax purposes, but is a pass-through entity under the rules of the foreign parent's jurisdiction.⁷⁰ In this alternative scenario, the U.S. operating subsidiary pays a dividend to the U.S. hybrid and the hybrid pays interest to the foreign parent. The following tax

⁶⁹ Under common entity terminology, "an entity taxed as a corporation in a foreign jurisdiction but treated as a partnership or disregarded entity for U.S. tax purposes is referred to as a 'hybrid.' An entity taxed as a partnership or other pass-through in a foreign jurisdiction but treated as a corporation for U.S. tax purposes is referred to as a 'reverse hybrid.'" Treasury Deferral Study, *supra* note 62, at S-34 n.1.

⁷⁰ This common example is outlined in 66 Fed. Reg. 12445, 12446 (Feb. 27, 2001) (preamble to Prop. Treas. Reg. § 1.894-1(d)(2)(ii)). See also Lee Sheppard, *Interest Deduction Denial by the Back Door*, 22 TAX NOTES INT'L 1494, 1494-95 (2001) [hereinafter *Denial*]; Lee Sheppard, *U.S. Treasury Official Discusses International 'Arbitrage'*, 21 TAX NOTES INT'L 696, 697 (2000) [hereinafter *Arbitrage*].

treatment results: Under U.S. tax law, the first payment is a dividend and is excluded from the hybrid's income and is not deductible by the payor.⁷¹ The interest payment from the U.S. hybrid to the foreign parent is deductible and can receive the lower withholding rate negotiated in the treaty (if there is one) with the parent's jurisdiction. The foreign jurisdiction, however, again views the payment received by the foreign parent as a dividend from the underlying U.S. corporation (not as interest from the hybrid entity). The "dividend" again benefits from the foreign jurisdiction's applicable foreign tax credit or exemption rules.⁷² Thus, for U.S. tax purposes, the hybrid transaction effectively replaces a direct dividend distribution from an operating U.S. subsidiary to its foreign parent (which is not deductible by the U.S. subsidiary and faces U.S. withholding tax) with an interest payment to the foreign parent (which is deductible on the U.S. side by the hybrid entity and has reduced U.S. withholding under the treaty). The arbitrage benefit derives from the fact that in both scenarios the foreign jurisdiction views the payment to the foreign parent as a dividend, yet in the hybrid scenario the United States "relinquishes" its taxing power because it views the payment as interest and assumes that the other jurisdiction does as well (and will correspondingly tax it). The conflicting classification of the U.S. hybrid entity lies at the center of this profitable mismatch.

II. PROOF OF A PROBLEM

A. Introduction

Merely describing arbitrage cases is insufficient to demonstrate that such transactions and structures constitute a problem requiring intervention. This Part seeks to establish why concern over cross-border tax arbitrage is legitimate and how that concern can be translated into a coherent response. First, this Part develops the criteria against which to measure cross-border tax arbitrage and applies them to the arbitrage case studies. Second, this Part asks what the risks of curbing arbitrage are and whether the harms from arbitrage outweigh those from remedial action. This assessment is a predicate to the effort in Part III to design a suitable framework for analyzing and responding to cross-border tax arbitrage.

⁷¹ I.R.C. §§ 243, 246 (2000).

⁷² See, e.g., *Denial*, *supra* note 70, at 1494-95; *Arbitrage*, *supra* note 70, at 697.

B. What Makes Cross-Border Tax Arbitrage a Problem in Need of a Solution?

1. Introduction

The breadth of literature exploring the newer subject of cross-border tax arbitrage is less extensive than that available for domestic arbitrage.⁷³ Already, however, the topic of cross-border tax arbitrage has generated notable controversy.⁷⁴ Some taxpayers maintain that the existence of cross-border tax arbitrage warrants no government action. At a minimum, this view demands that any government response be premised on demonstration of a problem. Thus, the first step is to identify the relevant criteria against which cross-border tax arbitrage can be evaluated. The core criteria underlying most evaluations of tax policy—efficiency and equity—remain central in the international tax realm. Therefore, the question, at least as an initial matter, is whether cross-border tax arbitrage poses efficiency or equity concerns.⁷⁵ Following that analysis, two related criteria, political accountability and revenue impact, are briefly considered. Both are closely linked to efficiency and equity, but can be better appreciated through an independent statement of their role.

⁷³ But see Rosenbloom, *supra* note 2, and Avi-Yonah, *supra* note 8, for recent and significant discussions of cross-border tax arbitrage. For an earlier, and influential, consideration of the subject, see West, *supra* note 14.

⁷⁴ See, e.g., Lee A. Sheppard, *Cross-Border Tax Arbitrage, 'Hybridity,' Mules, and Hinnies*, 16 TAX NOTES INT'L 579, 579 (1998).

⁷⁵ One would expect that other regulatory fields (for example, banking, bankruptcy, securities, environmental, and corporate) would prove a goldmine for thinking about cross-border arbitrage, especially in a setting in which there is no supranational ruling body. The reality, however, is that these fields ultimately produce little directly useful guidance. In fact, it is difficult in most instances even to identify examples of arbitrage, as that term is used in the international tax context. Although the literature from these fields regularly uses the term "arbitrage" for cross-border activities, a careful reading reveals that in these fields the term generally covers behavior that would be labeled competition in the tax world—the specific use of regulation to draw business to a country's environment by lowering the standard or level of regulation (whether that takes the form of lax rules or lower standards). The regulated party gains a benefit not by seeking conflict per se between two applicable and governing regimes, but rather by shopping for the most attractive regime (leading to fears in the regulatory literature of races to the bottom). Actual examples of arbitrage (of the cross-border tax arbitrage sort) prove difficult to find and are not the subject of much attention or analysis in these fields. The degree of silence in these other literatures serves as a barometer for the absence of a tax-like arbitrage. See *infra* note 302. On a broader analytical level, however, the fundamental questions concerning the relationship between and among countries' regulatory systems and how competing interests should be managed pervades all substantive regulatory regimes.

2. Efficiency

a. Introduction

The main efficiency question is whether and how cross-border tax arbitrage distorts taxpayer behavior. The question, however, is more nuanced than may be evident at first because of two special features of the transactions under scrutiny: they are cross-border and they involve arbitrage. Efficiency analyses in both of these areas have developed context-specific tools and terminology. Before investigating the efficiency outcomes in the arbitrage case studies, it will be necessary to draw upon the contributions of the existing literature (regarding international tax and domestic arbitrage) to efficiency analyses.

i. Efficiency in International Tax

In international tax, two basic efficiency perspectives are possible—worldwide efficiency and national efficiency. The two need not be the same at a given time, nor is it universally agreed by scholars, governments, or taxpayers which should dominate.⁷⁶ That said, most discussions of international tax policy operate from the view that worldwide efficiency is desirable.⁷⁷ From that baseline, international tax theorists identify two major ways in which international tax rules may distort behavior and undermine worldwide economic efficiency: (1) favoring investment either at home or abroad (violating “capital export neutrality” (CEN)), or (2) favoring certain investors in a single economic setting, thereby distorting savings decisions and potentially impacting competitiveness of businesses (violating “capital import neutrality” (CIN)).⁷⁸ For years these neutralities have formed an im-

⁷⁶ See, e.g., Treasury Deferral Study, *supra* note 62, at S-14 (incorporating CEN and CIN into the analysis); TSILLY DAGAN, THE COSTS OF INTERNATIONAL COOPERATION (Univ. of Mich., Pub. Law. & Legal Theory Research Paper No. 02-13, 2002), available at http://ssrn.com/abstract_id=315373 (on file with the author) (exploring how countries should decide whether to promote global efficiency and what that choice entails).

⁷⁷ See Treasury Deferral Study, *supra* note 62, at S-17 (“[p]olicies that maximize global welfare are considered first, because maximizing global welfare is probably the best way to maximize U.S. economic welfare”). But see Graetz, *supra* note 4, at 270–77 (suggesting a more complex view of the relationship between national interests and the global efficiency goals sought through the pursuit of CEN and CIN).

⁷⁸ Extensively debating the proper role of CIN and CEN in international tax policy is beyond the scope of this Article. The question is, nonetheless, quite important. For recent considerations of the subject, see Treasury Deferral Study, *supra* note 62, at S-14; Dagan, *supra* note 76, at 10; Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525 (2001) (examining the

portant (but not uncontroversial) foundation for international tax analysis as the touchstone for global efficiency.⁷⁹ CEN is measured by reference to a taxpayer's willingness to invest domestically or abroad. Locational neutrality is achieved when a resident taxpayer is indifferent as between a domestic investment and a foreign investment with the same pre-tax rate of return⁸⁰ (this occurs when the taxpayer faces the same marginal tax rate regardless of the investment choice made).⁸¹

The competing neutrality for organizing international tax policy, CIN, calls for all investments made in a given country (regardless of taxpayer) to face the same marginal tax rate. CIN can be thought of as requiring that all business conducted in a given location face the same total level of taxation, even though the taxpayers may be from a variety of countries.⁸² The choice between the two versions of neutrality is debated on several levels, including their empirical effects and the relevance of competitiveness concerns.⁸³

Despite this established backdrop for discussions of efficiency at the international level, there is a growing view that although the CEN and CIN constructs can be useful in orienting the efficiency analysis, they may provide too limited and constrained a conception of efficiency by highlighting particular measurements of global efficiency.⁸⁴ The efficiency inquiry in its fullest application should illuminate how cross-border tax arbitrage opportunities may impact taxpayer behavior, what distortions result, and what that should imply for government action. Perhaps the bulk of that investigation can be subsumed under the rubric of CEN and CIN as a convenient short-

conflict between neutrality and competitiveness in the context of subpart F); Graetz, *supra* note 4.

⁷⁹ See, e.g., Graetz, *supra* note 4, at 277-82.

⁸⁰ See, e.g., Avi-Yonah, *supra* note 15, at 1604; Graetz, *supra* note 4, at 270.

⁸¹ See, e.g., Treasury Deferral Study, *supra* note 62, at S-13-S-14; Graetz, *supra* note 4, at 270.

⁸² For this reason, CIN is often characterized as supporting international competitiveness because it would require that a U.S. corporation doing business in France bear the same total tax burden (and no more) on its French operations as a German or French corporation competing in France. The CIN and CEN debates complicate the international tax discussion because it is not possible to achieve both neutralities simultaneously (unless the tax bases and rates in all countries are identical). See, e.g., Graetz, *supra* note 4, at 272; Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. Econ. 793 (1980).

⁸³ See Graetz, *supra* note 4, at 272-77.

⁸⁴ See, e.g., Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581, 586-87 (1990).

hand, but it should not distract from the inherently broad scope of the question.

In terms of furthering the analysis of cross-border tax arbitrage, three points should be drawn from this traditional and pervasive framing of efficiency in the international context. First, the discussion highlights an important reality that must be confronted in Part III when we explore possible responses—that efficiency from an individual nation's perspective may differ from global efficiency. Even globally efficient moves can generate some winners and some losers. In the absence of a redistribution mechanism, countries predictably will resist moves toward global efficiency that create national disadvantage (particularly in the short term).⁸⁵ The impact of this national perspective on cross-border tax arbitrage is addressed in the discussion of sovereignty in Part II.B.4.b. Second, in many cases, an arbitrage will be inefficient by almost the same amount regardless of whether the standard is CEN or CIN.⁸⁶ In those cases, the major debate will be whether to eliminate the bulk of the distortion that both analyses would identify as undesirable, rather than whether CEN or CIN should be the exact measure. Third, the CEN/CIN difference will be most important in those cases in which the arbitrage involves U.S. tax rules specifically aimed at the question of how to interact with other countries' tax systems.⁸⁷ For such cases, the choice between the two efficiency measures is central to ascertaining and furthering the policies underlying the U.S. tax rule in question.

One final note on the international tax system's exploration of efficiency: a single taxation principle can be identified and articulated that reflects an expectation that income should be taxed once.⁸⁸ The complaints about cross-border tax arbitrage from government

⁸⁵ Recent work on international taxation and Pareto efficiency quantifies the intuitions underlying many national-level objections to harmonization efforts: global efficiency may not improve everyone's position if transfers between countries are not possible and losers are not compensated. See, e.g., CHARLES BLACKORBY & CRAIG BRETT, *TAX HARMONIZATION AND PARETO-EFFICIENCY* 13 (Univ. of B.C., Discussion Paper No. 98-16, Sept. 1998), available at <http://www.econ.ubc.ca/discpapers/dp9926.ppdf> (on file with the author); DAGAN, *supra* note 76; MICHAEL KEEN & DAVID E. WILDASON, *PARETO EFFICIENCY IN INTERNATIONAL TAXATION* 15-16 (CESifo, Working Paper No. 371, Nov. 2000).

⁸⁶ See *infra* note 132 and accompanying text.

⁸⁷ See *infra* note 146-147 and accompanying text.

⁸⁸ See, e.g., Avi-Yonah, *supra* note 15 (using the one-tax principle to justify controlling only two specific aspects of tax competition, targeted beneficial tax regimes and haven secrecy). Like these two versions of tax competition, arbitrage is not expected to reduce transaction costs or increase efficiency (except in the limited case of facilitating delivery of an intended tax benefit as in the tax-exempt bond case).

officials, international organizations, and commentators indicate an underlying rejection of the idea that cross-border income can face no taxation. A single level of taxation⁸⁹ is appropriate, and both double taxation and nontaxation violate global efficiency and equity. Reliance on this "single-tax" principle to support a focus on arbitrage requires: (1) evidence of international agreement on the principle;⁹⁰ (2) an explanation of the greater prominence of concern internationally for double taxation as compared to nontaxation; and (3) an examination of the implications for arbitrage decisions.

What evidence demonstrates a generally shared vision that income should be taxed once? Bilateral tax treaties clearly address the cases of double taxation. Debate exists as to whether the bilateral tax treaties can be construed to reject nontaxation as well.⁹¹ Given treaties' elective status for taxpayers, any support for a single tax norm from the bilateral treaty network would be more hortatory than established policy. Even undercurrents of support for one level of tax, however, are relevant. The concept of an international tax regime is much more fluid than that of a domestic tax system because there is no supranational authority, nor even a multilateral agreement. But just as international relations theorists believe in the reality of patterns, rules, and practices of international relations, international tax scholars see a global structure for international tax, despite the absence of a binding framework. A broad set of shared ideas and norms underlie the network of bilateral treaties, international organization tax pronouncements, and domestic rules regulating cross-border transactions.⁹² Additional evidence for a single-tax consensus manifests itself in a number of other multilateral and unilateral features of the international tax system.⁹³

⁸⁹ Understood as income being comprehensively subject to one country's tax rules.

⁹⁰ See, e.g., Avi-Yonah, *supra* note 8, at 169; Rosenbloom, *supra* note 2.

⁹¹ See, e.g., Avi-Yonah, *supra* note 8, at 169-71; Rosenbloom, *supra* note 2, at 164.

⁹² See generally Avi-Yonah, *supra* note 8, at 169-71; Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT'L L. 1641, 1641 (2001).

⁹³ For example, the OECD's report on harmful tax competition recommends several actions that will reduce the opportunity for nontaxation in both the source and residence countries: (1) adoption of domestic CFC rules that reduce taxpayers' ability to defer residence country tax on foreign source income (particularly income likely to face little or no source taxation); (2) recommendation of other anti-deferral rules reaching taxpayers beyond the traditional scope of CFC legislation; (3) more limited use of exemption systems as the tool for avoiding double taxation (in order to ensure taxation in either the source or residence country); and (4) termination of treaties with tax havens. OECD Report, *supra* note 15, at 37-50.

Assuming, then, a level of interest in the international community regarding nontaxation, why has double taxation received more prominent attention? Tax treaties explicitly address double taxation, and most treaty partners have domestic legislation designed to reduce or eliminate double taxation. The most probable answer is that although double taxation and nontaxation both create efficiency and equity costs, the two situations differ. Double taxation exacts a high price. Serious double taxation can completely eliminate the profit in a transaction (or worse yet, extract more in tax than was earned in income). Thus, governments have had an incentive to prevent significant double taxation and taxpayers have had a strong interest in seeking (and facilitating) protection. In contrast, nontaxation of income will not eliminate trade (although it will distort the shape it takes). The impetus for international cooperation here is less potent (and taxpayers are unlikely to be pressuring governments for reform). The difference may explain why the international community has, as a historical and practical matter, not responded with equal vigor.

ii. Domestic Arbitrage

One further specification that will aid the efficiency examination originates in the domestic tax arbitrage field with its established research history. Domestic tax arbitrage questions have circulated for many years,⁹⁴ exploring both the nature of potential arbitrage risks and possible remedies. In the domestic context, tax arbitrage refers to transactions that "while not necessarily profitable before tax, are profitable after tax . . . because the tax law treats income and deductions asymmetrically, allowing an immediate deduction for an expenditure (such as interest costs), but allowing complete or partial deferral or exemption of the income."⁹⁵ The literature focuses primarily on interest deductions as the type of deduction involved in the arbitrage structure, although the term is acknowledged to have a wider scope.⁹⁶

⁹⁴ See *infra* notes 95, 97, 104, 106; see also Stanley A. Koppelman, *Tax Arbitrage and the Interest Deduction*, 61 S. CAL. L. REV. 1143, 1153 (1988) (increasing Congressional concern over tax arbitrage); Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Mud-dling Toward Accommodation*, 50 TAX. L. REV. 153, 170 (1995) (trend toward restrictions on interest deductions).

⁹⁵ David J. Shakow, *Confronting the Problems of Tax Arbitrage*, 43 TAX. L. REV. 1, 2 (1987) (citations omitted).

⁹⁶ *Id.* at n.3; see also C. EUGENE STEUERLE, *TAXES, LOANS, AND INFLATION* 59 (1985) ("[b]ecause of the relatively high tax rate on interest payments, the most common form of tax arbitrage involves borrowing to purchase tax-preferred assets").

A major contribution from the domestic arbitrage field has been the exposition of two versions of tax arbitrage—normal and pure.⁹⁷ The classification of an arbitrage as normal or pure bears on the type of response that may be appropriate.

Normal tax arbitrage describes situations in which a taxpayer borrows⁹⁸ to buy a tax-preferred asset (one with a lower tax rate than that applicable to the interest expense). Thus, for example, when a taxpayer borrows to buy a house (which generates imputed income) or machinery (subject to significant accelerated cost recovery), the taxpayer has engaged in normal tax arbitrage.⁹⁹ This arbitrage will be profitable assuming that the after-tax rate of return on the investment (the "preferred asset") is higher than the after-tax rate of payment of interest on the borrowing.¹⁰⁰ The taxpayer, having made a zero net investment (borrows to buy), can generate profit from the tax system.¹⁰¹ What happens once this arbitrage exists? One potential effect is that the resulting arbitrage profit "increases demand for the tax-favored investment, thereby raising its price."¹⁰² (Borrowing to invest in tax-exempt bonds is thought to be a classic case of normal arbitrage.)¹⁰³ This price effect may reduce or eliminate the value of the tax benefit inherent in the preferred asset¹⁰⁴ (the arbitrage profit).

⁹⁷ See, e.g., STEUERLE, *supra* note 96, at 59–70; Alan J. Auerbach, *Should Interest Deductions Be Limited?*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 195, 203–05 (Henry J. Aaron et al. eds., 1988); Shakow, *supra* note 95, at 2–3; Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 565–67 (1985).

⁹⁸ As a starting point in the analysis, interest expense is assumed to be deductible.

⁹⁹ See, e.g., STEUERLE, *supra* note 96, at 59.

¹⁰⁰ *Id.* at 60.

¹⁰¹ See Shakow, *supra* note 95, at 3. In fact, the taxpayer may be encouraged to engage in transactions that only have value because of the tax treatment and would not otherwise be pursued.

An alternative, "less negative" characterization of the home-purchase arbitrage is possible. The transaction of borrowing to buy a home could be interpreted as making the home ownership incentive (seen in the nontaxation of the imputed rental income) available to all investors, whether financed through debt or their own capital. See Calvin H. Johnson, *Is an Interest Deduction Inevitable?* 6 VA. TAX REV. 123, 124 (1986) (examining this line of argument); Koppelman, *supra* note 94, at 1162–66 (same); Warren, *supra* note 97, at 560, 563 (same).

¹⁰² Shakow, *supra* note 95, at 2.

¹⁰³ *Id.* For debt used to purchase tax-exempt bonds, interest deduction limits were adopted as early as 1917. See Koppelman, *supra* note 94, at 1151.

¹⁰⁴ See Auerbach, *supra* note 97, at 201, 211. The taxpayer's ability to borrow to acquire tax-exempt bonds can "facilitate the sorting and capitalization and therefore benefit the issuers of the debt by providing them with a lower cost of capital." *Id.* at 211; Shakow, *supra* note 95, at 2; see also STEUERLE, *supra* note 96, at 65–67; Koppelman, *supra* note 94, at 1172–74. Through this pricing effect, full capitalization of the tax benefit could be

Even if the arbitrage profit is eliminated by the market, however, there may still remain potential misallocations, along with distributional and portfolio effects.¹⁰⁵ Moreover, a variety of factors, including the inefficiency of the market, may converge to limit the reliability of the market as a tool for eliminating arbitrage profit.¹⁰⁶

Pure tax arbitrage functions similarly to normal arbitrage, with a notable exception. If a taxpayer buys and sells the "same" income-preferred asset (a relatively circular transaction), then the taxpayer has engaged in pure tax arbitrage.¹⁰⁷ For example, if a taxpayer borrows and uses the funds to invest in an individual retirement account (IRA), pure tax arbitrage has been achieved.¹⁰⁸ The significant distinction between pure and normal tax arbitrage is that pure, unlike normal, does not face a market equilibration that can lower the taxpayer's return on the preferred investment.¹⁰⁹ In the IRA arbitrage above, the existence of the transaction does not lead to a decline in the return on IRAs, as may occur in a tax-exempt bond arbitrage transaction, when competition for the bonds raises their price/lowers

achieved with the bonds being held by the top-bracket taxpayers; Warren, *supra* note 97, at 564.

