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The Two Faces of the Single Tax Principle

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Introduction

Tax treaties generally require that signatories eliminate "double taxation" through the extension of either foreign tax credits, or exemptions for foreign source income ("FSI") by each country to its own residents, which the other country taxes on a source basis. The treaties also commonly seek to address "fiscal evasion." While this term only denotes illegal tax avoidance, some commentators discern a broader policy goal, embodied in the international tax regime, which includes the treaty network of avoiding "double non-taxation,"[1] or the creation of "stateless income"[2] that is not taxed anywhere.

Put these two concerns together and you arguably have a "single tax principle,"[3] holding that each increment of a multinational taxpayer's global income should be subject to tax somewhere exactly once, rather than either zero times or twice. For

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1. Reuven S. Avi-Yonah, *Who Invented the Single Tax Principle: An Essay on the History of US Treaty Policy*, 59 N.Y.L. SCH. L. REV. 305 (2014).

2. *See* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

3. *See, e.g.*, REUVEN S. AVI-YONAH, ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW 59–65 (2015).

convenience, this article will refer to double taxation as departing from the single tax principle on the "upside" and to double nontaxation as departing from it on the "downside."

When one focuses on exactly how many times a given increment of global income is taxed, one risks exalting formalism at the expense of substance. As noted elsewhere about double taxation, treating its elimination as a core principle

> confuses two distinct questions [about the taxation of cross-border activity]. The first is 'How much?' The second is 'How many times?' . . . [W]hile there may be good reason to care about high versus low taxes on cross-border activity . . . this does not imply that there is any direct normative reason to care about the *number* of taxes that are being levied on a given taxpayer or transaction. After all, most of us would rather be taxed twenty times at a 1 percent rate each time than once at 35 percent.[4]

While being taxed twice need not necessarily be worse than being taxed once, depending on the circumstances, the same point does not hold on the downside. Since zero multiplied by anything is zero, being taxed zero times cannot help but result in a lower tax liability than being taxed some positive amount once. For this simple arithmetical reason, the single tax principle operates differently in the two settings. On the upside, it can confuse and misdirect the analysis, while unduly limiting the design choices that are deemed available. By contrast, on the downside, it properly tees up an issue of genuine importance to international tax policy debate pertaining to stateless income[5]—although it leaves much to be said regarding whether, when, and why one should object to businesses paying tax nowhere rather than somewhere.

If one accepts these conclusions about the single tax principle,[6] what are the implications for tax treaties' future role in the de-

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4. DANIEL SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 6–7 (2014).

5. If the single tax principle were viewed as being satisfied on the downside, even when income was taxed at a rate of, for example, 0.0001 percent, the resulting formalism would greatly reduce the principle's usefulness. In practice, however, it seems to be interpreted as requiring that the tax rate not be too close to zero. This can create a line-drawing issue that raises broader questions about the underlying reasons for the single tax principle. However, this issue has not arisen much in practice.

6. One could perhaps reformulate the single tax principle as requiring that income be taxed at either the residence country rate or the source country rate,

velopment of international tax law and policy? Although in distinct ways, this article assesses the implications both on the upside and the downside as mainly negative. On the upside, while treaties surely can continue to play a constructive role in peer countries' efforts to coordinate the interactions between their tax systems, their focus on double taxation can potentially be misleading—although this article will argue that, in practice, there may be a greater scope for interpretive flexibility than has often been assumed. On the downside, the Organisation for Economic Co-operation and Development (OECD) and Base Erosion and Profit Shifting (BEPS) process[7] helps to show that a multilateral, not just bilateral process (as with treaties), is imperative insofar as countries decide that they want to address stateless income.

I. UPSIDE DEPARTURES FROM THE SINGLE TAX PRINCIPLE

Suppose the United States was choosing between (a) taxing all of its resident multinationals' FSI at the same 35 percent rate that it imposes on domestic source corporate income, without any deferral for its foreign subsidiaries' FSI, but with foreign tax credits, and (b) treating foreign taxes as merely deductible, but substantially lowering the tax rate for FSI. Under option (b), unlike option (a), U.S. companies with FSI would formally be subject to double taxation. Yet, option (b) would result in imposing

