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Money on the Table?:
Responding to Cross-Border Tax Arbitrage
Daniel Shaviro*

I. INTRODUCTION

In the international taxation literature, one cannot so much as scan an opening paragraph without substantial danger of “learning” once again that we live in an age of globalization, worldwide capital mobility, increasing inter-dependency, and (with suitable drumroll) threats to national sovereignty. Tedium aside, however, these claims have the virtue, at least—except for the last of them—of being unmistakably true.

Why isn’t national sovereignty endangered (or at least not unmistakably so) by global economic integration? If one defines it as national autarky, then presumably it is endangered—if only because, as the people of North Korea and Myanmar might attest, the global trends make autarky ever more unappealing. Suppose, however, that one instead defines sovereignty in a conventional international law sense, as embracing political independence, territorial integrity, exclusive jurisdiction over one’s territory and residents, and freedom from intervention by foreign sovereigns.¹ Then the fact that countries have ever more extensive strategic interactions and ability to affect each other is not a violation of sovereignty; rather, it is part of the context in which they exercise sovereignty. Even if countries have less latitude to make policy in disregard of outside competitive pressures or emerging worldwide uniformities, this might be viewed as merely influencing how they may choose to exercise their sovereignty.

Still, a debate about global economic trends in relation to sovereignty is too semantic to hold much ultimate interest. A more rewarding topic is how the trends affect countries’ strategic interactions. Harmonization and competition are two well-known modes of interaction between countries’ legal systems, sometimes viewed as

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1. See, for example, L. Oppenheim, *International Law: A Treatise* 286 (Longmans, Green 8th ed 1955).

polar opposites, but often overlapping. For example, a race to the bottom may involve effective harmonization through competition.

In evaluating the consequences of countries' strategic interactions, two key norms to keep in mind are national welfare and worldwide welfare. When the two norms offer consistent counsel, countries may find it easy to achieve mutual gain through cooperation. Even when the two norms seem to conflict, they can, in theory, be reconciled through policies that aim at maximizing worldwide welfare, but offer compensation to the losers. However, this Coase Theorem truism is subject to the usual problem of transaction costs, such as those with the underlying prisoner's dilemmas, where cooperation is best for the group but not for anyone acting in isolation. National and worldwide welfare also may be pushed apart by bargaining problems in a bilateral monopoly, wherein each actor seeks to capture as much as possible of the surplus that is available through cooperation, even at the risk of destroying it all.

International income taxation provides a good illustration of how national and worldwide welfare may interrelate in practice. Countries frequently tax income on both a source and a residence basis, reflecting their power and accepted legal jurisdiction both in personam and in rem. Given these dual claims, if an American invests in France or vice versa, both countries may feel entitled to tax the same income at their full statutory rates. However, such a "double tax" may lead to inefficient deterrence of cross-border investment, to the detriment of the government and people of both countries.

Coordination of the two countries' tax claims may help mitigate this result. Countries around the world have therefore agreed, through a web of bilateral treaties, to coordinate their competing claims via "source country priority." Many countries, including the United States, do this by offering foreign tax credits that effectively rebate the tax on what they deem to be foreign source income, to the extent not in excess of the domestic tax on such income.²

Implicit in the allowance of foreign tax credits is the view that other countries' taxes on the outbound investments of one's residents are relevant to one's own policy choice regarding taxation of these investments. Unilaterally granting foreign tax credits is generally not in a country's short-term self-interest, since, by fully reimbursing foreign taxes up to the credit limit, it invites residents to be indifferent to foreign taxes and foreign governments to impose "soak-up" taxes on inbound investment. Mitigating double taxation through foreign tax credits is therefore quite different from favoring free trade, which generally increases national welfare, even if

2. Some countries apply a "territorial" system, exempting from their tax at least certain categories of their residents' foreign source income. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex L Rev 1301, 1306-08 (1996).

done unilaterally.³ However, reciprocal allowance of foreign tax credits, even if well short of an ideal coordination technique, may leave both cooperating countries better off than would unmitigated double taxation. A country may, therefore, promote both national and worldwide welfare (at least, relative to doing nothing) when it grants foreign tax credits with the understanding that other countries are reciprocating but would likely play tit-for-tat if it reneged.

