

December 2010

Why Are There Tax Havens?

Adam H. Rosenzweig

Follow this and additional works at: <https://scholarship.law.wm.edu/wmlr>



Part of the [Tax Law Commons](#)

Repository Citation

Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 Wm. & Mary L. Rev. 923 (2010),
<https://scholarship.law.wm.edu/wmlr/vol52/iss3/5>

Copyright c 2010 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/wmlr>

WHY ARE THERE TAX HAVENS?

ADAM H. ROSENZWEIG*

ABSTRACT

Recently, the issue of tax havens has risen to the fore of the fiscal policy debate, with tax havens being singled out as the root cause of many of the fiscal shortfalls plaguing the governments of the world. Surprisingly, however, although there has been a fair amount of literature on why tax havens are harmful to the modern international tax regime, which countries become tax havens, and what means are available to combat tax havens, there has been less written specifically on the underlying question of why, notwithstanding all these points, tax havens exist in the first place, or why they persist in the face of such overwhelming criticism. This Article will fill that gap by directly confronting the question: why are there tax havens?

To this end, this Article will propose for the first time that the focus of the international tax laws of wealthier countries, such as the United States, on capital neutrality—or making the flow of capital across borders easier and cheaper—can actually create or exacerbate the incentives necessary for poorer countries to act as tax havens. This can be thought of as a “capital neutrality paradox” in that it is the pursuit of capital neutrality—meant to increase worldwide efficiency—which leads to more countries acting as tax havens, effectively undermining worldwide efficiency. Consequently, punishing such countries in response would also prove counterproductive, because it would only exacerbate these incentives created by

* Associate Professor, Washington University School of Law. I would like to thank Amitai Aviram, Cheryl Block, Dhammika Dharmapala, Christopher Hanna, Andrew Moin, Andrew Morriss, Kirk Stark, Peter Wiedenbeck, and the participants at the Columbia Law School Summer Tax Conference, the Washington University School of Law Incubator Series, the University of Illinois Law School Faculty Speaker Series, the Annual Junior Tax Scholars Forum, the Annual Meeting of the Law & Society Association, the Brooklyn Law School Economic Law Forum, and the SMU Dedman School of Law Tax Policy Colloquium for their helpful comments on prior drafts. Special thanks to my research assistant Allen Injijian whose work was invaluable to completing this project.

U.S. law in the first place. This “punishment paradox” in connection with the “capital neutrality paradox” can fundamentally alter the way in which the law should conceptualize and respond to the issue of tax havens. Rather than ask “why are there tax havens?”, the question would become “why pursue capital neutrality?” Rather than ask “what can we do to punish tax havens?”, the question would become “would punishment be effective?” Such an approach could not only lead to a more efficient international tax regime, but could also be the first step to finally answering the question of why there are tax havens.

INTRODUCTION

A raging debate on the perils of tax havens grips the nation. Unscrupulous taxpayers indefinitely defer paying their fair share of U.S. taxes by funneling their income through artificial companies in tax haven countries. Tax havens threaten the long-term fiscal health of the country, undermining the ability of the government to address the pressing economic and social emergencies of the day, and thus the integrity of the modern state itself. The alarm has been raised, the gauntlet has been thrown; leading academics have been decrying the use of tax havens as “tax witchcraft,”¹ and even the President of the United States himself has been imploring Congress to act.² Is this a description of the state of U.S. tax policy in 2010? No—it describes international tax policy debate in the late 1950s and early 1960s. Yet, despite over fifty years of debate, scholarship, analysis, legislation, and regulation, if one simply listened to the modern debate over tax havens, it would appear that little progress has been made over that time.³

1. Stanley S. Surrey, *The United States Taxation of Foreign Income*, 1 J.L. & ECON. 72, 94 (1958) (“The proposal would thus end the tax witchcraft which makes Panama or Liechtenstein or the Bahamas or even Canada the seat of enterprises of great magnitude owned and operated by American corporations.”); see also LAWRENCE B. KRAUSE & KENNETH W. DAM, THE BROOKINGS INST., FEDERAL TAX TREATMENT OF FOREIGN INCOME 13-19 (1964).

2. Special Message to the Congress on Taxation, 1 PUB. PAPERS 290, 295 (Apr. 20, 1961) [hereinafter Kennedy’s Special Message] (“[D]eferral has served as a shelter for tax escape through the unjustifiable use of tax havens.”); see also Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-The-Box Regulations*, 7 FLA. TAX REV. 185, 188 (2005).

3. See, e.g., DAVID L. BRUMBAUGH & JANE G. GRAVELLE, CONG. RESEARCH SERV., REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES (2007), available at http://assets.opencrs.com/rpts/RL34115_20070731.pdf; Martin A. Sullivan, *News Analysis: Will Obama Impose Sanctions on Tax Havens?*, 121 TAX NOTES 1346 (2008); Jackie Calmes & Edmund L. Andrews, *Obama Asks Curb on Use of Havens To Reduce Taxes*, N.Y. TIMES, May 5, 2009, at A1 (“It’s a tax code that makes it all too easy for a number—a small number of individuals and companies to abuse overseas tax havens to avoid paying any taxes at all,’ the president said.”); Press Release, Senator Carl Levin, Statement on Introducing the Stop Tax Haven Abuse Act, Part I (Mar. 2, 2009), available at <http://levin.senate.gov/newsroom/release.cfm?id=308945>.

What can explain this lack of progress?⁴ It cannot simply be attributable to myopia, inertia, or laziness; after all, the United States has enacted or fundamentally revised comprehensive anti-tax-haven legislation in 1962,⁵ 1976,⁶ 1986,⁷ and 1993,⁸ and it is currently the driving factor behind most international tax policy.⁹ Nor can it be a problem unique to the idiosyncrasies of U.S. tax policy, since tax havens have plagued most of the developed countries of the world—as evidenced by the recent “name and shame” campaign against tax havens led by the Organisation for Economic Cooperation and Development (OECD).¹⁰ Yet tax havens not only arise and persist in the face of such seemingly overwhelming attack and criticism, they seem to flourish.¹¹

4. See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 497 (1999) (“[D]eferral is a topic that has long been on the reform agenda. There has been extensive and continuous debate since 1961 (when President Kennedy proposed to end deferral for most CFCs).”). Some have claimed that the tax haven “problem” significantly predates the tax haven debates of the 1950s, and even the modern income tax regime itself. See, e.g., Terence Dwyer & Deborah Dwyer, *Transparency Versus Privacy: Reflections on OECD Concepts of Harmful Tax Competition*, in INTERNATIONAL TAX COMPETITION 259, 262-63 (Rajiv Biswas ed., 2002) (quoting Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776)). In fact, at least one book attributes the modern tax haven phenomenon indirectly to the 1066 Norman conquest of England. See RICHARD ANTHONY JOHNS, TAX HAVENS AND OFFSHORE FINANCE: A STUDY OF TRANSNATIONAL ECONOMIC DEVELOPMENT 78 (1983) (describing how the collapse of the Norman Empire in 1204 led to the annexation of the Channel Islands under the British Crown in 1254 and the granting of the Charter to the People of Jersey, Guernsey, Sark and Alderney of 1341 and 1394, which then led to the fiscal autonomy of the Channel Islands).

5. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960.

6. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

7. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874.

8. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

9. See, e.g., Reuven S. Avi-Yonah, *The Obama International Tax Plan: A Major Step Forward* 4 (U. Mich. Pub. Law & Legal Theory Working Paper Series, Working Paper No. 149, 2009), available at <http://ssrn.com/abstract=1400624>.

10. See ORG. FOR ECON. CO-OPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 8 (1998), available at <http://www.oecd.org/dataoecd/33/1/1904184.pdf> [hereinafter OECD, HARMFUL TAX COMPETITION].

11. It is as if only the names change: in the early 1960s it was Switzerland which was held up as the epitome of an abusive tax haven, see Kennedy’s Special Message, *supra* note 2, at 295, while in the early 1980s it was the Netherlands Antilles, see Craig M. Boise & Andrew P. Morriss, *Change, Dependency, and Regime Plasticity in Offshore Financial Intermediation: The Saga of the Netherlands Antilles*, 45 TEX. INT’L L.J. 377, 379 (2009), and by the early twenty-first century the title had passed to the Cayman Islands, see Calmes & Andrews,

Accordingly, the issue of combating tax havens has once again risen to the fore of the fiscal policy debate, being singled out by institutions such as the OECD and G20 as the root cause of many of the fiscal shortfalls plaguing the governments of the world.¹² To this end, an otherwise unassuming five-story building located in Grand Cayman named Uglad House has found itself in the eye of the most recent tax haven storm.¹³ What distinguishes Uglad House from other buildings is not its architecture or its name, but rather that it houses over 18,000 corporations, mostly owned by U.S. taxpayers.¹⁴ Consequently, a renewed—and familiar—chorus has arisen: Uglad House is a mere sham, aiding and abetting U.S. companies from paying their “fair share” of U.S. taxes. This obviously must be the case, the argument goes—after all, if 18,000 corporations truly were headquartered at Uglad House, wouldn’t it need a bigger parking lot?¹⁵

Contrary to this popular sentiment that Uglad House represents a den of tax iniquity for dishonest taxpayers to evade their fair share of U.S. taxes, this Article will contend that it can more properly be thought of as a symptom of the unintentional incentives created and perpetuated by the modern international tax regime

supra note 3. See also Lynnley Browning, *Swiss Deal with I.R.S. May Hide Some Tax Cheats*, N.Y. TIMES, Sept. 8, 2009, at B3; Rowena Mason, *Bankrupt Cayman Islands To Get £38m Bail-Out*, DAILY TELEGRAPH, Oct. 1, 2009, at 4, available at <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/6248284/Bankrupt-Cayman-Islands-to-get-38m-bail-out.html> (“It is unfair that when you see an article about tax havens it’s always illustrated by a palm tree, never a Swiss Alp.”) (quoting Tony Travers, Director of the Cayman Islands Financial Services Association).

12. See, e.g., Allison Christians, *Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20*, 5 NW. J. L. & SOC. POL’Y 19 (2010).

13. See U.S. GOV’T ACCOUNTABILITY OFFICE, *CAYMAN ISLANDS: BUSINESS AND TAX ADVANTAGES ATTRACT U.S. PERSONS AND ENFORCEMENT CHALLENGES EXIST* (2008), available at <http://www.gao.gov/new.items/d08778.pdf>.

14. *Id.* at 3.

15. See *The Rachel Maddow Show* (MSNBC television broadcast May 4, 2009), available at http://www.msnbc.msn.com/id/30641410/ns/msnbc_tv-rachel_maddow_show/ (“[Uglad House is] home to the fake headquarters of 18,857 companies that want to look like they’re headquartered there in order to avoid paying taxes somewhere else. If there really were 18,857 businesses there, don’t you think the parking lot would be a little bigger?”); cf. *The Colbert Report: Better Know a District—Delaware’s Mike Castle* (Comedy Central television broadcast Nov. 9, 2009), available at <http://www.colbertnation.com/the-colbert-report-videos/255199/november-09-2009/better-know-a-district---delaware-s-mike-castle> (showing Stephen Colbert’s satirical description of the single story building on 1209 North Orange Street, Wilmington, Delaware, that holds over 200,000 business addresses).

embodied in the laws of countries such as the United States. How can this be the case? Surprisingly, although there has been a fair amount of literature on why tax havens are harmful to the modern international tax regime,¹⁶ which countries become tax havens,¹⁷ and what means are available to combat tax havens,¹⁸ there has been little written in the legal literature specifically on the underlying theoretical question of why, notwithstanding all these points, tax havens exist in the first place, or why they persist in the face of such overwhelming criticism.¹⁹ This Article will begin to fill that gap by directly confronting the question: why are there tax havens?

At first this seems like an exceedingly obvious question—tax havens exist because countries use their tax laws to attract busi-

16. See, e.g., STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 109TH CONG., REPORT ON TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS, AND SECRECY 9 (Comm. Print 2006); OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 8; Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1577 (2000) [hereinafter Avi-Yonah, *Globalization*].

17. See Dhammika Dharmapala & James R. Hines Jr., *Which Countries Become Tax Havens?*, 93 J. PUB. ECON. 1058 (2009).

18. See, e.g., Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259 (2003); Allison Christians, *Sovereignty, Taxation, and Social Contract*, 18 MINN. J. INT'L L. 99 (2009); Steven A. Dean, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 HASTINGS L.J. 911 (2007); Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335 (2001); Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155 (2008) [hereinafter Ring, *Sovereignty Debate*]; Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155 (2007).

19. This is not to say that little is written as to why countries might want to be tax havens, only that such discussions tend to rely on assumptions as to the reasons for such behavior or on the empirical fact of the presence of tax havens rather than on the underlying theoretical question of why there are tax havens. See, e.g., Avi-Yonah, *Globalization*, *supra* note 16, at 1576-77; OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 8. Similarly, at least one book has suggested that certain tax haven activity was explicitly encouraged by wealthier countries. See J.C. SHARMAN, HAVENS IN A STORM: THE STRUGGLE FOR GLOBAL TAX REGULATION 24 (2006) (discussing Britain's conclusion that Vanuatu is "a natural tax haven"). Both contrast to the theoretical question of whether U.S. law can create or exacerbate incentives for poorer countries to become tax havens, however. This question has recently begun to be raised in the political economy literature, but it mostly focuses on the inability of countries to unilaterally cope with tax competition, taking sovereignty as a given rather than establishing a broader theoretical analysis of the incentives toward tax competition. See Markus Leibrecht & Thomas Rixen, *Double Tax Avoidance and Tax Competition for Mobile Capital*, in INTERNATIONAL TAX COORDINATION: AN INTERDISCIPLINARY PERSPECTIVE ON VIRTUES AND PITFALLS 61, 69-70 (Martin Zagler ed., 2010).

ness, either as a means to increase economic growth or to maximize tax revenue, or both.²⁰ The problem with this answer is that the literature has fairly well established that it must either be incorrect or irrational: first, using taxes as a means to compete with other countries over business investment generally does not benefit a country's long-term economic growth,²¹ and second, tax havens generally have not adopted revenue-maximizing rates or otherwise engaged in theoretically revenue-maximizing behavior.²² So are tax havens merely acting irrationally and contrary to their own long-term economic and fiscal interests, perhaps captured by special interest groups indifferent to the harms they are imposing on the world, or is some other underlying phenomenon at play?

This Article proposes the latter, focusing on the role that the fundamental policy superstructure of the international tax laws of countries such as the United States can play in creating or exacerbating all or part of the incentives necessary for countries to act as tax havens. In other words, what has been missing from the tax haven debate is the observation that the focus of most developed countries' international tax law on "capital neutrality"—in essence

20. See, e.g., Diane M. Ring, *Who Is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World*, 33 *FORDHAM INT'L L.J.* 649, 702 n.249 (2010) [hereinafter Ring, *Power Players*]; Timothy V. Addison, Note, *Shooting Blanks: The War on Tax Havens*, 16 *IND. J. GLOBAL LEGAL STUD.* 703, 711 (2009) ("A state becomes a tax haven for one undeniable reason: to attract capital to help promote growth in its financial industry.").

21. This is because competition leads to a "race to the bottom" as compared to a world without competition in which investment would be made anyway. See, e.g., Avi-Yonah, *Globalization*, *supra* note 16, at 1646 ("In summary, from the perspective of a typical developing country, the revenue loss from granting targeted tax holidays appears unlikely to be adequately offset by the benefits flowing from the resulting investment."). Thus, isolated successes such as Ireland do not necessarily prove tax haven behavior is effective, but rather that tax competition leads to a worldwide loss of revenue and growth with respect to investments that would have been made anyway. *Id.* at 1646; see also Avi Nov, *The "Bidding War" To Attract Foreign Direct Investment: The Need for a Global Solution*, 25 *VA. TAX REV.* 835, 867-71 (2006); James R. Hines, Jr., *Do Tax Havens Flourish?* 19 (*Nat'l Bureau of Econ. Research*, Working Paper No. 10936, 2004), available at <http://ssrn.com/abstract=625567>.

22. See, e.g., U.N. CTR. ON TRANSNAT'L CORPS., *THE IMPACT OF MULTINATIONAL CORPORATIONS ON DEVELOPMENT AND ON INTERNATIONAL RELATIONS* 40 (1974) (prepared by Carl S. Shoup) [hereinafter UNCTC, 1974 REPORT] ("It can be shown that the minimum tax bill occurs when the [less-developed country is] tax rate is exactly one-half the United States rate."); James R. Hines, Jr. & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 *Q.J. ECON.* 149 (1994) (finding the optimal tax haven rate between 5-8 percent).

minimizing double taxation on cross-border business and investment²³—can itself create or exacerbate incentives for other countries to engage in tax competition.

At first this appears counterintuitive: if U.S. law is truly neutral as to capital, how can it shape incentives for other countries to compete against the United States over capital? Answering this question requires revisiting some of the normative arguments supporting capital neutrality in the first place, primarily the concern with mitigating double taxation, that is, two countries imposing tax on the same item of income. By doing so, the theory goes, capital will more easily cross borders, increasing gains from trade and making every country better off.²⁴ The problem is that there is a cost to making capital more mobile in addition to a benefit: the more mobile capital becomes, the more easily countries can use tax incentives to attract such capital.²⁵ In other words, one country focusing on double taxation relief can make tax competition a cheaper and more readily available instrument for other countries to attract capital.²⁶

This could be thought of as a form of “capital neutrality paradox” in that it is precisely the pursuit of capital neutrality by a country such as the United States—intended to increase worldwide efficiency—which could lead to greater incentives for other countries to engage in tax competition, effectively undermining worldwide efficiency.²⁷ This does not mean that the costs of capital neutrality

23. See *infra* notes 34-37 and accompanying text. To this end, cooperation among countries—in other words, division of the worldwide tax base—has been seen as a secondary step. See Avi-Yonah, *Globalization*, *supra* note 16, at 1650; see also Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 MICH. J. INT'L L. 371, 382-87 (2004) [hereinafter Avi-Yonah, *International Redistribution*].

24. See, e.g., Eckhard Janeba, *Corporate Income Tax Competition, Double Taxation Treaties, and Foreign Direct Investment*, 55 J. PUB. ECON. 311 (1995).

25. See, e.g., Ring, *Power Players*, *supra* note 20, at 702 n.251.

26. Cf. Leibrecht & Rixen, *supra* note 19, at 62.

27. Alternatively, this could be thought of as the tax law exacerbating wealth disparities rather than as a stand-alone legal paradox. Cf. PETER J. MONTIEL, OBSTACLES TO INVESTMENT IN AFRICA: EXPLAINING THE LUCAS PARADOX (2006), available at <http://www.imf.org/external/np/seminars/eng/2006/rppia/pdf/montie.pdf> (arguing that a number of possible reasons exist to explain why capital does not flow from rich to poor countries, including lower productivity, lower human capital, information frictions, and low levels of domestic financial development). This Article will utilize the term “capital neutrality paradox” as shorthand to capture both concepts.

will outweigh the benefits, or that all countries will act on the incentive to engage in tax competition. Rather, the capital neutrality paradox suggests that there are incentives within the international tax regime toward tax competition which have until now not been taken into account.