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without regard to how many times it is taxed. Indeed, this might help explain why levying both residence country and source country taxes on the same income is deemed permissible under the single tax principle if the former offer foreign tax credits. (The alternative explanation of its consistency with the single tax principle would be that credits effectively negate the source country tax, as far as the taxpayer is concerned.) If the single tax principle were thus reformulated, however, it would effectively amount to arguing for following either capital export neutrality (which calls for applying the residence country rate) or capital import neutrality (which calls for applying the source country rate). Setting aside the oddity of one's indifference to *which* of these two rival principles is followed, which has been discussed elsewhere where the author views both, along with other "single-bullet" global welfare norms, such as capital ownership neutrality, as normatively unpersuasive and unhelpful. *See* SHAVIRO*, supra* note 4, at 14–16; Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a "Fix" on Recent International Tax Policy Developments* 4–5 (N.Y. Univ. Law Sch. Pub. L. & Legal Theory Research Paper Series, Working Paper No. 15-20, 2000).

7. *See* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013).

lower U.S. taxes on FSI than option (a), in any instance where, given the applicable source-based foreign rate, the U.S. tax rate for the FSI was lower than the "burden-neutral deduction tax rate."[8]

For example, suppose a U.S. company earned $100 of FSI in a country with a 20 percent corporate rate, and that under option (b) the U.S. tax rate for FSI was 15 percent. Given the existing 35 percent U.S. corporate rate, absent deferral, the company would owe $15 of U.S. tax under option (a), as opposed to just $12 under option (b) (i.e., 15 percent of the after-foreign-tax amount of $80). In such an instance, "the 'crime' of double taxation [under option (b)] would evidently be victimless."[9]

When deciding how to tax resident companies' FSI, there are two main reasons why a country might prefer option (b) to option (a). First, treating foreign taxes as merely deductible induces resident taxpayers to treat foreign taxes as a cost like any other. This is unilaterally optimal, unless there is more to the story, given that home country individuals do not get to spend the foreign tax revenues.[10] By contrast, 100 percent foreign tax credits, if provided immediately and without limitation, offer a 100 percent marginal reimbursement rate ("MRR") for foreign taxes paid, thereby potentially eliminating resident taxpayers' cost consciousness with respect to foreign tax liabilities.[11]

Second, option (b), leaving open the question of what tax rate should apply to resident companies' FSI, allows countries to decide how lightly or heavily they want to tax such FSI. By contrast, option (a) requires that this depend on the relationship between the domestic corporate tax rate and source countries' rates. Given the distinct issues that may govern the choices of domestic corporate tax rate and that for resident companies' FSI[12] (for example, tax elasticity at different margins), there is

8. Kimberly Clausing & Daniel Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?*, 64 TAX L. REV. 431, 435 (2011). For example, the burden-neutral U.S. tax rate for FSI is 18.8% if the foreign rate is 20% and 13.3% if the foreign rate is 25%. *See id.* at 436.

9. SHAVIRO, *supra* note 4, at 5–6.

10. *See* Shaviro, *supra* note 6, at 20–22. As discussed *infra*, what this article calls call "tagging" considerations, however, may support extending worse-than-deductible, albeit better-than-creditable, treatment to resident taxpayers' foreign tax liabilities.

11. *See id.* at 8–9.

12. *See id.* at 9–18.

no reason to think that requiring the two rates to travel in tandem—or having domestic tax burdens on FSI depend on foreign countries' tax levels—is optimal.[13]

In addition to having clear advantages from a residence country standpoint, option (b) is not necessarily disadvantageous to source countries. To be sure, such countries might prefer that the residence country offer foreign tax credits to its companies, thus reducing the companies' aversion to paying the source country taxes. Yet, the single tax principle unambiguously permits residence countries to exempt FSI, a deductibility-equivalent result for such taxes[14] that results in a domestic MRR of zero for such taxes.

A fuller account of why a given country might benefit from (1) taxing resident companies' FSI at a rate between zero and the full domestic tax rate, and (2) offering worse-than-deductible, but better-than-creditable MRRs for such companies' foreign tax liabilities, has been offered elsewhere.[15] This does pose the question, however, of whether this would require violating bilateral tax treaties that commit the signatories to adhere on the upside to the single tax principle. A recent prominent international tax reform proposal helps to show that the answer to this question is probably not.