Tax policy debate in the United States frequently ignores or misconceives the relevance to both worldwide and national welfare of interactions between our tax rules and those of other countries.⁴ This has been particularly apparent in the ongoing debate concerning what are known as "cross-border tax arbitrage" transactions. The United States Treasury has proposed to deny American tax benefits to taxpayers engaging in these transactions, provoking vehement opposition from taxpayers who would be adversely affected.⁵ Unfortunately, the debate has too often failed to focus adequately on national and worldwide welfare considerations. This paper therefore briefly examines cross-border tax arbitrage, in light of these considerations as affected by countries' strategic interactions.

II. WHAT IS CROSS-BORDER TAX ARBITRAGE?

Cross-border tax arbitrage has been defined as taking advantage of inconsistencies between different countries' tax rules to achieve a more favorable result than that which would have resulted from investing in a single jurisdiction.⁶ Without delving too deeply into technical minutiae, two relatively simple examples may help those who are not tax specialists to grasp the underlying idea.

Dual resident companies ("DRCs"). Countries typically apply residence taxation not just to individuals who are citizens or live inside their borders, but also to certain legal entities such as corporations. Yet the residence of a corporation is often not obvious or self-defining. Suppose, for example, that a company is incorporated in country A, has its main headquarters in country B, operates factories in countries C, D, and E, and sells its products through sales outlets that it maintains in all five of these countries plus twenty more. Where is it a resident? The United States determines

3. See Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, in Joel Slemrod, ed, *The Taxation of Multinational Corporations* 133, 140-42 (Kluwer 1995).
4. For a general discussion, see Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 *Tax L Rev* 353 (2001).
5. See IRS Notice 98-11, 1998-6 IRB 18 (proposing to limit certain cross-border tax benefits); IRS Notice 98-35, 1998-27 IRB 35 (withdrawing Notice 98-11). On the controversiality of Notice 98-11 see, for example, Robert A. Jacobs, *NYSBA Criticizes Treasury's Subpart F Study*, 2002 *Tax Notes Today*, No 8-20 (2002).
6. See, for example, Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 *Fla Tax Rev* 147, 171 (1996); H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System"*, 53 *Tax L Rev* 137, 142 (2000).

corporate residence based on where a given company is incorporated. The United Kingdom, by contrast, is among the countries that treat a company as a resident if it is deemed to be locally managed and controlled. A corporation can therefore qualify as both a US and a UK resident, if it is incorporated in the US but managed and controlled (at least for UK tax purposes) in the UK.

One further important detail is that in both countries a group of commonly owned resident corporations can file a consolidated return, resulting for some purposes in treatment of the group as if it were a single corporate taxpayer.⁷ Thus, one member's losses can be deducted against another's income. Fertile minds soon realized that this shared rule, in combination with the disparity between the two countries' corporate residence rules, could be exploited to the taxpayer's advantage.

Suppose that a multinational enterprise incorporates a company in the US and places its headquarters in the UK, thus making it a DRC that both countries treat as a "native." The DRC can be consolidated with both the enterprise's UK entities in the UK and its US entities in the US. Suppose further that both consolidated groups have positive taxable income, but that the DRC incurs tax losses. (This can be arranged through such means as making it highly leveraged and manipulating the reported "transfer prices" on its transactions with other group members.) If otherwise permitted by both countries, the DRC's tax losses can be deducted twice, against the income of both the UK and US groups. The result of this double deduction is that an amount of the overall worldwide group's income equal to the DRC's loss is taxed nowhere, at least for the present.

The United States responded to this gambit in 1986 by enacting a rule that denied the use of DRC losses on consolidated returns.⁸ Some years later, the UK followed suit with a similar rule, although several other countries that apply a headquarters rule for corporate residence have not done so.⁹ At present, therefore, the tax losses of DRCs are not allowable against consolidated group income either in the US or the UK.

Double-dip leases. A similar tax planning idea takes advantage of disparities between countries' rules for determining who receives depreciation deductions. Suppose that legal title to an airplane is held by a French taxpayer, but beneficial economic ownership goes to an American taxpayer under a long-term lease. France and the United States agree that depreciation deductions go only to the owner of the

7. Strictly speaking, consolidation is the US approach, whereas the UK permits losses to be surrendered by one member of the resident group to another. For present purposes, however, the two approaches are effectively the same.

8. 26 USC § 1503(d) (2002).