Even taking the incentives of the capital neutrality paradox as true, however, they would be irrelevant to the analysis of why there are tax havens if the benefits of capital mobility, such as gains from trade, were always greater than the benefits from tax competition for all countries involved. Accordingly, analyzing why there are tax havens necessitates asking the next question: whether there could in fact be any countries for which the incentives toward tax competition created by the capital neutrality paradox would be more appealing than gains from trade. Answering this question requires revisiting one of the (mostly unquestioned) assumptions underlying the modern international tax regime: that capital will flow to its highest and best use unless the tax law somehow prevents it from doing so. The empirical evidence consistently demonstrates precisely the opposite, however: that developing countries attract disproportionately lower amounts of capital than predicted under any version of neoclassical economic theory.²⁸

Consequently, for certain (mostly poorer) countries, capital flows absent tax competition will almost always be insufficient to provide

28. The phenomenon of capital not flowing to poorer countries in the amounts expected under the theory is generally referred to as the "Lucas Paradox," after Nobel-Prize-winning economist Robert Lucas. See Robert E. Lucas, Jr., *Why Doesn't Capital Flow From Rich to Poor Countries?*, 80 AM. ECON. REV. 92 (1990); see also Laura Alfaro, Sebnem Kalemli-Ozcan & Vadym Volosovych, *Why Doesn't Capital Flow from Rich to Poor Countries? An Empirical Investigation*, 90 REV. ECON. & STAT. 347 (2008); Michael A. Clemens & Jeffrey G. Williamson, *Where Did British Foreign Capital Go? Fundamentals, Failures, and the Lucas Paradox: 1870-1913* (Nat'l Bureau of Econ. Research, Working Paper No. 8028, 2000), available at <http://www.nber.org/papers/w8028>; Daniel Cohen & Marcelo Soto, *Why Are Poor Countries Poor? A Message of Hope Which Involves the Resolution of a Becker/Lucas Paradox* (Ctr. for Econ. Policy Research, Discussion Paper No. 3528, 2002), available at <http://ssrn.com/abstract=338160>. Others have posited that the issue is more of a puzzle than a paradox, because not only does capital fail to flow to developing countries as expected, but capital also has been flowing in the wrong direction, that is, from developing countries to developed countries. See, e.g., Pierre-Olivier Gourinchas & Olivier Jeanne, *Capital Flows to Developing Countries: The Allocation Puzzle* (Nat'l Bureau of Econ. Research, Working Paper No. 13602, 2007), available at <http://www.nber.org/papers/w13602>; Jiandong Ju & Shang-Jin Wei, *A Solution to Two Paradoxes of International Capital Flows* (Nat'l Bureau of Econ. Research, Working Paper No. 12668, 2006), available at <http://www.nber.org/papers/w12668>.

an adequate tax base to satisfy any definition of minimal revenue needs through their tax systems. Therefore, as wealthier countries adopt laws freeing capital to move more easily across borders, tax competition becomes an increasingly cheaper and more attractive way for poorer countries to attract tax base. Although the adoption of capital neutrality by wealthier countries does not cause the lack of tax base in poorer countries, it does provide, in effect, a powerful tool for these countries to attract capital otherwise unavailable to them.

The novelty of the capital neutrality paradox is not the concession that tax competition may be an inevitable part of a messy real-world international tax regime,²⁹ but rather that the perceived problems of tax competition over the years, and across jurisdictions, can be thought of theoretically not as isolated incidents of taxpayers exploiting loopholes or poorer countries acting irrationally, but as part of a larger set of disparate incentives for capital to locate in wealthier as opposed to poorer countries.³⁰ This is not merely because there are rich and poor countries in the world, but rather (in part if not in whole) due to countries such as the United States focusing on capital neutrality as their dominant international tax policy goal, thereby creating incentives toward tax competition.³¹ Only once these incentives are taken into account will it be possible to offset them in any meaningful way.

For example, the legal literature has for the most part concluded that punishing countries that engage in some forms of tax competition is an appropriate and desirable policy response.³² If, however,

29. See, e.g., Julie A. Roin, *Can Income from Capital Be Taxed?: An International Perspective*, in *TAXING CAPITAL INCOME* 211, 217 (Henry J. Aaron et al. eds., 2007) (“Taxation of transnational income would be easier without tax havens, but they probably cannot be eliminated.”); see also Richard E. Baldwin & Paul Krugman, *Agglomeration, Integration, and Tax Harmonisation*, 48 *EUR. ECON. REV.* 1 (2004); Signe Krogstrup, *Standard Tax Competition and Increasing Returns*, 10 *J. PUB. ECON. THEORY* 547 (2008).

30. See, e.g., Alfaro et al., *supra* note 28, at 347.

31. Of course, a country does not become a tax haven solely due to the incentives of the capital neutrality paradox, nor could all countries which might desire to engage in tax competition successfully do so. Rather, the capital neutrality paradox provides that there are incentives in the international tax regime for certain countries to engage rationally in tax competition, which have so far been underappreciated in the literature. *Cf.* Leibrecht & Rixen, *supra* note 19, at 62.

32. See Dean, *supra* note 18, at 929 (“For the OECD, the economic efficiency implications of tax flight provided both a normative rationale for their anti-tax haven initiative and a key

the capital neutrality paradox is correct, punishment may not only be ineffective in achieving its stated goal of reducing tax competition, but could actually be counterproductive, precisely because it could drive tax competition to other, more pernicious forms. While there is a theoretical limit to such alternatives, the literature has detailed numerous ways in which poorer countries can exploit the “neutral” tax laws of wealthier countries to create *negative* effective tax rates, thus making tax competition virtually limitless.³³ In this manner, the more tax competition is punished in the world of the capital neutrality paradox, the more intense, and harmful, the tax competition must become for tax haven countries to continue to meet their minimum revenue needs. Because it is precisely by exploiting the “neutral” baseline of countries such as the United States which makes this possible, punishment layered on top of a regime focused on capital neutrality would lead to more intensified tax competition, the precise opposite of the intended result. This could be thought of as a form of “punishment paradox”: punishing tax competition in a world with the capital neutrality paradox could actually lead to increased, and more intense, competition.

Given the combination of the capital neutrality paradox and the punishment paradox, the question becomes not why tax havens stubbornly seem to persist in the international tax regime, but rather to what extent tax havens are a function of incentives created or exacerbated by the focus on capital neutrality and punishment.³⁴ This inquiry represents a significant departure from previous approaches to conceptualizing tax havens, focusing not on the symptoms of the international tax regime—such as the 18,000-plus

reason the OECD believed the initiative would succeed.”); *cf.* Avi-Yonah, *Globalization*, *supra* note 16, at 1646 (“Whenever competition from other countries drives a developing country to provide tax incentives, eliminating the competition does not hurt the developing country and may aid its revenue-raising efforts, assuming it can attract investment by other means.”).

33. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79, 117 (2009).

34. In other words, the focus of international tax law should be on finding an optimal balance between capital neutrality and tax havens, rather than insisting on the impossible ideal of both achieving pure neutrality and eradicating tax competition. See, e.g., Marko Köthenbürger, *Tax Competition and Fiscal Equalization*, 9 INT’L TAX & PUB. FIN. 391 (2002) (concluding that tax base equalization can be optimal under certain assumptions).

corporations based at the Uglund House—but rather on the underlying legal incentives driving these perceived symptoms.³⁵

Taken from this perspective, the capital neutrality paradox and punishment paradox can offer new insights into old debates. To this end, Part I of this Article will describe the political economy models of tax competition, demonstrating why the traditional theory of tax havens considered tax havens to be harmful to the international regime and how recent political economy literature has begun to challenge this conclusion on multiple fronts. In particular, Part I will demonstrate that the political economy models conclude that there is no one inherent solution, but rather that the law itself plays a crucial role in defining and shaping the incentives which can lead to either cooperation or competition. Next, Part II will introduce modern international tax law into the political economy models described in Part I, revealing that the focus on neutrality in the tax laws can lead to the rise of the capital neutrality paradox—meaning the incentive for poorer countries to act as tax havens—and that the use of punishment in response can lead to the rise of the punishment paradox—meaning more tax havens, more intense competition, or both, in the face of increasing punishment. Part III will reframe the international tax law debate in light of these paradoxes, demonstrating that they can better explain both historical experiences of dealing with tax havens and the theoretical harms and benefits of tax havens on the international regime.

Finally, Part IV will discuss novel prescriptive solutions to U.S. law arising as a result of the factors illuminated above, introducing a “punishment plus” theory of combating tax havens. This theory

35. Correspondingly, proposals that merely shift from one form of capital neutrality to another, such as proposals to move to a European-style territorial tax system or to more aggressively widen the net of the current U.S. antideferral system, may be better or worse than current law but would not necessarily address the capital neutrality paradox. *Cf.* Fleming et al., *supra* note 33; David S. Miller, Unintended Consequences: How U.S. Tax Law Encourages Investment in Offshore Tax Havens (Oct. 19, 2010) (unpublished manuscript, available at <http://ssrn.com/abstract=1684716>). For example, at least one book attributes the rise of tax havens to the “place of management” rules for corporate residency adopted by the United Kingdom, *see* RONEN PALAN, RICHARD MURPHY & CHRISTIAN CHAVAGNEUX, *TAX HAVENS: HOW GLOBALIZATION REALLY WORKS* 112-14 (2010), while others blame the opposite United States rule for corporate residency, the “place of incorporation” rule. *See, e.g.*, Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 *TAX L. REV.* 261, 320-22 (2001).

incorporates the fiscal needs of other countries into modern U.S. tax doctrine, not out of notions of fairness or distributive justice, but rather to mitigate the incentives toward tax competition already built into the regime. In particular, Part IV will describe how indirect fiscal transfers could be built into the Internal Revenue Code through the foreign tax credit “basket” rules and other similar rules. This solution would help mitigate the pressure on poorer countries to engage in tax competition without undermining the fundamental structure or underlying policies of the international tax regime itself, potentially resulting in less competition and more revenue for all countries. In other words, tax competition as an inefficient and hidden form of fiscal transfer could be replaced with a more direct and efficient form of fiscal transfer. Punishment could then be used as a scalpel to surgically excise recalcitrant behavior from the system rather than as a sledgehammer, destroying all in its path.³⁶

I. THE INTERNATIONAL TAX REGIME: THE PROBLEMS OF DOUBLE TAXATION AND TAX COMPETITION

The traditional approach to analyzing the international tax laws of the United States—as with most if not all tax laws—has been to think of international tax in terms of its impact on the behavior of those individuals or businesses obligated to pay the tax. This approach focuses on balancing two underlying normative goals: maximizing the economic efficiency of the law or maximizing the equity of the law.³⁷ Due to the open nature of the international tax system, however, the traditional efficiency/equity balance under-

36. *Cf.* *Cal. Bankers Ass'n v. Shultz*, 416 U.S. 21, 85 (1974) (Douglas, J., dissenting) (“It is, I submit, sheer nonsense to agree with the Secretary that *all bank records of every citizen* ‘have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.’ That is unadulterated nonsense unless we are to assume that every citizen is a crook, an assumption I cannot make. Since the banking transactions of an individual give a fairly accurate account of his religion, ideology, opinions, and interests, a regulation impounding them and making them automatically available to all federal investigative agencies is a sledge-hammer approach to a problem that only a delicate scalpel can manage.”).

37. *See, e.g.*, Boris Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979); Richard Schmalbeck, *The Death of the Efficiency-Equity Tradeoff?: A Commentary on McMahan’s The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 1143 (2004).

taken in the domestic context requires a slightly different analysis.³⁸ For example, should tax liabilities, if any, imposed by another country influence how we analyze the efficiency of U.S. tax laws? If so, how? Should the same rule apply to two taxpayers who are otherwise similarly situated except that one operates in a foreign country? Would this unnecessarily defer the sovereign taxing power of the United States to the whims of other countries?

These problems can be illustrated through a relatively simple, yet quite realistic, example. Assume a small software business in the United States initially sells its software only within the United States. As the company begins to grow, potential customers from Canada contact the company and request to purchase the software. The company has to decide whether to open a small office in Canada, which would allow it to sell to local customers more cheaply and access the broader Canadian market, or to continue simply to take orders from its U.S. office and to ship software to Canada. Assume that if the company opens an office in Canada it would have to pay income tax in Canada in addition to the income tax owed to the United States, while without such an office it would not. Absent any relief, this “double taxation” could dissuade the company from expanding to Canada, even if opening the office would otherwise be better for the overall business.

In economic terms, the imposition of two taxes in this manner creates “deadweight loss” by distorting economic decision making of taxpayers as compared to a utility-maximizing world absent taxes.³⁹ The problem presented by this situation is how to fix double taxation when there are two sovereign countries involved. In other words, the United States cannot simply force Canada to forego taxing the business, nor can Canada do the same to the United States. Rather, unilateral or negotiated means of dividing the tax base must be developed so as to remove the distortion of double taxation while working within the constraints of the open economy.

38. See ABA Task Force on Financial Reform, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649 (2006) [hereinafter *ABA International Tax Reform Report*]; Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 171 (2000).

39. See Joel Slemrod, *Effect of Taxation with International Capital Mobility*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 115-16 (Henry J. Aaron et al. eds., 1988).

There are generally two ways in which a country, such as the United States, could unilaterally mitigate double taxation. First, the United States could simply exempt income which is subject to taxation in other jurisdictions. In this manner, U.S. investors would not be subject to double taxation, but rather would be subject to only the local, or “host,” country tax. Alternatively, the United States could continue to tax income earned in foreign jurisdictions, but subtract from the tax owed to the United States any taxes paid to foreign countries, or in other words grant a “credit.” In this manner, the taxpayer would only pay tax to the United States if the U.S. tax exceeded the amount of tax paid to the host country.

There is, to say the least, no consensus on which form of double taxation relief is optimal from an international tax perspective.⁴⁰ There has been a consensus for the most part, however, that countries should adopt some means of double tax relief, either unilaterally by granting a foreign tax credit or exempting foreign source income, on the one hand, or bilaterally through a tax treaty on the other.⁴¹ Regardless which of these methodologies is chosen, however, what is relatively clear is that double taxation relief has provided the normative foundation of most if not all of the modern international tax regime.⁴²

This consensus has been based primarily on the leading public finance model for the taxation of capital, which provides that taxes should be structured so as to minimize the harm to the worldwide production of goods;⁴³ in this manner, the theory goes, total produc-

40. See, e.g., Michael J. Graetz & Michael M. O'Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1108-09 (1997).

41. OFFICE OF TAX POLICY, TREASURY DEP'T, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY, at xi n.14 (2000), available at <http://www.treasury.gov/offices/tax-policy/library/subpartf.pdf> [hereinafter SUBPART F REPORT] (“The foreign tax credit reflects the fundamental tax policy decision made by most countries, in order to prevent double taxation, to give up the right to tax their residents to the extent that the country where the income is sourced imposes tax and to reserve the right to tax their residents to the extent that the source country does not impose tax.”).

42. See, e.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996) [hereinafter Avi-Yonah, *Structure of International Taxation*]; Brauner, *supra* note 18, at 294.

43. See, e.g., Christopher Bliss, *The Design of Fiscal Reforms in Revenue-Constrained Developing Countries*, 102 ECON. J. 940, 942 (1992) (“The modern theory of public finance in developing countries begins with the paper by Diamond and Mirrlees (1971).”); Michael Keen & Hannu Piekola, *Simple Rules for the Optimal Taxation of International Capital Income*,

tion grows and all countries are better off—that is, the tax would be Pareto-optimal.⁴⁴ Economic theory provides that deviations from this baseline are inappropriate because they would result in an inefficient allocation of worldwide resources, making all countries worse off.⁴⁵ In other words, worldwide efficient allocation of resources helps all countries, while anything which distorts the neutral allocation of resources makes everyone worse off, at least in the long run.⁴⁶

99 SCANDINAVIAN J. ECON. 447, 447-48 (1997).

44. This is referred to as the “Diamond-Mirrlees” model. See Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production I: Production Efficiency*, 61 AM. ECON. REV. 8 (1971); Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production II: Tax Rules*, 61 AM. ECON. REV. 261 (1971).

45. See, e.g., Harry Grubert, *Tax Credits, Source Rules, Trade, and Electronic Commerce: Behavioral Margins and the Design of International Tax Systems*, 58 TAX L. REV. 149, 179 (2005). Grubert states:

Consider, therefore, a domestic product that is a perfect substitute for a good produced in a low-tax country. Also, to make matters completely simple, assume that in both countries (tangible) capital is the only input needed to produce the good but efficiency can differ between countries. The high-tax location, the United States, is more efficient in this industry, with a requirement of x units of capital per unit of output. The low-tax country requirement is y units per unit of output with $y > x$. The low-tax location, however, may have an overall cost advantage when taxes are considered. If t_1 is the U.S. rate and t_2 is the foreign rate, then the foreign location will produce the good if $xr/(1-t_1) > yr/(1-t_2)$, where r is the *worldwide* required after-corporate-tax return.... If the above inequality holds, all production of the good will take place in the low-tax country, some of which will be exported to the high-tax country.

....

This equilibrium is clearly inefficient from both a national and world perspective. The capital is more productive in the United States.

Id. at 179. There is a literature that claims tax competition is valuable in that it limits the ability of countries to become “Leviathans,” that is, to grow unabated. See Anthony C. Infanti, *Spontaneous Tax Coordination: On Adopting a Comparative Approach To Reforming the U.S. International Tax Regime*, 35 VAND. J. TRANSNAT’L L. 1105, 1150-53 (2002). Opponents of tax competition reject this theory on the grounds that tax competition leads to reduced growth and revenue for all—that is, there is a negative externality. *Id.* The externality theory of tax competition is the starting point for this Article because it has served as the basis for most anti-tax-haven efforts.

46. This is in contrast to legal competition, which is often justified as beneficial for all parties involved in that it can lead to a sort of “race to the top” where jurisdictions offer increasingly beneficial provisions to attract people or investors. See generally ERIN A. O’HARA & LARRY E. RIBSTEIN, *THE LAW MARKET* (2009); David S. Law, *Globalization and the Future of Constitutional Rights*, 102 NW. U. L. REV. 1277 (2008). For a discussion of how tax competition can distort legal competition, see Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229 (2008).

Because tax competition, or using tax laws to artificially attract business and investment, runs contrary to this principle, the theory also provides that tax competition must be detrimental not only to the country losing the investment, but also to the competing country as well.⁴⁷ Accordingly, some have taken the next step, contending that the international tax regime should focus not only on relief from double taxation but also on double nontaxation, that is, income escaping tax altogether solely as a result of crossing borders.⁴⁸ Although there are multiple ways in which double nontaxation can occur, the primary target has been countries which intentionally exempt capital from tax in one way or another—in other words, tax havens.⁴⁹

Under this approach, tax havens must be bad because they distort economic decision making and are therefore inefficient.⁵⁰ Unlike double taxation, however, which can be resolved unilaterally by the home country through the granting of a foreign tax credit or exempting foreign income from tax, the presence of tax havens in the international regime cannot be overcome unilaterally; pursuant to almost any theory of sovereignty, the United States cannot force another country to change its tax laws solely to prevent U.S.

