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Conceptualizing a New Institutional Framework for International Taxation

Introduction

While it may not always make the headlines of the popular press or be in the forefront of the news, the international tax regime is confronting a once-in-a-generation defining moment. For the first time in almost one hundred years, the countries of the world are seriously considering fundamental changes to the most basic structures underlying the taxation of international and cross-border activities. This volume of the *Journal of Law & Policy*, “Conceptualizing a New Institutional Framework for International Taxation,” focuses on how and why the existing international tax order has begun to collapse and what issues can and should be considered in reconstructing a new institutional framework robust enough to address the needs of an increasingly global and digital economic world.

When the United States first adopted its modern income tax in 1913 following the enactment of the Sixteenth Amendment to the Constitution, international considerations were already at the fore. The problem confronting the United States was how to deal with U.S. taxpayers who were also paying tax to other jurisdictions. The concern was that if the United States imposed a tax in addition to that of the foreign country, the U.S. company would face a “double tax” that could discourage U.S. companies from doing business abroad. As the United States began to emerge as a global economic power, this was seen as a fundamental threat. To resolve this double tax problem, the United States faced three options: (1) negotiate with the other country over what the tax should be; (2) exempt income earned

by U.S. companies in foreign countries from U.S. tax; or (3) continue to tax income earned in foreign countries, but subtract any tax paid to the foreign country from the U.S. tax bill.

After significant debate, both within the United States and internationally, the United States pursued both the first and third options. As a default, the United States would continue to tax the worldwide income of U.S. companies but would grant a credit for foreign taxes paid. In addition, the United States also pursued tax treaties with willing counterparty countries in which the countries would agree on how to divide the income of such taxpayers. Under the treaty system that emerged, each country agreed only to tax the income of a taxpayer from the other country if that taxpayer had a “permanent establishment” in the country. In this way, U.S. companies primarily based in the United States but doing business in treaty partner countries would not face double taxation. For business done in non-treaty partner countries, the double taxation would be offset by the foreign tax credit.

This uneasy compromise—taxation credit-based regime for non-treaty countries and a residence-based regime for treaty ones—proved remarkably resilient. Recently, however, two threats to this order have arisen. First, individuals and some companies, with the assistance of foreign governments and banking institutions, have been found hiding assets offshore as a way to avoid reporting the income from such assets to their home country. Second, the rise of intellectual property and digital technology has begun to undermine the concept of “permanent establishment,” because these types of assets can easily be moved or located anywhere in the world. Paired with the increasingly global scope of business and the mobility of capital across borders, policing the old institutional order has begun to prove increasingly problematic, if not impossible.

This breakdown has led to action on several fronts. The Organization for Economic Cooperation and Development (OECD) began a project aimed at harmful tax competition with the intent of pressuring certain countries to adopt minimum standards of information sharing and tax cooperation. Many countries, led by the United States, added so-called “Limitation on Benefits” provisions to their treaties, denying treaty benefits to taxpayers unless they could demonstrate some objective economic connections with the country.

The United States unilaterally adopted the Foreign Account Transparency and Compliance Act (FATCA), which attempted to impose certain reporting requirements on foreign banks with U.S. depositors. Other multinational organizations, such as the G-20 and the United Nations, have also been involved, trying to incorporate the interests of a larger group of states, including those of developing or emerging economies, into the discussion. Most recently, the OECD has begun a study on Base Erosion and Profit Shifting (BEPS), attempting to generate a consensus on the issue of taxpayers shifting income around the world solely in search of lower taxes. The BEPS project resulted in an action plan that has called for many reforms among the members of the OECD.