9. See David R. Hardy, *A Company Without a Country: The Dual Consolidated Loss Regime*, 84 Tax Notes 747, 756 (1999) (providing overview of systems in the UK, Australia, the Netherlands, and Germany). The UK rule excludes dual resident companies from the UK consolidated group, rather than specifically addressing losses like the US rule.

property, as defined for tax purposes. However, France bases tax ownership exclusively on legal title, while United States tax law sometimes relies on indicia of economic ownership.

Thus, with careful planning, the airplane's acquisition cost may end up being deducted in full by both the legal owner in France and the beneficial owner in the United States. This may result in worldwide non-taxation, at least for a while, of an amount equal to the acquisition cost. Despite the similarity to the result of creating a DRC with tax losses, double-dip leases, while widely noted, have not been challenged even by the (at times assertive) United States Treasury.

III. ARE THESE REALLY ARBITRAGES, AND DOES IT MATTER?

Are these transactions really arbitrages? As with "sovereignty" in relation to globalization, that depends on how one defines the term. Economists define arbitrage as costlessly buying and selling, or borrowing and lending, the same item at different prices so that one is guaranteed a positive payoff. An arbitrage opportunity therefore provides the equivalent of a risk-free "money pump" for as long as it lasts.¹⁰ The idea that arbitrage is impossible at equilibrium has been called "the one concept that unifies all of finance."¹¹

Dual resident companies and double-dip leases are not arbitrages in this sense. They involve a net investment position that happens to receive favorable tax treatment taking into account all countries' tax systems, rather than an offset between positions. Markets do not eliminate them, but rather encourage their continued creation until the point where the marginal tax benefit is no longer worth the marginal non-tax cost. Anyone who is accustomed to the standard economic usage of "arbitrage" may therefore find its application here metaphorical at best, and misleading at worst.

Even if the transactions are not strictly arbitrages, however, might they fall within the common usage of "tax arbitrage"? In the tax policy literature, this term is commonly used to describe offsetting long and short positions that are taxed asymmetrically—for example, by pairing an excluded or deferred gain with a currently deductible loss.¹² An example would be borrowing to own a home, and thereby generating excludable imputed rental income along with deductible home mortgage interest expense. This usage of the term "tax arbitrage" is convenient, even though it

10. Philip H. Dybvig and Stephen A. Ross, *Arbitrage*, in Peter Newman, Murray Milgate, and John Eatwell, eds, *The New Palgrave Dictionary of Money & Finance* 43 (Macmillan 1992).

11. *Id.* at 48 (internal citation omitted).

12. See, for example, David F. Bradford, *Untangling the Income Tax* 39–40 (Harvard 1985); C. Eugene Steuerle and Bruce K. MacLaury, *Taxes, Loans, and Inflation: How the Nation's Wealth Becomes Misallocated* 57–61 (Brookings 1985).

applies to real net positions that markets do not eliminate,¹³ because the technique it describes (while consistent with equilibrium) is important to tax planning and government responses thereto.

Dual resident companies and double-dip leases are not tax arbitrages, however, for the same reason that they are not strict economic arbitrages. Again, they involve a single position, rather than a pair of asymmetrically taxed long and short positions. One might be able to use them in constructing a tax arbitrage, but this merely reflects that their worldwide tax treatment is favorable. Similarly, the income exclusion for a home's imputed rental value is not itself a tax arbitrage but can be used in constructing one.

Why, then, would anyone use the term "cross-border tax arbitrage" to describe the transactions? To some extent, it may be a rhetorical ploy to cast the transactions, like tax arbitrage in some of the tax policy literature, in an unfavorable light. The only way to defend it semantically would be to say that the taxpayer is "arbitraging" the inconsistencies between two countries' legal rules.

There is nothing inherently wrong with using the term this way if one likes. It is, after all, just a semantic issue. And perhaps the salience of giving the name "arbitrage" to these instances of clever legal jujitsu is worth the risk of confusion. Yet one should understand that the sense of semantic inconsistency that underlies this explanation of the term bears little relationship to the reasons why we might be concerned, from a national or worldwide welfare standpoint, about the transactions that are being described.