¹⁰⁵ See, e.g., STEUERLE, *supra* note 96, at 67 (identifying large portfolio shifts due to normal tax arbitrage); Koppelman, *supra* note 94, at 1190 (reviewing portfolio effects); Warren, *supra* note 97, at 567 (noting that even if the market response does eliminate the profit from normal arbitrage, the resulting situation and final allocation of the relevant assets may nonetheless be undesirable).

¹⁰⁶ See, e.g., STEUERLE, *supra* note 96, at 81-92 (discussing asymmetric tax treatment regarding different taxpayers where profitability in normal tax arbitrage depends on the taxpayer's marginal tax rate and the relationship between financial arbitrage and interest rates); Daniel I. Halperin, *Panel Discussion on Cost Recovery, Indexation and Interest*, in Frederic W. Hickman, *Interest, Depreciation, and Indexing*, 5 VA. TAX REV. 773, 815 (1986) (considering the market's efficiency in capitalizing the effect of the tax arbitrage profit); Koppelman, *supra* note 94, at 1177-86 (noting debate as to why full capitalization may not be achieved and reviewing some of the explanations); Shakow, *supra* note 95, at 8-9 (noting the explanation in the tax-exempt bond context that the bonds may be priced to attract lower rate taxpayers with the corresponding effect of keeping the pre-tax rate of return higher than would be expected); Warren, *supra* note 97, at 564-65 (questioning reliance on market effects to counter the problems of normal arbitrage because markets may be inefficient, interim arbitrage profits would still be available during the equilibration period, and international capital flows may limit the effects of interest rate increases).

¹⁰⁷ One investment may include both kinds of arbitrage. See STEUERLE, *supra* note 96, at 60-61 (describing a taxpayer's investment in a pension fund as including normal tax arbitrage if the fund acquires real estate and including pure tax arbitrage if it acquires interest-bearing assets).

¹⁰⁸ Auerbach, *supra* note 97, at 204-06; STEUERLE, *supra* note 96, at 60; see also STEUERLE, *supra* note 96, at 68 (describing a comparable transaction as "the taxpayer in a sense engag[ing] in transactions with himself").

¹⁰⁹ See, e.g., Auerbach, *supra* note 97, at 205.

their return. Why? By recognizing pure arbitrage as a transaction involving the "same asset," one can see that where investing and borrowing occur in the same market no net change in demand is produced and thus there is no price effect.¹¹⁰ In some sense, the tax preference is one of status that is not linked to the behavior of others or to a limited asset pool. If a taxpayer wants an IRA, he or she simply arranges the investment structure. Whether a neighbor wants to pursue the same transaction does not affect the availability of the taxpayer's IRA or its cost.¹¹¹

Although not determinative, the labels of normal and pure arbitrage are useful in evaluating the need to respond to arbitrage. If the market will be unable to eliminate the arbitrage profit, regulatory intervention may be needed.

b. *Efficiency Analysis of the Arbitrage Examples*

What are the general efficiency concerns with cross-border tax arbitrage? Essentially the expectation is that where the arbitrage proves to be more tax advantageous than a parallel domestic transaction, several effects will likely follow: (1) some domestic transactions will be replaced by cross-border ones;¹¹² (2) cross-border transactions will be conducted with those countries for which the tax intersection is most favorable; (3) there will be a disproportionate increase in those commercial business activities for which an attractive arbitrage exists; and (4) to the extent the transactions are not constrained by the market, limits on the behavior will derive from sources other than immediate market recalibration. The standard economic inquiry would view these arbitrage effects as indicators of inefficient investment decisions¹¹³ by taxpayers (presumably undesirable, at least

¹¹⁰ See, e.g., STEUERLE, *supra* note 96, at 68–69 ("In a riskless world with no transaction costs, pure arbitrage would have little or no effect on most real variables."); Shakow, *supra* note 95, at 5.

¹¹¹ In very simplified terms, the taxpayer borrows in the market to invest in an IRA that lends in the market to the taxpayer.

¹¹² See generally Stuart Leblang, *International Double Nontaxation: Hariton Misses the Point*, 80 TAX NOTES 507–08 (1998) (arguing that cross-border investments face a lower tax burden than exclusively domestic ones because of the advantage of cross-border tax arbitrage); Zelaya-Quesada, *supra* note 10, at G-8 (citing Acting Assistant Treasury Secretary for Tax Policy Jonathan Talisman's observation that Treasury is concerned about the economic distortion caused by cross-border tax arbitrage and the resulting nontaxation of income).

¹¹³ This assumes that the world without the arbitrage does not have other distortions that the particular arbitrage happens to offset.

where the effects were not the policy goals underlying the relevant tax rules).¹¹⁴ Of course, even if the arbitrage is widely recognized as an economic distortion, there may remain significant disagreement regarding the appropriate government response. That debate turns substantially on the nature and form of the proposed intervention and its inherent risks (reviewed later).

To put the cross-border tax arbitrage distortions in more concrete terms and to predict whether the market may respond to the arbitrages (that is, whether the arbitrages are more like normal or pure), this section reviews the arbitrage case studies introduced in Part I.

i. OID Arbitrage

The U.S.-Japan OID tax arbitrage (in which U.S. issuers obtain current interest deductions while Japanese holders report no current income)¹¹⁵ would likely produce market effects in both countries. U.S. OID bonds may be more attractive to Japanese investors than "comparable"¹¹⁶ non-OID bonds or than "comparable" Japanese OID bonds. In the case of the former (non-OID bonds), the U.S. OID bonds are preferable (despite similar issuer taxation) because the Japanese holder can defer interest taxation until receipt.¹¹⁷ In the case of the latter (comparable Japanese OID bonds), the U.S. OID bonds could be priced more attractively to the extent the Japanese OID bond issuer receives no current deductions and/or must withhold tax on issuance.¹¹⁸ Thus, where a market of Japanese purchasers faces the tax choices described above, the U.S. OID bonds would be a desirable

¹¹⁴ See, e.g., Auerbach, *supra* note 97, at 211 ([T]he "desirability [of the arbitrage, borrowing to buy tax-exempt bonds] would therefore depend primarily on whether the government wished to encourage tax-exempt borrowing and, if not, whether it had the ability to regulate the encouraged activity independently.").

¹¹⁵ See *supra* text accompanying notes 29-42.

¹¹⁶ The identification of comparable bonds requires some scrutiny because OID bonds have a "reinvestment" feature by virtue of the fact that the interest is not actually paid but is effectively retained and invested at the continuing internal rate of return.

¹¹⁷ Masui, *supra* note 38, at 865, 867 (If a Japanese taxpayer acquires a foreign, non-OID bond and receives interest through a securities company handling payment in Japan, then the Japanese final withholding tax at source applies; if the interest payment is not made through an institution in Japan, then the withholding does not apply and taxpayers are expected to report the income. If the Japanese investor holds a foreign OID bond the "interest" is classified as "other income" to be reported when the bond is redeemed.).

¹¹⁸ AULT ET AL., *supra* note 25, at 263 (a generally final withholding tax is imposed at issuance on the expected interest element of an OID bond issued by a Japanese domestic borrower.).

investment. The market reactions to this scenario could affect: (1) who holds the bonds; (2) the relative issuance of OID and non-OID bonds; (3) the capital flow into the United States; (4) the cost of capital for U.S. bond issuers; (5) the number of U.S. holders of OID bonds; (6) the collection of U.S. tax if an increasing number of OID bond holders bear no U.S. tax on the interest income; (7) the types of bonds Japanese holders seek; (8) the ability of Japanese bond issuers to compete for capital; and (9) the collection of tax revenue in Japan. Although one can identify impacts, the final analysis would be much more complicated and would depend on a variety of factors including: (1) the size of the Japanese bond-buying market; (2) the portfolios of investors; (3) the role of U.S. domestic tax exemptions¹¹⁹ in purchasing OID bonds; and (4) the cross-border cash flows and investments.

Much of this investigation is quite reminiscent of domestic tax-exempt bond analysis with some policy differences. In the tax-exempt bond context, if the market capitalizes the tax benefit, then the price is expected to move to a point where the investors obtain a return comparable to taxable bonds and the tax-exempt issuer becomes the ultimate beneficiary through a lower cost of funds.¹²⁰ This result is generally viewed as substantially consistent with the specific benefit that the federal government intended to deliver through the exemption (a subsidy to the qualified issuers). Turning to OID bonds, the U.S. tax rule represents an effort to tax income economically through a yield-to-maturity requirement. No affirmative subsidy or incentive is imbedded in these timing rules. If the market responds to the OID arbitrage and enables the issuer to obtain a lower cost of funds due to arbitrage, the net effect is not "efficient delivery" of an intended subsidy. There is no intended subsidy from the U.S. timing rule. Any U.S. issuer able to tap the Japanese OID bond-buying market can seek this benefit.¹²¹ Several conclusions should be drawn from this preliminary consideration of the economic effects of OID bond arbitrage: (1) the market will play a pivotal role; (2) a clear determination of the net effects of the arbitrage opportunity would be challenging to specify, although some view U.S. corporate borrowers as winners and Japa-

¹¹⁹ U.S. tax-exempt entities would not be deterred by the current taxation of interest on OID bonds because as tax-exempts, they typically bear no tax on the interest income.

¹²⁰ Assuming there are sufficient top-bracket taxpayers. See *supra* note 104.

¹²¹ See SCOTT & WELLONS, *supra* note 41, at 1034 (suggesting that in this OID arbitrage the U.S. borrowers obtained cheaper funds at the expense of the Japanese taxpayer).

nese taxpayers as losers;¹²² and (3) no specific U.S. subsidy exists to justify the distortions (the U.S. tax rule involved sought to implement economic taxation).

ii. Double-Dip Leasing

Although the analysis differs somewhat from the OID bond case, market effects on pricing and availability of double-dip leasing¹²³ are comparable. If, for example, attractive double-dip opportunities exist for airplane leasing by a U.S. lessee from a French lessor, some competition for French financing and for a share of the U.S. airplane-buying market would be expected because of the potential tax benefits from a cross-border transaction. The arbitrage benefits are distinct from and in addition to the baseline benefit of accelerated depreciation deductions. A U.S. purchaser acquiring a plane from a U.S. manufacturer receives a subsidy/incentive from the U.S. government in the form of accelerated depreciation, with a present value of X% of the cost. If the U.S. purchaser instead acquires a plane from a French manufacturer (and France offers a comparable accelerated depreciation benefit), then the subsidy for the cross-border transaction is 2X% of cost. Thus, the cross-border double-dip opportunity increases the distortion to produce more airplanes (and less of other goods). Recognition of the economic distortions identifies the fundamental efficiency effects but a more detailed portrayal may provide more guidance for U.S. policy. In this case, the U.S. purchaser would be interested up until the point that the after-tax cost of the French transaction (the contract price minus the value of the tax benefit) matched that of a purchase from a U.S. (or other) seller. If followed to this extreme, all of the arbitrage benefit would go to the French seller. In that case, the U.S. purchaser is obtaining no additional incentive/benefit from the arbitrage, and we may want to continue allowing the accelerated depreciation deductions to maintain the U.S. purchaser's level of investment (although to the extent U.S. purchasers have an incentive to seek out French sellers, the arbitrage may negatively impact U.S. manufacturers). France's perspective on this outcome depends on French interest in subsidizing the French

¹²² *Id.*; see, e.g., Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters and the 'Compaq' Case*, 21 TAX NOTES INT'L 1693, 1717 (2000) (exploring in the cross-border dividend stripping context the differing impacts of alternative "pricing" scenarios for foreign tax credits and noting the challenge of this inquiry).

¹²³ See *supra* text accompanying notes 43-50.

seller—France may view its deductions as promoting French airplane exports. Of course, that assumes that French planes are actually being transferred. If the French company is acquiring its planes from a U.S. manufacturer and onlending them to the U.S. purchaser through the leasing transaction, then no French export subsidy is actually achieved.

Another possibility is that the benefit from the arbitrage enures to the U.S. purchaser if the French sellers continue to cut their prices to attract purchasers, thereby shifting the benefit to the U.S. purchaser. In this case, the U.S. purchasers (airlines) may tend to invest more in airplanes than before (with their lower cost, they can charge lower fares). If the United States thought that the level of investment under the baseline accelerated depreciation rules was about right, then it may view such additional investment as “overinvestment” that leads to “unfair” competition with other related industries, such as transportation or entertainment. In reality, the ultimate allocation of benefit would depend on a number of factors including market size and composition, alternative country pairings for arbitrage, and market efficiency.¹²⁴ If the experience with the tax-exempt bond market is any indication, we might anticipate that the final allocation of benefit is somewhere between the extremes of all to the seller or purchaser. Empirical information indicating whether the net picture is closer to one end or the other, however, would be useful in making the required policy choices here.

Related to the market capitalization of arbitrage benefit is the question of impact on investment decisions and asset allocations. As with tax-exempt bonds, even if the market capitalizes the tax benefit, the resulting distribution of assets and investments might still be troubling.¹²⁵ A variety of possible distortions could result, including (1) encouraging leasing activity in sectors for which this tax benefit is possible (that is, particular assets); (2) encouraging leasing in a particular direction, such as U.S. lessee/French lessor;¹²⁶ (3) encouraging

¹²⁴ Again, recall the U.S. domestic tax-exempt bond market. In theory, the market could eliminate the arbitrage value as purchasers bid for the tax-exempt bonds up to the point where the after-tax returns of taxable and tax-exempt bonds were the same. In reality, a variety of factors may conspire to constrain this market effect including the issuer's need to reach a larger pool of purchasers than that represented by top-bracket taxpayers most benefiting from the tax-exempt status. *See supra* note 106.

¹²⁵ *See supra* notes 105, 106.

¹²⁶ The U.S. tax rules governing accelerated depreciation restrict such deductions for property used outside the United States. Thus, even if other tax rules and lease require-

leasing with particular countries; (4) facilitating French exports;¹²⁷ and (5) decreasing tax revenues from the level at which they would be if the countries had a common view of ownership.¹²⁸ In sum, the possible outcomes reflect multiple scenarios of economic distortion.¹²⁹

In deciding the government's response to double-dip leases, it may be significant that this arbitrage could promote investment, an original goal of accelerated depreciation.¹³⁰ If the double-dip arbitrage is expected to further goals that motivated the tax preference, should it be stopped? Even if the arbitrage appears to advance the preference goals, that conclusion might change if a more specific view of the "goal" were identified. For example, the arbitrage might expand the scale and degree of the incentive beyond what was intended. Or the arbitrage might skew some generally intended investment incentives toward a narrower set of assets and locations where double-dip benefits can be earned. These questions are considered in Part III as the part of decision making that is required for a thoughtful response to cross-border tax arbitrage.

Observations here about the tax conflict at the core of the arbitrage can be generalized. If countries measure income economically (even assuming some shared constraints and departures such as the treatment of imputed income), then de facto they are using very similar rules. Only where countries depart for policy or administrative reasons, or where the rule itself has no clear economic answer (such as source or entity classification), do the significant gaps and conflicts in rule design appear.

ments were satisfied for an asset leased out of the United States, the U.S. accelerated depreciation benefits may be unavailable. See I.R.C. § 168(g) (1) (B), (h) (2000).

¹²⁷ See *infra* note 230. Of course, this effect would not exist if the French lessor acquires the planes from a non-French manufacturer.

¹²⁸ See, e.g., Scott I. Jerris, *The Airline Industry and the "Double Dip"*, 19 INT'L TAX J. 82, 86 (1993) (discussing apparent "losers" in airline double-dip leasing).

¹²⁹ See, e.g., Park, *supra* note 43, at 148, 151-55 (examining the "tax-induced distortion of trade and capital flows" due to double-dip leasing).

¹³⁰ See, e.g., Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1753-55 (1982) (reviewing the Internal Revenue Code's departure from economic depreciation and cost recovery as part of a program to encourage investment). Such a claim (regarding the arbitrage's promotion of existing investment policies) would in fact require the combination of an empirical judgment about the arbitrage effects and an assertion about the degree and scope of the preference originally envisioned by the legislature.

iii. Dual-Resident Companies

Dual-resident companies¹³¹ present potential for arbitrage benefits that may or may not be influenced by the market. Recall that the benefits in this case are achieved by establishing a corporation as a resident of two countries (for example, the United States and the United Kingdom) with two sets of related corporations, the U.K. group and U.S. group. Losses are "dumped" into the DRC and then used to offset the income of the two groups as they file with the DRC in their respective countries. Even if the U.S. operations and the U.K. operations generate income, the ability to take the DRC's loss twice, against both sets of income, can enable the combined group to pay no U.S. or U.K. tax. Although there can be debate about which income the loss should offset, clearly some income should be subject to tax in one of the two jurisdictions. (This example illustrates a case in which the distinction between CEN and CIN could make a difference, but it is minor compared to the difference between allowing the arbitrage and limiting it under the less restrictive of the two efficiency measures.)¹³²

Described in this fashion, with the emphasis on the residency "status" of the DRC (which, at least in the United States, lacks a substantive component and depends on incorporation location), the market would seemingly have little effect on the availability of this benefit. If reincorporation posed no tax burdens¹³³ then as many tax-

¹³¹ See *supra* text accompanying notes 51-54.

¹³² For example, assume the U.S. group earns \$100 and the U.K. group earns \$100. If the U.S. tax rate is 35% and the U.K. tax rate is 30%, then the two taxpayer groups owe \$35 of U.S. tax and \$30 of U.K. tax respectively. If the U.K. group creates a DRC to acquire the U.S. group, and the DRC has \$100 of losses (perhaps financing costs from the acquisition), then the net tax picture changes. Economically, the total group now generates \$100 net income (\$100 U.S. income, \$100 U.K. income, and \$100 DRC loss). The U.K. group (which now includes the DRC), however, reports \$0 income and pays \$0 tax and the U.S. group (which also includes the DRC) reports \$0 income and \$0 tax. We could debate how much tax in total should be paid on the net \$100 (either \$30 or \$35 depending on how we tried to characterize the underlying economic activity as U.S. or U.K. investment and whether CEN or CIN should apply, which is difficult precisely because of the dual residency) but clearly \$0 is wrong by at least an amount of \$30. Thus, in this case, the difference between adopting CEN or CIN is less significant than the difference between arbitrage and the least restrictive limitation (although the residual discrepancy underscores continuing conflict in the tax rules).

¹³³ The current debate regarding corporate inversions may substantially change the tax picture for reincorporation. See, e.g., N.Y. State Bar Ass'n Tax Section, *Report on Outbound Inversion Transactions*, 2002, LEXIS 2002 WTD 106-31; OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, *CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS* (2002), available at LEXIS 2002 WTD 103-38.

payers as had the appropriate subsidiaries¹³⁴ could obtain this benefit. The major limits would be the initial ability to generate losses for the DRC and the existence of subsidiary groups in the relevant countries. All newly created businesses could consider this "residence" benefit in the planning stages and where feasible pursue it. A decision by one multi-national to structure its organization to obtain this benefit would not generally impact the ability of another taxpayer to do the same. One of the fears underlying U.S. criticisms of the dual-resident structure, however, was the belief that the arbitrage gave foreign corporations (foreign-owned DRCs) an advantage over purely U.S. domestic corporations in the competition for acquiring U.S. groups.

The unique tax benefits for a DRC were expected to provide the foreign acquirors with incentives "to acquire U.S. corporations."¹³⁵ The foreign-owned DRCs would in theory bid higher for U.S. groups, reflecting the value that the U.S. groups would bring them.¹³⁶ (The U.K. acquiror, through its ability to offset U.S. income with the DRC's loss, might view the U.S. income as effectively untaxed, and thus be able to afford a higher price for acquisition of the U.S. corporation.) Through these acquisitions, the foreign acquirors would "gain an advantage in competing in the U.S. economy against U.S. corporations."¹³⁷ (Perhaps if the U.K. acquiror did not pay a higher price for the U.S. corporation, then the benefit of the DRC's loss against the U.S. income could translate into lower prices in the U.S. subsidiary's business, impacting competition at that level.)

Although the perception of impact from foreign-owned DRCs was strong¹³⁸ (Congress received complaints of the unfair advantage gained by certain foreign persons investing in the United States through DRCs) the underlying reality was less clear. (A similar set of complaints was voiced about foreign acquisition of U.S. real estate prior to the adoption of I.R.C. § 897, which taxes foreign persons' investments in certain U.S. real property.) Whether there was a market impact from the DRCs bidding for U.S. corporations is a question of fact. If the DRC arbitrage was pursued primarily by taxpayers at the stage of structuring and organizing their U.S. and U.K. operations, it

¹³⁴ The arbitrage requires two sets of subsidiary groups, one in each country.

¹³⁵ Rosenbloom, *supra* note 2, at 146 (citing S. REP. NO. 99-313, at 420 (1986)).

¹³⁶ See, e.g., Sheppard, *supra* note 74, at 582 (stating that Congress was also concerned that the dual-residents "scheme provided an undue incentive to acquire foreign assets").

¹³⁷ Rosenbloom, *supra* note 2, at 146 (citing S. REP. NO. 99-313, at 420 (1986)).