In September 2013, the U.S. Senate Finance Committee, under then-Chairman Max Baucus, released a Staff Discussion Draft that sketched out alternative international tax reform options.[16] One of the main two options that this document described, called "Option Z," would apply as follows to certain FSI of U.S. multinationals. A percentage of each dollar of such FSI would be fully taxable to the U.S. parent, while the remaining increment of the dollar would be exempt. Foreign tax credits

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13. To be sure, the single tax principle permits one to exempt resident companies' FSI instead of granting foreign tax credits. However, this also limits discretion and may be below the preferred rate. *See id.* In addition, while under a worldwide/foreign tax credit system, one can use deferral to lower both the effective domestic tax rate for FSI and the marginal reimbursement rate for foreign taxes, which has adverse effects of its own. *See id.* at 22–26.

14. *See id.* at 9.

15. *See* Shaviro, *supra* note 6.

16. *See Summary of Staff Discussion Draft: International Business Tax Reform*, U.S. SENATE COMMITTEE ON FIN. (Nov. 19, 2013), http://www.finance.senate.gov/imo/media/doc/Chairman%27s%20Staff%20International%20Discussion%20Draft%20Summary.pdf.

would be allowed as to the taxable component, but not the exempt component of each dollar of such FSI.

As an illustration, suppose that the taxable percentage of such FSI was 60 percent. If the U.S. domestic corporate tax rate remained at 35 percent, this would mean that, in effect, each dollar of the FSI would be taxable at a 21 percent rate (i.e., 60 percent of the tax rate for domestic source income). The MRR for foreign taxes paid with respect to this FSI would be 60 percent.[17]

It is highly likely that Option Z avoids violating bilateral tax treaties. After all, for every dollar of FSI earned by a U.S. multinational and taxed abroad, double taxation is avoided as to the taxable component of that dollar via foreign tax creditability, and, as to the remaining component, through exemption. Thus, there is formal compliance with the bar on double taxation, if one is willing to accept bifurcation for purposes of the analysis.[18]

There also is a strong purposive argument in favor of allowing such bifurcation. Suppose, for example, one views the bar on double taxation as being meant to address the concern that countries are inclined to overburden cross-border activity. Thus, one must mitigate this concern by offering exemption or foreign tax credits. However, if each of these two mitigation methods is permissible, then arguably there is nothing wrong with Option Z's mix-and-match approach, given that one cannot actually reduce the overall mitigation that is provided.[19]

The point can be made more generally as follows: under an Option Z-style approach, the MRR equals the ratio between the tax rate on FSI and the tax rate on domestic source income. Simplified even further, so long as the MRR equals or exceeds the above ratio between the tax rates on FSI and domestic source income, one does not violate the single tax principle by combining a MRR that is below 100 percent MRR with a tax rate on FSI that is greater than zero.

There admittedly is room here for interpretive ambiguity. For example, if not all FSI and/or not all domestic source income is taxed the same, or if there are systematic tax base differences

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17. *See* Shaviro, *supra* note 6, at 45–46.

18. *See* Fadi Shaheen, *How Reform-Friendly Are U.S. Tax Treaties*, 41 BROOK. J. INT'L L. 1243 (2016) (arguing in detail that Option Z is treaty-consistent).

19. *See id.* (arguing that even if Option Z violated bilateral tax treaties, signatories would have little motivation to object, given that it does not harm them, and may even be preferable from their standpoint to exemptions).

between the domestic tax treatment of the two types of income, then testing for compliance with the above rule may potentially involve controversy. In a simple and straightforward case that lacks these issues, however, the comparison can simply be based on applicable marginal tax rates.

Is this a radical new approach to interpreting the single tax principle? The answer clearly is no. In particular, consider U.S. Internal Revenue Code section 965, enacted in 2004, which provides a temporary repatriation tax holiday. This provision combined, (a) making qualifying foreign dividends, in effect, 85 percent excludable, with (b) reducing allowable foreign tax credits by the same ratio.[20] Similar adjustments may apply to other items of FSI that are partly excludable or taxed at special low rates.[21]

Allowing interpretive nuance with respect to the bar on double taxation might provide for criticism, because a significant risk may exist in regards to opening the door for the imposition by treaty signatories of excessive tax burdens on cross-border economic activity. However, one could easily exaggerate countries' unilateral predilection to target such activity for heavy tax burdens. As suggested by the recent movement toward exemption in countries such as the United Kingdom and Japan, pressures of tax competition, plus an eagerness to help home-country corporate "champions" compete with their overseas business rivals, frequently outweigh the urge to maximize domestic tax revenues, and thus reduce the need to keep formal legal barriers in place.