From such a standpoint, the main reason for concern about cross-border tax arbitrages (to abandon further quibbling about the name, simply because it has gained such wide acceptance) is that they involve preferential worldwide tax treatment. Taxpayers who use DRCs or double-dip leases are effectively taxed nowhere on certain worldwide income. The resulting planning opportunities may have undesirable effects on taxpayer behavior and worldwide resource allocation because they violate tax neutrality, a norm that, in some circumstances, promotes efficiency. So, cross-border tax arbitrages are potentially undesirable for the same reasons as single-jurisdiction tax preferences, although their cross-border character may complicate the national welfare analysis.

As compared with tax preferences generally, cross-border tax arbitrages' distinctive feature is their involving what one might call "cross-border tax synergy," or an interaction between two tax systems to achieve favorable results that neither system would have offered standing alone. Once we identify the issue this way, we can see that "arbitrage" in the metaphorical sense of exploiting inconsistencies in the

13. Steuerle, *Taxes, Loans, and Inflation* at 59–60 (cited in note 12), using the terms "pure tax arbitrage" to describe arbitrages in the strict economic sense that are created by asymmetric tax treatment, and "normal tax arbitrage" to describe examples such as debt-financed home ownership.

application of a shared legal concept, such as corporate residence or tax ownership, is just a means rather than the end of ultimate interest. Semantic inconsistency is neither necessary nor sufficient to achieving cross-border tax synergy,¹⁴ and the inquiry into whether it exists in a given case may be unilluminating. Suppose, for example, that the UK had the same corporate residence rule as the US, but offered tax benefits to foreign corporations with local headquarters. If the end result were the same as that from being able to claim double deductions by exploiting inconsistent corporate residence rules, it should not matter whether we still regarded this as involving an “arbitrage” between inconsistent applications of the same tax concept.

In practice, developed countries’ tax systems are similar enough that cross-border tax synergies often involve exploiting inconsistent definitions of a single term of art.¹⁵ Thus, looking for cross-border tax arbitrages might be a good strategy for identifying cross-border tax synergies that may be of interest. Yet we should keep in mind that semantic inconsistency is not inherently something to be concerned about. Taxpayers are not being sneaky or dishonest when they find a clever way to steer through different countries’ tax rules; there is no moral duty of worldwide semantic consistency. At the same time, the fact that one can engage in these transactions without shame, if the rules permit them, tells us nothing about whether the rules should permit them.

IV. WELFARE IMPLICATIONS OF ADDRESSING CROSS-BORDER TAX ARBITRAGES

A. ARE THEY RELEVANT TO NATIONAL TAX POLICY?

Discussions of cross-border tax arbitrages often start from a presumption that tax benefits from the transactions must be allowed unless tax officials can identify a “legitimate objection.”¹⁶ Or we are told that the transactions cannot properly be addressed unless they are demonstrably worse than others that remain permissible¹⁷—seemingly an open invitation to treat the worst as the enemy of addressing the merely bad. We also are asked why, in evaluating the US tax treatment, say, of taxpayers with

14. An example of cross-border tax synergy without the “arbitrage” is merging companies in high-tax and low-tax countries in order to shift taxable income to the low-tax country without having to move economic activity there. An example of the legal arbitrage without the synergy is the use of a DRC where the consolidated group cannot use the losses in one of the countries.

15. There also are negative cross-border tax synergies resulting from such inconsistencies that are to the taxpayer’s detriment. A prominent example concerns the treatment of interest expense incurred by US multinationals. See Shaviro, 54 *Tax L Rev* at 376–77 (cited in note 4).

16. West, 3 *Fla Tax Rev* at 171 (cited in note 6).

17. Rosenbloom, 53 *Tax L Rev* at 148 (cited in note 6).

German double-dip leases, we should “be concerned about the rate of tax they are called upon to pay on rental income in Berlin.”¹⁸

The question is an easy one. The reason we should care about the German tax treatment of a transaction involving American taxpayers is that it may affect us. Other countries’ tax rules may influence our taxpayers’ incentives. Such rules are therefore likely to affect the investments that Americans make and the resources that they spend on tax planning. Their pre-tax and after-tax income may be affected by foreign tax rules, and so may our tax collections. Effects of this sort are normally considered to lie well within a government’s reasonable areas of concern.