¹³⁸ JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1064-65 (1987); Rosenbloom, *supra* note 2, at 147.

may have produced little market effect. Conversely, if the DRC arbitrage motivated foreign investors to acquire U.S. corporations as tax-advantaged assets (like tax-exempt bonds), then depending on the number of participants, a price effect may have occurred. Certainly the "perception of abuse" was powerful, and the simplicity and clarity of the DRC arbitrage made the case an easy target for ire and attack.¹³⁹

In evaluating the DRC arbitrage, three broader observations can be made. First, the DRC arbitrage requires a multinational taxpayer and thus favors global versus local ownership. Second, the DRC arbitrage exists only between a few countries and therefore serves as an incentive to shift investment in that direction. Finally, the substantive tax rule underlying the DRC structure (residence rule for corporations) varies widely and, in the case of the United States, is essentially elective.¹⁴⁰ No core policy goal other than administrability prompts the residence rule;¹⁴¹ no subsidy or advantage is meant to be conveyed.

iv. Hybrid Entities

The last arbitrage case study, which turns primarily on the status of the taxpayer, is less likely to be constrained by the market. A taxpayer's ability to designate a particular entity as a pass-through for U.S. tax purposes and a corporation for foreign tax purposes opens an array of arbitrage possibilities. One business's decision to avail itself of these structural opportunities, however, does not impact the ability of other companies to achieve comparable gains. The fact that multiple taxpayers go forward with hybrid entities imposes no limit on the value of each other's arbitrage (except to the extent that the volume of arbitrage activity prompts governmental action—akin to the

¹³⁹ Rosenbloom, *supra* note 2, at 147 n.45 (quoting a Congressional staffer's view that the DRC strategy "belonged in the 'hall of fame of tax abuse'").

¹⁴⁰ Under U.S. tax law a corporation is resident where incorporated, regardless of activities, management, or income. I.R.C. § 7701 (a) (4) (2000).

¹⁴¹ The degree of linkage between corporations and countries of residence is the subject of debate, as commentators have begun to question whether it makes sense to speak of a U.S. corporation or a French corporation in today's global economy. See, e.g., Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 27 TAX NOTES INT'L 225, 228-29 (2002) (discussing whether multinational corporations have a "national identity" and how that has changed over time); Robert B. Reich, *Who Is Us?*, HARV. BUS. REV., Jan.-Feb. 1990, at 53.

classic tax shelter, which works as long as all participants are discrete and the shelter remains unknown to the government).¹⁴²

Although the market seemingly has no direct constraining influence on this arbitrage (as it might with tax-exempt bonds), there are several potential economic distortions that may follow. In particular, foreign investments might generally be favored over domestic ones by U.S. taxpayers (so that hybrid entity arbitrages can be pursued), and investments in certain foreign countries would be favored over investments in others. Consider, for example, the hybrid entity arbitrage of the subpart F rules¹⁴³ in which the U.S. person's CFC (foreign subsidiary) in a high-tax jurisdiction was able to reduce that high foreign tax through an income-stripping technique with a hybrid entity in a third country while continuing deferral of U.S. tax under the subpart F rules. The Service expressed a strong negative view in Notice 98-11: "it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income."¹⁴⁴ Subsequent comments from the Service indicated a general sense that allowing these arrangements constituted an inappropriate capital export subsidy (that is, encouraged investment abroad).¹⁴⁵ Though the United States may believe that some deferral is legitimate, the subpart F rules set the parameters on when it will be available¹⁴⁶ by effectively

¹⁴² See, e.g., Joseph Bankman, *The New Market in U.S. Corporate Tax Shelters*, 18 TAX NOTES INT'L 2681, 2682 (1999) ("tax-oriented products that are likely to survive discovery are not characterized as tax shelters for purposes of this report however aggressive they may be"); Peter C. Canellos, *Business Purpose, Economic Substance, and Corporate Tax Shelters: A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 50 (2001) (the "common reaction of the key organizations representing tax professionals has been to focus on what they perceive to be the underlying weakness of tax shelter economics—the dependence on concealment and the audit lottery"); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 226 (2002) (discussing the audit lottery aspect of tax shelter conduct).

¹⁴³ See *supra* text accompanying notes 61–66.

¹⁴⁴ I.R.S. Notice 98–11, 1998–1 C.B. 433, at 18–19.

¹⁴⁵ See, e.g., Lee A. Sheppard, *IRS Talks About Foreign Hybrid Notice*, 78 TAX NOTES 402 (1998) (quoting Phyllis Marcus, Chief of Branch Two in the IRS Office of Associate Chief Counsel International, that "these arrangements go beyond capital export neutrality, the stated purpose of subpart F, and toward a capital export subsidy"). In addition, supporters of efforts to attack this particular arbitrage, which seemingly violates or undermines only the foreign countries' tax regimes, contend that "[t]he United States has a stake in closing [them down because the] opportunities may give foreign industries a competitive edge that could have an impact on U.S. firms and revenues." McCleskey, *supra* note 7, at G-2 (citing Treasury ITC Attorney Advisor Je Young Baik).

¹⁴⁶ Deferral might be considered legitimate to support goals of capital import neutrality and international competitiveness. The role and history of subpart F are hotly debated,

aiming to prevent U.S. taxpayers from shifting income to low tax jurisdictions (presumably an inefficient move). When a foreign jurisdiction imposes taxes comparable to the United States, a U.S. business's decision to invest abroad generally seems motivated by business and not taxes, and should be an efficient structuring of business activities.¹⁴⁷ If, however, the subpart F hybrid entity arbitrage is available, capital would be encouraged to leave the United States for other equally high-tax jurisdictions through which a hybrid entity strategy could be run to ultimately produce low taxes (a strategy not achieved within the United States). Thus, taxpayers would be influenced not by a direct tax advantage (there would be none), but rather by the indirect tax planning available only in the foreign jurisdiction. This precise argument is not enunciated by the Service, but seems to underlie its substantive position and more general comments.¹⁴⁸

The other hybrid entity example, domestic reverse hybrids,¹⁴⁹ exhibits two possible distortions. (In this arbitrage, a foreign corporation using a U.S. hybrid holding company obtained "dividends" from its underlying U.S. operating subsidiary that were treated as deductible to the U.S. payor and potentially untaxed to the recipient foreign corporation.) First, as the preambles to the proposed and final domestic reverse hybrid regulations suggested, the availability of this hybrid arbitrage with its tax benefits could give foreign acquirors a

and this reality will bear directly on the treatment of arbitrage involving the subpart F regime. *See, e.g.,* NAT'L FOREIGN TRADE COUNCIL, INC., INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, reprinted in 18 TAX NOTES INT'L 1375 (1999) (arguing that current global conditions have eroded the justification for the current subpart F regime, whose breadth is harmful to U.S. based corporations). *But see* Treasury Deferral Study, *supra* note 62, at S-50 (concluding that "[a]n anti-deferral regime continues to be needed").

¹⁴⁷ Preamble to Treas. Reg. § 1.894-1(d)(2)(ii), 67 Fed. Reg. 40,157 (June 12, 2002). *See infra* text accompanying notes 262-263. Implicit in this interpretation and characterization of the decision to invest abroad in a nominally high tax country is an expectation that this will promote both CEN and CIN assuming fairly similar tax bases.

¹⁴⁸ *Official Defends Notice 98-11 Guidance As Quick Action on Inadvertent Loophole*, TAX MGMT. FIN. PRODUCTS REP. 168, 169 (1998) (Attorney Advisor Will Morris of Treasury's International Tax Counsel's Office observing that the check-the-box loophole regarding hybrids "is luring U.S. business overseas and, while the expansion of U.S. companies is good, the general desire is not 'to have everybody overseas'"). To the extent this expansion involves investment in jurisdictions with nominally high, but effectively low taxes (through the arbitrage) CEN is violated because the taxpayer is not neutral as to the location of the investment. It is also possible that the expansion violates CIN if only the U.S. taxpayers are capable of obtaining such tax reducing benefits in the expansion jurisdiction.

¹⁴⁹ *See supra* text accompanying notes 69-72. The United States relinquished taxing rights on a payment under the treaty with the expectation that the treaty partner would tax it. Due to the use of a hybrid entity, however, the United States and its treaty partner did not classify the payment in the same way resulting in no tax in either country.

financing advantage over comparable domestic acquirors.¹⁵⁰ Second, this hybrid transaction may "defeat[] the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation for legitimate transactions, not to reward the manipulation of inconsistencies in the laws of the treaty partners."¹⁵¹ To the extent the bargains embodied in agreements can be circumvented, the contracting parties (countries) may be forced to consider more costly alternatives including: (1) negotiation of more detailed agreements; or (2) limitation of the scope of the agreements to prevent unwitting sacrifice of revenue.

v. Observations on Case Studies and Efficiency

This preliminary effort to investigate the efficiency effects of the four case study arbitrages reveals several important points. First, the task is a challenging and complex one. Even in the domestic context, where more attention has been devoted for a longer time to comparable questions, debate is still active. This observation becomes relevant to designing a decision-making process for government officials encountering numerous and novel arbitrage examples. Second, the analyses in different cases are likely to vary significantly in terms of how benefits and burdens are distributed, whether that distribution advances policy goals, and whether the magnitude of the distortions is substantial. Third, where tax rules deviate from "economic" taxation the potential for variation in tax treatment, and correspondingly for distortions, increases.

3. Equity

In addition to efficiency effects, two equity effects factor into the assessment of cross-border tax arbitrage, both of which have strong grounding in the domestic tax arbitrage literature, and derive from problems in the taxing of capital income.¹⁵² The first focuses on the

¹⁵⁰ See Preamble to Treas. Reg. § 1.894-1(d)(2)(ii), 67 Fed. Reg. 40,157 (June 12, 2002); Preamble to Prop. Treas. Reg. § 1.894-1(d)(2)(ii), 66 Fed. Reg. 12,445, 12,446 (Feb. 27, 2001).

¹⁵¹ See Preamble to Treas. Reg. § 1.894-1(d)(2)(ii), 66 Fed. Reg. 12,446 (Feb. 27, 2001) (also citing the legislative history of I.R.C. § 894(c), which denied treaty benefits for certain payments through hybrid entities).

¹⁵² See, e.g., Halperin, *supra* note 106, at 815; Hickman, *supra* note 106, at 775-76; Kurtz, *supra* note 94, at 173; Shakow, *supra* note 95, at 17 (reviewing some of the arguments and debates on domestic arbitrage); James W. Wetzler, *Notes on the Economic Substance and Business Purpose Doctrine*, 21 INS. TAX REV. 257, 258 (2001) (noting perception and

ability of a select group of taxpayers to reduce their taxes through arbitrage. Cross-border tax arbitrage may enable taxpayers to reduce or eliminate their income tax base. Depending on the scale and volume of arbitrage, revenue collection could be seriously undermined. As a result, other parts of the tax base would need to bear a greater tax burden to maintain revenue collections.¹⁵³ This "disappearing tax base" fear drives much of the movement against unfettered tax competition.¹⁵⁴ The general international tax literature supports the view that cross-border tax arbitrage is a pursuit enjoyed by taxpayers with income from capital, not labor.¹⁵⁵ Thus, the pervasive availability of cross-border tax arbitrage transactions to reduce taxes significantly could impact revenue collection and the distribution of the tax burden. The magnitude of this effect would depend on the volume of arbitrage activity and the scale of the tax savings involved. On the surface, one of the arbitrage case studies presented in Part I seems not to exhibit this equity problem. Specifically, the subpart F hybrid entity arbitrage enables the U.S. taxpayer to reduce its foreign income tax, which presumably would increase its U.S. tax as fewer foreign tax credits are created to offset the U.S. tax bill.¹⁵⁶ Whether this portrayal of the arbitrage accurately reflects reality depends in part on (1) the status of the U.S. taxpayer (in excess credit or excess limitation position);¹⁵⁷ (2) the stage at which the inquiry is made (Is the existence of

compliance risks to the tax system from "a totally permissive attitude toward tax planning," and citing the history of safe harbor leasing).

¹⁵³ See, e.g., McCleskey, *supra* note 7 (quoting Treasury Attorney Advisor Je Young Baik's observation that tax arbitrage across borders "ties into the broader issue of tax fairness—namely equalizing tax burdens between capital investment and labor"); Zelaya-Quesada, *supra* note 10, at G-8 (citing Acting Assistant Treasury Secretary for Tax Policy Jonathan Talisman's observations that cross-border tax arbitrage discriminates against those taxpayers without comparable access to arbitrage benefits and may force the governments to rely more on other revenue sources).

¹⁵⁴ See Chris Edwards & Veronique de Rugy, *International Tax Competition: A 21st-Century Constraint on Government*, 27 TAX NOTES INT'L 63, 80 (2002); see also OECD, *supra* note 15, at 14; Avi-Yonah, *supra* note 15, at 1575-76.

¹⁵⁵ Though not scientifically selected, the case studies described in Part I are all arbitrages involving investment of capital and tax rules governing leasing, ownership, interest timing, entity classification, corporate residence, and consolidation.

¹⁵⁶ See, e.g., Sheppard, *supra* note 74, at 582 (questioning the U.S. motive for limiting a taxpayer's efforts to minimize foreign income tax). See *infra* text accompanying note 169.

¹⁵⁷ Based on the rules granting and then limiting the use of foreign tax credits, taxpayers may find they have either excess (unused) foreign tax credits or excess limitation (foreign income available to absorb foreign tax credits). In theory, a taxpayer's relative position could vary from year to year although taxpayers often find themselves in the same position repeatedly because of the nature and location of their business, the relative tax rates, and their economic success.

foreign operations a given, with the only question being their structure, or is the decision whether to invest abroad a business behavior open to influence?);¹⁵⁸ and (3) the likely period of deferral. As to the second factor, if allowing the arbitrage constitutes a subsidy for investment abroad, then a corresponding decline in U.S. tax revenues and a need for alternative revenue sources could be anticipated.

The second equity concern, which may or may not be linked to the first, regards the perceptions of abuse.¹⁵⁹ If the taxpaying public perceives cross-border tax arbitrage as an abuse available to (and used by) a limited pool of taxpayers (those with capital, as opposed to wage income, who have the potential for cross-border operations), then public support for and confidence in the tax system may be undermined. This confidence risk to the tax system can develop even where the belief that some taxpayers are benefiting is factually inaccurate because the market has capitalized the arbitrage benefit.¹⁶⁰ Although it is not likely that large numbers of the taxpaying public have an intimate knowledge of the arbitrage strategies of U.S. corporations, this information could have an influence in two ways: (1) sophisticated high-tax individuals who do have such knowledge may be more inclined to pursue arbitrage or tax avoidance strategies themselves if they perceive such conduct to be standard corporate behavior; and

¹⁵⁸ For an analysis of the impact of foreign taxes on U.S. multinationals' decisions on where to invest, see Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT'L TAX J. 825, 825 (2000) (an empirical analysis of 1992 data on 500 U.S. manufacturers and 60 potential foreign locations found that "local average effective tax rates have a significant effect on the amount of capital that U.S. MNCs have in a given location").

¹⁵⁹ In the domestic tax arbitrage context, even where there is serious doubt as to whether any real unfairness exists, the "appearance" issue is understood to carry some practical implications for the system. See, e.g., Wetzler, *supra* note 152, at 258.

¹⁶⁰ See, e.g., STEUERLE, *supra* note 96, at 65-67; Koppelman, *supra* note 94, at 1172-74; Shakow, *supra* note 95, at 2 (With normal tax arbitrage, one potential outcome is that the arbitrage profit here "increases demand for tax-favored investment, thereby raising its price and lowering its return."). During the equilibrium process, though, some taxpayers would have benefited financially from the arbitrage. See Warren, *supra* note 97, at 564 ("arbitrage profits will be available during the period of equilibration"). Moreover, the effectiveness of the market in eliminating the arbitrage profit is far from guaranteed. See, e.g., Halperin, *supra* note 106, at 815 (considering the market's efficiency in capitalizing the effect of the tax arbitrage profit); Koppelman, *supra* note 94, at 1177-86 (noting debate as to why full capitalization may not be achieved and reviewing some of the explanations); Warren, *supra* note 97, at 564-65 (questioning reliance on market effects to counter the problems of normal arbitrage because markets may be inefficient, interim arbitrage profits would still be available during the equilibration period, and international capital flows may limit the effects of interest rate increases).

(2) the broader public may be cumulatively disillusioned as general reports of corporate strategies periodically reach the headlines.¹⁶¹

4. Two Further Criteria for Measuring Harm

Two additional concerns from domestic tax analysis illuminate the arbitrage inquiry: political accountability and revenue effects. Although both are closely connected to efficiency and equity, and much of their analytical role could be restated in those terms, some advantage is gained by separately considering them.

a. *Political Accountability*

The question of harm from arbitrage in terms of political accountability derives from the fear that voters may believe a certain tax regime has been enacted, but because of a lack of transparency in the tax rules (due here to arbitrage) they are unaware that the effective tax regime is quite different for some taxpayers.¹⁶² This situation is undesirable because: (1) a democratic system relies on voting and transparency in the law; and (2) more specifically, this lack of transparency can foster opportunities for behavior such as rent seeking by elected officials. How this observation should impact the analysis of arbitrage is a bit more complicated. This may be a weak factor if in a given case the arbitrage appears to further a U.S. policy. (That is, transparency would be desirable, but the effects of the hidden tax benefit promote goals supported by the voters so our fears may be mitigated.) Also, rent seeking may be less of a factor in some arbitrages. For example, where a taxpayer obtains benefits from new tax legislation that ultimately applies to only one or two taxpayers, the

¹⁶¹ See generally Julie Hirschfeld-Davis, *Big Guns Hired to Fight Tax Reforms; Firms Enlist Ex-lawmakers to Limit Expected Changes to Offshore Finance Breaks*, BALT. SUN, Aug. 9, 2002, at 1A ("Fueled by public outrage, measures that would curb the now-legal practice—known as 'corporate inversion' . . . are swiftly making their way through the House and the Senate."); Jonathan Weisman, *Patriotism Raining on Tax Paradise; Lawmakers are Chafing at Firms that Exist Offshore Only on Paper*, WASH. POST, Aug. 21, 2002, at E01 (covering corporate inversion transactions in which U.S. corporations effectively change their residency to achieve tax reductions).

¹⁶² The assumption here about the knowledge of the voters/citizenry (they do not really know what is happening) seems the opposite of what is projected in the equity analysis (we worried about the negative effects on the broader taxpaying public of knowledge of corporate tax avoidance). It is possible that both could be somewhat true; the public could have a sense that corporations and other sophisticated taxpayers are engaging in tax avoidance, but be unaware of the specifics and thus be uncertain about where and how to demand change from their political representatives.

likelihood of rent seeking seems high. In contrast, where a taxpayer benefits from interactions with other tax regimes (arbitrage), the risk of rent seeking (at least at the initial stages of the arbitrage existing) seems lower. Political accountability is likely to be a stronger factor in the analysis where certain taxpayers are getting results clearly not intended by voters (with "intent" loosely defined, given the difficulty of ascertaining even Congressional intention), and the magnitude of the benefits are significant. These are probably cases in which the efficiency analysis itself would identify an important distortion from the arbitrage.

b. Revenue Effects

An obvious goal of the tax system is to generate revenue to support government functions. If arbitrage significantly impairs the collection of revenue, the effect is important for two reasons: (1) cuts in government expenditures may be necessary, and (2) a shift in the tax burden may be required to produce supplemental revenue. As to the first, the cuts would be undesirable if the nation thought that it was providing an appropriate level of services. If eliminating the arbitrage benefit protects revenue on the U.S. side, then at least in the short term that action is desirable from a revenue perspective. (Other considerations may counsel against pursuing what appears to be an immediate revenue gain.)

As to the second point, the ability of a select group of taxpayers to reduce their tax burden through means unavailable to most other taxpayers raises the possibility that the government will impose additional tax on those taxpayers unable to avoid tax. This constitutes both an equity concern (as discussed above in section II.B.3) and a revenue concern, to the extent it is not feasible to replace the lost revenue through additional tax measures.

C. Assessment of Cross-Border Tax Arbitrage: Is Intervention Appropriate?

Based on the preliminary examination on equity and efficiency grounds, cross-border tax arbitrage poses potentially serious problems by violating norms we traditionally support through the tax system, however imperfectly. In fact, the critiques of government intervention typically do not challenge the basic observations about efficiency and equity effects of arbitrage. When, then, do the competing views on arbitrage diverge? The conflict over cross-border tax arbitrage crystallizes in evaluating the costs of responding to arbitrage. The costs of limiting arbitrage fall into two broad categories: (1) administrability;

and (2) risks to systemic values of sovereignty and diversity. Administrability connects the tax system's efficiency and equity norms to the reality of a working tax regime, most particularly to the need to decide which transactions to attack. Sovereignty and diversity capture the residual interests impacted by arbitrage decisions.

1. Implementation of Anti-Arbitrage Measures: Line Drawing and Administrability

Imagine for a moment fairly widespread agreement on the efficiency and equity problems generated by cross-border tax arbitrage. It is at the next step, solving these problems, that the analysis encounters the challenges of real world implementation. Translating a goal of eliminating cross-border tax arbitrage into a plan of action quickly highlights the more practical aspects of the task: line drawing. How do we draw an intellectually defensible line between bad tax arbitrage and good tax arbitrage (which would be allowed because it constitutes good tax minimization)¹⁶³ in a multi-jurisdictional system?¹⁶⁴ One possibility is we avoid line-drawing issues by either completely eliminating or completely accepting cross-border tax arbitrage. Complete acceptance would mean that governments would make no effort to unearth and root out arbitrage, and would therefore draw no lines. As an *ex ante* policy position, however, complete acceptance of arbitrage ignores, without further consideration, the nature, variety, and degree of harms caused by arbitrage. Even if the challenges of curtailing arbitrage are significant, the option should remain available to the government to protect its interests.

Another possibility is we avoid line drawing by completely eliminating cross-border tax arbitrage. Once again, this path obviates the need to make distinctions; it implicitly requires that the tax rules applied by the United States effectively mirror those of the foreign jurisdiction. Although greater coherence and uniformity of tax treatment may make sense domestically, such aspirations at the global level come at the expense of other policy goals including administrability and diversity. In some cases this choice may even undermine efficiency if the arbitrage counters a pre-existing inefficiency in the

¹⁶³ Commentators have argued that cross-border tax arbitrage is not wholly different from general tax planning. See Rosenbloom, *supra* note 2, at 144. The same debate over the distinction between general tax planning that should be permitted and "excessive" tax planning that should be curtailed rages on in the corporate tax shelter arena. See, e.g., Wetzler, *supra* note 152, at 257-58.