47. See, e.g., John Douglas Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon*, 88 J. PUB. ECON. 1065, (2004); John Douglas Wilson, *Trade, Capital Mobility, and Tax Competition*, 95 J. POL. ECON. 835 (1987). This theory of tax competition relies substantially on the Ricardian concept of comparative advantage. Under this theory, all countries are better off specializing in their comparative advantage and trading with each other rather than attempting to be self-sufficient. See PAUL R. KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS* 10-11 (6th ed. 2003). For an overview of the theoretical models regarding the benefits of international trade, see generally MIKE W. PENG, *GLOBAL BUSINESS* 124-47 (2009). For a general discussion of the efficiency considerations in structuring tax laws, see RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 289-94 (4th ed. 1984).

48. See SUBPART F REPORT, *supra* note 41, at 99 (“[A]ny such regime should avoid rules that may lead to international double taxation or double non-taxation or that radically increase administrative burdens.”).

49. So far any attempt at a more formal definition of “tax haven” seems to devolve into some form of totality of the circumstances analysis, see OECD, *HARMFUL TAX COMPETITION*, *supra* note 10, at 20-21, or, even worse, an “I know it when I see it” approach, see PALAN ET AL., *supra* note 35, at 45. It is for this reason that this Article will not attempt to define what constitutes a “tax haven.” Instead, this Article will assume that a tax haven is any country which engages in tax competition to attract capital. This assumption is used solely as a basis to further the incentives-based analysis discussed in this Article.

50. See *supra* notes 43-49 and accompanying text.

taxpayers from avoiding U.S. tax liability.⁵¹ Instead, the answer that has developed over time has been for the countries harmed by tax havens—primarily large developed countries—to “combat” tax havens by punishing the havens themselves or the taxpayers investing in them.⁵²

This narrative, which has served as the basis of most of the modern anti-tax-haven efforts, has begun to be challenged on multiple fronts in the literature, however.⁵³ The primary thrust of this challenge has been a recent focus on the limitations of comparative advantage theory, the theory that all countries are better off if each country specializes in its comparative advantage and engages in trade.⁵⁴ One of the curious aspects of the theory of comparative advantage is that trade among nations is mutually beneficial only so long as capital, labor, or both are constrained across national borders; it is only the limited mobility of capital and/or labor that creates benefits from comparative rather than absolute advantage.⁵⁵ Consequently, when either labor or capital is mobile, the conclusion that comparative advantage and trade will always and necessarily inure to the benefit of all countries begins to weaken. Rather, the only conclusion that can be drawn is that total worldwide efficient allocation of resources will increase, but not necessarily that all countries will be better off.⁵⁶

51. See Christians, *supra* note 18, at 99; Ring, *Sovereignty Debate*, *supra* note 18, at 156-57.

52. See OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 37.

53. Dhammika Dharmapala, *What Problems and Opportunities are Created by Tax Havens?*, 24 OXFORD REV. ECON. POL'Y 661 (2008).

54. See, e.g., Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 141-42 (2001).

55. See, e.g., Michael H. Davis & Dana Neacsu, *Legitimacy, Globally: The Incoherence of Free Trade Practice, Global Economics, and Their Governing Principles of Political Economy*, 69 UMKC L. REV. 733, 760 (2001) (“Ricardo admitted that comparative advantage works only when both labor and capital have no substantial mobility.”); Robert E. Prasch, *Reassessing the Theory of Comparative Advantage*, 8 REV. POL. ECON. 37, 40-41 (1996). See generally KRUGMAN & OBSTFELD, *supra* note 47, at 10-37.

56. See Douglas A. Kysar, *Sustainable Development and Private Global Governance*, 83 TEX. L. REV. 2109, 2137 (2005) (“Thus, the critical footnote to the comparative advantage theory in a world of internationally mobile capital is that nations are not necessarily *all* better off under liberalized trade, as is commonly argued. Instead, only the aggregate wealth of nations is certain to be enhanced, while any particular nation may come out ahead or behind.”).

Similarly, tax policy that encourages increased mobility of capital across borders may well benefit overall worldwide growth by minimizing distortions to economic decision making, but may not necessarily benefit all countries, as previously had been assumed. If this is the case, it is possible for certain countries to be worse off in a world of mobile capital—notwithstanding overall worldwide growth.⁵⁷ As a result, the traditional model has begun to be questioned on multiple fronts.⁵⁸ For example, relaxing even one of the assumptions in the model, such as assuming each country has independent revenue needs rather than assuming countries try to maximize worldwide revenue growth, can radically change the analysis of a Pareto-optimal system, even leading to directly contrary conclusions.⁵⁹

Even more radically, a recent strand of literature has concluded that it is possible, in a world with disparate wealth allocations and corresponding disparate returns to capital, that the existence of poor countries with zero tax rates can actually be welfare maximizing, the exact opposite of the traditional model.⁶⁰ To the extent that merely changing one of the assumptions regarding relative preferences of countries or relative starting points in wealth can have such profound impacts on the theoretical conclusions arising from these models, the policies derived from the traditional theory of minimizing double taxation to maximize worldwide efficient allocation of resources and punishing tax competition must be reconsidered as well. The remainder of this Article will begin the process of doing so.

57. See Paul Krugman, *International Finance and Economic Development*, in FINANCE AND DEVELOPMENT: ISSUES AND EXPERIENCE 11, 18 (Alberto Giovannini ed., 1993) (“It is even possible to make straightforward arguments suggesting that international financial integration will promote greater inequality rather than greater convergence in per capita income.”).

58. See Michael Keen & David Wildasin, *Pareto-Efficient International Taxation*, 94 AM. ECON. REV. 259, 259 (2004).

59. Changing only this one assumption can result in a source-based tax system with full offsetting credits serving as indirect fiscal transfers, which would be Pareto-superior to residence taxation—the exact opposite of the traditional approach. *Id.* at 269. *But see* Jeremy Edwards, *Gains from Trade in Government Revenue and Pareto-Efficient International Taxation*, 5 TOPICS ECON. ANALYSIS & POL’Y 1, 1 (2005), available at <http://www.bepress.com/cgi/viewcontent.cgi?article=1385&context=bejeap>.

60. See, e.g., Baldwin & Krugman, *supra* note 29, at 21; Krogstrup, *supra* note 29, at 555-57.

II. DOUBLE TAXATION RELIEF AND TAX COMPETITION: THE TWO PARADOXES

Before analyzing prescriptive solutions to the problems of the modern international tax regime, it is necessary to contemplate why such a state has arisen in the first place. No cabal among states, or other explicit conspiracy, has been alleged, nor does one seem likely. Rather, this Article will contend that the phenomena of tax competition and tax havens can be attributed, at least in part, to two distinct, but related, implicit sources: the capital neutrality and punishment paradoxes. The capital neutrality paradox provides that as barriers to capital crossing borders are reduced, the ability to attract capital through tax competition increases, thereby creating or exacerbating divergent interests over the taxation of mobile capital between marginally capital-attractive jurisdictions and marginally capital-unattractive jurisdictions.⁶¹ The punishment paradox, meanwhile, provides that punishing countries which engage in tax competition as a result of the incentives of the capital neutrality paradox will necessarily be counterproductive.

This combined effect can be thought of either as a function of the law of unintended consequences or as a natural outgrowth of existing power dynamics; regardless, taken alone this result may not change any traditional international tax analysis. Once an addi-

61. This Article will use the generic terms “marginally capital attractive countries” and “poorer countries” interchangeably rather than a more specific term for two reasons: first, it is sufficient to describe the theory of the capital neutrality paradox and thus additional specificity might only distract from the discussion, and second the political economy literature is divided as to what precisely attracts capital to certain tax havens over others, whether it be political stability, infrastructure, population, or other resources. *See, e.g.*, Sam Bucovetsky & John Douglas Wilson, *Tax Competition with Two Tax Instruments*, 21 REGIONAL SCI. URB. ECON. 333, 335 (1991); Dharmapala & Hines, *supra* note 17, at 1058. Further, it is unclear in the literature whether capital endowments or production capability dominate in tax competition analysis. *See supra* note 45. For these purposes, it is irrelevant whether the return at issue is the real risk-adjusted return to capital, the nominal return to capital, or the endowment- or production-based return to capital. So long as any of them results in a country or countries having differing marginal returns on capital, the capital neutrality paradox holds. *See* Krugman, *supra* note 57, at 13 (“In fact, most economists looking at the realities of trade and factor prices have concluded that poorer countries simply have worse production functions, and hence that the marginal product of capital is not in fact as high as their low capital-labour ratios would suggest.”).

tional factor is added, however—that tax laws are used primarily to raise revenue—the analysis changes, and perhaps dramatically. More specifically, once it is assumed that tax laws are intended to raise revenue, it is also reasonable to assume that countries which adopt a tax system have some minimal amount of revenue that must be raised; if not, the country would not enact a tax system. Adding this “minimal revenue need” assumption to the traditional model can lead to some unexpected conclusions: first, under the capital neutrality paradox, that tax laws themselves can potentially create incentives toward tax competition, and second, under the punishment paradox, punishing tax competition can potentially hurt the overall international tax regime rather than help.

This is precisely where the role of law becomes relevant; if the laws of a particular country, such as the United States, shape the interactions of countries within the international tax regime in this manner, the responses to such competition would necessarily change as well. It therefore becomes necessary to focus on the role of law in shaping the existing international tax regime before reaching any theoretical conclusions as to the most efficient cooperative solution.⁶²

A. *The Capital Neutrality Paradox*

As discussed above, neutrality as to capital in the form of double taxation relief and punishing tax competition has formed the baseline of most modern international tax laws, although there is no consensus on which specific type of double taxation relief is most appropriate.⁶³ What has been missing from this debate, however, is the realization that it is irrelevant which form of double taxation relief a country adopts, at least looking solely from the perspective

62. This approach is not new to the legal literature, although it does appear novel as applied to tax competition. See Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1737, 1738 (2002); Robert Cooter, Commentary, *Can Lawyers Say Anything About Economic Growth? Comment on Frank Cross's Law and Economic Growth*, 80 TEX. L. REV. 1777, 1778 (2002); see also Joyce Palomar, *Contributions Legal Scholars Can Make to Development Economics: Examples from China*, 45 WM. & MARY L. REV. 1011, 1012 (2004) (“Development experts and legislators need more than broad economic theory, however.... The next steps in this effort require legal analysts.”).

63. See Graetz & O’Hear, *supra* note 40, at 1108-09.

of the costs and benefits of tax competition.⁶⁴ Rather, any move toward reducing the cost of cross-border capital investment can lead to the creation or worsening of the incentives to engage in tax competition. In other words, as the tax laws increasingly focus on neutrality toward capital, capital becomes more mobile across borders, making it cheaper and easier for other countries to use their tax laws to attract capital. This is the heart of the capital neutrality paradox: one country's pursuit of neutrality can actually increase the incentives toward competition for other countries, potentially undermining the benefits sought by pursuing neutrality in the first place, or, even worse, resulting in an even less efficient allocation of resources than if nothing had been done.

To this end, assume a no-tax world with three countries, *A*, *B*, and *C*, no transaction costs, and full information. Country *A* provides the highest return on capital, and Country *B* is marginally more attractive for capital investment than Country *C*. In a world absent taxes and transaction costs, capital investment would first maximize return in Country *A*, then seek investments in Country *B* until the combined marginal return on those investments in Country *A* and *B* intersected with those in Country *C*, in which case investors would be indifferent. Since capital would flow to its most efficient uses in all circumstances, the worldwide economy would be Pareto-efficient.

This can be demonstrated with a simplified numerical example.⁶⁵ Assume that at time zero Country *A* would provide a return to capital of 10 percent, Country *B* would provide a return to capital of 8 percent, and Country *C* would provide a return to capital of 7

64. The two leading candidates, "capital export neutrality" (CEN) and "capital import neutrality" (CIN) focus on different forms of neutrality toward capital: CEN focuses on imposing uniform taxation of capital regardless of location of investment, while CIN focuses on equalizing taxation of capital among local competitors. Among the alternatives to these dominant theories include "national neutrality" attributed to Peggy Musgrave and "ownership neutrality" attributed to Mihir Desai and James Hines. See, e.g., Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003); Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 556 (2003); Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53, 54-55 & nn.1-2 (2006).

65. The example is simplified because the effect of investment on returns would not be binary but rather continuous, and the division would not be equal. Regardless, the intuition demonstrated by the example holds when broadened to a more dynamic and robust formulation.

percent. The first \$1,000,000 of capital would be invested in Country *A* for the highest return on capital, which reduces the return to 8 percent. At that point, the next \$1,000,000 of capital is split between Countries *A* and *B* until the return to capital in both countries is reduced to 7 percent, that is, the return in Country *C*. Only at that time would any capital be invested in Country *C*, as its marginal return to capital would no longer be lower than those of Countries *A* and *B*. In the first stage, however, there would be no capital left to be invested in Country *C* at this point as it had already been fully invested in Countries *A* and *B*. Under these simplistic assumptions, the worldwide return on the \$2,000,000 of capital is equal to the \$100,000 earned in Country *A* from the first \$1,000,000 investment, plus the \$80,000 earned in Countries *A* and *B* from the second \$1,000,000 investment, for a total of \$180,000.

The distribution of the benefits would be unequal, however, since Country *C* would receive the fewest benefits from capital investment. Under these numbers, Country *A* would have generated \$140,000 in capital return and Country *B* would have generated \$40,000 in capital return, while Country *C* would have zero capital return. In the next investment cycle, however, capital would begin flowing to Country *C* because the marginal returns to capital of Country *A* and *B* would have dropped to 7 percent as well. Thus, only by maximizing the total efficiency of worldwide capital would there be sufficient total capital available for Country *C* to receive any capital investment.

Contrast this result to one in which some capital, for example, \$100,000, was forced to be invested in Country *C* at the beginning of the process. The return on that \$100,000 would be \$7,000 instead of \$10,000 if it had been invested in Country *A*, and thus the world as a whole would be poorer by \$3,000.⁶⁶ In other words, maximizing worldwide capital efficiency could be Pareto-optimal notwithstanding distributional concerns because any attempt to offset this distributional inequity could result in deadweight loss exceeding any distributional gains.

66. Calculating the real economic loss would be much more complicated, but this example is sufficient solely for illustrative purposes. Regardless, the intuition remains the same even in a more precise calculation.

Once taxes are introduced, however, this narrative begins to break down, precisely because the role of the tax law is to raise revenue. Thus, assume that Countries *A*, *B*, and *C* each impose a tax rate of 20 percent on capital. If more than one country imposed tax on capital invested across borders, double taxation would result and capital would inefficiently avoid such investments. The simplest and most straightforward way to offset this double taxation would be for each country to simply exempt earnings in other countries from tax. In such a case, assuming the same worldwide distribution of capital, Country *A* would collect \$28,000 in tax revenue, Country *B* would collect \$8,000 in tax revenue, and Country *C* would collect zero tax revenue. Even though the three would collect very different amounts of revenue, the theory goes, all should agree to such an arrangement in the interest of maximizing the long-term growth of all three economies.

This is not necessarily the case, however, once two crucial, and likely more realistic, assumptions are introduced: (1) that each country has a minimum revenue need,⁶⁷ and (2) that direct international fiscal transfers are limited or impossible.⁶⁸ These two assumptions effectively undercut the conclusion that maximizing worldwide efficiency will always and necessarily inure to the benefit of all countries involved. Rather, each country must first ensure that it meets its own minimum revenue needs first, and only then attempt to maximize overall worldwide growth.

This approach effectively undermines the traditional approach to international taxation to first maximize worldwide growth and then redistribute tax revenue solely as a matter of fairness or distributive justice.⁶⁹ If, however, the minimum revenue need itself

67. See Avi-Yonah, *Globalization*, *supra* note 16, at 1634-35. This Article uses minimum revenue needs as the determining factor, but a similar result holds if the poorer country prefers capital investment more than worldwide growth, such as if tax revenue has a declining marginal utility or if capital accumulation is a valuable end in itself. See KATHARINA HOLZINGER, TRANSNATIONAL COMMON GOODS: STRATEGIC CONSTELLATIONS, COLLECTIVE ACTION PROBLEMS, AND MULTI-LEVEL PROVISION 93-99 (2008) (finding similar results when using political benefits from attracting capital rather than minimum revenue needs).

68. See Avi-Yonah, *Globalization*, *supra* note 16, at 1649 (“Explicit redistribution among countries is rare, especially given widespread dissatisfaction with foreign aid.”); Keen & Wildasin, *supra* note 58, at 260.

69. See *id.* (“It is widely accepted that redistributive income taxation can be justified by considerations of vertical equity and the declining marginal utility of income. But there

is influencing the incentives to tax competition, then it must be included in the economic efficiency step of the analysis, rather than thought of as a second and unrelated “fairness” step.⁷⁰ The remainder of this Article will therefore treat minimum revenue needs as part of the incentive structure of the international tax regime rather than as an exogenous policy issue.

Under this framework, Country *A* as the first mover has to take into account multiple considerations: first, it must ensure that it can raise its minimum revenue; second, it will want to maximize worldwide economic efficiency; and third, it will want to prevent other countries from engaging in tax competition so as to reduce its tax base. Under these conditions, there is no one policy that Country *A* can adopt as a matter of international tax law so as to both maximize capital neutrality and achieve the ideal distribution of tax revenues because any move toward capital neutrality by Country *A* will reinforce existing capital disparities as among Country *B* and Country *C*. In other words, assuming preexisting capital disparities means that capital neutrality will always disproportionately benefit some at the expense of others.

Without considering revenue needs, this reality is no different than a world absent taxes, that is, there are rich countries and poor countries. If Country *C* has a sufficient domestic tax base, and that tax base is sufficiently inelastic, then the focus on capital neutrality by Country *A* may not adversely impact Country *C*.⁷¹ Assuming Country *C* does not have a sufficient domestic tax base, or that such base is sufficiently elastic, however, to raise its minimum revenue, the only recourse would be to try to attract tax revenue away from Country *A* or Country *B*. Thus, Country *C* would be forced to use its tax system, not to pursue capital neutrality, but rather to pursue tax revenue from the international tax base.

appears to be no sound theoretical reason to restrict redistribution to members of any single tax jurisdiction. If there were a world taxing authority, it would be justified in redistributing wealth on a worldwide basis.”) (footnote omitted).

70. See Leibrecht & Rixen, *supra* note 19, at 62 (“[I]ndependent jurisdictions interact strategically in setting taxes.”).

71. This is a crucial assumption in the literature regarding tax competition, that is, that countries can realistically only tax economic rents and no other returns located in their jurisdiction, absent cooperation among states to prevent tax competition. See *id.* at 1642.