The foreign tax treatment of a given transaction involving one’s own taxpayers is merely a factual input, like any other, to the question of how the different rules that one might select would affect national welfare. Indeed, the only difference that comes to mind between this input and any other is that this one may tend, albeit not uniquely, to raise issues of strategic interaction between different countries. For example, if the Germans notice that we are expressly responding to their tax rules, then perhaps they will become more likely to respond, in turn, to ours. Such strategic interactions are always relevant to the consequences of adopting a given policy, and accordingly should be taken into account here, just as in any other setting.

For analytical convenience, however, I start my evaluation of cross-border tax arbitrages from a national welfare standpoint by assuming that the United States response to a given cross-border tax arbitrage is entirely unilateral, in the sense of not affecting other countries’ decisions. I then turn to issues of strategic interaction.

B. UNILATERAL RESPONSES TO CROSS-BORDER TAX ARBITRAGE (AND OTHER CROSS-BORDER TAX SYNERGIES)

A good starting point in evaluating the United States tax issues raised by double-dip leases and DRCs is to ask why we allow income tax deductions, such as for depreciation or a consolidated group member’s losses, in the first place. The fact that allowing these deductions may improve the accuracy with which the tax system measures net income is merely a means. The end, presumably, is to improve the efficiency and distributional consequences of our income tax, and government rules generally, relative to the case where the deductions are not allowed. Thus, for example, suppose there was a proposal to tax supermarkets on their gross sales receipts, without allowing them to recover costs of goods sold and operating expenses, while all other businesses continued to be taxed as at present.¹⁹ It seems likely that this proposal would inefficiently discourage supermarkets relative to other business

18. *Id.* at 151. For an important exception to the style of analysis that I am criticizing, see Reuven S. Avi-Yonah, *Commentary*, 53 *Tax L Rev* 167 (2000).

19. The distinction between the tax treatment of supermarkets and other undertakings is needed because they would not be relatively disadvantaged, say, by a comprehensive retail sales tax.

undertakings.²⁰ It also might prompt costly avoidance responses by supermarkets (for example, purporting to be middlemen that do not actually own the goods they sell, thereby avoiding the application of the unfavorable tax rules).

Now suppose we learned that, for some odd reason, allowing supermarkets the same sorts of deductions as any other business would actually reduce efficiency and equity. Then the case for taxing them on their gross sales receipts might be a good one after all. Denying them all deductions and other cost recovery would have two compelling advantages. First, it would, by express hypothesis, directly increase efficiency and equity. Second, if the gross sales receipts tax on supermarkets raised revenue, despite any possible Laffer curve effect, and if the government had fixed revenue goals, then adoption of this tax would reduce the need to induce further economic distortion by levying higher taxes in some other setting.

Assuming for now that other countries will not address cross-border tax arbitrages, this seemingly absurd hypothetical offers a compelling way to look at DRCs and double-dip leases. Allowing corporate groups to deduct one member's losses against another's net income and providing cost recovery with respect to depreciable business assets may generally be good ideas. However, if a foreign government is kind enough to provide deductions for these items, then why should we do so as well? Doubling the deductions provides a worldwide tax preference for these transactions that may increase economic distortion by inducing American taxpayers to choose investments with inferior pre-tax returns. It may also cost the United States tax revenues that would end up being replaced through distortive taxes on something else. Accordingly, just as in the supermarket hypothetical, denying DRC and double-dip lease deductions is potentially a win-win proposition from a policy standpoint.²¹

Suppose one disagreed with the specifics of this analysis—believing, for example, that selectively available double cost recovery for airplanes improves efficiency. That view would not require disagreement with the national welfare-based framework for analysis of cross-border tax arbitrages that I advocate here. It would merely suggest applying the framework in a given case to reach a different conclusion.

My analysis also should not be interpreted as suggesting that cross-border tax arbitrages should generally be disallowed, even in the purely unilateral setting where there are no strategic interactions with other countries. Just like the evaluation of tax benefits in the purely domestic setting, the issue calls for a case-by-case analysis. Suppose, for example, that a particular cross-border tax arbitrage serves mainly to

20. The proposal's distributional effects would depend on how it affected pre-tax returns. It is plausible that, as Boris Bittker has put it, all the inequity would be converted into inefficiency by taxpayer exit from the supermarket business. See Boris I. Bittker, *Equity, Efficiency, and the Income Tax: Do Misallocations Drive Out Inequities?*, 16 San Diego L Rev 735 (1979).