¹⁶⁴ See, e.g., Rosenbloom, *supra* note 2, at 144, 147; Sheppard, *supra* note 74, at 581.

system. Also, "eliminating" all cross-border tax arbitrage leaves no room for arbitrages that further an intended national incentive.

Assuming these extreme positions are rejected, the inevitability of arbitrage in a multi-jurisdictional setting compels us to confront the question of line drawing, even before we decide where, on a normative basis, to draw the line. We need to be clear about what the "problem" is with cross-border tax arbitrage and how we decide when the problem is severe enough to merit action. The preliminary step in this process is to examine the specific line-drawing concerns.

The first major line-drawing critique challenges narrowly targeted anti-arbitrage rules in cases in which comparable tax benefits can be achieved by alternative transactions.¹⁶⁵ If only the simple, "elegant" arbitrages are caught by anti-arbitrage rules, what is the justification?¹⁶⁶ For example, tax benefits similar to those obtained with DRCs can be gained through alternative, less direct techniques.¹⁶⁷ What justifies anti-arbitrage rules that proscribe only benefits obtained through the DRC structure,¹⁶⁸ but leave in place substitute transactions? One response may be that the restriction of one arbitrage is part of a learning curve and does not represent a final vision of what transactions could and should be prohibited. When additional information on tax planning activities becomes available to the government, the scope of the restricted and targeted arbitrage transactions may increase. Arguably, the tax regime need not await a fully designed, comprehensive attack on dual losses before it makes inroads on a very popular mechanism.

Another explanation may be the recognition that the "unelegant" version is quite convoluted to attack and by its very nature limited in scope. The elegant version, with presumably fewer steps and lower transaction costs, poses a much greater risk and may reasonably be singled out for attack. Of course, this assessment may not be factually accurate in every case; it is possible that stopping the easy version and forcing taxpayers to pursue the more complicated tax planning options ultimately causes more harm due to the deadweight loss.¹⁶⁹

¹⁶⁵ As discussed more fully *infra* at text accompanying notes 206–210, a broad rule seeking to deny all arbitrage benefits would be unduly inclusive and difficult to implement for both taxpayers and the government.

¹⁶⁶ See, e.g., Rosenbloom, *supra* note 2, at 144.

¹⁶⁷ See *id.* (discussing other options for the dual-loss benefit).

¹⁶⁸ See I.R.C. § 1503(d) (2000) (enacted to attack DRC arbitrage involving dual losses).

¹⁶⁹ See, e.g., David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315–16 (2001) (the existence of "frictions" explains why in some cases taxpayers pursue close substitutes of a prohibited transaction and in other cases they do not);

The concern for substitute arbitrage transactions recalls a similar debate regarding financial instruments. Congress and Treasury have produced legislation, regulations, and rulings aimed at curbing abusive financial instrument transactions, even where comparable transactions remain beyond the reach of the new tax provisions.¹⁷⁰ The line drawing is not unique to cross-border transactions and we have demonstrated a willingness to regulate a select group of transactions in which the restrictions have a positive impact on behavior and volume. Line drawing can be valuable if the risk of encouraging taxpayers to shift to more inefficient structures has been included in the calculus.¹⁷¹ Although cross-border tax arbitrage and financial instrument transactions are not identical,¹⁷² both share the tension between "good" tax planning and inappropriate tax avoidance.

A second line-drawing critique leveled at anti-arbitrage rules challenges the justification for U.S. attention to tax benefits, but not to nontax benefits, offered by another country.¹⁷³ That is, if U.S. tax law has been satisfied, why care if a related tax benefit is available in the other country? Why exhibit interest in that benefit and no others? Nontax benefits typically attract little scrutiny for reasons of practicality and comparability. To the extent a tax system aims for equitable treatment of its taxpayers, some assessment of each taxpayer's net situation is necessary. If certain advantages or benefits conferred by the federal (or state) government are not included in the calculus,

Shaviro, *supra* note 122, at 1712 (in the context of corporate tax shelter evaluations, there is dead weight loss where we push taxpayers to structure their transactions even more inefficiently to obtain a tax benefit); Wetzler, *supra* note 152, at 258 ("To the extent that taxpayers still undertake tax planning despite the dead weight loss [caused by restructuring the transaction to avoid the tax penalty] a permissive approach to tax planning would be preferable because it would avoid the costs represented by the deadweight loss."); see also Yin, *supra* note 18, at 209, 216–18 ("incremental changes" in tax law to combat tax shelters may produce more inefficiency and distortion if taxpayers decide to pursue an alternative but more costly path to their tax benefit).

¹⁷⁰ See, e.g., Schizer, *supra* note 169, at 1318, 1343–45 (although it was understood that I.R.C. § 1259 (taxing constructive sales) could be easily avoided the provision was enacted for policy and administrability reasons).

¹⁷¹ See *id.* at 1315–16 (considering the role of frictions and the likelihood that taxpayers will pursue substitute transactions in the decision to tax certain transactions); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1631 (1999) (examining the role of efficiency in the quest to draw lines in the tax law).

¹⁷² For example, the financial instrument cases often are entirely domestic so sovereignty concerns do not arise.

¹⁷³ For example, just as taxpayers may benefit from the second set of accelerated depreciation deductions, they could benefit from regulatory provisions, or grants of land, or technology.

then the taxpayer's condition will not be accurately reflected. That said, we do not, as a general matter, comprehensively incorporate the impact of other regulatory programs into the tax picture. Although the division of the government's legislative and administrative functions into discrete spheres of activity, often with little or no overlap, does have a somewhat arbitrary quality, practicality dictates these divisions. Given the enormity of the current income tax system, the decision to set boundaries on what will be encompassed by tax analysis carries strong administrative appeal. The exclusion of nontax benefits reduces the number of rules to evaluate and ignores benefits that might be harder to compare with tax provisions.

The third line-drawing critique asks why care if a taxpayer gets a tax benefit in another country through the arbitrage, but not if the taxpayer obtains a foreign tax benefit through a different means (for example, tax rates). The absence of attention to "unrelated" tax benefits (those not derived from conflicting tax laws) likely reflects several factors. First, some unrelated benefits such as low tax rates may correlate loosely with the services and infrastructure provided by the other country. In that case, the "advantage" garnered by the taxpayer because of a benefit available only in the other country does not really pose a competitive disadvantage to other taxpayers. Second, if there is no direct link between the foreign country tax benefit and the arbitrage transaction, then the existence of that tax benefit should not distort business behavior toward the specific arbitrage transaction. Third, as with the nontax benefits, administrability may narrow the scope of inquiry to limit the inclusion of numerous and diverse benefits in the arbitrage analysis. The exclusion of "unrelated" tax benefits from the arbitrage discussion also may reflect a systemic compromise with the values of sovereignty and diversity that are examined in the next section. Efficiency, equality, sovereignty, and diversity cannot all be fully realized in the tax world. "Unrelated" tax benefits may have an efficiency effect, but inclusion of such rules in the orbit of anti-arbitrage analysis places greater pressure on sovereignty, diversity, and administrability goals.

2. Implementation of Anti-Arbitrage Measures: Risks to National Policy

In addition to the more traditional line-drawing regulatory concerns, plans for implementing anti-arbitrage strategies trigger objections based on sovereignty and diversity grounds. Does cross-border tax arbitrage warrant government intervention given the potential

costs to these values from increased harmonization?¹⁷⁴ This section independently evaluates this question even though some of the content in sovereignty and diversity could be reformulated in terms of efficiency and equity. At a minimum, the terms are a useful shorthand for a set of efficiency and equity issues. One caveat on these risks: the degree of risk to sovereignty and diversity depends on the scope, quantity, and frequency of "harmonizing" efforts. At present, large-scale harmonization seems unlikely as well. It is the fear of such effects, however, that influences the behavior of nations in pursuing limited, if any, harmonization.

Sovereignty concerns arise in both political and academic discussions of cross-border tax arbitrage.¹⁷⁵ Each country is an independent actor in the global scene,¹⁷⁶ directing its primary attention and responsibility to drafting and enforcing its own laws.¹⁷⁷ The fear is that as a country relinquishes its power to design its own tax policy, either by generally basing its taxation on foreign treatment or by pursuing multilateral options, sovereignty would be undermined. Tax rules would, in theory, cease to reflect national policy goals. But why exactly are incursions against sovereignty problematic? Several different answers exist, depending on the context and the values captured by the term "sovereignty."

First, sovereignty can have a loose and somewhat hazy connection to national identity and to the idea that a core power of the country is sacrificed in the pursuit of tax harmonization. This usage most closely tracks generalized objections to harmonization on sovereignty grounds. Second, sovereignty can refer to the values of the political process and decision-making system. In a democratic society, the expectation is that elected officials who are answerable to the voting

¹⁷⁴ Even more classically unilateral measures should be understood to have a strong harmonizing component.

¹⁷⁵ See, e.g., Miranda Stewart, *Commentary [on E.U. Harmonization]*, 54 TAX L. REV. 111, 123 (2000) ("Sovereignty is the defining feature of a nation state in public international law; in a sense, it can be 'equated with Statehood.'" (quoting Ramon J. Jeffery)).

¹⁷⁶ See, e.g., Sol Picciotto, *The Regulatory Criss-Cross: Interaction Between Jurisdictions and the Construction of Global Regulatory Networks*, in INTERNATIONAL REGULATORY COMPETITION AND COORDINATION 89, 98-99 (William Bratton et al. eds., 1996) (examining the concept of sovereignty). In contrast, under a federal system, the states may be equal, but they are ultimately superceded on many fronts by the national government. See, e.g., Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 895 (1992).

¹⁷⁷ See, e.g., Picciotto, *supra* note 176, at 98 ("Some restrictions on the apparently unlimited power to adopt national policies in the common interest are accepted as resulting from the need to bargain with other formally equal sovereigns on the basis of the national interest of each . . .").

public design tax policy ever-cognizant of their connection to the electorate.¹⁷⁸ As the locus of decision making shifts to a more global setting, the connection between the national electorate and the power center is weakened.¹⁷⁹ Sovereignty, understood as national self-determination, is undermined. The fact that current political reality may not match an idealized vision of democracy does not necessarily diminish the rhetorical power of this claim, although it does affect the empirical assessment of how decision making actually changes with a move to more global settings. Finally, sovereignty can serve as a proxy for the pursuit of national interests. It is in this sense that sovereignty plays its most direct role in the balancing test of Part III—in the protection of domestic policy evidenced in the tax rules. When decisions are made at the national level the assumption is that domestic interests are paramount and the goal is to maximize the national interest (understood as national efficiency or identified national policy aims).¹⁸⁰ The shift of the rulemaking power (explicitly, in a multilateral forum, or implicitly, in a matching approach) raises the distinct possibility that the resulting tax rules will not maximize a particular nation's interests.¹⁸¹ Even if the international community designs arbitrage policy to maximize global efficiency, individual nations may be losers. In the absence of lump sum transfers from the winners to the

¹⁷⁸ See, e.g., *id.* ("The exercise of [sovereign] power is legitimated within the state by the generation of consensus around the national common interest through [the] institutions and processes of political participation involving all citizens on a basis of formal equality.").

¹⁷⁹ See David Charny, *Regulatory Competition and the Global Coordination of Labor Standards*, 3 J. INT'L ECON. L. 281, 299 (2000) ("It is much easier to design institutions that are locally democratic than globally democratic, particularly in terms of responsiveness to the 'cultural' aspects of what counts as democratic decisionmaking; moreover, preferences and social circumstances are likely to be more homogeneous within localities than across a set of boundaries."); see also Shaviro, *supra* note 176, at 967–70, 973–74 (considering the role of experimentation and responsiveness to voters in deciding how much discretion state and local governments should have in a federal system).

¹⁸⁰ Admittedly this task is difficult; there are multiple goals, varying time frames, and assorted information constraints. In addition, the competing visions of government behavior (typically public choice and public interest) parallel the Leviathan critique of government action and force us to question fundamental assumptions about whose interests are being furthered. Nonetheless, some version of a national set of interests is likely to emerge. EC Report, *supra* note 3 ("the choice of tax regime in each Member State is determined by the different perceptions of the role of taxation in raising revenue and in serving as an instrument of economic and social policy").

¹⁸¹ Cf. EC Report, *supra* note 3 ("whereas national governments are currently accountable to their legislatures for taxation and expenditure matters, such democratic control is much weaker at the Community level").

losers, not all nations should favor the globally efficient rules.¹⁸² The implications of this aspect of sovereignty are discussed further in Part IV's look at the connections between arbitrage and the tax harmonization debate.

The remaining policy objection to anti-arbitrage efforts regards the impact on tax diversity. Not only is the existence of varying tax systems around the world a natural and expected outcome,¹⁸³ it carries potentially positive effects.¹⁸⁴ The opportunity for countries to experiment with different tax rules allows a range of ideas to circulate, with the most successful rising to more shared prominence. One example of this impact can be witnessed in the history of the United States' Advance Pricing Agreement Program ("APA program") which was developed as an alternative mechanism for resolving certain multilateral transfer pricing questions.¹⁸⁵ At the introduction of the APA program, many taxpayers and foreign countries were skeptical. After several years of observing the program, however, both taxpayers and foreign countries increased participation. Some foreign countries began to design and adopt programs of their own.¹⁸⁶ Had broad global support been required for its implementation, the APA program would have been significantly delayed, if adopted at all. The ability of one or a few countries to innovate on a trial basis, however, enhanced the likelihood of experimentation and percolation, allowing the "best" ideas to gain more universal acceptance.¹⁸⁷

The value of diversity in decision making is well known in the domestic judicial context. One advantage of a multiplicity of judicial circuits is this "percolation" effect. An issue can be examined in several circuits, with each circuit having the opportunity to develop its

¹⁸² See *supra* note 85.

¹⁸³ See, e.g., EC Report, *supra* note 3 ("[t]he existing tax diversity across Community countries is the outcome of trade-offs" in each country regarding efficiency, equity, feasibility, and social policy).

¹⁸⁴ See generally Roin, *supra* note 15, at 557-61 (outlining some benefits from diverse jurisdictions); Alan O. Sykes, *Regulatory Competition or Regulatory Harmonization? A Silly Question?*, 3 J. INT'L ECON. L. 257, 259 (2000) ("The optimal regulatory policy is unknown, and regulatory competition will allow experimentation that reveals information about what is optimal.").

¹⁸⁵ See, e.g., Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. REV. 143 (2000).

¹⁸⁶ See generally ERNST & YOUNG, LLP, GLOBAL TRANSFER PRICING UPDATE, reprinted in 27 TAX NOTES INT'L 553, 557-69 (2002).

¹⁸⁷ Regardless of the long-term future and role of APAs, the observation here regarding the increased likelihood of experimentation where diversity exists, remains.

own resolution. After the various approaches have been tested and critiqued, the most successful should emerge as the widely adopted one (through Supreme Court intervention, purposeful adoption in other circuits, or further federal legislation).¹⁸⁸ If responses to cross-border tax arbitrage demand a high degree of conformity, then opportunities for percolation and gains from jurisdictional diversity will be relinquished. Perhaps the best accommodation here is to pursue more targeted harmonization after the benefits of diversity on a certain issue have been realized.

What weight should be given to the arguments that anti-arbitrage rules¹⁸⁹ may undermine sovereignty and diversity values? There is no question that these goals are valuable. Nations are dependent on revenue collection for their very lifeblood (money) to sustain their governments. Moreover, tax systems developed to satisfy this funding need also implement important nontax policy goals. It is no surprise that governments, politicians, and even citizens express serious reservations about any incursions against these domestic controls. That said, sovereignty and diversity are not limitless goals. For example, sovereignty is already limited by a number of formal and informal constraints. The power of international consensus generated through international organizations such as the Organization for Economic Co-operation and Development (OECD), or the risk of retaliatory measures from other countries, currently constrain national action.¹⁹⁰ Even if sovereignty becomes further constrained by a move to limit some arbitrage, however, that decision does not mandate use of a single response. As explored in Part III, tailoring anti-arbitrage approaches to specific cases is both sensible and feasible.

¹⁸⁸ See, e.g., Ashutosh Bhagwat, *Separate But Equal?: The Supreme Court, the Lower Federal Courts, and the Nature of the "Judicial Power,"* 80 B.U. L. REV. 967, 979 (2000) ("It has long been a predicate of Supreme Court decisionmaking that before the Court grants certiorari to finally resolve an issue, it will often choose to allow the issue to 'percolate' in the courts of appeals, so that the Court has the benefit of multiple perspectives."). Of course in the international context, the percolation cannot be resolved conclusively by a binding decision given the absence of a supranational authority. Nonetheless, a more informal percolation can occur.

¹⁸⁹ Either ad hoc tax treatment mirroring foreign rules or collective agreement on tax rules.

¹⁹⁰ For example, in response to California's effort to impose worldwide unitary taxation, "the Parliament in the United Kingdom enacted legislation . . . that would have authorized retaliation against non-UK-resident corporations that had a presence in a unitary state. Due to changes in California's law, the state at issue, the legislation was never put into force." JOANN M. WEINER, U.S. DEP'T OF THE TREASURY, USING THE EXPERIENCE IN THE U.S. STATES TO EVALUATE ISSUES IN IMPLEMENTING FORMULA APPORTIONMENT AT THE INTERNATIONAL LEVEL (1999), available at LEXIS 1999 WTD 182-23, n.32.

With respect to diversity in tax policy, even in our federal system diversity is not an absolute value. The pervasive scope of federal legislative, administrative, and judicial powers moderate diversity. The balancing of diversity and uniformity on the federal level suggests that they represent "conflicting" goals, managed through compromise on a contextual basis. Individual state decisions provide the opportunity for creative development of policies and programs that enhance local sovereignty and community self-determination. At the same time, certain topics are reserved exclusively (or optionally) to the federal government when the value of uniformity and consistency across state borders is deemed paramount.¹⁹¹ In the end, examples of conflicting state legislation and federal uniformity coexist. The balance between the two categories can shift over time as priorities change. At the international level, there is no immediate risk that creativity will vanish from the tax arena in the near future. No active policy currently on the table calls for a supranational body with full binding authority to dictate tax legislation.¹⁹²

These policy challenges to anti-arbitrage rules force acknowledgment of what can be lost if we seek to eliminate cross-border tax arbitrage. The entire debate arises, however, only because the arbitrage creates efficiency and equity problems at the outset. The sensible resolution involves an accommodation—a balancing—of all the goals. The task in Part III is to recognize the competing policy goals driving the arbitrage debate and to devise a method for coordinating their analysis and resolution. What we should demand is an organized, thoughtful framework for appraising cross-border tax arbitrage, ever-mindful of the fragile but necessary choices we make.

D. *Conclusions on Cross-Border Tax Arbitrage*

Critiques of anti-arbitrage rules raise relevant, and for their scope, seemingly on-target objections. Although it is important to be cognizant of the potential problems and pitfalls, it should be possible to craft an approach to cross-border tax arbitrage that responds adequately to the competing goals of the domestic and "international" tax systems. Perhaps some pessimism regarding anti-arbitrage rules

¹⁹¹ See Nim Razook, *Uniform Private Laws, National Conference of Commissioners for Uniform State Laws Signaling and Federal Preemption*, 38 AM. BUS. L.J. 41, 59 n.88 (2000) ("Among the most significant examples of federally preemptive legislation are anti-trust, pure food and drug, protection of labor, securities, civil rights and consumer laws.").

¹⁹² Even the European Union is very far from substantial tax harmonization. See *infra* note 304.

derives from an unrealistic view of the tax system and too narrow a vision of what could constitute a response to arbitrage. Holding U.S. arbitrage policy to an idealized standard fails to recognize the realities of tax policy making that permeate the system. At no point in the history of the U.S. income tax have we had a completely internally coherent system. Our departure from a Haig-Simons system due to competing policy goals¹⁹³ has produced a tax system without clear lines. We regularly call upon the tax system to balance competing goals in a fairly contextual manner, and we do not label one policy as superceding all others in code design. If efforts to curb arbitrage require line drawing and impose some limits on sovereignty and diversity we should not be surprised or dismayed. A decision to ignore arbitrage, although fairly unambiguous, allows sovereignty, administrability, and diversity to universally trump efficiency and equity. A better choice is to develop a way to evaluate the competing claims on arbitrage. Willingness to consider responses to cross-border tax arbitrage does not mean a response will always be made, or that if made the response will always be the same.

The next step is to develop an approach for arbitrage questions that facilitates and enhances predictable, reasoned determinations and incorporates the range of possible U.S. responses. Establishing an approach does not erase the difficulty of line drawing and goal balancing. That challenging task will remain. What it can do, however, is provide a framework for identifying core features of arbitrages and their relationship to responses, thereby moving the discussion of cross-border tax arbitrage beyond dichotomous characterizations to encourage more comprehensive and creative ways of designing cross-border tax arbitrage policy. Ultimately, successful limits on arbitrage will involve careful consideration of both the nature of the underlying transactions and issues and the range of remedies that can be crafted. The development of such a framework is the subject of Part III.

III. IMPLEMENTING A NORMATIVE FRAMEWORK FOR CROSS-BORDER TAX ARBITRAGE: CHALLENGES AND OBSERVATIONS

A. Introduction

The analysis in Part II supports the conclusion that cross-border tax arbitrage can be a significant problem. The next question, the

¹⁹³ In a purely domestic context, the tax system accommodates competing goals, including efficiency, equity, and administrability.

subject of this Part, is how the United States should develop its response to arbitrage. Although a nation's reaction to cross-border tax arbitrage is unlikely to be flawless and uncontroversial, its policy can follow a reasonable and coherent rationale. Arbitrage analyses and solutions may be somewhat contextual, but they should derive from and contribute to a broader framework.¹⁹⁴ What is this framework that we should be applying?