In many ways, the BEPS project, taken together with FATCA, Limitation on Benefits treaty clauses, and the Harmful Tax Competition project, demonstrates an unraveling of the modern international tax regime. In light of this unraveling, Washington University School of Law held a colloquium on “Conceptualizing a New Institutional Framework for International Taxation” on April 1, 2013. Participants included Allison Christians, Associate Professor and H. Heward Stikeman Chair in Tax Law at McGill University; Itai Grinberg, Associate Professor of Law at Georgetown University Law Center; Michael Lennard, Chief of International Tax Cooperation and Trade at the United Nations Financing for Development Office; Diane M. Ring, Professor of Law at Boston College School of Law; and Lee Sheppard, Contributing Editor at *Tax Analysts*. This volume of the *Journal of Law & Policy* includes an edited transcript from that colloquium, which starkly demonstrates the breakdown of the international tax regime and the issues confronting the development of any new system from multiple different perspectives. In addition, this volume also contains three Essays on issues related to the topic. Taken together, these pieces represent a cross section of issues, concerns, proposals, and ideas related to the challenge of building a new institutional framework for the future of international taxation.

AVOIDANCE, EVASION, AND TAXPAYER MORALITY
ALLISON CHRISTIANS

Professor Christians directly addresses the question of how to draw the line between avoidance, which is legally permissible, and evasion, which is not. This problem has plagued tax law since the beginning, but has become of central importance to international tax law in light of the realities of the modern global economy. If taxpayers are free to play one country off of another, to exploit the rules of one legal regime to minimize tax in another, and to hide assets in one country from the eyes of other countries, the entire regime will necessarily fail. Yet any attempt to address this weakness has met with significant resistance, primarily because it is difficult if not impossible to achieve consensus on all of the details among the countries of the world.

Professor Christians addresses this by examining the distinction between avoidance and evasion through the lens of soft law and morality. To the extent that morality can be used to draw this line, attempts by the OECD and others to prevent evasion through methods such as transparency become more likely to prove successful. In this manner, Professor Christians provides a theoretical tool which can be used to bridge the gap between the struggle to combat international tax evasion on the ground and the theoretical bases upon which to do so.

TWILIGHT OF THE INTERNATIONAL CONSENSUS:
HOW THE MULTINATIONALS SQUANDERED
THEIR TAX PRIVILEGES
LEE A. SHEPPARD

In this Essay, Lee Sheppard confronts the difficult problems that arise in the transition from the old institutional framework to the new one. Sheppard clearly delineates the primary points of weakness in the institutional order and identifies where the important players in the process—individual states, the OECD, other multinational organizations, and, perhaps most importantly, the multinational corporations themselves—will attempt to have influence. As the old international consensus fades in light of the challenges presented by

the modern economy, the battle lines over who will win and who will lose in the emergence of a new consensus begin to emerge.

Sheppard then applies this new framework to some of the most pressing issues plaguing the modern international tax regime—intangibles, the digital economy, domestic political pressures, and international political pressures. Walking through each, the Essay demonstrates just how difficult it will be to reach consensus on any of these main points. The Essay then suggests that perhaps the only way to build a new consensus is to completely destroy the old one first, removing the vestiges of winners and losers under the existing regime so the relevant parties can focus on the challenges ahead.

AN *ANTIGUA GAMBLING* MODEL
FOR THE INTERNATIONAL TAX REGIME
ADAM H. ROSENZWEIG

Professor Rosenzweig addresses the breakdown of the international tax regime from a different angle, by looking to the lessons that can be learned from other, successful international legal regimes. In particular, this Essay considers the recent—and so far only—example of the use of cross-retaliation in the World Trade Organization (WTO), used by small states against large states for violations of their underlying agreements. In permitting cross-retaliation, the WTO institutional structure recognizes that some small countries do not have sufficient economic or political power to negotiate a resolution of a conflict with larger countries. Instead, the WTO permits the smaller states to retaliate with respect to other agreements within the regime, so as to compensate the smaller states for the harm caused by violations undertaken by the larger ones.

This Essay demonstrates how the WTO cross-retaliation regime operates by investigating the recent *Antigua Gambling* case in the WTO. In that dispute, the WTO held that the United States violated its obligations under the General Agreement on Trade in Services by banning offshore gambling websites, and, in response, the WTO permitted Antigua and Barbuda to retaliate by disregarding its obligations under the Trade Related Aspects of International Property agreement. The Essay then demonstrates how cross-retaliation can be a useful tool in overcoming disparate incentives between relatively

wealthier and relatively poorer countries, and proposes some ways in which a new international tax regime could adopt or implement cross-retaliation as part of any new institutional framework.