21. The actual rationale for the US rule limiting the use of DRC losses by US consolidated groups, as stated in the 1986 legislative history, emphasized "competitiveness" rather than the efficiency concerns that I would find more persuasive.

mitigate domestic double taxation of corporate income. This might be a laudable result if one generally favors corporate integration. Finally, I intend no implication that only positive or pro-taxpayer cross-border tax synergies should be addressed. Those that are unfavorable to multinational businesses merit evaluation on national welfare grounds as well, and their imposing a kind of tax penalty relative to purely domestic activity may frequently count against them.²²

In the discussion thus far, I have glossed over just how broadly applicable this mode of analysis may be. Since it looks exclusively at the national welfare effects of unilateral deduction denial by the United States, it is not limited to cases of cross-border tax arbitrage. This should come as no surprise, once I have dismissed as merely semantic the question of whether two countries' legal rules are being inconsistently "arbitrated" against each other. Indeed, it is not even limited to cases of cross-border tax synergy. Rather, the set of cases in which the analysis could apply is potentially close to unlimited.

Suppose, for example, that the UK offers what we consider unduly favorable tax treatment to the oil industry, or otherwise favors that industry through government spending or special regulatory exemptions. It is conceivable in such a case, assuming unilateral action, that the United States could increase national and also worldwide welfare by providing an income tax penalty that was designed to reverse those undue UK benefits whenever they were enjoyed by a United States taxpayer.

More generally, one could imagine the United States scouring the world in search of inefficient subsidies that it was in a position to reverse, to its own national benefit and perhaps that of the world economy through offsetting income tax (or other) penalties. Pushed to this extreme, however, one may begin to question whether such an enterprise might end up proving misguided and counterproductive. In particular, one might wonder what other countries would think about this course of action, and how they would respond to it.

The point this makes, however, is simply that unilateral action by the United States cannot be assumed. Particularly, though not uniquely, if we are making money by effectively reversing other countries' deliberate economic policies, those countries might respond by doing things that we would not like. And such a possibility must be considered even in the case of a cross-border tax arbitrage that likely reflects an inadvertent interaction resulting from slight differences in tax rules, rather than the other country's considered economic policy.

To the extent we can act unilaterally, however, there are likely to be win-win cases where the United States does well by doing good. That is, we may be able to raise revenue by reducing inefficiencies in the national and world economies. Responding to such opportunities—for example, by denying US benefits to DRCs or

22. Shaviro, 54 *Tax L Rev* at 404–06 (cited in note 4) (criticizing the negative cross-border tax synergy arising from differences between United States and foreign rules for "sourcing" interest expense).

double-dip leases if this would increase national welfare as I tentatively suggest—potentially offers us a result that is even better than free money. Leaving this (better than) free money on the table, by not responding to cross-border tax arbitrages where a response is in our national interest, would be foolish.

C. STRATEGIC INTERACTIONS BETWEEN COUNTRIES' TAX SYSTEMS

Again, my assumption in the previous section that the United States can act unilaterally was just an analytically convenient starting point. Other countries are always capable of responding to what we do. Moreover, when we directly, and perhaps even explicitly, adopt policies that respond to or rely on their legal rules, they may be especially likely to pay attention. For example, deliberately offsetting their subsidies with penalties might lead to retaliation, although in any given case we might conceivably get away with it or benefit on balance despite the response.

How should we generally expect other countries to respond when we deny US tax benefits to a multinational enterprise by reason of a cross-border tax arbitrage? No less than in the subsidy reversal case, this might in practice amount to an open invitation to the other country to reconsider its rule in light of ours. We have, after all, raised the subject of the rules' interacting effects, and, in a case like the DRC or double-dip lease, denied deductions specifically because the other country is or may be granting them.

There is, however, a significant difference from the case of reversing other countries' deliberate subsidies. In the double-dip lease example, France presumably is not aiming to maximize the worldwide tax subsidy to airplanes. Nor is it likely to be raising the tricolor in support of the proposition that depreciation deductions ought always to go to legal owners. Its aim, rather, may simply be to implement a net income concept by allowing depreciation, while defining tax ownership in the manner that it happens to find convenient administratively. We might not, therefore, be defeating French policy goals by denying our own depreciation deductions in cases of duplicative tax ownership. A similar analysis might apply to DRCs, the UK corporate residence rules, and the UK treatment of consolidated groups.