The answer derives almost explicitly from Part II's delineation of the criteria against which to evaluate the effects of arbitrage. Whether an arbitrage constitutes a problem meriting intervention depends on the evaluation of several goals—efficiency, equity, political accountability, revenue effects, administrability, sovereignty, and diversity. Thus, the ideal framework is a balancing test that would be applied to determine U.S. arbitrage tax policy on a case by case basis.¹⁹⁵ Unfor-

¹⁹⁴ "[A]ddressing them [cross-border arbitrage transactions] on a transaction-by-transaction basis is like attempting to slay the mythological Hydra—you kill one head over here, and [two] more appear over there." *Cross-Border Arbitrage, Check-the-Box Draw Treasury Monitoring Talisman Says*, 4 TAX MGMT. FIN. PRODUCTS REP. 781 (Dec. 17, 1999) (quoting Acting Assistant Treasury Secretary for Tax Policy Jonathan Talisman).

¹⁹⁵ An obvious question follows from this presentation: Is there any real difference between "initial" creation of rules and a "later" revision that justifies a separate process or analysis in the arbitrage context? On a theoretical level there is no valid distinction between initial and revisionary rule making. At all moments in time we have a backdrop of rules and are making decisions about whether to change that backdrop either through wholesale alterations in the law or through modifications and extensions. Either way, the intellectual process should be the same—evaluation of current conditions, goals, and impacts. But on a practical level, there is a difference between cases of (1) changing rules because of arbitrage and (2) drafting rules based on a broad set of facts. Most domestic tax law is drafted without detailed consideration of the intersection with foreign regimes. Examples of this practice include timing rules and entity classification. *See, e.g., supra* note 60 (in the context of entity classification, there was debate about whether to extend the "domestic" plan to all entities given the risk of abuse through conflict with foreign law). Thus, as a practical matter, the serious question of how to handle conflict with rules of other countries often does not emerge until later. Moreover, a cursory glance at foreign tax laws may not reveal the full global implications of the new rules. The existence and details of arbitrages often are not known until the transactions occur. Realistically, one imagines that rulemakers are more educated about and alert to intersections between U.S. laws and policies than foreign ones. That said, important domestic tax law interactions have been missed. For example, the implementation of new accelerated depreciation rules in 1981 combined with available investment tax credits led taxpayers to pursue transactions that were profitable only after taxes. Thus, responses to arbitrage develop differently from general legislation. The process can be understood as one of refinement: round one, enactment of domestic law with loose attention to global interactions (as a practical matter, not because of theoretical limitations); round two, recognition of cross-border tax arbitrage and the need to decide whether and how to respond. The international effects of U.S. tax rules are relevant but not determinative to U.S. tax policy and should be included in a

tunately, the implementation of such a balancing test faces three major constraints and complications: (1) limited information; (2) nationalism; and (3) game theory. The implications of these factors must be explored before we can understand how the balancing test will operate in practice. Thus, this Part is divided into five substantive sections. The first traces the impact of the three constraints on the balancing test. The second considers the techniques available for responding to arbitrage and their relationship to the balancing test. The third explores whether there are any useful simplifications of the initial balancing test that can be adopted. The fourth applies the balancing test to the case studies. The final section offers some observations on the balancing test and its application.

B. *Constraints and Complications for the Balancing Test*

1. Information

Any effort to implement the balancing test requires information on the relevant elements. The difficulties we have experienced in reaching a consensus on the efficiency effects of domestic arbitrages¹⁹⁶ suggest that the efficiency inquiry will be even more complicated in the multi-jurisdictional setting of cross-border tax arbitrage. The issues are newer and less studied, and they implicate additional factors due to the cross-border flows. Moreover, the information necessary to reach conclusions regarding matters such as sovereignty requires projections about the scope of tax policy and the anticipated taxpayer responses to anti-arbitrage rules. Of course, these challenges are not unique to the cross-border tax arbitrage balancing test. The difficulty of the task, however, does not negate its importance. At this point it is sufficient to note that informational constraints are an inherent, but not disqualifying, part of this process.

2. Nationalism

An important question identified in Part II plays a central role in the implementation of a balancing test: Who is applying the test? An individual country (such as the United States) or the international community? The answer seriously affects the conclusions reached re-

comprehensive analysis. This step could be taken in round one, but in reality it often does not occur until round two.

¹⁹⁶ See generally *supra* notes 102-106.

garding the factors, in particular efficiency and sovereignty. For example, in assessing the efficiency effects of a particular arbitrage the conclusions that would be reached if worldwide efficiency were the measure (either CEN or CIN) may differ from those reached if national efficiency were the measure, at least in the absence of guaranteed transfers to the losers under the move toward global efficiency.¹⁹⁷ The absence of a supranational tax authority means that such transfers cannot be compelled. As a result, the balancing test may look different from a national perspective. Of course, it may not be clear who the winners and losers are going to be under a particular rule given limits on information. In that case, countries may be willing, absent another overriding national factor, to assume that global efficiency is sufficiently aligned with national efficiency to be an adequate substitute.

A national perspective will also impact the conclusions reached regarding the assessment of sovereignty in the balancing test. As noted earlier, "sovereignty" functions as an umbrella term for a number of concerns that may follow from an effort to harmonize tax rules to eliminate arbitrage opportunities. The sovereignty definition most relevant here is the use of the term as a proxy for the pursuit of national interests. If the resolution of a given arbitrage question is multilateral agreement on a harmonized rule, that result may not fully reflect a particular nation's interests. This result could occur either because the country is an uncompensated loser in a globally efficient move, or because the country has other policy goals not reflected in the efficiency analysis that are impacted by the change in tax rule. Correspondingly, the nation's own conclusions on the balancing test may be influenced by the risks to sovereignty from a multilateral resolution.

What should be made of these observations regarding the divergence between national and global interests? First, there is a strong temptation (implicit in much discussion of global efficiency) to view all national departures as bad and inherently undesirable. That view is unfair and inconsistent with the standards applied to other arenas of international policy (for example, defense or environment) where an assessment of national interests is presumed to be a critical part of the process.¹⁹⁸ The fact that national interests may form a part of the deci-

¹⁹⁷ Regulatory diversity is unlikely to be a prominent feature in a nationally driven balancing test, given the degree to which it is a common benefit.

¹⁹⁸ See Graetz, *supra* note 4, at 279-80.

sion making does not mean that the nuanced, complicated, and highly interactive dimensions of cross-border tax relations will be ignored. Nor does it indicate that a significant divergence between national and global perspectives should always be anticipated.

Second, the fact that nations, which are the dominant decision-makers in international tax, will evaluate policy outcomes with an eye to national interests is both a political reality and a correlate to representative democracy in a multi-jurisdictional world. National governments represent the interests of their underlying voters, a connection that is an inherent and appropriate feature of the political process.¹⁹⁹

Third, observations about the potential conflict between globally and nationally desired outcomes (due to the existence of uncompensated losers) suggests an important role for international organizations. If these bodies can play a persuasive and credible mediating function by negotiating outcomes that recognize the possible losers and seek to compensate their losses directly or indirectly, the gap between global and national perspectives on the balancing test may be narrowed.

3. Game Theory

An obvious consequence of the fact that decisions about arbitrage and the balancing test are initially undertaken by nations on an individual basis is the importance of game theory predictions in a nation's calculation of not only whether, but also how, to respond to arbitrage. For example, if a country concludes that the continued existence of a particular arbitrage is undesirable it might contemplate both unilateral and multilateral responses. Depending on the predicted reaction of other nations to those responses, the original country may modify its anti-arbitrage plan. This need to take other nations' actions into account further complicates an already challenging balancing test. Examples of the interactive effects of nations' behavior are considered in the following discussion of response options. As we develop more experience with cross-border tax arbitrage and with anti-arbitrage strategies, we can apply a sophisticated understanding

¹⁹⁹ Of course, there remains the question of precisely whose interests the national decisionmakers are pursuing. See *supra* note 180.

of game theory to anticipate and structure behavior, refining the application of the balancing test.²⁰⁰

4. Comments on the Balancing Test Complications

The preceding review of the effects of limited information, nationalism, and game theory on the application of the balancing test is not an indictment of balancing. These factors would likely impact any alternative approach as well. Understanding their role, however, helps us predict the strengths and weaknesses of the balancing test as it would be applied in practice. The next step is to identify the possible responses that the United States could pursue if the balancing test indicates that action should be taken.

C. Options for Eliminating Arbitrage

The determination that an arbitrage example is sufficiently troublesome to warrant government intervention still leaves a significant question unanswered: What kind of response is appropriate? The decision can be broadly characterized as a choice between unilateral action and multilateral action. This depiction, however, greatly oversimplifies the reality of crafting arbitrage responses. First, the distinction between the balancing question of whether to respond and the implementation question of how to respond is not so clear. Although the two questions can be usefully separated, their analyses are inherently interactive. Knowledge of the likely effects of various anti-arbitrage rules may influence the decision of whether to respond.

Second, the broadly described categories of responses (unilateral and multilateral) are not mutually exclusive and may be used contemporaneously, sequentially, or conditionally as part of a response plan. For example, the United States could decide to pursue unilateral action first, with the expectation of forcing other countries into a dialogue.²⁰¹ Conversely, the United States could seek a multilateral change first, with unilateral action as a backstop. The multilateral approach could be preferable if the United States anticipated that a unilateral move would elicit a retaliatory response by the other country

²⁰⁰ For a sense of the range of interactions captured by game theory analysis, see, for example, ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* (2001).

²⁰¹ At a minimum, a nation can adopt unilateral measures either as an interim or longer-term strategy.

without leading to multilateral dialogue.²⁰² A multilateral approach could also be advantageous if there is limited support for a rule change domestically (for example, because of agency capture). Evidence of an emerging international consensus would lend support and power to a domestic effort to change the tax treatment.

Third, the definitional distinction between unilateral and multilateral action is not as strong as it initially appears. Depending on what type of unilateral response is adopted, it may be very close to certain multilateral scenarios. For example, if a country decides unilaterally to institute a matching rule (it will follow the tax treatment provided in the other country to the transaction) or to change its substantive rule to correspond to the dominant global treatment of the transaction, a notable degree of harmonization has been achieved.²⁰³ In fact, the difference between this picture and one in which, as a result of multilateral discussion, a few countries change their rules to reflect the global trend, may be minimal.

Fourth, the category of multilateral action is itself complex and includes various options. Although the process underlying a multilateral response should include dialogue and opportunity for debate among nations, it need not take a particular form nor include the ceding of authority to a multilateral body. In fact, change may not be necessary for many countries depending on the degree of convergence already evidenced in their tax rules. The scope of multilateral dialogue can range from bilateral to small group to highly inclusive discussions, based on the degree of interest, the complexity of the issue, and the anticipated reaction of different parties.

Despite the interactive and complementary aspects of unilateral and multilateral responses, they do differ in terms of the degree of explicit discussion and cooperation they entail. Thus, an obvious question arises: When is a multilateral approach likely to be successful? One can identify a subset of cross-border tax arbitrage issues particularly suited to multilateral resolution, including cases in which: (1) the problem is of a significant scale (to justify the intervention and efforts of numerous nations); and (2) the subject is a somewhat arbi-

²⁰² See *infra* text accompanying notes 255–256.

²⁰³ Unilateral harmonization can be considered “implicit cooperation” by “defer[ing] to other countries by limiting the scope of regulatory jurisdiction or providing *de jure* or *de facto* national treatment to foreign nationals.” Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 Nw. J. INT’L L. & Bus. 241, 248–49 (1991).

trary tax designation (such as corporate residence)²⁰⁴ or a developing trend (for example, accrual taxation, transfer pricing rules, or subpart F rules).²⁰⁵ Of course, even where harmonization of tax rules is achieved at the multilateral level, there still remains the potential for arbitrage. Although the rules on paper may be uniform, there can be significant differences in the application of the rules, creating de facto arbitrage (at least where the enforcement variations are predictable and known).²⁰⁶ In this case, though, where countries share the same formal rules, procedures for resolving inconsistent rule applications may be realistic.

D. *Simplification?*

The foregoing identification of the balancing test and its inherent complexities raises the question of whether there is any way in which to simplify the arbitrage inquiry a country needs to undertake. Several potential simplifications are considered below.

1. General Soak-up Rule

Assuming the existence of cross-border tax arbitrage will not be ignored (which is the "simplest" course of action), one simplifying possibility is to adopt a general "soak-up" rule as the preliminary U.S. position. Specifically, the rule would state that the U.S. tax treatment reported by a taxpayer for a transaction must match the treatment in the corresponding foreign jurisdiction (similar to a rule that required tax/book conformity). One advantage of this rule is that it does not require the government first to identify particular arbitrages and prescribe the tax reporting. In theory, it captures all arbitrages without the government even knowing they exist. Additionally, this rule is seemingly globally efficient by removing, for example, the "extra" deduction while securing the resulting revenue bonus for the United States (motivating the label "soak-up" rule). Upon further considera-

²⁰⁴ The arbitrary quality of the designation does not mean that countries would not have intense views.

²⁰⁵ These would be issues for which the percolation of ideas may be more complete, and substantial consensus already underway independent of the arbitrage.

²⁰⁶ This reality was recognized in the IFA symposium on double-dip leasing. Participants discussed moving toward a uniform rule on asset ownership for depreciation purposes, but then noted that, even if all countries adopted an economic substance rule, the final determinations might vary because of differences in application of the standard. See *supra* note 45 (discussing IFA report on cross-border leasing).

tion, however, this course of action is less desirable than it appears and fails to deliver the predicted benefits for several reasons.

First, the broadly drafted rule applies not only to arbitrages intentionally pursued by the taxpayer, but any case in which the tax treatment in the other country differs. We can assume that taxpayers in the "intentional" arbitrage cases are aware of the tax conflict and are equipped to delineate the differences on their returns. The same reporting obligation, however, would be imposed on a taxpayer who may not be aware that the other party to the cross-border transaction receives different tax treatment in the other country. Of course, the U.S. taxpayer could, as a condition of all cross-border transactions, require the counterparty to provide a disclosure as to anticipated tax treatment. In reality, the transaction costs of pursuing the information and the likely success of obtaining it may make this rule unduly burdensome for taxpayers.

Second, even though the rule as proposed does not require the United States to specify the particular form of the soak-up (that is, exactly what change to U.S. tax treatment will occur as a result of the conflict in countries' tax treatment of the transaction), that determination must be made by the taxpayer upon filing, and by the government upon audit.²⁰⁷ In some cases the answer may seem relatively obvious. For example, in the case of a DRC, the expectation might be that the U.S. deduction for the loss should be denied. But upon closer inspection the answer can be more confusing in the absence of case-specific guidance. Should the U.S. loss be denied only where the foreign loss is actually taken and used to reduce foreign income? Or should the residency of the DRC be reported differently because the real conflict is in residence rules? Or should the U.S. group be deconsolidated? Each of these choices creates different effects for the U.S. taxpayer, and each could be viewed as an appropriate soak-up response to the existing conflict with the other country. Of course, there will even be debate in some cases as to whether the reporting in the other country is truly in conflict with the U.S. tax treatment. Again, using the DRC case as an example, the case study scenario paints a fairly uncontroversial picture of conflicting tax rules. But what about more convoluted methods for obtaining a comparable benefit²⁰⁸ that do not involve a single entity or transaction with

²⁰⁷ The phrase "soak-up" may imply that the rule could just provide that the United States will tax if the other country does not, but that enunciation of the rule still requires a determination of each country's tax treatment for a given transaction.

²⁰⁸ See Rosenbloom, *supra* note 2, at 157-59.

conflicting treatment in the two countries? Would such substitute transactions be captured in this broad soak-up rule?

Third, even though the broad soak-up rule seems to promote efficiency by limiting the arbitrage benefit, closer inspection suggests that this may not be true. In the absence of any case-specific inquiry we do not know whether taxpayers are likely to shift to more costly substitute transactions²⁰⁹ (for example, an alternative to the DRC).²¹⁰ Also, the arbitrage under attack by the soak-up rule may, in reality, be an efficient taxpayer response to existing tax conditions that cannot otherwise be remedied through a more direct alternative. This is an empirical question that would require a case-specific review to be answered.

Fourth, the soak-up rule does not take into account whether adoption of such a unilateral move is the best first move for the United States. For example, depending on the context, that move may be considered aggressive and lead to a retaliatory response. Finally, a comprehensive soak-up rule does not allow for the possibility that the United States might view the arbitrage as advancing U.S. policy. For example, if the underlying U.S. tax rule seeks to implement particular policy goals, such as investment, it is possible that the benefits from an arbitrage transaction involving that investment would be interpreted as furthering the U.S. policy on that behavior. Given these significant reservations, a broad soak-up rule is unlikely to be a desirable U.S. response to the existence of cross-border tax arbitrage.

2. Modified Soak-up Rule

Another potentially simplifying possibility could be a modified soak-up rule that tried to take account of some criticisms of the general soak-up rule. In the modified rule, the United States would specifically identify both the arbitrage cases covered by the rule and the reporting treatment expected. Ambiguity, due either to uncertainty as to the foreign treatment or as to whether such treatment should be viewed as in conflict, would be substantially eliminated. The remaining three critiques from the broad soak-up rule, however, continue to apply. The very reason this soak-up rule is appealing (it requires no further inquiry once an arbitrage has been identified because the response to all identified arbitrages is predetermined) may

²⁰⁹ See, e.g., Schizer, *supra* note 169, at 1315–16.

²¹⁰ See Rosenbloom, *supra* note 2, at 157–59.

cause it to be inefficient. Only a context-specific analysis would reveal whether in fact it is truly efficient to curtail the arbitrage (either because of costly substitutes or because the arbitrage offers taxpayers second-best self-help in resolving an existing inefficiency).

The modified soak-up rule also fails to evaluate the potential game theory implications of an arbitrage that may make a different response a better first move. This behavioral observation also relates to the expectation that the unilateral move will be revenue-generating for the United States.²¹¹ If the other country implements a comparable rule, it is not clear that the United States will gain any revenue bonus, especially when the possibility of substitute transactions exists. Finally, an automatic response to enumerated arbitrages does not consider whether any U.S. policy is furthered by the arbitrage.

None of these objections is meant to suggest that the United States should not seriously consider unilateral action in response to the existence of cross-border tax arbitrage. What these observations do, however, is challenge the suggestion that unilateral action should be adopted as the United States' automatic first move for arbitrage.²¹²

3. Rough-Cut Balancing

Perhaps the most realistic accommodation that should be made in the context of implementing the balancing test is simply to recognize that the determinations reached regarding the various factors will be inherently uncertain, debatable, and subject to change (whether, for example, upon acquisition of additional information in the case of efficiency assessments, or upon a change in underlying information in the case of shifting government policy). We should not hesitate to pursue the balancing test just because we cannot measure the different elements with a high degree of confidence. The very reasons that this task is difficult make any alternative path risky as well. It is possible that in the future, with more experience in arbitrage analysis, we may be able to draw conclusions about the likely

²¹¹ See, e.g., *infra* note 256 and accompanying text.

²¹² The availability of multilateral forums will be relevant in balancing the efficiency and game theory concerns. A unilateral first move that elicits retaliation may be undesirable if it unduly discourages certain transactions, and multilateral dialogue is unlikely (resources, attention, time, and political capital are not unlimited and may mean many issues will not reach the multilateral agenda). Similarly, if past experience indicates that immediate multilateral agreement is unlikely (see, for example, double-dip leases), then unilateral action should not be premised on the assumption that it will only be short term and a multilateral resolution will be achieved promptly.

balancing outcome of certain categories of arbitrage and therefore consider adopting a rebuttable presumption regarding their treatment. At present, however, there is no indication that we have developed enough experience with the balancing test to implement such an option.

E. *Application to the Case Studies*

In order to gain a sense of how the balancing test can be applied, this section turns to the major arbitrage examples outlined in this Article. The mission is to sketch how the test can be used to guide U.S. tax policy, what kinds of questions it prompts us to consider, and what inquiries it requires us to make. Rather than pursue an exhaustive examination of each case, the analyses focus on the unique features of each arbitrage most likely to influence the balancing, including efficiency, line drawing, substitutability, sovereignty (especially national policies), and response options.

1. Original Issue Discount Bonds

How would the test apply in this context? The basic problem is a distortion driven by the conflict between U.S. and Japanese timing rules.²¹³ The U.S. policy (not perfectly achieved) of taxing interest income in accordance with economic accrual governs the U.S. party to the transaction (the U.S. corporate issuer).²¹⁴ As the efficiency analysis in Part II suggested, we might anticipate that U.S. issuers could offer lower rates of return, which would be good from a U.S. perspective in that it allows those corporations a lower cost of capital—at the expense of the Japanese Treasury. Analysts have suggested that the empirical results from this arbitrage indicate that the U.S. corporate issuers are the economic winners (with a lower cost of

²¹³ See *supra* text accompanying notes 38–42.

²¹⁴ The United States has an accrual rule which it views as better approximating economic income than prior “wait until the end” rules. The effect is not perfect because tax rules assume a steady yield to maturity which may not match the structure of interest rates on longer-term bonds. See, e.g., Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking Into Account the Term Structure of Interest*, 44 *Tax L. Rev.* 335, 348 (1989). The accrual rule is not uniformly implemented. For example, the taxation of market discount bonds differs from that of OID bonds despite their economic comparability. Administrability likely explains the greater flexibility granted market discount bonds. See, e.g., *supra* note 36. In other contexts, the current accrual approach of OID is limited. See, e.g., I.R.C. § 163(e)(3)(a) (2000) (denying a current deduction under certain circumstances for OID on bonds held by related foreign persons).

funds due to the arbitrage) at the expense of the Japanese taxpayers.²¹⁵

To the extent the arbitrage shifts more Japanese investors to the U.S. bond market there may be some effect on the mix of bonds issued in the United States (OID v. coupon bonds).²¹⁶ Even if a shift toward OID bond issuances develops, it seems unlikely to produce a dramatic revenue cost for the United States. That is, although U.S. issuers might be inclined to issue more OID bonds (possibly leading to less interest income being taxed by the United States),²¹⁷ the resulting lower cost of capital should correspondingly reduce the size of interest deductions reported by the U.S. issuers.