What may perhaps surprise some is that, under neoclassical economic theory, this should never be the case because Country *A* would represent the poorest country while Country *C* would represent the wealthiest.⁷² In such case, neither Country *A* nor Country *C* should have any problem meeting minimal revenue needs, as Country *C* is wealthy already and Country *A* attracts the most capital through economic returns. Under this theory, sometimes referred to as convergence, as the supply of capital in a particular country increases, the returns on capital decrease as compared to those in countries with a lower supply of capital,⁷³ while countries with lower supplies of capital will have higher demand for capital, leading to higher returns.⁷⁴ The result would be poorer countries paying a higher return on capital than wealthier countries, meaning capital should generally flow from high capital countries to low capital countries.⁷⁵ Correspondingly, all countries should have an incentive to adopt some form of double taxation relief; wealthy countries would be better off since their domestic capital would achieve higher returns abroad, while poorer countries would be better off by increasing the amount of capital flowing to them.

The problem with this analysis is that it ignores the empirical reality identified in the literature that capital in fact does not flow to poorer countries as predicted under the neoclassical model.⁷⁶ Rather, either capital flows less to such countries than would be

72. See KRUGMAN & OBSTFELD, *supra* note 47, at 672.

73. *Id.* at 667.

74. See, e.g., Michael J. Trebilcock, *What Makes Poor Countries Poor?: The Role of Institutional Capital in Economic Development*, in *THE LAW AND ECONOMICS OF DEVELOPMENT* 15, 16 (Edgardo Buscaglia, William Ratliff & Robert Cooter eds., 1997).

75. See KRUGMAN & OBSTFELD, *supra* note 47, at 672; see also DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 6 (1990) (“[S]tandard neoclassical and international trade theory ... implies that over time economies, as they traded goods, services, and productive factors, would gradually converge.”).

76. See *supra* note 28 and accompanying text; see also KRUGMAN & OBSTFELD, *supra* note 47, at 671-72; NORTH, *supra* note 75, at 6-7. A similar phenomenon has been observed in the context of bilateral investment treaties, although the evidence is not necessarily as clear. See, e.g., Deborah L. Swenson, *Why Do Developing Countries Sign BITS?*, 12 U.C. DAVIS J. INT’L L. & POL’Y 131 (2005); Jason Webb Yackee, *Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?*, 42 LAW & SOC’Y REV. 805 (2008).

expected under the model⁷⁷ or actually flows in the opposite direction.⁷⁸ Consequently, in the example Country *A* would be the wealthiest country while Country *C* would be the poorest. Under these circumstances, Country *C* would likely be unable to meet its minimum revenue needs solely out of its domestic tax base since it could not attract capital through economic returns alone and is capital-poor to start with.

Taken alone, this may be troubling from a distributional standpoint, since poor countries could become locked in a cycle of poverty without access to capital.⁷⁹ Once the law of international tax is introduced, however, the analysis becomes particularly troubling—precisely because the role of the tax law is to raise revenue for public goods or redistribution. Thus, the issue no longer centers on fairness, development, or distributional issues, but instead on the incentives created by the tax laws on the behavior of countries, and in particular whether poorer countries have an incentive to engage in tax competition because they are otherwise unable to raise sufficient revenue to meet their minimum revenue needs.⁸⁰

77. See Lucas, *supra* note 28, at 92.

78. Presumably in part because these findings so directly contradict neoclassical economic theory, it was not until 1990 that it was established that this was the case. In an influential paper, Robert Lucas demonstrated that significantly less capital flowed to India in the twentieth century than should have under any classical economic model. See *id.* at 92. This finding was so dramatic, in particular because it could not be explained by legal differences since India was at the time a British colony, that it earned the moniker of the “Lucas Paradox”—that is, an empirical finding that could not be explained under any existing economic model. See *supra* note 28 and accompanying text. The Lucas Paradox led to further explorations of capital flows over different periods of time, which consistently confirmed the Lucas Paradox. For example, it has been demonstrated empirically that substantially less capital flowed to poorer countries during the period of British hegemony than would be expected, see Clemens & Williamson, *supra* note 28, at 1, and that significantly less capital has flowed to Africa in recent years than would be expected, see MONTIEL, *supra* note 27, at 1-2; Alfaro et al., *supra* note 28; Cohen & Soto, *supra* note 28, at 1-2. That this finding is robust across periods of time and across jurisdictional boundaries necessitates, at a minimum, taking such findings seriously in crafting tax policy. See Gourinchas & Jeanne, *supra* note 28.

79. See Cohen & Soto, *supra* note 28.

80. This has begun to be reflected in a recent strand of economics literature, sometimes referred to as “new economic geography.” See, e.g., Paul Krugman, *The Role of Geography in Development*, in ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS 89, 90 (Boris Pleskovic & Joseph E. Stiglitz eds., 1998); Frédéric Robert-Nicoud, *The Structure of Simple ‘New Economic Geography’ Models*, 5 J. ECON. GEOG. 201 (2005). This literature focuses not on where capital should flow theoretically, but rather builds on the premise that a “core” of wealthy countries and a “periphery” of poorer countries exists or arises under

The paradox arises precisely because smaller countries can use their tax laws to attract capital by exploiting policies adopted by wealthier countries to mitigate double taxation in the first place.⁸¹ In other words, if Country *A* and Country *C* both imposed a tax on a single item of income such that there was double taxation, there would be no amount of tax competition Country *C* could engage in to attract the capital. Even if Country *C* offered a *zero* tax rate, the capital would have no incentive to leave Country *A* since it would pay the full Country *A* tax regardless of where it was located. The only thing that makes tax competition a useful instrument for Country *C* is the ability to exploit the anti-double-taxation regimes of Country *A*.⁸²

Returning to the example, assume Country *A* has a minimum revenue need of \$25,000 and knows that a world with perfect capital neutrality would result in capital earnings of \$140,000. As a result, Country *A* adopts a 20 percent tax rate solely on its domestic tax base to raise \$28,000 in tax revenue. Under this approach, Country *A* has a sufficient tax base to both raise its minimum revenue and maximize worldwide growth (by exempting foreign income). Country *B* has a minimum revenue need of \$8,000 and thus also adopts a 20 percent tax rate solely on its domestic tax base of \$40,000; although smaller than Country *A*, Country *B* still has a sufficient tax base to raise \$8,000 in tax revenue and exempt foreign income.

certain assumptions. See, e.g., Baldwin & Krugman, *supra* note 29, at 6; cf. Yoram Margalioth, *Tax Competition, Foreign Direct Investments, and Growth: Using the Tax System To Promote Developing Countries*, 23 VA. TAX REV. 161, 172 (2003). From this approach, what happens is not a “race to the bottom,” in which all countries lower rates to zero, but rather a split, in which wealthy countries have a positive tax rate on capital while poorer countries end up with a zero tax rate on capital. See Rainald Borck & Michael Pflüger, *Agglomeration and Tax Competition*, 50 EUR. ECON. REV. 647, 647-48 (2006). Of particular importance to this analysis is that the lower the barriers to movement of goods and capital, the more likely this bifurcated outcome becomes. This is precisely the case when capital neutrality forms the focus of international tax laws, yielding the capital neutrality paradox.

81. See Leibrecht & Rixen, *supra* note 19, at 66-67.

82. See *id.* at 63 (“[Double tax avoidance rules] provide an institutional foundation of tax competition.”). That the form of such exploitation may differ depending on the method of double tax relief is less relevant than the incentives that poorer countries would have to adopt laws to further such exploitation. For example, under an exemption model the incentive might be to relocate capital whereas under a credit model the incentive might be to relocate the nominal taxpayer. Either way, the poorer country would have an incentive to accommodate the move through its laws. I am indebted to David Hasen for this insight.

Country *C*, however, has no tax base because worldwide capital is fully invested in Countries *A* and *B*.⁸³ Country *C* does, however, have a minimum tax revenue need of \$1,000. Without attracting a sufficient tax base at some positive tax rate, Country *C* would not be able to raise its minimum revenue. Conceptually Country *C* could raise its minimum revenue in one of two ways: (1) it could impose tax on capital located in Country *A* or Country *B*, or (2) it could use its tax laws to attract capital into its taxing jurisdiction to meet its minimum revenue needs. For example, it could impose a .6 percent tax on the \$180,000 tax base⁸⁴ of Country *A* and Country *B* in addition to the 20 percent tax imposed by those countries, resulting in double taxation, or it could attempt to attract capital away from Countries *A* and *B* by offering higher after-tax returns.

Since capital invested in Country *C* would not be subject to tax in Country *A* or Country *B* because they each adopted territorial exemption, Country *C* reduces its tax rate to 5 percent to attract tax base. As a result, the second \$1,000,000 of capital faces a vastly different decision based on after-tax returns than before-tax returns: investments in Country *A* or Country *B* would earn 6.4 percent after-tax while investments in Country *C* would earn 6.65 percent after-tax.⁸⁵ Assume Country *C* attracts \$290,000 of capital away from Countries *A* and *B* as a result, earning a 7 percent pre-tax return (\$20,300) instead of an 8 percent pre-tax return (\$23,200). Although this is clearly inefficient from a worldwide capital perspective, from Country *C*'s perspective it is worthwhile since it is now able to raise \$1,015 of tax revenue,⁸⁶ meeting its minimum revenue need. Conversely, Countries *A* and *B* collectively lose \$4,640 of tax revenue.⁸⁷ Notwithstanding that this is inferior from both an overall worldwide revenue and overall worldwide

83. Further, since Countries *A* and *B* each independently set their rates at 20 percent to meet their own revenue needs based on their assumptions as to available tax base, they do not have much if any revenue to transfer or divide tax revenue with Country *C*.

84. This would be the level sufficient to meet its minimum revenue needs of \$1,000 ($\$180,000 * .6\% = \$1,080$).

85. For Country *A* and Country *B* the after-tax returns are equal to $(1-20\%) * (8\%)$, while for Country *C* the after-tax return is equal to $(1-5\%) * (7\%)$.

86. $\$20,300 * 5\% = \$1,015$.

87. $\$23,300 * 20\% = \$4,640$.

economic growth perspective, Country *C* rationally engaged in tax competition.

This result will always be the case when before-tax and after-tax returns diverge, under these assumptions. Thus, a perfect solution would be to always equate the two. For example, assume Countries *A* and *B* adopt a credit for foreign taxes paid upon income subject to tax in those countries. Theoretically, such an approach would completely ameliorate both the double taxation and the ability of Country *C* to use taxes to attract capital. Returning to the example, assume an investor is considering whether to invest \$290,000 of capital in Country *C*. The \$20,300 of income generated in Country *C* would be taxed at 5 percent in Country *C* and 20 percent in Country *A* or *B* (less the credit). The taxpayer would pay \$1,015 of tax to Country *C* and owe \$3,625 of tax to Country *A* or *B*, for a total of \$4,640. In this manner, the capital has no incentive to move to Country *C* since it will pay the Country *A* or *B* tax no matter what and receives a higher before-tax return in either Country *A* or *B*. Thus, under the foreign tax credit approach, Country *C* could not use tax competition to attract capital.

The problem with this theoretically perfect solution is the revenue constraint discussed above.⁸⁸ As evidenced in the example, to ensure that taxpayers never pay more than its domestic tax rate a country would have to refund foreign taxes paid.⁸⁹ Taken to an extreme, if a foreign country's tax rates were greater than those of the home country, the home country would actually have to refund taxes in excess of its tax rate, resulting in *negative* tax revenues. Since the assumption is that taxes are imposed to raise revenue, this is not a logically consistent conclusion. As a result, the credit must be capped in some manner.⁹⁰

For example, assume Country *B* imposes a tax rate of 30 percent rather than 20 percent and Country *A* adopts an unlimited foreign tax credit. If \$100,000 was subject to tax in Country *B* and also subject to tax in Country *A*, there would be a 50 percent tax absent

88. See *supra* note 67 and accompanying text.

89. See, e.g., Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VA. L. REV. 919, 927-28 (1989) [hereinafter Roin, *The Grand Illusion*].

90. See *id.* at 928-30.

relief. Country *A* permits a credit for Country *B* taxes, however. Thus, \$30,000 of tax is paid to Country *B* and Country *A* imposes a tax of \$20,000 minus credit for the \$30,000 paid to Country *B*. As a result, Country *A* must write a check of \$10,000 to achieve an effective 20 percent tax rate, effectively a negative 10 percent rate. There is nothing theoretically stopping Country *B* from raising its rates forever, since Country *A* would continue to refund excess taxes in this manner. Of course, the limit is the amount of money Country *A* needs to spend on its own public goods, in effect a minimum revenue constraint. As a result, assume Country *A* must cap the credit it will give in some manner—at this point, the possibility for before-tax and after-tax returns to diverge reemerges, making tax competition relevant once again to the analysis.

In effect, the capital neutrality paradox provides that increasing the mobility of capital out of wealthier countries, regardless of form—with the additional assumptions of minimum revenue need and limited fiscal transfers—creates the possibility of rational incentives for certain countries to compete over capital through taxes. This conclusion runs directly counter to most of the incentive-based analyses of tax havens in the legal literature, which assume a “race to the bottom” model that can be resolved through common interests in cooperation.⁹¹ The capital neutrality paradox reverses this conclusion by focusing on the pursuit of neutrality-derived principles by wealthy countries as causing or exacerbating the incentives of poor countries to engage in tax competition. In such a case, no amount of coordination among countries, or assurances of cooperation with other countries, would necessarily slow tax competition.⁹² Even worse, it would imply that the greater cooperation among wealthier countries, the greater the incentive would be to compete on the part of poorer countries. Put differently, the risk to a tax haven is not that other poor countries would undercut them if they cooperated with wealthy countries, but that competition is

91. See Julie A. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 552-54 (2001); cf. Avi-Yonah, *Globalization*, *supra* note 16, at 1643.

92. Cf. HOLZINGER, *supra* note 67, at 98-99.

necessary to raise minimal amounts of tax revenue in the face of a wealthy country cartel.⁹³

Perhaps one reason the capital neutrality paradox, based on minimum revenue assumptions, has not been identified in the past is because many tax haven countries adopt income tax rates of zero or near-zero—either explicitly through rates or through granting tax holidays—and thus the assumption has been that such jurisdictions raise little to no revenue through tax competition.⁹⁴ Instead, it has been argued for the most part that tax competition is used to attract business investment for the benefit of local economies, such as increasing business for local lawyers, accountants, bankers, and other financial service industries.⁹⁵ Such an assumption would miss several potential means of raising revenue with respect to such capital, however, including through a small income or wage tax on incremental local salaries, consumption taxes on incremental foreign consumption within the tax haven such as meals, lodging, and similar activity, or most likely, excise-type taxes on the privilege of exploiting tax competition, such as franchise taxes on the formation or operation of legal entities.⁹⁶ These latter forms of revenue could be of particular benefit to a country selling income tax benefits to foreign investors because they directly charge the consumers for such benefits. Although these sources of revenue would tend to be miniscule compared to the worldwide loss of income tax revenue resulting from the tax competition, they could

93. Cf. Diane M. Ring, *Democracy, Sovereignty, and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555, 582 (2009) (discussing the effects of the OECD tax competition project on tax havens); see also Alexander Townsend, Jr., Comment, *The Global Schoolyard Bully: The Organisation for Economic Co-Operation and Development's Coercive Efforts To Control Tax Competition*, 25 FORDHAM INT'L L.J. 215, 251-58 (2001) (same).

94. See OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 21.

95. *Id.*; see also *supra* note 20.

96. See, e.g., Randall Jackson, *U.K. Pushes Cayman Islands To Introduce New Taxes*, 2009 WORLDWIDE TAX DAILY 169-1 (Sept. 2, 2009) [hereinafter Jackson, *Cayman Islands*] (“Companies registered in the islands are charged no direct taxes at all. George Town therefore relies on indirect income sources such as customs duties, stamp duties, and transaction fees such as those charged on property sales, mortgages, land leases, rents, and business licenses based on the number of employees, according to media reports. The business licenses, one of the prime income sources, can reportedly cost up to KYD 500,000.”); cf. Ilan Benschalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm’s Length Allocation Method*, 28 VA. TAX REV. 619, 643 (2009).

well be sufficient for the poorest countries in the world to meet their minimum revenue needs.⁹⁷ In other words, what might be an inconsequential amount of tax revenue in the United States could well be sufficient to fund public goods such as roads and electricity in a jurisdiction such as the Cayman Islands for a year.⁹⁸

From this perspective, what is important is both the level of tax revenue in a given jurisdiction and its sensitivity to taxes, not the per capita wealth or GDP of a jurisdiction. For example, the Cayman Islands could be subject to the pressures of the capital neutrality paradox if its tax base is highly elastic to taxes even though its current per capita GDP is relatively high.⁹⁹ In such a case, when revenues are insufficient to invest in public goods such as roads and schools and raising taxes is not a realistic option, the country could be thought to be caught in the capital neutrality paradox.¹⁰⁰

The fact that some countries meet their minimum revenue needs through tax competition does not mean that every small, poor country will become a tax haven, or that even if such a country desired to be a tax haven it could do so. In fact, it is likely that only the most marginally attractive jurisdictions would be able to successfully implement tax haven strategies.¹⁰¹ For example, in all

97. Cf. O'HARA & RIBSTEIN, *supra* note 46, at 111-13 (discussing how states such as Delaware where franchise taxes compose a large percentage of total revenue are more likely to engage in charter competition).

98. See, e.g., Landon Thomas Jr., *Offshore Haven Considers a Heresy: Taxation*, N.Y. TIMES, Oct. 4, 2009, at A1 (“[The leader of the Cayman government] credits the tax-free policy for transforming the islands. A native of the Caymans, Mr. Bush recalls growing up in poverty ‘There were no cars, no electricity—there will be no going back to living under the coconut tree,’ he said ‘The people have prospered—this country was built on this model.’”).

99. See Leibrecht & Rixen, *supra* note 19, at 62 (noting that tax base must be sensitive to tax rate as a condition for tax competition to arise); see also Miller, *supra* note 35, at 6.

100. See Randall Jackson, *U.K. Overseas Territory Tax Havens Face Financial Strain*, 2009 WORLDWIDE TAX DAILY 176-4 (Sept. 14, 2009) [hereinafter Jackson, *Financial Strain*]; Mason, *supra* note 11 (“The Cayman Islands has so far resisted the idea of direct taxation of its residents and companies, arguing that this would jeopardise its livelihood as one of the world's biggest financial centres with the 12th richest GDP per head.”). A similar phenomenon has also been seen in relatively “wealthy” countries such as Ireland. See, e.g., Ross Douthat, *Ireland's Paradise Lost*, N.Y. TIMES, Nov. 22, 2010, at A23; Quentin Fottrell, *Ireland Cuts Budget in Bid To Tame Debt*, WALL ST. J., Dec. 10, 2009, at A19; Martin A. Sullivan, *Can Hard-Pressed Ireland Keep Its Low Corporate Rate?*, 2010 TAX NOTES TODAY 196-94 (Oct. 12, 2010).