Suppose that the United States addressed both of these cross-border tax arbitrages by denying the duplicated deductions, and that for some reason France and the United Kingdom were entirely unable to change their own rules. Under this circumstance, both countries might well be grateful to us for stepping in. Deduction denial by the United States might conceivably induce their own residents to make better pre-tax investments and spend less money on tax planning. France and the UK also might conceivably gain revenue if their taxpayers engaged in fewer of these transactions by reason of the US response.

Now, however, suppose (a lot more reasonably) that France and the UK are perfectly capable of enacting their own responses to these transactions. Even if they are sympathetic to the end result of eliminating double deductibility, they may wonder

why the United States should capture the entire direct fiscal benefit. Why should we get to freeride on the fact that they were offering deductions that both sides agree should be taken only once, when they could just as easily freeride on us? They might further think of us as administrative freeriders, if we conditioned our denial of tax benefits on findings of corporate residence or tax ownership that were made by their tax systems.

In sum, by responding unilaterally with deduction denial, the United States could be viewed as aggressively grabbing nearly all of the available joint surplus from a bilateral monopoly (involving the welfare gain that the countries can reap by coordinating their tax rules). Other countries might rationally expect to benefit from demanding a greater share of the joint surplus, even at the risk of destroying it all. Threats and chicken games are, after all, a common feature of bargaining over the division of surplus.

One should not be entirely surprised, therefore, that the UK has enacted its own duplicative (for US–UK dual corporate residents) response to the DRC problem.²³ The potential for double non-deductibility in the case of US–UK dual residents has begun to prompt taxpayer complaints, although initial efforts to address it through the treaty process resulted only in an agreement that the two countries' competent authorities should reach some agreement.²⁴

When both of a DRC's resident countries respond with overlapping deduction disallowance rules, the distortion may be less than that from double deductibility, since incurring DRC losses is to some extent elective. Nonetheless, it may amount to overkill given the possibility of cases where one has business reasons for establishing a DRC that is making risky investments with the possibility of loss. Even if both the US and the UK would benefit, no matter what the other country did, from unilaterally denying the deductions, it is conceivable that they would do better still by coordinating their rules to allow the deductions a total of once. This might involve splitting the deductions fifty-fifty, or through any other objective formula, even if arbitrary.

To date, double-dip leases present the opposite scenario. Neither the United States nor the foreign countries that base tax ownership rules exclusively on legal title have thus far sought to claim what is arguably free money on the table by denying duplicative deductions. So here there may be collective "underkill" rather than overkill.

23. Germany has also recently enacted a loss disallowance rule for DRCs. However, several other countries (such as Australia and the Netherlands) that employ a headquarters approach to corporate residence have not, at least as yet, followed suit. See Eugen Bogenschuetz and Kelly Wright, *Change Begets More Change: The Permanent German Tax Reform*, 25 *Tax Notes Intl* 1125, 1131 (2002).

24. See Philip R. West, *Highlights of the New U.S.–U.K. Tax Treaty*, 92 *Tax Notes* 663, 666 (2001).

These two examples help to show that achieving desirable coordination between countries' responses to cross-border tax arbitrage is not all that easy. The problem may have less to do with ineluctable disagreement between sovereigns, such as concerning the division of joint surplus, than with inattention, competing priorities, and domestic political considerations.

The US Treasury, for example, might have little inclination to devote its scarce human resources to coordinating our responses to cross-border tax arbitrages with those of other countries even if it had the authority to do so. It has faced intense domestic political opposition even when proposing responses that would give the United States 100 percent of the direct fiscal benefit. And even if there were more domestic support in principle to devising joint responses with other countries, obtaining congressional approval via a treaty or legislation might be quite difficult. Members of the tax committees in both Houses of Congress often have agendas of their own. They also have a collective institutional interest in objecting to the use of the treaty process to implement substantive tax law changes, which involves only the Senate under the jurisdiction of the Senate Foreign Relations Committee.

Yet all this need not deter the United States from responding unilaterally to cross-border tax arbitrages. Other countries may frequently be slow to act, and taxpayer self-help through tax planning and the exertion of political pressure may serve to mitigate instances, like the DRC, of bilateral overkill. Unilateral action should not be undertaken, of course, in cases where it involves bad policy standing alone. Yet opportunities to free-ride on other countries' willingness to offer deductions, or to allow business income to escape their source-based taxes, may often be worth exploiting, on the ground that they are likely to combine doing well with doing good.