With the likely domestic benefits and the minimal impact on underlying tax policy (accrual), the OID case presents little impetus for a unilateral U.S. response (denying the U.S. issuer's OID deduction). The dominant U.S. policy involved (economic taxation of interest) would be ill-served by any unilateral move away from current rules. Thus, the United States should not under these circumstances adopt cash-basis taxation here (the equivalent of a unilateral move). The preferable action would be a "multilateral response," with the actual action occurring on the Japanese side. The U.S. OID rules are part of a trend to design income tax rules that are more consistent with concepts of economic income, thereby decreasing distortions. To the extent countries adopt tax rules grounded in economic accrual, regulatory conflict and arbitrage opportunities diminish. Although many rules have an "arbitrary" component that precludes viewing one country's rules as superior, the OID regime arguably has a stronger claim to correctness. The preferable multilateral response in this context would be a recognition of the global value of economic taxation, particularly in financial transactions. Given the trend toward eco-

²¹⁵ See SCOTT & WELLONS, *supra* note 41, at 1034. Potentially the United States could lose tax revenue if a larger portion of bond investors bear no current U.S. tax as compared to the pre-arbitrage world. Actual calculations here would require determinations of whether investors constitute additional participants or direct replacements of taxable parties. Further complicating the prediction is the observation that, if U.S. issuers obtain a lower cost of capital, then their interest expense deductions should be smaller.

²¹⁶ The answers to these empirical questions are not simple, and at present they have not been explored in the economic and tax literature. Fortunately, however, detailed resolution of this specific arbitrage case is not critical to the more comprehensive question of how to think about arbitrage problems in general.

²¹⁷ As outlined earlier in Part II, this result would depend on a number of assumptions about the role of the Japanese purchasers and whether they replaced existing taxable bond holders or constituted an additional pool of investors. See *supra* text accompanying note 119.

conomic accrual taxation, at least for debt and interest, Japan would be urged to join this trend. The arbitrage example would serve as an occasion to reconsider its own domestic policy. Although countries may be wary of instituting accrual rules for market discount bonds, given the degree of sophistication required for compliance, that concern seems weak in the OID context where the issuer can provide the holder the data necessary to report income. Japan, however, continues its schedular withholding tax approach to interest, which does not reflect economic taxation (in some cases, the amounts are not even treated as interest and tax is due at redemption).²¹⁸

2. Double-Dip Lease

Recall that this arbitrage derives its values from two elements: (1) the accelerated depreciation deductions which are frequently incentive-based departures from economic depreciation; and (2) the asset ownership rules—where tradeoffs between administrability (for example, ownership based on title) and substance (for example, ownership based on economic indicia) set the stage for conflict.²¹⁹

The primary function of accelerated depreciation deductions has been to foster investment activity. The cross-border tax arbitrage opportunity here presumably enhances that incentive.²²⁰ Of course, the investment goals of Congress may have been more nuanced—that is, Congress may have sought investment at a particular level, with particular countries, balanced across particular industries. The availability of the arbitrage might change these levels. For example, as described in Part II, to the extent some or all of the benefit inures to the U.S. lessee, it will presumably be able to make further investments in airplanes (their lower costs allow them to charge lower fares). How positively that investment should be viewed depends on why we encouraged investment initially and whether we are concerned, past a certain point, about the U.S. lessee's advantage in competing with other U.S. businesses (for example, transportation or entertainment) that cannot obtain a comparable benefit.

Without good evidence of the intended scope of the investment incentive, or the degree to which the arbitrage varies from it, unilat-

²¹⁸ See *supra* note 38.

²¹⁹ See *supra* text accompanying notes 45–49.

²²⁰ Depending on which party obtains the net tax benefit, U.S. investment in planes will be increased (a little or a lot) or unchanged.

eral denial of ownership benefits may not be appropriate.²²¹ The existing U.S. tax benefit for investment (the value of the acceleration) may represent Congress's ideal incentive, or may represent the most Congress could "allot" to this policy. If additional benefit accrues to a U.S. taxpayer through the arbitrage intersection, it is not clear this result would be viewed negatively. Moreover, if the United States unilaterally eliminated the double-dip arbitrage by denying accelerated deductions to the U.S. party, the net effect is unpredictable and turns on how the market has priced the transaction. Unless the market equilibrates domestic and cross-border acquisitions, the U.S. acquiror may now favor domestic purchasers untouched by the anti-arbitrage rule.

A multilateral review of the rules underlying double-dip leases (the conflict as to whether economic substance or legal title should determine ownership in leasing transactions) offers an alternative approach for constraining leasing arbitrage. Some initial multilateral steps have been taken; the International Fiscal Association (IFA) examined the issue as its primary topic during the 1990 Congress. Unfortunately, little consensus emerged from the process. The 1990 IFA General Report on Cross-Border Leasing (General Report) suggested a uniform designation of all cross-border leases as operating leases (a binding default classification).²²² The IFA Resolutions Committee, following upon the work of the General Report, observed that many of the industrial nations from which most leasing activity derives rely on economic analysis to classify leases as either operating or finance.²²³ Accordingly, its resolution recommended harmonization through reliance on an economic characterization, not through the "random" selection of a legal classification (for example, deeming all leases to be operating as proposed by the General Report).²²⁴ Presumably, the expectation was that if countries all attempted to classify and tax leases on the basis of their economic substance, then there would be widespread harmonization. The resolution urged the OECD to study this problem and make recommendations to its members on

²²¹ In addition, unilateral denial of accelerated deductions that turns on foreign taxation will raise the burden of proof, information, and documentation issues identified earlier, where the counterparty is unrelated to the U.S. taxpayer.

²²² IFA General Report, *supra* note 7, at 44. The idea of a uniform characterization had been articulated before. See, e.g., Park, *supra* note 43, at 176 (asserting that "Treasury and OECD should encourage adoption of the accountants' standards in income tax treaties for all provisions, including withholding rates and source of income, that involve lease characterization").

²²³ IFA General Report, *supra* note 7, at 29-30.

²²⁴ *Id.*

harmonization possibilities, ranging from unilateral to bilateral and multilateral action.²²⁵ Thus, even within the IFA, divergent views as to the appropriate treatment of double-dip leases reigned and little real consensus was achieved.²²⁶ In fact, the General Report had considered the option of harmonization ultimately advocated by the Resolutions Committee, but it concluded that "[i]t must be regarded as impossible to make all countries agree on making a distinction between operating and finance leases and to do it the same way."²²⁷

The IFA's failure to achieve a consensus on this question suggests that the desire for uniformity is not strong enough for countries to depart from their individual preferences for economic substance or legal ownership standards and commit to compromises on ownership classification schemes. Or perhaps, even more likely, countries perceive an export incentive operating in the double-dip lease,²²⁸ and thus, are less inclined to cooperate to remove that incentive.²²⁹ This view, if adopted by France in the case study, would presume that the planes sold were French-manufactured. If French lessors could achieve the same arbitrage benefit by acquiring planes from a U.S. manufacturer and then leasing them to U.S. airlines, then France's export effect would diminish or vanish.

Individual countries have in fact demonstrated a variety of reactions to double-dip leases (although one notable theme seems to be a lack of significant concern where the arbitrage is perceived to facilitate exports).²³⁰ In leasing transactions, the United States has advanced its more general theme of economic "substance over form"²³¹

²²⁵ *Id.*

²²⁶ See, e.g., Andersson, *supra* note 43.

²²⁷ IFA General Report, *supra* note 7, at 44.

²²⁸ The U.S. tax benefits for outbound leases have been dramatically curtailed by domestic restrictions on depreciation deductions for property used outside the United States. See I.R.C. § 168(g) (1) (A) (2000).

²²⁹ Also, it is important to note that IFA is not a governmental-based organization; thus many of the participants are tax practitioners who may hold different views on the arbitrage.

²³⁰ See, e.g., Andersson, *supra* note 43 (anticipating that countries will not be quick to eliminate tax benefits that aid exports); see also IFA General Report, *supra* note 7, at 32 (concluding that many of the countries providing National Reports on leasing did not have special domestic tax rules for double-dip leases, and seemed to indicate little interest in the foreign taxation of the lease transaction).

²³¹ See, e.g., *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) ("The incidence of taxation depends upon the substance of a transaction. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."). This

(at least where there is "strong proof" that the substance differs from the form).²³² In the cross-border context, however, the United States has hesitated to accept readily a taxpayer's reliance on substance where it contradicts the form, particularly where that form is accepted by the foreign country.²³³ This position could stymie arbitrage by U.S. taxpayers who are often nominally the lessee of a counterparty in a jurisdiction that relies predominantly on "legal ownership." In such cases the U.S. party would need to make a successful substance-over-form claim to obtain the double-dip benefits. The Service, however, has recently suggested that dual-tax ownership in a double-dip lease will not be a concern where it derives from differing tax rules governing ownership.²³⁴ Thus, if the foreign jurisdiction implements a different ownership rule (for example, legal title), the United States will not be particularly stingy in accepting the U.S. taxpayer's substance argument. But if the dual ownership arises where the United States and the other country have the same (or not clearly different) legal rule for ownership yet reach opposing conclusions, the Service will scrutinize the U.S. taxpayer's claim of ownership.²³⁵ Why? The latter case poses a significant risk that different facts were presented to the two governments.²³⁶ The U.S. decision, previously more tacit and now more explicit, to allow certain double-dip leases comports with this paper's analysis. The basis for U.S. unilateral intervention is limited given the intentional subsidy policy underlying the accelerated depreciation deductions (and tax credits).²³⁷ This leaves the international community to prioritize the risks of this arbitrage.²³⁸

expressed aspiration has not always matched the resulting tax analyses. Moreover, the distinction between substance and form may not always be easily ascertained.

²³² See, e.g., IRS Coordinated Issue Paper, *supra* note 22, at L-3; Tech. Adv. Mem. 97-48-005 (Nov. 28, 1997).

²³³ See, e.g., Andersson, *supra* note 43; Tech. Adv. Mem. 97-48-005 (Nov. 28, 1997).

²³⁴ Tech. Adv. Mem. 97-48-005 (Nov. 28, 1997).

²³⁵ *Id.*

²³⁶ *Id.*; see also *Coleman v. Comm'r*, 87 T.C. 178, 203-04 (1986) (relying on a "strong proof standard" in a cross-border lease transaction for the U.S. party to claim ownership contrary to the form of the transaction).

²³⁷ Nothing in this analysis, however, should be taken to suggest that Congress should not revisit its decision to offer incentives for certain investment activities. Other countries have made such changes. See *infra* notes 239-244. The merits of Congressional policy to encourage particular taxpayer behavior is always open to reconsideration in light of additional information, changed factors, and shifting priorities.

²³⁸ The U.S. willingness to challenge, or at least investigate, some leasing cases does not contradict this conclusion for no unilateral action. The United States targets cases in which the contradictory ownership conclusions may be due to taxpayer misrepresentation, not national sovereignty.

Although the current lack of success in mobilizing the international community may indicate a limited value placed on this arbitrage problem, there are other indicators that the arbitrage could be one well-suited to a multilateral resolution. A series of recent changes in countries' tax laws have reduced the attractiveness of cross-border leasing. These changes included more limited investment tax credits, lengthened depreciation periods, reductions in the corporate tax rate, and attacks on leasing transactions that constituted shelters.²³⁹ A few of these changes targeted cross-border leasing specifically. Most changes belonged to a family of tax reforms affecting corporations and investments more generally. For example, in August 1996, proposed changes to Japan's declining balance depreciation method were announced and dampened interest in the Japanese cross-border leveraged leasing market.²⁴⁰ Previously, Japan had taken center stage in much aircraft leasing.²⁴¹

The original U.S. partner for double-dip airplane leases had been the United Kingdom (a U.K. lessor and a U.S. lessee). At that time, the United Kingdom had high tax rates and up to 100% write-off of cost in the first year of investments.²⁴² Later, however, the U.K. tax authorities diminished the appeal of these double-dip leases by imposing special rules for leases with a foreign user, perhaps indicating the United Kingdom did not believe the rules advanced the interests of U.K. plane manufacturers (either because the planes involved were manufactured outside the United Kingdom, or because the United Kingdom did not intend that incentive).²⁴³ Changes in the U.K. tax rates and first-year recovery rules further limited interest in the leasing. Whether broad-based support for a multilateral response to double-dip leasing develops will depend in part on the degree to which the changes in investment and corporate taxation reduce the volume of arbitrage. Further multilateral discussion along the lines of the IFA

²³⁹ Cf. Andersson, *supra* note 43, at 2.

²⁴⁰ See Akira Akamatsu & Christopher P. Wells, *Japanese Tax Bureau's Bombshell Puts Leveraged Lease Market in a Tailspin*, 13 TAX NOTES INT'L 1763 (1996); Richard S. Koffey & Richard L. Umbrecht, *Japanese Cross-Border Leasing into the United States*, 43 TAX LAW 149, 149 (1990) (citing Japan as a growing and significant source of cross-border leasing into the United States).

²⁴¹ See, e.g., Rice, *supra* note 43, at 1036-37 (noting the prominence of Japan in aircraft leasing); Thorold Barker, *Airlines Seek Turbulence-Free Ride from Currency Exposures: To Hedge or Not to Hedge Is a Thorny Problem That BA and Other Airlines Must Address*, FIN. TIMES (London), Feb. 12, 1999, at 18 (leverage leasing with Japanese parties served as an attractive financing option "until the Japanese government changed the law this year").

²⁴² Rice, *supra* note 43, at 1035.

²⁴³ *Id.*

dialogue may be valuable for national regulators, even if agreement continues to prove elusive.²⁴⁴

3. Dual-Resident Corporations

Through conflicting residence rules, DRCs benefit from the ability to use a DRC's loss against the income of the local related group in two separate jurisdictions.²⁴⁵ In the extreme this could lead to complete nontaxation of income and loss of government tax revenue with its attendant effects.²⁴⁶ Thus, an initial question is what analysis underlies U.S. selection of its residence rule. The U.S. incorporation rule prizes administrability²⁴⁷ over a substantive connection²⁴⁸ between country and corporation. This administrability goal remains preserved in the DRC arbitrage despite other effects from the arbitrage.

With respect to the broader role of DRCs, the United States anticipated that domestic corporations would be at a competitive disadvantage in vying with foreign DRCs for acquisition of U.S. corporations because of the added value of the U.S. corporations to the DRC. The accuracy of these predictions is debated, and they seem insufficient to establish a strong risk to U.S. policy that should be defended through unilateral denial of the losses. Although it may be appropriate to eliminate one set of deductions, no clear grounds exist for the United States to be the country making that change. Moreover, the other country in the pairing would likely have comparable interests and incentives and could quickly react to a unilateral U.S. move to seize the available revenue (that is, deny the deduction). In contrast with the previous case, double-dip leases, the DRC arbitrage is not based on an incentive driven tax rule, thus other countries may be more likely to react by withdrawing their "tax benefit" as well. Also, the DRC involves related (in fact, consolidating) parties; therefore, a

²⁴⁴ See Sykes, *supra* note 26, at 66 (explaining that "it is valuable for national regulators to participate actively in international standard-setting activities, even if those activities do not result in a standard because of insufficient consensus").

²⁴⁵ See *supra* note 132 for a numerical DRC example.

²⁴⁶ See *supra* text accompanying note 132. Whether the existence of the benefit will lead foreign owned DRCs to acquire U.S. corporations at a competitive advantage over U.S. purchasers is less clear.

²⁴⁷ Places of incorporation can be readily determined in most cases.

²⁴⁸ Such a "connections" residence test requires evidence as to the corporation's conduct of affairs with a potentially fact-intensive review.

country may be less concerned about conditioning domestic tax treatment on the tax treatment in the other country.²⁴⁹

Ultimately, Congress targeted DRCs. The U.S. Senate Finance Committee determined that a corporation that uses its losses to offset foreign income should not be able to use those same losses to reduce another corporation's U.S. income. The rationale was that domestic investors were being discriminated against vis-a-vis foreign investors because the latter could enjoy a double benefit.²⁵⁰ (This investor discrimination concern resurfaced in legislative history regarding the domestic reverse hybrid.)²⁵¹ The Committee proposed that losses of a foreign-owned DRC be prevented from reducing the taxable income of other U.S. corporations in its consolidated group. The ultimate statutory reform enacted in I.R.C. § 1503(d) in 1986 provided that "[t]he dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year."²⁵² Regulatory authority was granted to exclude DRC losses that did not offset a foreign corporation's income under foreign law.²⁵³ The U.S. course of action raises the question of why Congress felt compelled to act in a case in which the balancing test suggests it may not have been advisable to do so unilaterally. Based on the legislative history and commentary surrounding the arbitrage,²⁵⁴ the most likely answer is a combination of strong pressure from U.S. corporations and a powerful sense of outrage at what seemed an insultingly blatant thwarting of the single-tax principle. In addition, unilateral action was available to Congress whereas multilateral action would typically require the administration's involvement.

After the United States implemented rules denying DRC losses, the United Kingdom responded in 1988 with a regime. The United States anticipated this move by the United Kingdom and specified in

²⁴⁹ See *infra* Part III.D.1, raising the question of whether taxpayers have adequate information to report on taxation in the other country.

²⁵⁰ See S. REP. NO. 99-313, at 420-21 (1986) ("The committee believes that the dual resident company device creates an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations."). See *supra* text accompanying notes 135-139.

²⁵¹ See *supra* note 150.

²⁵² I.R.C. § 1503(d) (2000).

²⁵³ See JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1066 (1987).

²⁵⁴ See *supra* notes 135-139.

the legislative history of I.R.C. § 1503 that the exception for DRC losses not used in the other country would not apply to situations in which the foreign country adopted a "mirror" rule denying use of DRC losses.²⁵⁵ Congress feared that in such cases the combination of the foreign country's denial of loss and the United States' exception from loss denial would effectively allocate all gain from the attack on dual consolidated loss arbitrage to the foreign fisc.²⁵⁶ The potential for no loss deduction in either country seems undesirable as measured against goals of efficiency and equity. In fact, the legislative history specifically advocated the use of bilateral agreements to share the gains from eliminating the DRC benefits.²⁵⁷

The possibility remains that members of the global community may identify residence rules as one of those pockets of regulation susceptible to greater harmonization, thereby resolving the efficiency and equity problems of the arbitrage. This change would likely come with little harm to diversity. The issue of "residence" has been brewing from the early days of cross-border taxation, allowing ample time for percolation of ideas. In terms of sovereignty, residence rules are less likely to be embedded in domestic tax policy because they are inherently international in nature. Of course, conflict remains possible if countries believe (accurately or not) that they may be losers in the process (either because of the harmonization itself or because of the specific residence rule chosen). The DRC outcome highlights a potential risk of unilateral action—retaliation that results in inefficient taxation. The fact that the taxpayers may be avoiding problems by not using DRCs does not demonstrate that the unilateral moves were successful tax policy. The taxpayers might be pursuing less desirable substitute transactions. Of course, taxpayers might have developed alternatives even in the presence of a coordinated bilateral reaction to DRC benefits. The double denial of losses in the current government positions, however, might have hastened the pursuit of planning alternatives.

²⁵⁵ JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1065 (1987) ("[T]he United Kingdom has indicated that it will seek to prevent the use of interest-deduction related losses generated by U.S. corporations that are U.K. residents against the taxable income of other U.K. residents.").

²⁵⁶ *Id.* ("Congress . . . did not intend that such a rule of foreign law cause all the revenue gains from termination of the [DRC] device to inure to the benefit of the foreign revenue authority.").

²⁵⁷ *Id.* at 1066.

4. Hybrid Entities

The last of the case studies is perhaps the most controversial. The increased feasibility of creating a hybrid entity whose classification differs across national borders has ushered in a new era of arbitrage opportunities. Their success depends heavily on conflicts in entity classification, particularly those conflicts enhanced by the U.S. check-the-box regime. Despite this common thread in the hybrid entity arbitrages, each arbitrage case requires a different government response. Therefore, it makes sense to address the two hybrid entity examples separately.

In the domestic reverse hybrid entity case,²⁵⁸ the combination of conflicting entity classification of the U.S. hybrid holding company, differing rules for interest and dividends, and treaty concessions on source taxation produced little or no taxation of the transaction in the United States and the foreign country. The arbitrage undermines the U.S. treaty decision to relinquish taxing rights on the "interest" payment. The decision was premised on the understanding that the income would face taxation in the treaty partner country. In the absence of such foreign taxation, no double taxation would result and the United States would have been unwilling to surrender its right to tax the income. The conflicting entity classification rules of the two countries effectively undid the "deal" and the expectations in the treaty. Allowing the arbitrage to continue unfettered would significantly undermine U.S. treaty negotiations and enforcement of bargains.