II. Downside Departures From the Single Tax Principle

Why object to stateless income, or income that is taxed zero times rather than once? The question is harder and more complicated than it may initially seem. From the unilateral national welfare standpoint of a given country, foreign taxes are just a cost. Thus, suppose a U.S. company, owned by U.S. individuals, can pay taxes of either €10 million or zero on its operations in

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20. *See* I.R.C. § 965(d) (2004). It is true, however, that this provision applied to taxpayers electively, rather than mandatorily.

21. For example, U.S. taxpayers must take account of rate differentials between ordinary income and particular categories of capital gain in applying the foreign tax credit limitations of Code section 904. *See* Treas. Reg. § 1.904(b)-1 (2004).

the European Union without any effect either on its level of U.S. investment or on its U.S. tax liability (depending solely on whether the U.S. rules discourage it from engaging in EU tax planning). This might turn, for example, on whether the company can use the U.S. check-the-box rules to shift taxable income from high-tax EU countries into tax havens, without thereby incurring U.S. tax liability under subpart F of the Internal Revenue Code.[22]

In this scenario, there is little or no reason for the United States to object unilaterally to the company's creation of stateless income. Nonetheless, both the United States under subpart F, and various exemption countries, under their own controlled foreign corporation rules, often tax resident companies' FSI when it either has been reported as arising in a tax haven, or is of a kind that seems likely to end up in a haven.[23] Similar concerns appear to underlie the OECD's BEPS project.

As has been argued elsewhere that this reflects countries' often having

> good reason for disfavoring high levels of actual or suspected foreign tax minimization. Income that is reported as arising in a tax haven may be unlikely to have been earned there economically, given that havens often have limited productive capacity. In addition, as a matter of successful tax planning, shifting reported income so that it arises outside of the domestic tax base, even if it initially shows up in a foreign jurisdiction, with a significant tax rate, in which one has boots (so to speak) on the ground, often is merely a first step towards further on-shifting it to a tax haven. Thus, it is reasonable for countries to use the fact that income has been reported as arising in a tax haven – or is of a kind that seems likely to end up in a tax haven – as a "tag" indicating an increased likelihood that it was actually earned at home.[24]

To be sure, countries' aversion to overseas tax avoidance is not continuous and ongoing. In the United States, for example, the government has tolerated U.S. companies' use of check-the-box rules to avoid subpart F's checks on avoidance of other countries' taxes, which arguably reflects the view that the United States

22. Subpart F refers to I.R.C. §§ 951–965.
23. *See* Shaviro, *supra* note 6, at 20–21.
24. *Id.* at 20.

benefits, rather than loses, from such activity.[25] Considerable variation in countries' tolerance of, or hostility to, overseas tax avoidance should come as no surprise, given the underlying ambiguity (and likely heterogeneity) of the domestic national welfare effects.

Accordingly, with respect to downside departures from the single tax principle, outcomes that matter substantively, not just formally, are indeed at stake, however, the principle fails to illuminate why, whether, and when countries should actually find it objectionable. In addition, insofar as it wishes to address it, the OECD's BEPS process is a rich testament to the likely need to proceed multilaterally, rather than through unilateral or bilateral treaty network options. We will learn more in the next few years regarding just how successful (or not) this process turns out to be. In any event, however, it clearly reflects a widespread judgment that the traditional treaty structure is not adequately equipped to meet new challenges.

CONCLUSION

In assessing the single tax principle, which arguably underlies bilateral tax treaties, one should distinguish between upside departures, which occur when the same dollar of income is taxed more than once, and downside departures, which occur when it is not taxed at all. This article argues that a focus on barring upside departures can be quite misguided. While overtaxing cross-border activity relative to that occurring in one country may be undesirable, this should not stand in the way of letting residence countries tax foreign source income at a reduced rate in lieu of wholly offsetting source country taxes via foreign tax credits. As for barring downside departures from the single tax principle, such as by addressing stateless income, this often is desirable from a given country's unilateral national welfare standpoint (and is even more clearly worth pursuing multilaterally), yet the issues raised are more complicated than what adherence to the single tax principle appears to suggest.

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25. *See, e.g.*, Daniel Shaviro, *BEPS Conference at Bocconi University in Milan* (May 21, 2014), http://danshaviro.blogspot.com/2014/05/beps-conference-at-bocconi-university.html (noting that many European tax policy commentators view the U.S. check-the-box rules in this way).