Where unilateral action would not be good policy, this can be argued on the merits of the particular case, or in more broadly applicable terms. One might argue, for example, that preventing United States taxpayers from exploiting a given planning opportunity that is available to foreign investors would in some way disadvantage us. Or one might argue that, given the arbitrariness and growing avoidability of our corporate residence rules, there is no point in seeking increased foreign source tax collections from US corporations. Still another argument might be that, given the existence of various negative cross-border tax synergies, permitting multinational businesses to exploit favorable synergies serves on balance to reduce tax distortion.

The great virtue of such arguments is that, whether right or wrong, they address the right set of issues. They thus would advance a debate that has too often focused on claims that other countries' tax rules, despite their clear effects on us, are, for some unstated reason, none of our business.

V. BROADER PERSPECTIVE ON CROSS-BORDER TAX ARBITRAGE AND TAX HARMONIZATION

Do the issues raised by cross-border tax arbitrage offer any broader lessons regarding either the desirability or the feasibility of general tax harmonization? On the question of desirability, the fact that neither tax harmonization nor tax competition is always best has been widely recognized. "At that level of generality, one might as well ask whether government is good or bad."²⁵ One rough rule of thumb that may provide guidance, however, is the view that harmonizing income tax bases often makes sense even if tax competition with respect to rates is retained or indeed encouraged.²⁶

Eliminating cross-border tax arbitrages resembles tax base harmonization, but with an important difference. It does not require that different countries actually adopt the same rules. Thus, suppose France and the United States would have difficulty in agreeing to the same tax ownership rule, whether out of national pride, or because they face different administrative tradeoffs, or because changing one's existing rule would be costly to each country in some way. A rule eliminating duplicative deductions for double-dip leases, whether adopted unilaterally or bilaterally and no matter how the revenue were divided, would not require either country to agree which rule was best, or to depart from its own preferred and settled administrative practice. Accordingly, some of the arguments against tax base harmonization do not apply to proposals to move towards elimination of cross-border tax arbitrages.

A broader point concerns how, in this setting and others, international institutions might be developed to facilitate desirable international cooperation in tax matters. Some commentators have urged the creation of a "GATT for Taxes" or a "World Tax Organization," analogous to existing institutions that oversee international trade.²⁷ An admitted problem, however, is the lack of any obvious reference point akin to free trade. Even among experts, there is no international consensus regarding such matters as to what sort of tax to levy at the corporate level and how to relate that tax to the taxation of shareholders.

A multilateral tax organization need not, however, take as its mission the creation of worldwide tax base uniformity. Instead, it can aim to coordinate international cooperation where that would be mutually advantageous but is impeded by transaction costs. Eliminating cross-border tax arbitrages and other tax synergies

25. Daniel Shaviro, *Some Observations Concerning Multijurisdictional Tax Competition*, in Daniel C. Esty and Damien Geradin, eds, *Regulatory Competition and Economic Integration: Comparative Perspectives* 49, 67 (Oxford 2001).

26. See, for example, Daniel Shaviro, *Federalism in Taxation: The Case for Greater Uniformity* 100-08 (AEI 1993).

27. See, for example, Jack M. Mintz, *The Role of Allocation in a Globalized Corporate Income Tax* 36, Working Paper No 98-134 (IMF 1998); Vito Tanzi, *Taxation in an Integrating World* 140 (Brookings 1995).

through the reciprocal reduction of duplicated or poorly coordinated tax benefits would be one possible application. A second, the flip side of this enterprise, might be reining in countries' occasional inclination to adopt narrow definitions of foreign source income and thereby to "cheat" at the margin in offering foreign tax credits or exemption. Furthering international cooperation in tax collection, administration, and information-gathering might be a third undertaking.

Unilateral action by the United States to deny tax benefits in cases of cross-border tax arbitrage might seem to be a long way from this endpoint. And indeed such unilateral action mixes the competitive with the cooperative, since, while potentially aiding other countries that are slow to act, it does so by grabbing the entire direct fiscal benefit that others might want to share. Yet addressing cross-border tax arbitrage has at least the potential to help everyone move in the direction of greater worldwide cooperation, while also possibly advancing purely national ends in the here and now.