As a result, the United States has a strong interest in limiting this arbitrage. In terms of how to proceed, both unilateral and multilateral (including bilateral) options could be valuable. Given the lack of any affirmative policy incentive supporting the arbitrage, and the fact that it derives from the abuse of an international agreement drafted precisely to handle cross-border coordination, a prompt response would not be unreasonable. As a general matter, a unilateral reaction can be achieved more quickly to contain the arbitrage (especially where more than one treaty is involved). In this context, the response presumably would be understood as a temporary measure. The fact that the country on the other side of the transaction is a treaty partner indicates the existence of a route for direct dialogue, as well as an expectation that treaty-related matters will be the subject of mutual

²⁵⁸ See *supra* text accompanying notes 69–72.

discussion and "equitable" sharing of revenue. To prevent misunderstandings, the preliminary role of unilateral action should be identified in such a case.²⁵⁹

The United States did respond to this arbitrage with regulations reclaiming taxing jurisdiction over the income surrendered under the treaty and not taxed because of the arbitrage. Now, the payments to the foreign corporation in such hybrid cases will be treated as a dividend for Internal Revenue Code (Code) and treaty purposes, thereby denying the reduced treaty rate for interest and producing an income classification consistent with that of the recipient country.²⁶⁰ In explaining the motivation behind this new rule, the preamble to the proposed regulation stated:

The IRS and Treasury believe that it is inappropriate for related parties to use domestic reverse hybrid entities for the purpose of converting higher taxed U.S. source items of income to lower taxed, or untaxed, U.S. source items of income. To do so defeats the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation for legitimate transactions, not to reward the manipulation of inconsistencies in the laws of the treaty partners.²⁶¹

The other hybrid entity arbitrage case²⁶² utilizes conflicting entity classification rules to reduce a foreign subsidiary's taxable income for foreign tax purposes, without generating U.S. taxable income under subpart F. How should the United States assess the impact of the arbitrage? As outlined earlier, the arbitrage can be viewed as a benefit to U.S. corporations at the expense of the foreign country's fisc (U.S. corporation's high foreign tax is reduced) or it can be viewed as an incentive to invest abroad (U.S. corporation can achieve an effectively lower tax rate through foreign investment plus arbitrage). The resolution turns in part on the question of whether the arbitrage undermines an important U.S. policy in subpart F. This inquiry has fostered

²⁵⁹ Here, the treaty partners might be more inclined to see the unilateral action as restoring the spirit of the treaty. Unilateral moves generally allocate the extra tax from eliminating the arbitrage to the intervening nation. That outcome may irk other nations. See *supra* text accompanying notes 54-55.

²⁶⁰ T.D. 8999, 2002-28 I.R.B. 78 (Treasury Guidance Regarding Payments with Respect to Domestic Reverse Hybrid Entities).

²⁶¹ Prop. Treas. Reg. § 1.894-1(d)(2)(ii), 66 Fed. Reg. 12,445, 12,446 (Feb. 27, 2001).

²⁶² See *supra* text accompanying notes 63-68.

substantial controversy. One view contends that the arbitrage undermines the subpart F rules. This assertion, however, requires knowing the policy goals of subpart F itself—a source of significant debate. In fleshing out the policy behind subpart F, conflict has erupted over its historical intent, the coherency of any overarching policy, and the relationship of those goals to the position of subpart F in the U.S. tax system today. The resolution of this broader debate directly impacts the examination of the hybrid entity arbitrage case. More pointedly, the conflict over subpart F highlights an inherent challenge in the balancing test—the need to identify U.S. policy goals. Although it is beyond the scope of this Article to undertake the task of sorting out subpart F policy generally, some observations may be possible in the narrower case of this arbitrage.

As explored in Part I, the immediate effect of this hybrid entity arbitrage was the reduction of foreign income taxes, generally a desirable outcome from the U.S. perspective. Whatever the goals of subpart F may be, they are not to increase foreign taxes *per se*.²⁶³ The arbitrage example started with foreign income not subject to subpart F (perhaps because it was manufacturing income). Implicit in the exclusion of this income from subpart F was the view that such income deserved deferral because of the presumed business motive for its being offshore. The question, then, is why not allow that taxpayer to take further steps to reduce foreign tax on the manufacturing income already deemed permissibly deferred. A direct infringement of subpart F policy appears difficult to articulate. Certainly, though, potential distortions may follow from the arbitrage. A taxpayer making the initial decision to invest abroad presumably has compared the costs and benefits of domestic and foreign investment, and has decided that the balance weighs in favor of foreign investment. Adding the arbitrage to the mix would reduce foreign taxes on the foreign activities. At this point, the arbitrage only seems to lower the foreign tax bill—at no cost to the United States. The arbitrage benefit, however, may become incorporated into the initial locational calculus and may lead taxpayers to invest even more abroad, thus altering the initial balance. How then should we measure the arbitrage's impact on U.S. subpart F policy?

The answer depends on one's current views of subpart F. As a result, it is changeable in the event a new emerging consensus develops

²⁶³ Historically, subpart F has been the locus for debate over the risks and benefits of deferral of foreign source income.

on the role of subpart F and antideferral regimes. Critical to the evaluation of subpart F is a determination about the relative place of CEN and CIN in U.S. tax policy. In contrast to many other cases of arbitrage, the core U.S. tax rule at issue (here, subpart F) actually concerns the allocation of investment activity globally and the relationship between tax regimes. If CEN is our dominant vision of global efficiency then deferral should be very limited and thus subpart F expanded. Accordingly, curtailing arbitrage that seems to undermine subpart F would be appropriate (recall the argument that allowing this arbitrage will encourage foreign investment generally because taxpayers will realize the increased opportunities to reduce tax on even manufacturing income where that income is earned abroad and not domestically).²⁶⁴ If, however, CIN is our dominant vision of global efficiency, then deferral should be expanded and subpart F's reach limited to its clear statutory terms. In that case, an arbitrage that does not explicitly violate subpart F might not merit strong attack. Unfortunately, inquiry in this case study is further complicated by the observation that taxpayers are effectively reducing Country X tax, which seems in violation of even CIN (under CIN, activities in Country X should bear the Country X rate of tax and not the U.S. rate of tax). If, however, other taxpayers in Country X are pursuing comparable tax reduction strategies, then CIN might support allowing the arbitrage.

Assuming for the moment a consensus that the arbitrage harms U.S. subpart F policy (either on the CEN dimension or on the CIN dimension if other taxpayers are not reducing their Country X tax), a unilateral move would seem appropriate given the impact of the arbitrage on those subpart F goals and the degree to which any more multilateral resolution would likely involve a U.S. change in tax rules (entity classification). Of course, the captured transactions would also provide a revenue bonus (although it would presumably be short-lived, given comparable U.S. and foreign tax rates, because taxpayers would cease this hybrid transaction).²⁶⁵ The net effect would be to bolster the CFC jurisdiction's (Country X in the case study) tax collections by preventing the CFC from reducing that country's taxes. On the surface, the CFC jurisdiction should be pleased with this unilateral U.S. move. Whether that would prove true turns on whose interests the CFC jurisdiction is promoting. If that jurisdiction imposes

²⁶⁴ See *supra* notes 145-148.

²⁶⁵ The rule could be designed as a low-tax kick-in (which is likely to be over-inclusive, and not necessarily dictated if CIN is motivating our policy here), or as a more complicated rule targeting this type of arbitrage.

nominally "high" tax rates in response to domestic voter demands, but de facto supports and allows the arbitrage because it promotes the interests of a select group of taxpayers,²⁶⁶ then the jurisdiction's reaction may be mixed: publicly supportive and privately displeased.

The United States did attack this general use of hybrids in the now infamous Notice 98-11 which announced that Treasury and the Service planned to issue regulations governing the use of hybrids under subpart F and effectively treat the interest income as subpart F income.²⁶⁷ Taxpayers responded vigorously to the notice, accusing the Service of acting as a "worldwide tax cop" (an allusion to the fact that in the case study it seems that Country X is the immediate and obvious revenue loser in the transaction that the Service is intervening to protect).²⁶⁸ Moreover, they questioned the sensibility of the United States effectively seeking higher foreign taxes for U.S. taxpayers (by stopping such taxpayers from reducing their foreign income tax bills through the use of hybrid transactions).²⁶⁹ Technical critiques of the government's proposed rules turned on Treasury's authority to issue such guidance and the validity of any reliance on existing statutory provisions to support the effort.²⁷⁰ Shortly after Notice 98-11, temporary and proposed regulations were issued,²⁷¹ but following further debate on subpart F they were withdrawn. New proposed regulations were issued a year later (July 1999).²⁷² The preamble explicitly confronted the relationship between the hybrid entity question and the underlying tensions in subpart F,²⁷³ explaining that the proposed regulations were based on Treasury and Service assessments of the current subpart F regime and did not bar or limit future debate on the proper role and direction of subpart F.²⁷⁴ The regulatory action

²⁶⁶ In fact, one could characterize a U.S. unilateral move here as supporting political accountability in Country X to the extent that Country X voters did not know that foreign corporations were reducing their effective rate of Country X tax.

²⁶⁷ I.R.S. Notice 98-11, 1998-1 C.B. 433-34.

²⁶⁸ Jim P. Fuller, *U.S. Tax Review*, 16 TAX NOTES INT'L 299, 299 (1998); see *supra* text accompanying notes 63-68 (describing this hybrid entity arbitrage).

²⁶⁹ See, e.g., N.Y. State Bar Ass'n Tax Section, *Notice 98-11: Tax Treatment of Hybrid Entities*, 79 TAX NOTES 877, 881-82 (1998).

²⁷⁰ See *id.* at 878-79.

²⁷¹ See T.D. 8767, 1998-1 C.B. 875 (temporary and final regulations providing guidance under subpart F relating to partnerships and branches); Prop. Treas. Reg. § 1.952-1, 63 Fed. Reg. 14,669 (Mar. 26, 1998) (proposed regulations providing guidance under subpart F relating to partnerships and branches).

²⁷² Prop. Treas. Reg. § 1.954-1, -2, 64 Fed. Reg. 37,727 (July 13, 1999).

²⁷³ *Id.* at 37, 727-29.

²⁷⁴ *Id.*

against the subpart F hybrid entity arbitrage generated more controversy than the treaty-based regulations.²⁷⁵ Violated treaty expectations created a stronger policy claim than that available for the subpart F rules.²⁷⁶

One final observation about hybrid entity arbitrages: independent of any unilateral intervention, the recurrence of arbitrages based on entity classification raises the possibility that a multilateral approach may be valuable. If entity classification rules are the source of much arbitrage,²⁷⁷ then greater harmonization should reduce arbitrage. A multilateral response may consist of the United States evaluating the global landscape and determining that its decision to offer a fully elective entity classification regime (for many entities) is somewhat out of step with most countries on this issue, is unsupported by important U.S. interests, and that a wider harmonization can be achieved at relatively little cost (to either diversity or sovereignty) by a U.S. shift in classification rules. A change of entity classification rules, as opposed to subpart F or withholding rules, could further harmonization and secure global consensus on the topic. This characterization of entity classification harmonization implicitly assumes that the increased harmonization would be desirable. The expectation is justified not only by the presumption of no serious sovereignty or diversity concerns (given the long percolation period for classification questions and the U.S. focus on fairness and waste), but also by the recognition that taxpayers are unlikely to pursue high transaction cost alternatives. Anecdotal evidence, including informal conversations with tax practitioners, suggests that the check-the-box rules have increased arbitrage not just rerouted it, perhaps because the certainty of the new classification regimes encourages more classification-based tax strategies. Absent indications to the contrary, enhanced uniformity on this question seems worthwhile.

²⁷⁵ See, e.g., Thomas R. May, *Treasury Attacks Domestic Reverse Hybrid Planning*, 22 TAX NOTES INT'L 1869, 1872-76 (2001) (critiquing the domestic reverse hybrid regulations on grounds that they go beyond the statutory authority of I.R.C. § 894(c) and may violate the nondiscrimination provisions of article 24 of the U.S. Model Treaty).

²⁷⁶ The powerful role of treaty-based interaction between countries' tax rules and the potential bargaining underlying it was noted earlier by Philip West in his examination of the ways in which domestic and foreign tax law can be connected. West, *supra* note 14, at 180-82. It is also likely that the tax planning opportunities created under subpart F hybrid entity arbitrages were more extensive than those under domestic reverse hybrids.

²⁷⁷ Despite the degree of maneuvering and flexibility available under the prior entity classification regime, the check-the-box rules opened new opportunities in planning.

D. Comments on the Arbitrage Framework

This outline of the balancing test and its application to the four case studies demonstrates its complex role in arbitrage analysis. The test can be the structure for both conveying the line-drawing process and for disciplining its implementation. The fact that each analysis requires balancing of competing claims and goals in no way mitigates the importance of a more formal structure for the process. To complete the review of the balancing test, this section offers some concluding observations on its use.

First, the content of an arbitrage's evaluation under the balancing test is not permanent. If, and when, U.S. policy goals change, the balance achieved may also change. The IRS and Treasury have explicitly warned, for example, that such a policy shift may occur following the increased attentions to subpart F. Second, the balancing test is not a static tool, but is part of a fluid analysis. A decision about an arbitrage case may not be possible at a given moment in time. If limited information exists regarding the nature and impact of an arbitrage, the government can consider an interim step designed to collect data and monitor the arbitrage. For example, the United States could institute information reporting requirements for taxpayers to receive certain U.S. tax benefits. Also, some gatekeeper requirements could be instituted to aid in the gathering of information. (Unlike the tax shelter context, however, the purpose of these requirements would not be *de facto* discouragement of particular transactions, but rather documentation of the scale, range, and size of the relevant behavior in order to evaluate the significance of the arbitrage.)

Third, a central element of the analysis is the ability to discern which U.S. policies are animated by particular tax rules. It is worth emphasizing again that this step is an art, not a science. Not only can there be disagreement about the policy goals themselves but also debate as to the scope and degree of those goals. The subpart F regime serves as a prime example of such debate, but other topics are not immune to controversy—witness the inquiry into the incentives behind accelerated depreciation.

Finally, the balancing test does not purport to restrict the range of responses that a country may adopt. In fact, many techniques exist, including reporting requirements, unilateral disallowance of U.S. tax benefits, revision of domestic law, bilateral agreements, and multilateral consensus (formal or informal). Certain cases may be more suited to unilateral action than others, but multilateral responses are always available. Moreover, the relationship between unilateral and

multilateral responses is very flexible and can be deployed quite effectively when, for example, unilateral action is used to prompt a broader discussion of the arbitrage, or when the creation of a multilateral consensus allows a nation successfully to implement unilateral measures. The importance of multilateral dialogue cannot be underestimated here because the arbitrage analysis itself only goes to the question of whether the arbitrage produces enough harm that we can and should intervene through available mechanisms (unilateral and/or multilateral) to eliminate the arbitrage benefit. A critical question remains—how to allocate the benefit captured from the anti-arbitrage response (assuming there is a discernable benefit and taxpayer behavior does not change so drastically as to eliminate it). This question is at the heart of much of international taxation; the design of tax rules not only impacts taxpayers as such, but it also distributes revenue between and among nations. Ultimately, these distributional concerns behind anti-arbitrage rules will be resolved through the intersection of negotiating strength, compromise, trade, and considerations of inter-nation equity.

The implications of a country's decisions about cross-border tax arbitrage, including whether and how to respond, extend beyond the specific case to broader issues in international tax. The next Part takes up the important connections between cross-border tax arbitrage and two dominant and controversial topics in international tax: tax competition and tax harmonization.

IV. BEYOND CROSS-BORDER TAX ARBITRAGE—COMPETITION AND HARMONIZATION IN THE INTERNATIONAL TAX COMMUNITY

A. *Introduction*

The primary undertaking in this Article has been the question of whether and how countries, such as the United States, should respond to cross-border tax arbitrage. To appreciate fully the texture of the debate and its ramifications, it is necessary to step back and consider the broader context in which this question arises. The United States is one nation among many—each with the power to tax and a regulatory framework to collect it. What vision should animate decisions governing the important intersections between and among taxing authorities? In particular, how does the arbitrage discussion relate to two alternative visions of international regulatory dynamics—competitive and cooperative?

Implicit in this Article's focus on arbitrage is the view that examples of tax competition²⁷⁸ and arbitrage are sufficiently distinct to warrant independent consideration of each. That said, significant commonalities exist and conclusions reached for one may offer guidance for the other. Moreover, both examples of tax competition and arbitrage force us to confront harmonization: How much cooperation and competition should be part of the international regulatory vision? This Part reviews the intersections of competition and harmonization with cross-border tax arbitrage.

B. Tax Competition and Arbitrage

What is cross-border tax competition? A simple description would characterize this as behavior by which a jurisdiction seeks to attract business and investment activities through significant, sometimes targeted, tax reductions and benefits.²⁷⁹ The furor over tax competition attaches to whether such competition is good or bad, how to tell the difference, and how to respond. The OECD 1998 Report on Tax Competition identifies what it considers two versions of harmful tax practices ("tax havens"²⁸⁰ and "harmful preferential tax regimes"), which it classifies under the general heading of "harmful tax competition."²⁸¹ Bad tax competition, so defined, involves the use of tax goodies targeted at foreign investment. Other tax commentators have built upon this foundation to suggest that there is indeed good and bad tax competition, with the line between the two drawn to reflect the trade-offs—harm to efficiency and equity from competition compared with the benefit to countries from designing their own fiscal, revenue, and spending policies to reflect national goals, values, and interests.²⁸²

²⁷⁸ The term "tax competition" could refer to specific examples of countries targeting tax rules to gain investment, or to the more conceptual issue of how countries should seek to interact on a regulatory level. This section uses the term "tax competition" for the specific targeted tax rules which are the subject of intense discussion and scrutiny in the international tax community.

²⁷⁹ Regulatory competition has an intentional quality, with related behavioral consequences for both the regulator and regulated. *See, e.g.*, Charny, *supra* note 179, at 282–83 (regulatory competition characterized "loosely [as] any situation in which one jurisdiction sets a . . . standard because that standard gains an advantage *vis-a-vis* the economy of another jurisdiction").

²⁸⁰ "Tax havens" are denoted by the presence of four factors: (1) no/nominal taxes; (2) lack of effective information exchange; (3) lack of transparency; and (4) no substantial activities. OECD, *supra* note 15, at 22–23.

²⁸¹ *Id.* at 8.

²⁸² *See, e.g.*, Avi-Yonah, *supra* note 15.

Not all tax analysts readily concede that cross-border tax competition poses such clear efficiency and equity harms. Hence, they question whether it should be aggressively restricted. Where tax competition can, for example, be characterized as competition on the package of government services provided for a given tax rate, taxpayers can seek out their preferred level of service, leading to more efficient tax systems.²⁸³ A country could offer a lower tax rate; but one very rough implication (assuming a comparable tax base) is that the taxpayer in that country is receiving fewer services. (It is also quite possible that higher services are available, but are being funded by another tax sector.) Along this line, tax competition behavior may reflect different "marginal costs" among competing countries, which, in the language and analysis of the market, should be a valid basis for competition among jurisdictions.²⁸⁴ Resolution of some (but not all) of this debate will require further empirical evidence regarding the nature of cross-border tax competition and the nature of the decisions by countries to offer inducements and of taxpayers to accept them. Does the market model, with tax competition producing efficient levels of government service, aptly capture the behavior? Or does tax competition in this regulatory environment dictate a different interpretation?²⁸⁵ Other issues will remain after the empirical analyses, including how to weigh competing values (for example, efficiency, equity, administrability, and sovereignty) and how to rate the likely outcomes of alternative responses to tax competition.

Where does cross-border tax arbitrage connect to this picture of tax competition—beyond the important observation that both issues wrestle with the proper relationship between and among nations' tax regimes? First, many of the fundamental concerns identified with arbitrage pertain to tax competition as well, including efficiency and equity. Second, many of the same goals are implicated by the possible responses, including sovereignty²⁸⁶ and diversity.²⁸⁷

²⁸³ This thinking draws directly on the early theoretical tax competition analysis by Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). See, e.g., Roin, *supra* note 15, at 545-46; see also Avi-Yonah, *supra* note 15, at 1611.

²⁸⁴ See, e.g., Roin, *supra* note 15, at 550.

²⁸⁵ Modern tax competition economic scholarship has expanded the analysis from the idealized Tiebout-based models to explore circumstances of wasteful tax competition. See John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269, 270-73 (1999).

²⁸⁶ For example, critics of the OECD Tax Competition Report (including the United States during a change of position) characterize it as an attempt by a group of countries to keep tax rates high and stifle competition. See, e.g., Robert Goulder, *New Coalition Strikes Back at OECD Tax Haven Campaign*, 89 TAX NOTES 1352, 1352-53 (2000) (detailing the

What then are the major differences between tax competition and arbitrage? First, the OECD's harmful tax competition report identifies a distinction between "unintentional mismatches" and "special" tax regimes.²⁸⁸ Although there is reason to question the reliability of "intentionality" as a touchstone for discriminating good and bad tax practices here, the focus on the motivations underlying the tax rules does identify important practical differences between arbitrage and tax competition.²⁸⁹ The degree of intentionality in the "creation" of the tax benefit may directly correlate with: (1) the country's perception of its exercise of sovereignty in establishing the benefit; (2) the likelihood that a conscious national cost-benefit analysis was made of the tax treatment (even a rough estimate);²⁹⁰ and (3) the range of probable resolutions to conflict with other countries' tax rules. If a

extensive efforts of the Center for Freedom and Prosperity to challenge and undo the OECD's efforts to limit "harmful tax competition"); Paul O'Neill, *U.S. Treasury Secretary Statement on OECD Tax Havens*, 22 TAX NOTES INT'L 2617 (2001) ("I am troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system. . . . The United States does not support efforts to dictate to any country what its own tax rates or tax system should be . . ."). But see Cordia Scott, *U.S. Treasury Secretary says OECD Tax Haven Crackdown is Out of Line*, 22 TAX NOTES INT'L 2539, 2540 (2001) (OECD Secretary General Donald Johnston complained that U.S. policymakers do not understand the OECD position—and that the position "has nothing to do with insisting that a jurisdiction use a particular tax structure or tax rate . . . [W]hat the project is aimed at is . . . tax cheats.").

²⁸⁷ The existence of different systems, as noted earlier, means that alternative approaches to issues can percolate. Cf. Jeffrey Owens *Discusses Details of OECD Harmful Tax Practices Report*, 21 TAX NOTES INT'L 94 (2000) (Owens said, "Tax competition can have positive effects. For example, the implementation in one country of a long needed tax reform may encourage other countries to undertake similar tax reforms in order not to lose their relative international competitiveness.").

²⁸⁸ OECD, *supra* note 15, at 15–16.