101. See Dharmapala & Hines, *supra* note 17, at 1060-61.

likelihood—even if they offered identical tax benefits—based solely on geography, South Pacific countries, such as the Cook Islands, would be unlikely to attract as many investors based in Connecticut as Caribbean countries such as the Cayman Islands. Likewise, Ireland may be more attractive as an entrée to Europe than non-EU members such as Belize, while Switzerland may well be more attractive as a source of bank secrecy than Vanuatu. Notwithstanding that each country might have an incentive to engage in tax competition due to the capital neutrality paradox, some will necessarily be more successful than others at doing so; this by itself does not mean the incentives toward competition are not present.¹⁰² Similarly, other nontax factors may outweigh incentives to tax competition, such as gains from trade in the case of China and the United States; again, this does not mean such incentives are not present, but only that they are not determinative. Accordingly, the conclusion can be reached that *one* of the incentives driving countries toward tax competition, and for some states perhaps the defining one, arises due to the choices and policies embedded in the international tax rules of wealthier countries such as the United States.

B. The Punishment Paradox

The primary lesson to be learned from the capital neutrality paradox is that to fully analyze the impact of a particular international tax law it must be thought of not only with respect to the distortion of taxpayer behavior due to changed costs, but also on the incentives created for other countries.¹⁰³ Consequently, when tax competition is perceived in a system, two alternatives need to be considered: (1) to identify the incentives leading to the competition and overcome them by increasing the cost of noncooperation through the use of law (the “punishment theory”), or (2) to identify the incentives leading to the competition and then amend the underly-

102. In fact, there is evidence that countries compete over the type of tax competition offered, leading to specialized tax havens. See Leibrecht & Rixen, *supra* note 19, at 70 (“[T]ax havens actively search for market niches and try to specialize in different tax planning activities.”).

103. See Allison Christians, Steven Dean, Diane M. Ring & Adam H. Rosenzweig, *Taxation as a Global Socio-Legal Phenomenon*, 14 ILSA J. INT’L & COMP. L. 303, 313-14 (2008).

ing international tax laws so as to ameliorate the incentives for noncooperation.¹⁰⁴ The punishment theory has dominated the international tax laws and the international tax literature to date, but the second may be more appropriate, especially given the capital neutrality paradox.

For purposes of this discussion, it may be useful to more clearly define punishment in these contexts. Punishment is intended to reduce the incentives to countries to become tax havens—that is, engage in harmful tax competition—by reducing the yields to such behavior. Thus, assuming tax havens use low taxes to provide higher after-tax yields as a way to attract capital, imposing a tax penalty on any capital invested in such countries—that is, reducing the after-tax yield for investment in such countries—would be an effective punishment to offset the tax competition.¹⁰⁵

Assuming *arguendo* that tax havens engage in competitive behavior due to the capital neutrality paradox, observing that countries engage in tax haven activity necessarily establishes that the current international tax regime creates incentives for them to do so. In such a case, punishing a taxpayer for investing in a tax haven as a means of encouraging cooperation would only exacerbate the overall effect of the paradox by increasing the after-tax cost of capital for investments made in the haven country,¹⁰⁶ as the after-tax returns for taxpayers decreased due to the punishment, the

104. A third option, preventing the mobility of capital, is not discussed in this Article since it is both not a realistic description of the modern world and presumably the efficiency losses of significant restrictions on capital mobility would vastly outweigh any anti-tax-competition benefits. See Mihir A. Desai & Dhammika Dharmapala, *Do Strong Fences Make Strong Neighbors?* (June 2010) (unpublished manuscript, available at <http://ssrn.com/abstract=1651620>); see also *supra* note 44. But see Johannes Becker & Marco Runkel, *Even Small Trade Costs Restore Efficiency in Tax Competition* (CESifo, Working Paper No. 3221, 2010), available at <http://ssrn.com/abstract=1697991>.

105. Punishment of private capital investing in tax havens is the primary form of punishment that will be considered in this Article. A second type of punishment, in the form of shaming or blacklisting the haven itself, has also been adopted. See OECD, *HARMFUL TAX COMPETITION*, *supra* note 10, at 61. To the extent this type of punishment is also intended to reduce the return on capital in such countries by increasing uncertainty or increasing social norm punishment for investing in such countries, it in effect serves the same purpose and thus can be thought of in the same manner for purposes of this Article.

106. See Robert T. Kudrle, *Did Blacklisting Hurt the Tax Havens?* 16-17 (Paolo Baffi Ctr. Research Paper Series, No. 2008-23, 2008), available at <http://ssrn.com/abstract=1243695> (finding mixed results from the effects of OECD anti-tax-haven initiatives).

demand for more tax incentives to return to the previous after-tax returns would grow.¹⁰⁷ Thought of another way, punishing tax havens could be considered as a form of transfer of capital, and thus tax revenue, from the tax haven back to the punishing country, thereby increasing the incentive for the tax haven to compete over that capital even more aggressively.¹⁰⁸

The resulting incentives from such punishment, that mobile capital will increasingly seek out new forms of tax benefits and certain countries will increasingly need to raise revenue, could rationally lead a particular country to engage in even higher levels of tax competition to retain the same after-tax return on capital—and thus tax base—as before the punishment was enacted. Perversely, they might even have to engage in even greater tax competition, since they would need to attract even more tax base than before as a result of needing to adopt lower effective tax rates in response to the punishment. In other words, attempts to “punish” domestic taxpayers with activities in tax havens would increase the pressure on such taxpayers to demand greater tax benefits from abroad, correspondingly increasing the incentives for tax havens to provide them.¹⁰⁹ This effect continues so long as there remain available additional (and more costly) instruments to engage in tax competition and countries willing to use them to attract capital base.

107. See Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *The Demand for Tax Haven Operations*, 90 J. PUB. ECON. 513, 520-23 (2006). The increase in demand occurs precisely because the penalty is not universal, in which case it would not change the relative cost of capital across borders. Cf. Michael S. Knoll, *International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes* 29-31 (U. of Penn. Inst. for Law & Econ., Research Paper No. 08-21, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259927 (discussing this effect in the context of tax sparing).

108. See David E. Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and a Corrective Subsidy*, 25 J. URB. ECON. 193, 194 (1989).

109. Ironically, the Joint Committee on Taxation implicitly acknowledged as much even while arguing in support of the punishment theory by conceding that withdrawing from the Bermuda Insurance Tax treaty would likely have little substantive effect on the total amount of tax haven shelters. See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO SELECTED INTERNATIONAL TAX ISSUES 65 n.188 (Comm. Print 2007) (“Even if terminating the U.S.-Bermuda tax treaty would have little practical effect, its termination might be viewed as an indication of U.S. tax treaty policy.”).

The heart of the punishment paradox is that this will always be the case in a world with the capital neutrality paradox, *precisely because* the prescriptions derived from capital neutrality encourage capital to flow across borders. This is the crucial step in the punishment paradox, because the economics literature for the most part tends to assume that countries can only reduce tax rates to zero.¹¹⁰ The reality, however, is that legal instruments can be crafted to create negative effective tax rates,¹¹¹ precisely by exploiting the baseline “neutral” rules in countries such as the United States.¹¹² Consequently, without punishing every tax instrument capable of attracting capital—which would be impractical if not impossible so long as neutrality underlies the baseline rules¹¹³—punishment will not eliminate the incentives in the system for there to be tax competition; rather, it will merely shift the competition to other countries, other instruments, or both.

For example, assume a system with four countries, the United States, Japan, Bermuda, and Uzbekistan. For simplicity, assume the United States and Japan both adopt exemption systems and neither Bermuda nor Uzbekistan have sufficient domestic tax base to raise their minimum revenue needs. As a result, both Bermuda and Uzbekistan engage in tax competition of some sort to attract tax base. Due to a number of factors, including geography, currency, language, and institutions, the market prefers Bermuda to Uzbekistan for tax haven investments, and thus Bermuda attracts substantial tax base away from the United States and Japan while Uzbekistan attracts little, but positive, tax base away from them. Subsequently, Japan and the United States jointly punish Bermuda by imposing a penalty on taxpayers who invest in Bermuda, reducing the after-tax marginal return on capital in Bermuda. The intended effect is to keep tax base in the United

110. Baldwin & Krugman, *supra* note 29, at 12-13.

111. See Fleming et al., *supra* note 33, at 140-42.

112. For example, as discussed in more detail *infra* Part III, such exploitation may be effected through methods such as transfer pricing, loss allocation rules, or income blending rules. See Fleming et al., *supra* note 33, at 118, 131, 140-42. There is no perfect solution for any one of these problems, such as replacing transfer pricing with formulary apportionment, let alone for all of them. *Id.* at 128 (“Formulary apportionment is not a panacea.”).

113. Further, there is no reason to believe that equalizing the worldwide after-tax marginal returns on capital in this manner would itself be an optimal solution. See Knoll, *supra* note 107, at 33-34.

States and Japan. Concurrently, such an approach brings the risk-adjusted marginal return on capital in Bermuda closer to that of Uzbekistan, making Uzbekistan a more attractive tax haven destination for taxpayers.

In effect, by punishing taxpayers for investing in a tax haven, the law could serve mainly to transfer tax base from one tax haven to another, rather than to mitigate the tax haven problem for the system as a whole.¹¹⁴ This effect would continue for as long as countries had different marginal returns on capital and minimum revenue needs. Returning to the example, assume the United States has the highest marginal return on capital and Japan has the second highest. Even if Japan and the United States were to impose significant penalties on both Bermuda and Uzbekistan, this would only make the marginal after-tax return on capital in Bermuda and Uzbekistan approach that of Japan. At some point, Japan would have an incentive to use its own tax laws to attract tax base away from the United States, or perhaps more realistically, to maintain its own domestic tax base.

If it is unrealistic to imagine Japan becoming a tax haven, apply a similar analysis to a world with over one hundred countries, with the progression moving from Bermuda, Jersey, and Mauritius in the lowest tier, to Liechtenstein and Morocco in the next tier, and Austria, Ireland, and the Netherlands in the third tier. As nations punished Bermuda, Jersey, and Mauritius, the incentive would shift to Liechtenstein and Morocco, and if nations then punished them the incentive would shift to Austria, Ireland, and the Netherlands.¹¹⁵ There is no reason to think this is unrealistic—after all, in the real world the title of tax haven has, over the years, passed down from countries such as Canada and Luxembourg to Switzerland and then to the Cayman Islands.¹¹⁶

114. See Wildasin, *supra* note 108, at 194.

115. Although Austria, for example, is a much wealthier country than Mauritius, Austria, in addition to Luxembourg and Belgium, was recently accused of engaging in certain types of tax haven behavior. See Charles Gnaedinger, *Luxembourg, Other Tax Havens React to OECD Gray List*, 2009 WORLDWIDE TAX DAILY 64-4 (Apr. 6, 2009). Similarly, after “anti-inversion” legislation was enacted in the United States, taxpayers shifted activities from “island havens” to countries such as Ireland and Switzerland. See Lee A. Sheppard, *News Analysis: Taking the Good With the Bad in the Anti-Inversion Rule*, 2010 TAX NOTES TODAY 31-2 (Feb. 16, 2010).

116. See *supra* note 11.

Even worse, the punishment paradox could potentially result in countries institutionalizing tax competition, making it substantially more difficult, if not impossible, to reverse. This would be the case when a country was only able to raise an amount of tax revenue exactly at or just slightly above its minimum revenue need through tax competition. Since the country used tax competition to attract tax base, it is safe to assume the tax base would be highly elastic to tax rates. Thus, any attempt to raise tax rates in any meaningful manner would lose net revenue by causing tax base to flee. Assuming a country on the margin of its minimum revenue need could not afford to lose revenue in this manner, it would therefore be unable to raise rates.

Under this theory, such countries could be thought of as caught in an inefficient cycle. First, to attract capital, and tax base, they must engage in tax competition, but once they engage in tax competition they do not have any additional source of revenue to build the institutions required to attract fresh capital, making tax competition even more necessary, leading to even further inefficient institutions.¹¹⁷ Accordingly, it is possible that once countries become tax havens they can effectively be trapped, unable to raise sufficient revenue to spend on development beyond their minimum revenue needs.¹¹⁸ If this is correct, punishment could be thought of as impaling tax havens on a Morton's Fork:¹¹⁹ if they increase domestic

117. See Mancur Olson, Jr., *Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor*, in *DEVELOPMENT AND UNDERDEVELOPMENT: THE POLITICAL ECONOMY OF GLOBAL INEQUALITY* 381, 401-03 (Mitchell A. Seligson & John T. Passé-Smith eds., 2003). Further, even if they wanted to, such countries might not have the institutions necessary to undertake the structural reforms to lead to growth. See Dean, *supra* note 18, at 926-28 (describing how tax havens do not have the institutions to administer a modern income tax).

118. See Joshua Aizenman & Yothin Jinjark, *Globalisation and Developing Countries—A Shrinking Tax Base?*, 45 *J. DEV. STUD.* 653, 668 (2009) (finding that globalization forces developing countries to move from easy-to-collect to hard-to-collect taxes, leading to a reduced tax base); Roy W. Bahl & Richard M. Bird, *Tax Policy in Developing Countries: Looking Back—And Forward*, 61 *NAT'L TAX J.* 279, 289-90 (2008); Jackson, *Cayman Islands*, *supra* note 96.

119. A Morton's Fork is a practical dilemma in which both choices offered are equally unattractive, as opposed to a Hobson's Choice in which there are nominally two options but in reality only one. See 9 *OXFORD ENGLISH DICTIONARY* 1106 (2d ed. 1989). For examples of a Morton's Fork, see *McCullen v. Coakley*, 571 F.3d 167, 182 (1st Cir. 2009), and *Burroughs v. Metro-Goldwyn-Mayer, Inc.*, 683 F.2d 610, 623 n.13 (2d Cir. 1982). For a discussion of these issues more generally, see Allison Christians, *Global Trends and Constraints on Tax Policy in the Least Developed Countries*, 42 *U. BRIT. COLUM. L. REV.* 239 (2009).

taxes to raise revenue, they lose the tax base they attracted with tax competition in the first place, while if they do not they cannot raise additional revenue to invest in those public goods necessary to spur development beyond their minimum revenue needs.¹²⁰ Absent relieving the pressure to rely on such institutions by providing other ways to access capital, such countries may effectively be incapable of ceasing to act as tax havens even in the face of increasing punishment.

Lastly, although beyond the scope of this analysis, the punishment theory could potentially raise some troubling normative concerns as well. For example, at least one article has argued that “restricting developing countries’ ability to compete for foreign investment by offering tax incentives does not truly restrict the countries’ autonomy or run counter to their interests”¹²¹ because cooperation is in the interest of all countries. If, however, the legal regime of the United States itself creates or exacerbates the incentives for certain countries to become tax havens, to then have wealthier countries punish them for following the incentives created by the wealthier countries themselves could be precisely the type of imposition on sovereignty and autonomy identified as normatively troubling in the literature.¹²²

C. The International Tax Paradoxes Operationalized

The story that poorer countries might have an incentive to use their tax laws to attract capital investment is not new, nor is the story that United States taxpayers would have an incentive to seek

120. See, e.g., Alice Sindzingre, *Financing the Developmental State: Tax and Revenue Issues*, 25 DEV. POL’Y REV. 615, 622-27 (2007) (finding sub-Saharan African countries are constrained from using tax policy for development due to dependence on commodities, the effects of trade liberalization, and the impact of aid); Jackson, *Financial Strain*, *supra* note 100; cf. NORTH, *supra* note 75, at 9 (“The organizations that develop in this institutional framework will become more efficient—but more efficient at making ... the basic institutional structure even less conducive to productive activity.”).

121. Avi-Yonah, *Globalization*, *supra* note 16, at 1646; see also ORG. FOR ECON. CO-OPERATION & DEV., TOWARDS GLOBAL TAX CO-OPERATION 5 (2000).

122. See, e.g., Christians, *supra* note 18, at 144-48. A detailed examination of this issue within the context of an incentives-based analysis would be necessary to craft prescriptive solutions, but is beyond the scope of this Article.

out low-tax jurisdictions to minimize their taxes.¹²³ The novelty of the capital neutrality paradox and the punishment paradox is the insight that these previously presumptively unrelated legal problems can really be thought of as legal manifestations of the larger underlying issues of disparate incentives as between wealthier and poorer countries in the international tax regime.¹²⁴ In other words, by choosing a baseline of capital neutrality, the law creates a form of tax competition that cannot be punished. As a result, punishing more blatant forms of tax competition simply shifts tax competition into this potentially more harmful form. The following discussion will describe some familiar shortcomings of different neutrality-based regimes and explain how they can more accurately be thought of as symptoms of these larger, unifying paradoxes.

1. Territorial Exemption and Tax Competition

Although not the primary policy behind U.S. tax law, partial or complete territorial exemption has served as the basis for the international tax laws of many of the worlds developed countries.¹²⁵ To pursue this policy, a country would impose a territorial tax, or a tax only on income generated within the territory of the jurisdiction.¹²⁶ By so doing, income earned outside the jurisdiction would be exempt from the income tax of that jurisdiction, but subject to the income tax of the source jurisdiction.¹²⁷ For example, assuming Germany has a purely territorial regime, income earned by BMW from sales of cars in Germany would be subject to German income

123. See, e.g., J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 342-44 (2001); Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609, 1613-14 (2001) [hereinafter Peroni, *Stuck in the Middle*].

124. Cf. Miller *supra* note 35 (cataloguing myriad provisions of the Internal Revenue Code which can provide an incentive to domestic capital to invest offshore).

125. See, e.g., Ernest R. Larkins, *Double Tax Relief for Foreign Income: A Comparative Study of Advanced Economies*, 21 VA. TAX REV. 233, 273 (2001).

126. See, e.g., Paul R. McDaniel, *Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?*, 8 FLA. TAX REV. 283, 290 (2007).

127. This is an oversimplification, since most countries adopting a territorial system in reality have some form of hybrid system using anti-abuse or other rules to reach some foreign income. See SUBPART F REPORT, *supra* note 41, at ix-xi.

tax, while income earned from sales of cars in the Netherlands would presumably be subject only to Dutch income tax.

The classic criticism of territorial taxation is that it encourages tax rate competition because a taxpayer can choose how much tax to pay simply by choosing in which jurisdiction to operate.¹²⁸ Thus, in the example above, assume the Netherlands has a much lower rate of tax than Germany. In such a case, all else being equal, BMW would have an incentive to sell cars in the Netherlands rather than Germany, solely to save taxes.¹²⁹ Correspondingly, to the extent the Netherlands desired to attract tax base, it could do so by offering lower tax rates than those in Germany. As a result, exemption is often directly linked with tax competition.¹³⁰

The connection between exemption and tax competition can be seen by extrapolating the generic capital neutrality paradox to an example where countries adopt territorial taxation. Assume a world in which the United Kingdom is the equivalent of Country A, France is the equivalent of Country B, and Gibraltar is the equivalent of Country C. The United Kingdom exempts foreign source income from U.K. income tax. France, having a sufficient domestic tax base and sharing significantly in increased growth with the United Kingdom, also adopts a territorial taxation system. Assume that as a result Gibraltar is left with zero tax revenues per year, but a fixed minimal revenue need to provide public goods. Adopting a territorial taxation system would benefit worldwide economic growth, but the benefit to the Gibraltar tax base would come only after the world-

128. See Martin Lobel, *Territorial Taxation: An Invitation to Tax Avoidance and Evasion*, 122 TAX NOTES 109, 109 (2009); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 982 (1997) [hereinafter Peroni, *Back to the Future*] (“[A]doption of the territorial system of taxation by the United States would likely lead to increased tax competition by countries adopting tax holidays or ineffective taxation at the source, thus undermining the fairness of international taxation viewed from a global perspective.”).

129. This assumes gain from the sale of inventory is sourced in the place of sale, which is the rule in the United States. 26 U.S.C. § 865(b) (2006). It is for this reason that few countries have “pure” territorial regimes, but rather adopt anti-abuse rules to prevent taxpayers from artificially allocating income to a foreign jurisdiction solely to avoid tax. See *supra* note 127. To the extent that actual business activity conducted outside the jurisdiction is not subject to tax, however, the territorial regime could be considered to apply.

130. See, e.g., Michael J. McIntyre, Commentary, *The Design of Tax Rules for the North American Free Trade Alliance*, 49 TAX L. REV. 769, 772-73 (1994) (“The source principle and capital import neutrality foster and legitimize tax competition.”).

wide capital grew sufficiently such that the marginal returns on capital in both the United Kingdom and France equilibrated to less than the marginal return on capital in Gibraltar, causing capital and tax base to shift to Gibraltar.

In other words, the vast majority, if not all, of the expected benefit from worldwide economic growth due to Gibraltar adopting a territorial income taxation system would inure to the benefit of the United Kingdom and France, with only minimal benefits to Gibraltar. Gibraltar would then have to decide whether sufficient tax base would inure to its benefit as a result of cooperation such that it could meet its minimum tax revenue needs. Assuming this would not be the case, Gibraltar would have no choice but to find some other way to attract a sufficient tax base so as to raise its minimum tax revenue.

One method would be to exploit the territorial taxation systems of the United Kingdom and France by adopting a low or zero income tax, with some method of raising revenue such as a franchise tax. Since any income generated in Gibraltar would be exempt from tax in both the United Kingdom and France, its taxpayers would pay a much lower overall rate by relocating their tax base to Gibraltar, resulting in higher after-tax profit, even for lower pre-tax economic returns. In effect, the adoption of exemption by the United Kingdom as a first mover would create a system in which France cooperated but Gibraltar had the incentive to engage in tax competition in the form of low or zero rates.

Presumably, Gibraltar would prefer to maintain a positive income tax on its domestic tax base while also providing low rates to foreign capital. This type of tax competition, often included in the definition of ring-fencing,¹³¹ is by its own terms easy to identify and, consequently, easy to punish—for example by denying exemption or imposing a penalty on income earned in countries with ring-fencing.¹³² If, however, the United Kingdom were to punish Gibralt-

131. See, e.g., Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 FLA. TAX REV. 1, 62 (2008) (citing OECD, HARMFUL TAX COMPETITION, *supra* note 10).

132. This is in fact the policy of U.S. tax law, which disallows a foreign tax credit for countries that impose a different rate of tax on foreign investors eligible for a foreign tax credit than on domestic capital. See 26 C.F.R. § 1.901-2(c)(1) (2010). See generally JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION, ¶ B4.03[5][C] (2009).

tar for ring-fencing in this manner, the incentive for Gibraltar would not be to cease competing over capital—since it would still need to meet its minimum revenue needs—but rather only to stop ring-fencing and shift the means of competing, for example, by adopting a uniform low rate for *all* taxpayers in Gibraltar. Since Gibraltar's new rule would no longer discriminate on its face among types of capital or investors, it would be much more difficult, if not impossible, for the United Kingdom to punish Gibraltar; after all, how could the United Kingdom punish its taxpayers for investing in Gibraltar and paying the same rate of tax as local Gibraltar taxpayers? Especially when, in fact, that was the precise intent of the United Kingdom in adopting territorial exemption in the first place? Even worse, the adoption of territorial exemption itself is precisely what made the use of such rates an effective way to attract capital.

The result, however, would be that Gibraltar would raise even less revenue from its domestic tax base, requiring even more aggressive forms of tax competition to meet its minimum revenue need.¹³³ Further, if the United Kingdom or France were to punish low rates generally, Gibraltar could then adopt aggressive forms of income allocations, such as transfer pricing,¹³⁴ to allow U.K. and French investors to more cheaply and easily shift capital away from their home countries.¹³⁵ In other words, by adopting exemption the United Kingdom and France created a baseline of tax competition that effectively could not be punished, but was more harmful than other more obvious forms of competition.

133. See Michael Keen, *Preferential Regimes Can Make Tax Competition Less Harmful*, 54 NAT'L TAX J. 757, 758 (2001); Sam Bucovetsky & Andreas Haufler, *Tax Competition When Firms Choose Their Organizational Form: Should Tax Loopholes for Multinationals be Closed?* (CESifo, Working Paper No. 1625, 2005).

134. Transfer pricing refers to a strategy of multinational taxpayers manipulating the price it charges affiliates across borders to artificially allocate profits to low-tax jurisdictions and away from high-tax jurisdictions. See generally KUNTZ & PERONI, *supra* note 132, ¶ A3.01. For example, if a widget costs \$1 to make and would sell for \$10 in the market, a U.S. company would typically have \$9 of income in the United States. Instead, however, the company could sell the widget to an Irish affiliate for \$2 rather than \$10, resulting in a reduction of income subject to tax in the United States, a high-tax jurisdiction, from \$9 to \$1. A subsequent sale of the widget in the market by the Irish affiliate for \$10 would result in \$8 of income in Ireland, a low-tax jurisdiction. By using transfer pricing, the company effectively shifted \$8 of income away from the United States to Ireland.

135. See Bucovetsky & Haufler, *supra* note 133, at 24.

2. *Worldwide Tax Base, Credits, and Blending*

The worldwide tax base, credits, and blending story is a little more complicated than the territorial exemption story, but can also powerfully demonstrate the potential explanatory strength of the capital neutrality paradox. Assume the United States is the equivalent of Country A, the United Kingdom is the equivalent of Country B, and the Cayman Islands is the equivalent of Country C. The United States taxes the worldwide income of its citizens and residents while granting a credit for taxes paid to foreign governments. For example, assume a U.S. investor invests \$1,000,000 in the United Kingdom, the U.S. tax rate is 35 percent, and the U.K. tax rate is 30 percent. The investment returns \$100,000, which is taxed at 30 percent in the United Kingdom. The investor pays the United Kingdom \$30,000 and brings back \$70,000 to the United States. The United States also taxes the investor on income of \$100,000 and imposes a tax of \$35,000. Due to the tax paid to the United Kingdom, however, the United States subtracts \$30,000 from the \$35,000 tax bill. Consequently, the investor pays the United States an additional \$5,000 and is left with an after-tax total of \$65,000—the same as if it had been a purely domestic investment.¹³⁶

As discussed above, the well-documented problem with the foreign tax credit regime is that, to be a pure model, the United States would have to refund any foreign taxes in excess of the U.S. tax rate.¹³⁷ For example, if the United Kingdom imposed a 40 percent tax rather than a 30 percent tax, such that the investor paid \$40,000 to the United Kingdom, the United States would have to actually *pay* the investor \$5,000 to end up with an after-tax total of \$65,000, the same as if it had been a domestic investment; this would effectively subsidize the United Kingdom in the interest of “pure” capital neutrality.¹³⁸ Since an unlimited foreign tax credit of this type would eventually completely erode the tax base of a country such as the United States, understandably no country has

136. $\$100,000 * (1 - .35) = \$65,000$.

137. See *supra* note 89 and accompanying text.

138. See Roin, *The Grand Illusion*, *supra* note 89, at 929-30.

adopted this approach; rather, the credit regimes are capped in some manner.¹³⁹

To this end, assume that the United States denies a foreign tax credit for foreign taxes exceeding the total U.S. income tax liability of a U.S. taxpayer on its worldwide income. Even though U.S. taxpayers would pay no net income tax to the United States so long as their foreign tax was equal to or greater than their U.S. tax liability, it would be possible for their total tax liability to exceed the U.S. tax rate. Under a simplistic analysis, the United Kingdom and the Cayman Islands would adopt the highest possible tax rate so as to maximize use of the credit—or raise revenue on foreign investors at the expense of the U.S. Treasury—because the investor would be indifferent to which country it pays the tax, so long as its total worldwide tax liability is not greater than the what the domestic tax would have been. Looking solely at the incentives for each country on a bilateral basis with respect to the United States, assuming the U.S. tax rate is 35 percent, the United Kingdom and the Cayman Islands would each have the incentive to adopt a 35 percent tax rate. In this manner, U.K. or Cayman taxes on U.S. taxpayers would be fully offset by the U.S. foreign tax credit.

The problem with this analysis is that the United Kingdom and Cayman Islands would not act purely on a bilateral basis with the United States, but rather would also be competing with each other to attract U.S. capital. Pursuant to the Lucas Paradox,¹⁴⁰ however, the United Kingdom would always provide a higher marginal return on capital than the Cayman Islands; in effect, this grants the United Kingdom a “first bite” at exploiting U.S. foreign tax credit capacity. Consequently, even if the Cayman Islands were to adopt a 35 percent tax rate, it would still only attract capital on that amount of U.S. investment in which the marginal return on capital in the Cayman Islands exceeds the blended marginal return on capital in the United States and the United Kingdom. This would leave the Cayman Islands with little to no choice but to engage in tax competition to meet its minimum revenue needs.¹⁴¹

139. *See id.*

140. *See supra* note 28 and accompanying text.

141. The same analysis applies, but operationalized in a different manner, if the foreign tax credit were limited to only “foreign source” income of U.S. taxpayers, rather than the total

For example, if the U.S. corporate tax rate was 35 percent, the United Kingdom would have no incentive to increase its tax rate above 35 percent on U.S. investors since any excess would not be credited in the United States and thus would distort investment in the United Kingdom. However, assume that at least some countries do have effective tax rates in excess of the U.S. effective corporate tax rate.¹⁴² As a result, U.S. taxpayers could be left with an “excess” foreign tax credit, meaning they paid taxes to foreign governments that could not be used in the United States.¹⁴³ The way for the taxpayer to “free up” these excess foreign tax credits would be to generate additional foreign source income that has less than the U.S. effective tax rate imposed on it—the lower the effective foreign tax, the more valuable the foreign source income becomes to U.S. investors in excess credit positions.¹⁴⁴

Under a simplified example, assume a U.S. investor pays \$50,000 in foreign taxes on \$100,000 of foreign income, and in addition has \$100,000 of income from a U.S. bank account. The investor owes tax of \$70,000 to the United States,¹⁴⁵ but due to the “foreign source” limitation on the foreign tax credit, can only claim as a credit taxes against the \$100,000 of “foreign” income, or \$35,000. Thus, the investor still owes an additional \$35,000 of tax to the United States. This \$35,000, added together with \$50,000 paid to the foreign country, results in a worldwide total of \$85,000 in taxes, as opposed to \$70,000 if the investment had been purely domestic.¹⁴⁶

Assume instead that the investor earns the second \$100,000 of income from a bank account in the Cayman Islands, which charges no income tax. The investor still owes \$70,000 of taxes to the United

worldwide tax liability of U.S. taxpayers, which is in fact the current policy of the United States. 26 U.S.C. § 904 (2006); see KUNTZ & PERONI, *supra* note 132, ¶ A1.03[1].

142. The United States has historically had a relatively low effective corporate tax rate, even in recent years when it has been at the higher end of the OECD member countries. For a survey of statutory and effective corporate tax rates, see Peter R. Merrill, *Competitive Tax Rates for U.S. Companies: How Low To Go?*, 122 TAX NOTES 1009 (2009).

143. This is generally referred to as an “excess” foreign tax credit. See Charles I. Kingson, *The Great American Jobs Act Caper*, 58 TAX L. REV. 327, 341 (2005) (“Any amount of foreign tax paid that exceeds the 35% needed to eliminate that U.S. tax on foreign income is referred to as excess foreign tax credit.”).

144. See Avi-Yonah, *Structure of International Taxation*, *supra* note 42, at 1326-28.

145. $\$200,000 * 35\% = \$70,000$.

146. See *supra* note 89 and accompanying text.

States, but now has \$200,000 of “foreign source” income instead of \$100,000 and can therefore claim up to \$70,000 of foreign tax credit. As a result, the investor can utilize the entire \$50,000 of foreign taxes paid to the United Kingdom as a credit and pay the United States only an additional \$20,000 of tax. Due solely to “creating” low-taxed foreign source income by moving the bank account from the United States to the Cayman Islands, the U.S. investor would save \$15,000 in total worldwide taxes.

The above example is a simplified version of the classic “blending” concern in the United States foreign tax credit regime, that is, blending income from high-tax and low-tax countries to exploit the foreign tax credit.¹⁴⁷ The response in the United States has been to deny the ability to blend income in this manner. The United States has increased the effective tax rate for such investment by adopting “baskets” of income that cannot be blended together.¹⁴⁸ One such antiblending mechanism would be a per-country basket, in which credits for taxes paid to one country could not be used to offset taxes arising with respect to income from other jurisdictions.¹⁴⁹ For example, under a per-country basket, the United States taxpayer would not be able to “soak up” excess U.K. foreign tax credits with Cayman Islands foreign source income, since only U.K.-sourced income could be offset by U.K. foreign tax credits.¹⁵⁰

At first glance, the per-country basket would seem to be a perfect solution to the capital neutrality paradox; if taxes paid to the United Kingdom could not be credited against income from the Cayman Islands, then taxpayers could not play the blending game by moving assets to the Caymans as a means to use excess U.K. foreign tax credits. Such a conclusion assumes that tracing the source of income to a particular country is feasible, or even has any economic salience at all, which is unlikely.¹⁵¹ Even assuming this away, however, the per-country approach misses the bigger problem with antiblending

147. See Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 392-93 (2003) [hereinafter Peroni, *Hitchhiker's Guide*].

148. 26 U.S.C. § 904(d) (2006).

149. See Peroni, *Hitchhiker's Guide*, *supra* note 147, at 394-95.

150. See, e.g., Peroni, *Back to the Future*, *supra* note 128, at 996.

151. See Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, “What's Source Got To Do With It?” *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 137-38 (2002).

rules: not only do they prevent blending of income with income, but they also prevent blending of losses with income. Consequently, the per-country basket limitation simply increases the incentives for the Cayman Islands to create or inflate special rules with respect to deductions or losses rather than income, such as converting nondeductible expenses into deductible ones, as a means to attract foreign investment.¹⁵² In fact, this was the primary policy reason for the repeal of the per-country limitation in the United States in 1976.¹⁵³

Taken together, under the capital neutrality and punishment paradoxes, regardless of the particular credit approach adopted by countries such as the United States, the incentives to certain countries to engage in tax competition would exist, not only through cross-crediting but also through “soaking up” excess foreign tax credits, blending losses, or other more complex techniques to lower overall worldwide effective tax rate.¹⁵⁴

III. HOW DID WE GET HERE? THE MOVE TO NEUTRALITY AND THE RISE OF THE INTERNATIONAL TAX PARADOXES

The lesson to be learned from the above analysis is that the current regime of partly cooperative and partly noncooperative dynamics should be thought of not simply as a temporary hurdle to be overcome in pursuit of a common goal of neutrality and cooperation, but rather as a structural component of the international tax

152. *E.g.*, Treasury Dep't, *Business Taxation and Competitiveness*, 116 TAX NOTES 399, 422-23 (2007) (describing how a company with excess foreign tax credits could benefit by converting nondeductible dividend payments into deductible royalty payments in the host country).

153. *See* STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 236 (Comm. Print 1976) [hereinafter 1976 BLUEBOOK] (“The use of the per-country limitation often permitted a U.S. taxpayer who had losses in a foreign country to obtain what was, in effect, a double tax benefit. Since the limitation was computed separately for each foreign country, losses in any foreign country did not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries from which other income was derived The Congress does not believe that taxpayers should be permitted to obtain the double tax benefits described above. Accordingly, the per-country limitation was repealed.”).

154. In addition to cross-crediting, there are numerous other means by which a credit regime can create ways to utilize tax havens to create negative effective tax rates through tax competition. *See, e.g.*, James Kvaal, *Removing Tax Subsidies for Foreign Investment*, 111 TAX NOTES 1299 (2006).

regime perpetuating the capital neutrality and punishment paradoxes. From this perspective, the tax haven issue facing the international tax regime becomes potentially more difficult to overcome, but also potentially more tractable in the long run. As with any theory, however—especially one so at odds with received wisdom—an analysis of whether and to what extent it better explains the observed world can further its legitimacy. Part III will do so, analyzing the development of some prominent anti-tax-haven rules in the United States to determine not only whether the above analysis is arguably based on more realistic assumptions than prior models but also whether it more closely reflects the reality of the tax haven experience.¹⁵⁵

Prior to 1961, the United States treated the foreign income of U.S. taxpayers very differently depending upon how the foreign income was earned.¹⁵⁶ Income earned directly by an individual or through a branch of a domestic business was immediately included in the income of the U.S. taxpayer and subject to the foreign tax credit, which had already been in place for nearly fifty years,¹⁵⁷ while income earned through a foreign corporate subsidiary was not subject to tax in the United States unless it was repatriated (for example, through a dividend).¹⁵⁸ Thus, U.S. investors could achieve deferral of, and at times effective exemption from, U.S. taxes on foreign earnings simply by choosing to operate their foreign businesses or investments through a corporate form rather than as a branch.¹⁵⁹

155. Part III is neither intended to make a strong theoretical or empirical claim of proof based on the experience of Subpart F nor to serve as a detailed legal historical analysis. Rather, it is meant to demonstrate the robustness of the theory of the capital neutrality paradox as consistent with historical experience. Reframing the history of anti-tax-haven efforts could well be valuable as an independent goal but is outside the scope of this Article.

156. See KRAUSE & DAM, *supra* note 1.

157. 26 U.S.C. § 901 (2006). See generally ELISABETH A. OWENS, THE FOREIGN TAX CREDIT (1961) (discussing the foreign tax credit as it existed in 1961).

158. KRAUSE & DAM, *supra* note 1, at 6-7.

159. *Id.* at 7 (“By operating through a foreign subsidiary, a U.S. enterprise can avoid any U.S. tax on the profits derived from the foreign operations until these profits are repatriated to the United States.”); KUNTZ & PERONI, *supra* note 132, ¶ B3.01. Even after the adoption of Subpart F, this general statement remains true for a large percentage of foreign operations of U.S. corporations. See generally *id.* ¶ B3.