²⁸⁹ See, e.g., Roin, *supra* note 15, at 546 (describing tax competition as when "one country seeks to entice investment within its borders (and possibly enhanced tax revenues) through the expedient of reduced business taxation").

²⁹⁰ For example, low tax rates (either general or targeted) are affirmatively enacted and therefore more likely to be transparent. This observation has been generalized in the regulatory context:

[T]here is good heterogeneity and bad heterogeneity—the principal line is between heterogeneity that reflects honest differences in tastes and incomes and a few related factors, and heterogeneity that reflects indifference, inadequate information or capture. Heterogeneity that arises for the first set of reasons is not only acceptable but probably desirable as a policy matter. Heterogeneity driven by the second set of considerations is undesirable, and would be eliminated (or its effects eliminated) in an ideal world.

Sykes, *supra* note 26, at 57.

country is not seeking to encourage a particular transaction it may be more amenable to cooperative or joint action.

Second, mismatches in arbitrage differ from tax competition on rates because in the latter case there may be no "mismatch," just a willingness on the part of the other country to forgo a portion of potential revenue through ring fencing, nondisclosure, or other techniques. If these strategies attract investment from U.S. and non-U.S. taxpayers, a U.S. response to the situation can be difficult to craft, other than matching the offer. For example, tax competition for portfolio investment through reductions in withholding rates leaves few options (other than seeking worldwide taxation for one's own taxpayers). To the extent investment and business opportunities are comparable, an act of tax competition must be countered in order to attract the investments at stake, if not the revenue. Thus, although some of the harms in arbitrage and tax competition might be related (distortions of behavior), the U.S. role and control differ.

Third, even where countries share similar views on "appropriate" tax rates and behavior (for example, no "ring fencing"), arbitrage can occur, though tax competition problems may be unlikely. These robust tax systems that seek to tax income comprehensively can still experience cross-border tax arbitrage because of the individuality of their systems.²⁹¹ A "victory" on the part of the OECD or other collective body in attacking harmful tax competition would not eliminate cross-border tax arbitrage and would not answer the questions of how to respond.

Finally, when tax competition problems do mirror those of arbitrage, the reactions and conclusions may be quite different. For example, both may raise questions about the risks of convergence and harmonization. In the tax competition context this concern may be most commonly reflected in the Leviathan critique—fears of governmental abuse in the absence of the constraining influence of competition.²⁹² An accepted balance between the efficiency harms and the positive benefits of competition may be reached by some agreed minimum threshold of proper behavior (a minimum level of uniformity), leaving tax competition in place beyond that level.²⁹³ For arbi-

²⁹¹ Although the striking similarities among tax systems are frequently noted in the tax literature, the complexity of the regimes (both domestic and cross-border provisions) provides ample opportunity for cross-border tax arbitrage.

²⁹² See, e.g., Avi-Yonah, *supra* note 15, at 1614–16; Wilson, *supra* note 285, at 296–98.

²⁹³ See, e.g., EC Report, *supra* note 3, at 564 (recommendations); OECD, *supra* note 15, at 43; Avi-Yonah, *supra* note 15, at 1666–74 (proposals for a refundable withholding tax on

trage cases, such partial solutions may be less plausible and the trade-offs with harmonization more direct.

Thus, not only are arbitrage and tax competition analytically and empirically distinct (as they are currently defined) but the analysis of good versus bad tax competition and the resulting policy conclusions do not adapt directly to arbitrage. Current proposals for eliminating what has been termed "harmful" tax competition, such as withholding, would not impact most arbitrage opportunities.²⁹⁴ Arbitrage is less likely to be an inherently positive feature in the tax system, except to the extent that its existence proclaims the diversity of tax rules and encourages countries to reevaluate their systems. Yet, substantial elimination of arbitrage would create significant harmonization, which forces contemplation of the risks in seeking more global uniformity.

One last consideration on the relationship between arbitrage and tax competition is whether arbitrage could become tax competition if the rules are left in place once the arbitrage potential has been identified. Perhaps yes, but typically no. Often the rule is left in place because there is no clear support for change, the distortions may not be significant, the domestic policy supporting the tax rule is powerful, or the costs of change seem high. Also, "bad" tax competition is typically viewed as the use of "targeted" rules, whereas arbitrage can stem from the opposite situation—domestically determined rules confronting, not targeting, the global setting.

C. Tax Harmonization

A pervasive theme underlying much of the discussion in the literature of tax competition, tax arbitrage, and globalization is the nagging question of harmonization—how much should we be pursuing it, and will it be happening in any event? The connection between harmonization and the competition/arbitrage discussion is patent. Where tax rules and tax rates are substantially harmonized, the opportunity for taxpayer behavior to be influenced by the arbitrage or competition opportunities is substantially diminished. Of course, as

portfolio interest, and a refundable gross basis withholding tax on businesses selling goods and services into a jurisdiction). But see Daniel J. Mitchell, *An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy*, 21 TAX NOTES INT'L 1799, 1799 (Oct. 16, 2000) (characterizing the OECD proposal as "eliminating or substantially reducing the competition [the] high-tax nations face from low-tax regimes").

²⁹⁴ See EC Report, *supra* note 3, at 565; OECD Report, *supra* note 15, at 60; Avi-Yonah, *supra* note 15, at 1652–74 (suggesting certain withholding and other mechanisms).

with competition and arbitrage, the subject of harmonization is an umbrella for discussing goals underlying the tax system—it alone does not constitute a goal. Harmonization (generally contrasted with competition) focuses on how nations' independent tax systems should interact, and more specifically, how much they should pursue coordination.²⁹⁵ This Section asks what can be added to the harmonization debate from an improved understanding of tax arbitrage.

First, the effort in this Article to examine the sources of conflict in tax rules highlights the differences between harmonization and convergence of tax regulation. Taking harmonization to encompass intentional and voluntary²⁹⁶ efforts to coordinate tax rules, it becomes evident that certain types of conflict will be more susceptible than others to a collaborative approach and in these cases harmonization is realistic. For example, cases (such as residency rules)²⁹⁷ in which the tax rules have an arbitrary quality and are motivated by nontax policy objectives may generate less hostility to a harmonization effort. Of course, the absence of demonstrably strong national interests underlying a tax rule does not guarantee cooperation, as suggested by IFA's experience with leasing rules, especially if there is an insufficient sense of urgency regarding the arbitrage problem.²⁹⁸ In other cases, tax regulations may converge through no intentional effort of the nations if sufficiently common goals are shared by the tax systems. A prime example is the increasing attention to economic taxation and accrual, particularly in financial contexts. Presumably the attention to taxing economic income, combined with increasing sophistication about timing and income, may lead countries to more similar rules without a specific intent to harmonize. The claim is not that scientific

²⁹⁵ See, e.g., STEPHEN BOND ET AL., INSTITUTE FOR FISCAL STUDIES, CORPORATE TAX HARMONISATION IN EUROPE: A GUIDE TO THE DEBATE (2000); HANS-WERNER SINN, THE NEW SYSTEMS COMPETITION (CESifo, Working Paper No. 623, Dec. 2001); Stewart, *supra* note 175, at 115–18.

²⁹⁶ The term is used loosely here in recognition of the realities of international cooperation. Decisions to join with other nations to adopt common practices can be motivated by a range of factors, including the mere fact that a group has decided to harmonize or that certain nations view the step as desirable and exert pressure on other nations to participate. See, e.g., Jeffery Atik, *Science and International Regulatory Convergence*, 17 NW. J. INT'L. L. & BUS. 736, 753 (1996-97) (noting that smaller nations may find themselves to be "regulation taker[s]").

²⁹⁷ Even this example is not without controversy. One can readily imagine the political fallout that could develop if certain entities currently taxed as U.S. residents ceased to be so treated under a new regime, even if other entities effectively replaced them.

²⁹⁸ See *supra* text accompanying notes 227–230. The proper interpretation of the IFA experience on leasing requires a view as to whether the arbitrage was thought to support exports.

principles will ultimately dictate tax policy and provide uniformity in regimes,²⁹⁹ but instead that it is quite plausible that a certain degree of convergence may occur independently and that it may occur in predictable areas of taxation.

Harmonization and convergence as described here could appear as polar opposites. In reality, the forces at work in each case can, and likely do, combine in varying degrees. Thus, one can imagine that harmonization efforts would be easier where there is no strong national policy underlying the specific rule but where there is a discernable and somewhat objective norm to guide the selection of a rule (such as economic taxation of income). Even if the dominant force behind multilateral cooperation on an issue is the lack of individual national commitment to current rules, the ability to structure the discussion around an "objective" norm may facilitate a resolution.

The second observation on harmonization gleaned from the arbitrage analysis concerns the ways in which harmonization may be achieved. The fact that tax rules conflict for different reasons influences how coordination can be managed. Arbitrage conflict may be more readily resolved in the absence of an intentional avilment of that conflict by the country. Why? The absence of interest in utilizing the arbitrage diminishes the likelihood of a net gain to the nation from the conflict and of national reluctance to change the rule. Beyond assessing the basic potential for agreement, it may be possible to predict whether a formal multilateral effort will be necessary and whether it will be difficult. The classic example of regulatory cooperation from the nontax literature involves aviation rules, such as communication standards on landing.³⁰⁰ Continued success in aviation depends on widespread agreement on these matters, and the technical nature of the issues indicates that such agreement may be realistic because it would not intrude upon important national policies.³⁰¹ Tax arbitrage may not offer as striking examples, but it is possible to envi-

²⁹⁹ See Atik, *supra* note 296, at 736-39, 754, 758 (science can function as the baseline for regulatory agreement, although there are significant limits to relying on science and it may be unable to provide unchallenged principles of decisionmaking for regulators).

³⁰⁰ See generally Kal Raustiala, *Compliance and Effectiveness in International Regulatory Cooperation*, 32 CASE W. RES. J. INT'L L. 387, 400 (2000).

³⁰¹ "On matters of technical compatibility (railroad gauges, communications protocols for fax machines), for example, where the issue involves a largely arbitrary choice among competing standards, a single choice for all markets can exploit all conceivable economies of scale and avoid wasteful incompatibilities." Sykes, *supra* note 184, at 263.

sion such coordination with the losses of DRC.³⁰² The ability to draw upon a range of mechanisms for harmonization of tax rules increases the possibility of such harmonization by matching the technique to the problem.

The third connection between arbitrage and harmonization draws upon the difference between a case by case perspective on harmonization and an overall assessment. The basic approach of this Article has been to encourage the analysis of arbitrage problems against the backdrop of competing objectives of our tax and regulatory system. The analysis is undertaken individually with the expectation that the answer will vary depending on how the factors coalesce. Harmonization is not all desirable nor all objectionable, but is evaluated based on the balancing outlined earlier. That said, is there some cumulative effect on the goals of the tax system that is more than the sum of the effects of the individual arbitrage conflict cases? For example, in thinking about the value of sovereignty or diversity, is this value weighted differently when a single rule is under scrutiny, as compared to a decision to harmonize substantially a broad swath of tax rules? Given this possibility, inquiry into harmonization takes on a distinctive role because it looks to the broader impacts of significant coordination, independent of the context-specific rationale for the uniformity and independent of the mechanisms used to achieve it.

³⁰² The closest parallel to tax arbitrage comes from the international banking world and offers a useful insight on the relationship between multilateral efforts, sovereignty, and administrability. The banking question concerns which country should govern a foreign bank branch—the home or host jurisdiction. Where conflicting positions were taken (i.e. the home jurisdiction thought the host was responsible and vice versa) a serious gap in regulatory coverage could result. Presumably, the bank could benefit from this gap by being more risky in its behavior. The response to the international branch problem was multilevel. On an international level, the Bank for International Settlements (BIS) played a key role in establishing standards for cross-border bank supervision. The Basle Concordat of the BIS outlines "minimum standards for the supervision of international banking groups and their cross-border establishments." See BASLE COMMITTEE ON BANKING SUPERVISION, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS-BORDER ESTABLISHMENTS (June 1992). On a domestic level, the United States enacted legislation controlling foreign bank activities in the United States, and requiring certain federal permissions to establish a U.S. branch. See *id.*, reprinted in SCOTT & WELLONS, *supra* note 41, at 111–15. Approval is contingent upon a specified level of bank supervision in the home jurisdiction. *Id.* at 113–14.

An interesting observation can be drawn from this rather singular example of nontax regulatory arbitrage. Where arbitrage is a sufficiently rare occurrence, it may be possible to reach agreement on a coordinated response. Not only is the threat to sovereignty rather limited, in that only one issue is covered, but a comprehensive attack on arbitrage can be envisioned because in fact there is so little to discuss (even if there are a range of policy discussions and concerns regarding the final resolution).

Finally, the balancing test for arbitrage supports the rather unsurprising conclusion that a combination of harmonization and competition/independence is the most desirable outcome in cross-border tax regulation.³⁰³ A remaining question, however, concerns how the harmonization occurs and its longer-term effects: Is it possible that the method by which harmonization on tax issues is achieved could alter the dynamics among the nations and create a momentum that would produce more harmonization than might otherwise be thought desirable? An important dimension to the arbitrage analysis is the recognition that there are multiple ways in which increased uniformity of tax rules can be pursued by countries. Not only is a unilateral approach a step toward harmonization, but within the category of multilateral approaches the range of mechanisms is substantial, from acknowledging that one's rules are out of step with a reasonable, developing consensus, to negotiating a compromise treatment through an international body such as the OECD. Given this scope of harmonizing responses, are there collateral effects to the choice among methods? For example, would the creation or use of an international body develop a pattern of interaction among jurisdictions that would lead increasingly to more tax issues being subsumed under their harmonizing influence? Initially, the question may seem extreme given the absence of concerted efforts at tax coordination (for example, in entity classification, residence, and leasing rules). When tax coordination is combined with other spheres of interaction, however, such as monetary and market regulation along the lines of the European Union, the potential for a steam-rolling effect seems slightly more plausible. Of course, this possibility should not be overstated. The degree of difficulty experienced by the European Union in trying to harmonize corporate taxation serves as a marker of the challenge in that level of coordination.³⁰⁴ Nonetheless, an important direction of re-

³⁰³ Such a general proposition has been espoused in the regulatory analyses: neither full competition nor complete harmonization is desirable in regulatory fields "where important international cross-border effects of regulation arise. Instead a considerable degree of cooperation is almost always needed, yet non-homogeneity of regulatory policies is almost always desirable as well." Sykes, *supra* note 184, at 257; see also Daniel C. Esty & Damien Geradin, *Regulatory Co-opetition*, 3 J. INT'L ECON. L. 235, 237 (2000); DANIEL SHAVIRO, SOME OBSERVATIONS CONCERNING MULTI-JURISDICTIONAL TAX COMPETITION (N.Y. Univ. Law Sch., Public Law & Legal Theory Working Paper No. 13, 2000).

³⁰⁴ See, e.g., Robert Goulder, *OECD Tax Symposium Looks to Outside Governments for New Era of International Cooperation*, 21 TAX NOTES INT'L 91, 91 (2000) (OECD head of fiscal affairs Jeffrey Owens observing that the goal of the OECD's project regarding tax competition "is about international cooperation to eliminate illegal tax evasion; it is not about tax harmonization"). Even in the context of the European Union (E.U.), where independent

search in regulatory harmonization will be the influence of harmonization techniques on future iterations of conflict and coordination with a group of nations.

CONCLUSION

This Article has pursued two goals. First, it has argued that plausible grounds for government intervention against cross-border tax arbitrage can be articulated once the two extreme options (complete acceptance and complete elimination of arbitrage) have been eliminated. The decision to intervene turns on an assessment of factors which, while not susceptible to automatic conclusions, are nonetheless familiar in a tax system beset by competing claims and goals. Second, this Article has sought to specify a framework to use in organizing the analysis of competing goals so that examination of individual arbitrages has a more consistent methodology. The result is the balancing test which is premised on identifying the set of national and international goals that must be accommodated in arbitrage policy and which evaluates those goals in the context of real decision making by national actors against an international backdrop.

Clearly no uniform response to cross-border tax arbitrage is appropriate or realistic. Nor is the ideal response readily apparent and unanimously agreed. The challenge is to use the balancing test to organize discussion and evaluation of arbitrage. Important empirical inquiries about arbitrage effects as well as challenging policy choices must still be made domestically and in partnership with other countries. The process, however, can advance more systematically, with a grounded theoretical overview of cross-border tax arbitrage in place.

Pursuing the analysis of cross-border tax arbitrage also requires us to confront the core question underlying this and other major problems in international taxation—how to envision the relationship between and among countries' tax regimes. Several dominant observations emerge from the study of cross-border tax arbitrage. First, be-

nations exhibit a high level of cooperation, tax harmonization is a very sensitive subject. For example, in the discussion of proposals and possibilities for E.U. corporate tax reform, commentator Joann Weiner noted, in reaction to an Institute for Fiscal Studies Report, that adoption in the E.U. of a formula-apportionment system like the one used in the United States and in the Canadian provinces would face opposition because it "requires the member states to give up their direct tax and create a central income tax. Member states continue to oppose this step strongly, making [this option, an E.U.-level corporate income tax,] an unlikely option for the near future." *Institute for Fiscal Studies Issues Report on EU Corporate Tax Harmonization*, 20 TAX NOTES INT'L 2267, 2271 (2000).

fore we can explore the interaction of countries' regulatory regimes we must define the relevant criteria and goals by which to judge the work of those regimes. Reference to competition and cooperation is insufficient to direct policy on cross-border regulation. They are tools and techniques of multilateral interaction, not substantive goals. Second, we need to consider how those goals will be assessed by the different actors and how that may generate strategic behavior. Third, we should draw upon the unique abilities of international organizations in terms of gathering information, offering a forum for debate and compromise, and lending credibility to national regulatory efforts. The detailed cross-border tax arbitrage inquiry illustrates the tensions in competing approaches to countries' relationships and reinforces the need for a textured understanding of the many dimensions of the relationships. As we gain more experience in the dynamics of cross-border arbitrage, we should develop a more sophisticated vision of inter-nation relations that emboldens international regulatory theory, and ultimately enhances the intersections among regimes.

APPENDIX³⁰⁵

It is useful to observe that the benefit is not the existence of a "second set of deductions." In the case of a clear operating lease there are two sets of deductions. The owner would take depreciation deductions and lessee would take rental deductions. The advantage of the double-dip case is that unlike rental deductions, the second set of deductions is deemed to be for depreciation and thus taken at a more accelerated rate. In addition, credits may be available. The following example demonstrates this comparison by calculating deductions for three scenarios: (1) the lease is treated as lease (lessee gets rental deductions), (2) the lease is treated as sale but depreciation is not accelerated, and (3) the lease is treated as sale and depreciation deductions are accelerated.

Hypo: A leases aircraft to B for 3 years (the expected life of the plane). B agrees to pay "rent" of \$1000 in year 1, \$500 in year 2, and \$250 in year 3. On the basis of this we might imagine that A paid \$1510 for this plane at the beginning of year 1 (assuming the present value discounted at 10% from the 3-year stream of income from the plane). In this case, what would be the tax results if:

- (1) country B treats as lease
- (2) country B treats as sale—
 - (a) economic depreciation
 - (b) accelerated depreciation

1. Lease Characterization

A has income as follows:

Year 1	\$1000 rental income	\$849 depreciation deduction (economic)	=	TI of \$151
Year 2	\$ 500	\$433	=	TI of \$ 67
Year 3	\$ 250	\$228	=	TI of \$ 22

B has expense deductions as follows:

Year 1	Rent of \$1000
Year 2	Rent of \$ 500
Year 3	Rent of \$ 250
	<u>\$1750</u>

³⁰⁵ Some of the economic depreciation numbers in this example were derived from an economic depreciation chart by Alvin C. Warren, Jr., on file with the author.

2.a. Sale Characterization for B with Economic Depreciation

A: (same treatment)

B:

	Interest* (deduction)	Depreciation**		
Year 1	\$151	\$ 849	=	\$1000
Year 2	\$ 67	\$ 433	=	\$ 500
Year 3	<u>\$ 22</u>	<u>\$ 228</u>	=	<u>\$ 250</u>
	\$240	\$1510		\$1750

* The purchase price would have been \$1510 for this asset that can generate the following income stream (\$1000, \$500, \$250 over its 3-year life) given a discount of 10%. However, deferring payment of the \$1510 over 3 years at 10% interest produces payments to the seller-financier of \$1000, \$500, \$250 where in year 1 the interest component is \$151, in year 2 it is \$67 and in year 3 it is \$22. The balance in each year is the payment of principal.

** Assuming economic depreciation and given that this asset was purchased for \$1510 at the outset because it will produce a stream of income over its 3-year life of \$100, \$500, and \$250 given a 10% discount rate.

Note: The total annual deduction allowed B is the same whether the transaction is viewed as a lease or financial sale—assuming these facts—i.e., assuming economic depreciation deductions granted by country B.

2.b. Sale Characterization for B with Accelerated Depreciation

A: (same treatment)

B:

	Interest Deduction	Depreciation*		
Year 1	\$151	\$ 920	=	\$1071
Year 2	\$ 67	\$ 510	=	\$ 577
Year 3	<u>\$ 22</u>	<u>\$ 80</u>	=	<u>\$ 102</u>
	\$240	\$1510		\$1750

* Assuming same purchase price etc. as in prior scenario (\$1510) but accelerated depreciation deductions.

Two important observations emerge from this example:

- (1) the total deductions allowed to taxpayer B by country B are the same in all examples
- (2) where B is viewed as a lessee or as a purchaser getting deductions for *economic depreciation*, the deduction pattern is the same and the characterization should have limited impact (if there is an investment tax credit the sale version would be desirable). However, where B is viewed as a purchaser *and* is allowed to “accelerate” depreciation deductions, the difference in timing can be valuable. In such cases, obtaining conflicting tax treatment in the two countries produces a positive value to the parties in the form of the acceleration of the second set of depreciation deductions.