In 1961 the Kennedy Administration made this distinction a focus of its tax policy reform initiative.¹⁶⁰ Initially, the Kennedy Administration proposed that all income earned by foreign corporations owned by U.S. taxpayers be taxed immediately in the same manner as if the corporation were a branch of the U.S. taxpayer.¹⁶¹ This proposal was based primarily on the policies of treating businesses operated through a branch and those operated through a corporate subsidiary equally, and on removing certain tax benefits from investing or operating offshore which, over time, could reduce the overall tax base available to the United States.¹⁶²

The proposal was changed substantially in Congress, where the focus was more on “tax havens”—in other words, situations where U.S. taxpayers simply parked assets offshore in a foreign corporation to avoid U.S. tax.¹⁶³ It did so by amending the Kennedy proposal to limit its application to focus on specific types of income, defined as “Subpart F income,” which was the type of income that particularly concerned Congress.¹⁶⁴ Under this approach, U.S. persons who owned a controlling interest in a foreign corporation would be required to pay tax on such “bad” income earned by the foreign corporation immediately, while “good” income could remain untaxed until repatriated.¹⁶⁵

The history of Subpart F has commonly been described in these terms, that is, as a compromise between proponents of complete repeal of deferral and proponents of deferral as promoting competitiveness of U.S. business operating abroad.¹⁶⁶ Looked at more

160. See Kennedy’s Special Message, *supra* note 2, at 294-97.

161. See Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON L. REV. 667, 683-84 (2007).

162. See Kennedy’s Special Message, *supra* note 2, at 295-96.

163. See S. REP. NO. 87-1881, at 83 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3385-86 (“[The committee] sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.”).

164. See Boise, *supra* note 161, at 684.

165. See KUNTZ & PERONI, *supra* note 132, ¶ B3.03[1]; see also Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185, 200 (2005) (“The essential compromise reflected in subpart F is an objective to curb tax haven sheltering without denying tax deferral to income from active business operations in low-tax countries.”).

166. See, e.g., Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S.*

closely, however, it becomes clear that Subpart F was targeted less at broad notions of horizontal equity and efficiency and more at stopping specific abusive tax havens.¹⁶⁷ Similarly, the legislative history of Subpart F tends to focus more on abusive tax havens and less on competitiveness more generally.¹⁶⁸

Interestingly, however, a significant portion of the history is often missing from this traditional story.¹⁶⁹ In particular, even in the original Kennedy proposal, certain corporations were exempted from the plan to tax all income of U.S.-controlled foreign corporations.¹⁷⁰ These corporations—“less developed country corporations” (LDC Corporations)—were those formed in a list of eligible less-developed countries and engaged in certain business activities in those jurisdictions.¹⁷¹ Notwithstanding the specific details of how these

International Taxation, 25 VA. TAX REV. 313, 329 (2005) (“It is common to assert that Subpart F as enacted represented a compromise between CEN and competitiveness, in that the Administration gave up on taxing CFCs on all of their income.”); Peroni, *Stuck in the Middle*, *supra* note 123, at 1609-10.

167. This story has become accepted in the tax literature, although the effectiveness of Subpart F to achieve this goal has been questioned. *See, e.g.*, Lokken, *supra* note 165, at 187 (“[A] principal reason for the enactment of subpart F was to curb U.S. companies’ ability to shelter income from taxation in tax haven countries.”); *see also* SUBPART F REPORT, *supra* note 41, at 22 (“Congress may thus have believed that by ending deferral only in the tax haven context and with respect to passive income, it addressed the goals of equity and efficiency without unduly harming competitiveness.”); Michael Stronberg, *Tax Aspects of Doing Business Abroad—Subpart F Income*, 17 DEPAUL L. REV. 153, 158 (1967) (citing 1962 U.S.C.C.A.N. 3381).

168. *See* H.R. REP. NO. 87-1447, at 57-58 (1962).

169. There are some isolated references to these provisions, mostly in their repeal, but little discussion as to how they fit into the larger history of Subpart F. *See, e.g.*, Graetz, *supra* note 35, at 263, 275, 308. The history of these provisions is referenced in the SUBPART F REPORT, however. *See* SUBPART F REPORT, *supra* note 41, at 21 n.38.

170. *See* Kennedy’s Special Message, *supra* note 2, at 296 (“At the same time, I recommend that tax deferral be continued for income from investment in the developing economies. The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued income tax deferral for these areas will be helpful in this respect.”).

171. More specifically, a corporation was a LDC Corporation if it was formed in any country identified by the President as a less-developed country, although Congress adopted a list of countries that the President could not label as “less developed.” *See* STAFF OF H.R. COMM. ON WAYS AND MEANS, 90TH CONG., LEGISLATIVE HISTORY OF H.R. 10650, at 58 (1967). The list included the following countries: Australia, Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Hong Kong, Italy, Japan, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, South Africa, San Marino, Sweden, Switzerland, and the United Kingdom. *Id.* In addition, countries of the Sino-Soviet bloc were prohibited from being considered LDCs. *Id.*

provisions worked, the purpose of the LDC provisions was to effectively subsidize investments in less-developed countries by explicitly excepting them from the general rules and policies embodied in Subpart F.¹⁷²

The LDC Corporation exclusion survived the congressional amendments to the Kennedy proposal and became an integral part of the Subpart F regime as enacted in 1962.¹⁷³ This regime did not last long, however. By the early 1970s, observers increasingly criticized the perceived inefficiency of the LDC Corporation provisions,¹⁷⁴ because these provisions distorted capital allocation across borders.¹⁷⁵ Ironically, this criticism was not based on the lack of effectiveness of the LDC Corporation provisions, but rather on their success, as the provisions had influenced the decision making of U.S. corporations toward investing in less-developed countries.¹⁷⁶ Critics of the LDC Corporation provisions noted that the argument that such provisions could eventually lead to increases in United States growth or tax revenue had not materialized to the extent projected.¹⁷⁷ In addition, the mechanisms adopted, including deferral, gross-up relief, and ordinary income relief, were argued to be too imprecise to achieve the desired incentives for investment in such countries.¹⁷⁸

172. See SUBPART F REPORT, *supra* note 41, at 21 n.38 (“Although Congress did include provisions within subpart F to promote investment in less developed countries, these provisions were not intended to address competitiveness concerns but to encourage development in these countries.”).

173. See Stronberg, *supra* note 167, at 164, 166-67.

174. See Alan G. Choate, Steven Hurok & Samuel E. Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis, and Prospects*, 44 TEMP. L.Q. 441, 494-96 (1971).

175. *Id.*

176. See *id.* at 495; *cf.* 1976 BLUEBOOK, *supra* note 153, at 243 (“The Congress believes that in the interest of uniform tax treatment between developed and less-developed country corporations ... this double allowance should be removed.”).

177. Michael Stukenberg, *The Effects of the 1975 Tax Reduction Act on the Taxation of Subpart F Income*, 9 VAND. J. TRANSNAT'L L. 377, 395 (1976).

178. See H.R. REP. NO. 94-658, at 218 (1975), reprinted in 1976 U.S.C.C.A.N. 2897, 3113 (“The size of the tax benefit to the U.S. investor depends on a variety of factors, such as the foreign tax rate in the country where the investment is made and in other countries, and the capital gains tax rate in the United States. Further, the relationship of the tax benefits to the investor to the benefits obtained by the developing country is erratic since the size of the tax benefit may bear no relationship to the amount of development capital invested.”).

Lastly, and what most seemed to puzzle policymakers at the time, the countries themselves did not seem to be taking advantage of this “gift” given to them by the United States.¹⁷⁹ Since the provisions adopted were mechanical, it was relatively simple to calculate an optimal rate through which the less-developed countries could maximize their domestic revenue and still exploit the benefits of the LDC Corporation laws.¹⁸⁰ Yet almost all less-developed countries had been adopting rates significantly below this mathematically ideal rate.¹⁸¹ This was pointed to as proof that less-developed countries were incapable, politically or otherwise, of exploiting the generosity of such provisions.¹⁸²

As a result, by 1976 all of the LDC Corporation provisions were repealed, with the result that almost all foreign corporations were treated the same for purposes of Subpart F.¹⁸³ This was done primarily in the name of furthering “neutrality” so as to minimize distortions to cross-border investment and thus increase worldwide growth.¹⁸⁴ The repeal of the LDC Corporation provisions was not done in a vacuum, however, but rather acted to remove a benefit from companies investing or operating in countries with lower marginal returns on capital—effectively a punishment on investing in poorer countries.¹⁸⁵

179. See UNCTC, 1974 REPORT, *supra* note 22, at 33.

180. This rate turned out to be half of the United States rate. See 1976 BLUEBOOK, *supra* note 153, at 243 (“The maximum tax differential ... occurred when the foreign tax was half that [of the United States].”); UNCTC, 1974 REPORT, *supra* note 22, at 39, 40 (“It can be shown that the minimum tax bill occurs when the LDC tax rate is exactly one-half the United States rate.”).

181. See 1976 BLUEBOOK, *supra* note 153, at 243; UNCTC, 1974 REPORT, *supra* note 22, at 33.

182. See UNCTC, 1974 REPORT, *supra* note 22, at 33.

183. See H.R. REP. NO. 94-658, at 218, 230-31.

184. See 1976 BLUEBOOK, *supra* note 153, at 243; Stukenberg, *supra* note 177, at 395 (“Prevention of tax avoidance and ending deferral are the primary justifications offered for the total elimination of the privilege of reinvestment of qualified income in an LDC.”). Interestingly, by 1976 the second primary policy of the original Subpart F, creating incentives for unaligned countries to affiliate with the United States rather than the Soviet Union, seemed to disappear from the debate. This may be because the affiliations in the bipolar world were perceived as solidified, or perhaps the need for unaligned countries seemed less important in the 1970s. See Stukenberg, *supra* note 177, at 396 (“[I]t is difficult to see the rationale for eliminating the LDC benefits unless the United States has decided to revoke its long standing policy of encouraging the economic development of the Third World.”).

185. See Stukenberg, *supra* note 177, at 395-96 (“[I]t is foolish to speak of a ‘neutral’ tax

Around the same time, the United States grew increasingly concerned over the attempt by tax havens to attract U.S. investors by exploiting the U.S. foreign tax credit provisions.¹⁸⁶ In particular, one of the primary concerns was the use of “soak-up” taxes, or taxes imposed by foreign countries solely on U.S. investors and solely to the extent the U.S. investor would be repaid by the U.S. government through the foreign tax credit.¹⁸⁷ In effect, soak-up taxes were intended to have the U.S. Treasury indirectly subsidize the tax haven.¹⁸⁸ By the late 1970s, the IRS had identified soak-up taxes as troubling, and in 1980 the Treasury Department issued new Temporary and Proposed Regulations intended to address soak-up taxes.¹⁸⁹ By 1983, these regulations were modified to, among other things, explicitly disallow a foreign tax credit for soak-up taxes, and were then finalized and promulgated into law.¹⁹⁰ Taken together,

policy between the LDC’s and the developed nations. Because of the inherent disincentives to investing in LDC’s, removing the tax incentives creates a form of neutrality but at the cost of accentuating inequality.”).

186. The issue of “treaty shopping” also arose around the same time. In particular, the use of the Netherlands Antilles to access Eurobond markets exploded in the late 1970s as U.S. investors discovered they could route investments to the Eurobond market through the Netherlands Antilles and, due to the inheritance of the Netherlands tax treaty with the United States, avoid most if not all taxes. See Boise & Morriss, *supra* note 11, at 379-83 nn.8-9. Although at first some were ambivalent to, if not supportive of, this method of reducing effective tax rates, this “treaty shopping” was eventually deemed so abusive that by the late 1980s the United States had withdrawn from the tax treaty with the Netherlands Antilles and treaties with other similarly situated former European colonies. See Richard K. Gordon, *On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers*, 88 N.C. L. REV. 501, 519 (2010) (“The treaty with the Netherlands Antilles, oddly, was tolerated so that overseas investors could invest in the U.S. corporate debt market without having to pay gross tax to the United States.”). Interestingly, although the use of the Netherlands Antilles as a portal to the Eurobond market had effectively become moot due to changes in the U.S. tax law, withdrawal from the treaty was justified at the time at least in part as a form of punishment for tax haven behavior. See Boise & Morriss, *supra* note 11, at 382; Frith Crandall, *The Termination of the United States-Netherlands Antilles Treaty: What Were the Costs of Ending Treaty Shopping?*, 9 NW. J. INT’L L. & BUS. 355, 372 (1988).

187. In addition to soak-up taxes, the regulations attempted to address royalties disguised as taxes, noncompulsory taxes, and indirect taxes such as sales taxes masquerading as income taxes. See Marc M. Levey, *Creditability of a Foreign Tax: The Principles, the Regulations, and the Complexity*, 3 J.L. & COM. 193 (1983).

188. *Id.* at 204 (“If a [soak-up tax] is imposed, Treasury would function as a funding agent for the foreign government.”).

189. See Temporary Income Tax Regulations Relating to the Creditability of Foreign Taxes, 45 Fed. Reg. 75,647, 75,648 (Nov. 17, 1980) (codified at 26 C.F.R. pts. 1 & 4); Creditability of Foreign Taxes, 45 Fed. Reg. 75,695 (Nov. 17, 1980) (codified at 26 C.F.R. pt. 1).

190. See Creditability of Foreign Taxes, 48 Fed. Reg. 46,272, 46,280 (Oct. 12, 1983) (codified

the repeal of the LDC Corporation provisions and the promulgation of anti-soak-up tax rules significantly limited the benefit of investing in what were perceived to be abusive tax havens by the early 1980s.

What is particularly interesting is that there were tax haven problems before the enactment of Subpart F and promulgation of anti-soak-up rules, and there have been tax haven problems since, notwithstanding that these provisions were adopted primarily with the goal to put a stop to tax havens. Why have these efforts been so ineffective? Under the punishment theory this does not make sense; if being a tax haven is profitable, the solution must be to punish tax havens to remove the profit. By removing deferral for some of the most troubling tax haven activity, Subpart F served to punish U.S. taxpayers investing in tax havens, while denying foreign tax credits acted in much the same manner. Under the punishment theory, these actions should have reduced the number of tax havens, the amount of capital invested in tax havens, or both. Yet not only has the number of countries acting as tax havens increased since the enactment of Subpart F, but the total amount of capital residing in these tax havens has exploded as well.¹⁹¹

Further, if punishing a particular tax haven was successful in convincing that tax haven to cease harmful tax competition, the risk of incurring such punishment should make it more costly for *all* countries to engage in tax haven behavior,¹⁹² thus deterring other countries from becoming new entrants into the tax haven business. Yet the reality is that more countries act as tax havens now than in 1962,¹⁹³ and more do so now than prior to the promulgation of the

at 26 C.F.R. pts.1 & 4); Foreign Tax Credit, 48 Fed. Reg. 14,641 (Apr. 5, 1983) (codified at 26 C.F.R. pts. 1 & 4.). Subsequently, the IRS continued to issue Revenue Rulings identifying more aggressive and hidden versions of soak-up taxes within the tax codes of other countries. See Rev. Rul. 2003-8, 2003-1 C.B. 290 (Costa Rica); Rev. Rul. 87-39, 1987-1 C.B. 180 (Uruguay).

191. See, e.g., Miller *supra* note 35, at 6-9 (citing sources estimating total lost tax revenue of \$11 billion to \$60 billion per year); Martin A. Sullivan, *Shifting of Profits Offshore Costs U.S. Treasury \$10 Billion or More*, 104 TAX NOTES 1477, 1481 fig.3 (2004); see also *supra* note 34 and accompanying text.

192. Cf. Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241, 266 (2007) (explaining the role of the risk of detection within the Bentham-Becker formula for the calculation of tax-evasion penalties).

193. See Ronen Palan, *Tax Havens and the Commercialization of State Sovereignty*, 56 INT'L ORG. 151, 151 (2002) ("Over the past three decades there has been a spectacular rise in the

anti-soak-up tax regulations.¹⁹⁴ The punishment theory narrative cannot fully explain this development.

The capital neutrality and punishment paradoxes potentially provide a better explanation for both these successes and failures, however. First, the capital neutrality paradox would provide that neutral tax laws would serve to increase incentives of poorer countries to engage in tax competition. Subpart F, as initially enacted, though, was not neutral; rather, Subpart F specifically subsidized poorer countries through the LDC Corporation provisions.¹⁹⁵ Thus, Subpart F had two effects: First, it made it more expensive to use then-traditional tax haven techniques through historical tax haven jurisdictions such as Switzerland. Second, Subpart F made it relatively cheaper to invest in other less-developed countries.¹⁹⁶ In effect, it “punished” countries engaged in what was then deemed abusive tax haven behavior while “rewarding” those poorer countries that had not done so.

The repeal of the LDC Corporation rules changed this paradigm by moving closer to neutrality and, effectively, punishing less-developed countries by removing the tax subsidy for investment in them. By punishing these countries in this manner, such countries lost revenue, increasing the need to find alternative sources of revenue. At the same time, demand by U.S. taxpayers—in particular large multinational corporations—for alternative means to reduce worldwide tax liability increased as well, because the ability to use LDC Corporations to this end had been repealed. As these taxpayers moved to other means such as exploiting soak-up taxes, these methods were also punished. In other words, as Subpart F moved closer to neutrality, the incentives for poorer countries to engage in tax competition increased.

number of microstates serving as tax havens.”). For the periods from 1968 to 1972, see RICHARD A. GORDON, *TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS* 4-5 (1981).

194. See Boise & Morriss, *supra* note 11, at 426.

195. See Graetz, *supra* note 35, at 275 (“President Kennedy’s proposals were not neutral between investments in developed and developing countries, offering a tax advantage to the latter.”).

196. This can be thought of as a form of the classic “carrot and stick” approach to tax jurisprudence. See, e.g., Giuseppe Dari-Mattiacci & Gerrit De Geest, *Carrots, Sticks, and the Multiplication Effect*, 26 *J.L. ECON. & ORG.* 365, 366 (2010); Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 *CONN. L. REV.* 431, 491 (2008) (“Currently, U.S. tax regulation relies too heavily on sticks and not enough on carrots.”).

What arose concurrently was a group of countries willing to “sell” their jurisdictional sovereignty as a place to engage in such transactions in exchange for minimal tax revenues—such as Bermuda for insurance,¹⁹⁷ the Cayman Islands for hedge funds,¹⁹⁸ Luxembourg for hybrid equity schemes,¹⁹⁹ and even Nova Scotia for hybrid entity schemes.²⁰⁰ Why any one country may have been successful at a particular form of tax competition speaks to other factors,²⁰¹ but the incentive to engage in tax competition can well be attributed, at least in part, to the move in Subpart F toward neutrality and punishment.

Similarly, adoption of antidiscrimination rules such as the anti-soak-up tax regulations pressured these countries to adopt uniform rates of tax on all capital income.²⁰² Since presumably these jurisdictions could not attract or retain capital if they imposed higher taxes on all investors, the result of such a nondiscrimination rule was to pressure such countries to adopt low or zero tax rates on *all* capital income, not just on that of U.S. investors. This, in turn, further reduced the ability of these countries to meet their minimal revenue needs, thereby increasing the pressure to turn to more

197. See, e.g., Daniel M. Crane & Linnsey K. Workman, *Bermuda Triangle: Tax Havens, Treaties, & U.S. P&C Insurance Competitiveness*, 94 TAX NOTES 73, 78 (2002).

198. Martin A. Sullivan, *Offshore Explorations: Caribbean Hedge Funds, Part 2*, 118 TAX NOTES 255, 255 (2008) (“[M]ore than half of the world’s hedge funds are legally domiciled offshore, and the four offshore leaders are the Cayman Islands, the British Virgin Islands, the Bahamas, and Bermuda.... And of those four, the Cayman Islands by a wide margin dominates its competition.”).

199. See David Buss, David Hryck & Robert Rothman, *Tax Minimization Strategies Using Offshore Holding Companies*, 83 TAXES 13, 14 (2005) (“There is also a special type of instrument referred to as a ‘preferred equity certificate’ (PEC) which is treated as debt for Luxembourg purposes but is usually treated as equity for U.S. tax purposes.”).

200. See, e.g., Peter H. Blessing, *Cross-Border Acquisition Financing*, 843 PLI/TAX 791, 855-56 (2008) (discussing FSA 200206010, which held the structure complied with U.S. tax law). The United States and Canada recently entered into a new treaty protocol that would substantially limit the benefit of such structures. See Philip F. Postlewaite, Stephanie R. Hoffer & Matthew T. Kemp, *The Adaptation of U.S. Tax Treaties to Changing Business Forms—A Case Study of Hybrid Entities*, 34 INT’L TAX J. 33, 40 (2008).

201. See Leibrecht & Rixen, *supra* note 19, at 70 (“[T]ax havens are in competition with each other and with high-tax countries.”).

202. See 26 C.F.R. § 1.901-2(e)(2), ex. 1 (2009) (denying a foreign tax credit for special taxes imposed by a foreign country on residents of only four other countries).

aggressive forms of tax competition, making the entire system worse off.²⁰³

Revisiting the history of anti-tax-haven efforts, including the experience of the LDC Corporation provisions, can prove useful in both learning the lessons of the past and in learning the limitations of traditional theories of tax competition. Upon closer inspection, this history demonstrates that the punishment theory is at best incomplete. In its strongest form, the capital neutrality paradox both better explains and better predicts the experiences with anti-tax-haven efforts than does the traditional punishment theory of tax havens. At a minimum, however, the history of anti-tax-haven provisions more closely corresponds with the capital neutrality and punishment paradoxes than with the punishment theory of tax havens, making it at least useful to envision prescriptive solutions to tax competition within the framework of these paradoxes and how they contrast to those under the punishment theory of tax havens.

IV. TOWARD RESOLVING THE INTERNATIONAL TAX PARADOXES

Given the dynamics of an international tax regime with the capital neutrality paradox, as discussed above, it is not surprising that traditional responses to competition in the international tax arena, standing alone, could be insufficient or even counterproductive. What proves more difficult, however, is crafting better legal rules in light of the capital neutrality paradox, precisely because the real world is more complicated than the model. In this case, the primary complication when extrapolating from the theory to crafting appropriate prescriptions is the assumption of states as unitary actors; of course, states are not human beings, but rather groups of people making collective decisions, which themselves could be subject to collective action, heuristics, interest groups, and other problems.

Does this prove fatal to incorporating the capital neutrality paradox into U.S. international tax law? Not necessarily; rather, it counsels prudence in its application. The primary lesson that can be

203. See Keen, *supra* note 133, at 758.

learned from the capital neutrality paradox is that neutrality and cooperation may not be able to coexist in every particular circumstance. At a minimum, this lesson can help us question the long-standing assumptions underlying the punishment theory of international tax, a theory that has underlined most anti-tax-haven efforts. Further, it can prove valuable even given the limitations of the unitary actor assumption in situations where the law focuses on neutrality to reexamine if such a policy is negatively impacting capital flows to developing countries.

By identifying these situations, it can be possible to determine if modifications to the pure neutrality policy could yield Pareto-superior results.²⁰⁴ In other words, by relieving some of the pressure of the capital neutrality paradox, tax competition could improve as compared to current law even if some countries would act irrationally due to internal politics or otherwise.²⁰⁵ To the extent current policy prescriptions from the punishment theory rely on claims of optimality, taking them seriously requires at a minimum considering alternatives under the capital neutrality paradox as well.

Such an approach is particularly relevant in light of the recent debate over the Stop Tax Haven Abuse Act.²⁰⁶ The Act contains numerous provisions that would change the treatment of both taxpayers and tax havens, including new rules on information reporting, statutes of limitations, and penalties.²⁰⁷ The primary feature of the Act, however, is to significantly increase punishment of tax havens and the taxpayers who invest in them with the intent of reducing harmful tax competition, based primarily on the punish-

204. For models of how fiscal transfers can optimize tax competition, see Thiess Buettner, *The Incentive Effect of Fiscal Equalization Transfers on Tax Policy*, 90 J. PUB. ECON. 477, 493 (2006) (using the different tax rates in German municipalities to conclude that fiscal transfers can produce an optimizing “incentive effect”); Carl Gagné & Stéphane Riou, *Globalization, Asymmetric Tax Competition, and Fiscal Equalization*, 9 J. PUB. ECON. THEORY 901, 920 (2007) (concluding that, through tax revenue equalization schemes, fiscal transfers can yield efficient outcomes even when countries lack cooperative tax policies).

205. See Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, 42 INT'L ORG. 427, 432-33 (1988).

206. H.R. 1265, 111th Cong. (2009).

207. See STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT 204, 218 (Comm. Print 2009).

ment theory of tax havens.²⁰⁸ In light of the capital neutrality and punishment paradoxes, however, the Act might not only be ineffective in squeezing tax competition out of the international system, but could actually exacerbate the problem. In such a case, the very terms of the debate over this legislation, and the prescriptive solutions therein, need to be revisited and revised so as to avoid unintentionally increasing tax competition—a common goal of virtually all traditional international tax analysis to one degree or another.²⁰⁹

This does not mean that punishment could not be the appropriate prescription in a particular solution, or that it is mutually exclusive with whatever prescriptions might derive from the capital neutrality paradox. In fact, assuming a viable solution to the capital neutrality paradox would relieve some of the pressure on the minimum revenue needs of the poorest countries in the world, both the effectiveness and normative appeal of punishment for recalcitrant jurisdictions would be strengthened as well.²¹⁰ This could be thought of as a form of “punishment plus” theory—that not only is punishment appropriate or necessary in certain circumstances when combined with the prescriptions under the capital neutrality paradox, but that it can also be defended more strongly from both an efficiency and normative standpoint.²¹¹

Since the capital neutrality paradox arises when the assumption of limited direct fiscal transfers is introduced, presumably one of the

208. See H.R. 1265 (stating that the purpose of the Act is “[t]o restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation”).

209. See OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 56-57. *But see* Infanti, *supra* note 45, at 1151-52; Qing Hong & Michael Smart, *In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment* 17 (CESifo, Working Paper No. 1942, 2006), available at <http://ssrn.com/abstract=976577>.

210. See David G. Noren, Commentary, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337, 339-40 (2001) (“Whatever one thinks of the severity and immediacy of this problem, it seems clear that some combination of tax and regulatory carrots and sticks will have to be deployed to keep this business activity and the tax dollars therefrom connected with major destination markets like the European Union and the United States.”); *cf.* Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 595 (1998) (“In reality, a combination of expression and coercion accounts for the effectiveness of many laws.”).

211. Broadly speaking, in the terminology of the traditional equity/efficiency tradeoff, “punishment plus” could be thought to increase efficiency because it improves incentives toward worldwide efficient allocation of resources and normative because it takes distribution of resources into account. See *supra* note 37 and accompanying text.

easiest ways to overcome the capital neutrality paradox would be to use direct fiscal transfers,²¹² not to reward tax competition or bribe countries to cooperate,²¹³ but as a means to satisfy the minimum revenue needs of tax havens and thus remove these particular incentives to tax competition from the system.²¹⁴ In other words, tax competition acts as an inefficient form of fiscal transfer that could be replaced with a more efficient form.²¹⁵ Direct fiscal transfers are unlikely to serve as a complete answer to overcoming the capital neutrality paradox, however, due to a number of reasons, including domestic political opposition and fear of foreign corruption and waste.²¹⁶ Notwithstanding these limitations, approaches similar to direct fiscal transfers have begun to be proposed in the literature under certain circumstances, and are worthy of consideration in their own right, even if they may have limited utility in directly overcoming the capital neutrality paradox.²¹⁷

212. This concept is contrary to the notion of using “tax expenditures” as incentives to effectuate governmental policy. Cf. Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 707 (1970).

213. Cf. Joseph Guttentag & Reuven S. Avi-Yonah, *Closing the International Tax Gap*, in BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 106 (Max B. Sawicky ed., 2005) (proposing that developed countries offer “transition support” to tax havens that cease competitive behavior).

214. This is because two fundamental assumptions underlie the capital neutrality paradox: (1) minimum revenue needs, and (2) limited direct international fiscal transfers. See *supra* notes 67-68 and accompanying text. Overcoming either assumption would therefore mitigate the capital neutrality paradox.

215. See Wildasin, *supra* note 108, at 194; see, e.g., Martin A. Sullivan, *The IRS Multibillion-Dollar Subsidy for Ireland*, 2005 TAX NOTES TODAY 137-3 (July 18, 2005).

216. See, e.g., United Nations Convention Against Corruption, Oct. 31, 2003, S. TREATY DOC. NO. 109-6, 2349 U.N.T.S. 41; Avi-Yonah, *International Redistribution*, *supra* note 23, at 374 (“[A]n increase in the official aid to the level required ... is not in the cards.”); Jacquelyn S. Porth, *Corruption Undermines Trust, Erodes Development*, AMERICA.GOV, May 19, 2009, <http://www.america.gov/st/business-english/2009/May/20090424141654sjhtrop0.950741.html>. Although outside the scope of this Article, one potential benefit of using tax law for indirect transfers is that revenues should theoretically flow to the most stable and least corrupt of the poorer countries, as they would be the most marginally attractive for foreign capital. Cf. Dharmapala & Hines, *supra* note 17, at 1065 fig.2.

217. See Dean, *supra* note 18, at 963-65 (proposing that the United States enter into tax flight treaties with certain jurisdictions to divide the incremental revenue resulting from tax information exchange agreements); Paul R. McDaniel, *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 GEO. WASH. INT’L L. REV. 265, 274 (2003) (proposing a gross-up and tax credit for certain deemed-paid taxes to developing countries); Bruce Zagaris, *The Procedural Aspects of U.S. Tax Policy Towards*

Assuming direct fiscal transfers are not possible, indirect fiscal transfers need to be considered as one potential avenue to overcome the capital neutrality paradox.²¹⁸ At least one political economy model has explored this possibility, concluding that it could be Pareto-optimal for a wealthy country to grant a refundable credit to its taxpayers for taxes paid to a poorer country as a means of fiscal transfer.²¹⁹

In many ways, this approach is similar to the historic practice of “tax sparing” typically considered in connection with tax policy with respect to poorer countries. Tax sparing refers to the concept that a home country should grant a tax credit to its taxpayers for taxes that would have been imposed by a host country absent some tax incentive.²²⁰ For example, assume Malawi generally imposed a 25 percent income tax on capital investment but offered to reduce the tax to 10 percent for a U.S. investor. Under current foreign tax credit rules, the U.S. investor would be eligible for a credit of only 10 percent; under tax sparing, however, the investor would be eligible for a credit of 25 percent notwithstanding that only 10 percent was in fact imposed. In this manner, the United States can subsidize investment in poorer countries while permitting the host country to use its tax policy to attract capital investment.

Although at first tax sparing appears similar to the concept of indirect fiscal transfers, they are conceptually distinct. First, and primarily, tax sparing has generally been promoted not as a means to improve the U.S. tax system on its own terms, but rather to further unrelated normative goals of development or distributive justice.²²¹ Second, tax sparing has generally been considered in

Developing Countries: Too Many Sticks and No Carrots?, 35 GEO. WASH. INT'L L. REV. 331, 337-41 (2003) (discussing promise and limitations of Tax Information Exchange Agreements like the one between the U.S. and Barbados); see also Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555 (2007).

218. See generally Wildasin, *supra* note 108.

219. See Keen & Wildasin, *supra* note 58, at 270.

220. See Dean, *supra* note 18, at 930 n.85.

221. See Karen B. Brown, *Transforming the Unilateralist into the Internationalist*, in TAXING AMERICA 214, 225 (Karen B. Brown & Mary Louise Fellows eds., 1996) (“The failure of the United States to accept the tax sparing credit has derailed many developing country treaty negotiations.”). By way of contrast, recent work has proposed a form of tax sparing to be used to optimize the income tax system by equalizing the treatment of explicit and implicit host country taxes. See generally Knoll, *supra* note 107.

connection with bilateral treaty negotiations as a sort of bargaining chip for poorer countries to enter into treaties with wealthier countries, although there is a legitimate debate as to the utility of such a use for tax sparing provisions.²²² Lastly, the United States has never enacted tax sparing with another country,²²³ and those countries that have, such as Canada, are reconsidering the effectiveness of doing so.²²⁴

One question that arises, however, is whether tax sparing could be used as a tool to overcome the capital neutrality paradox notwithstanding its historical justifications.²²⁵ The historical experience with tax sparing in other jurisdictions does not bode well for the effectiveness or usefulness of such an approach.²²⁶ Perhaps more importantly, tax sparing requires poorer countries to *lower* tax rates to receive the benefits. Thus, tax sparing could potentially exacerbate the two paradoxes for countries on the margin of their minimum revenue needs, because lowering effective tax rates could result in dropping total revenue below minimal revenue needs. Taken together, given the historical experience, the bluntness of the approach to the capital neutrality paradox, and the normative associations with tax sparing, this Article will consider other more tailored alternatives.

Assuming tax sparing is either an ineffective or unrealistic option for overcoming the capital neutrality paradox, one of the simplest alternatives presumably would be to revive the LDC Corporation provisions of Subpart F,²²⁷ providing U.S. taxpayers a significant

222. See, e.g., Kim Brooks, *Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?*, 34 QUEEN'S L.J. 505, 552-53, 556 (2009).

223. See Brown, *supra* note 221, at 225.

224. See Brooks, *supra* note 222, at 530.

225. See McDaniel, *supra* note 217, at 274-76 (proposing a unilateral tax credit for certain developing countries).

226. For example, due to the significant worldwide efficiency costs and potential for abuse, the use of tax sparing has fallen into disfavor even in countries initially highly supportive of the concept, such as Canada. See, e.g., Deborah Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 CAN. TAX J. 879, 892-93 (2001); see also Kim Brooks, *Canada's Evolving Tax Treaty Policy Toward Low-Income Countries*, in GLOBALIZATION AND THE IMPACT OF TAX ON INTERNATIONAL INVESTMENTS 15 (Arthur J. Cockfield ed., forthcoming), available at <http://ssrn.com/abstract=1352647>; Robert J. Peroni, *Response to Professor McDaniel's Article*, 35 GEO. WASH. INT'L L. REV. 297, 299-300 (2003).

227. See *supra* notes 170-72 and accompanying text.

incentive to retain and reinvest earnings in less-developed countries and leading to a greater domestic tax base in these countries.²²⁸ In this manner, less-developed countries would be able to build or retain a greater independent capital tax base, relieving pressure on the need to engage in tax competition.

To the extent that (and in the unlikely world where) the repeal of the LDC Corporation provisions provided a robust explanation for the rise of tax havens, reenactment of the LDC Corporation provisions would be an ideal response. After all, if repealing the LDC Corporation provisions caused the rise of the tax havens, then reinstating them should mitigate the problem. Even assuming this strong causation story is not the case, which seems more likely, such a proposal has many benefits. First, it is not novel, meaning that the uncertainty with respect to implementing it would not be as great as proposals created anew. Although the impact on capital would be different in the modern financial world than in 1962, the administrative costs at a minimum would presumably be lower than other proposals due to this historical experience with such provisions.²²⁹ Further, the primary criticisms at the time of the repeal of the LDC Corporation provisions—that they caused revenue loss by transferring revenue from the United States to less-developed countries for little competitive or distributive benefit—would be less relevant in a world of the capital neutrality paradox because that cost would be offset by reducing the incentives for eligible countries to engage in tax competition. At a minimum, the fiscal impact of such proposals

228. See, e.g., Joosung Jun, *U.S. Tax Policy and Direct Investment Abroad*, in *TAXATION IN THE GLOBAL ECONOMY* 55, 57-58 (Assaf Razin & Joel Slemrod eds., 1990). Alternatively, the proposal could be expanded to permit movement of retained earnings between any LDC Corporations such that capital would not be “trapped” in any one less-developed country. I discuss a proposal with a similar effect in the different context of international tax arbitrage transactions. See generally Rosenzweig, *supra* note 217.

229. Perhaps the most difficult task will be drafting the list of eligible less-developed countries. This in itself, however, did not prove fatal to the operation of the LDC Corporation provisions themselves. Not only was there little controversy over the list of countries, there is nothing in the legislative history indicating that drafting the list was a reason behind its repeal. See *supra* Part III. Further, the OECD has had no problem drafting a list of tax havens for purposes of punishing harmful tax competition, which seems to indicate that, at a minimum, it is not beyond the abilities of the United States to do so as well. See OECD, *HARMFUL TAX COMPETITION*, *supra* note 10, at 57. Lastly, targeting tax relief to certain poorer countries is already an embedded feature of current U.S. tax law in other contexts. See Rosenzweig, *supra* note 217, at 604 n.98 and accompanying text.

would need to be analyzed on a case-by-case basis rather than dismissed as necessarily and always revenue-reducing under a neoclassical theory of tax competition.

The other primary criticism of the LDC Corporation provisions at the time was that they were too blunt an instrument to achieve the desired goals.²³⁰ That is, by exempting LDC Corporations from certain antideferral and gross-up provisions, the law explicitly subsidized investment in such countries but in a manner uncalibrated to the amount of increased investment in such countries or the benefits derived therefrom.²³¹ The issue for the modern debate, therefore, is whether these provisions could be reenacted in a more tailored manner so as to more directly accomplish the new policy goal of mitigating the incentives toward tax competition. This is where the LDC Corporation provisions begin to appear less promising, and perhaps more importantly seem to indicate the inaptness of Subpart F as a tool to overcome the capital neutrality paradox. If deferral and gross-up relief are too blunt, then what else could be accomplished within the confines of Subpart F, a provision specifically focused on deferral and gross-ups? This likely proves critical to the utility of LDC Corporation provisions as a means to combat tax havens, or at a minimum makes them less than ideal as compared to other more direct proposals.²³²

Could there be such better options within the confines of the Internal Revenue Code? This Article contends the answer is yes—so long as assumptions about the mechanics of certain “unrelated” provisions of the Internal Revenue Code could be reimagined. One such option could be to create a more narrowly tailored indirect fiscal transfer within the international tax rules of the Code, but outside of Subpart F. For several reasons, one of the most promising would be to build an indirect fiscal transfer into the existing foreign tax credit basket rules.²³³ Although the use of foreign tax credit baskets to achieve fiscal transfers as a means to overcome the capital neutrality paradox may strike some as odd, the use of the

230. See *supra* notes 174-78 and accompanying text.

231. See *supra* note 178 and accompanying text.

232. See McDaniel, *supra* note 217, at 291-92.

233. See 26 U.S.C. § 904 (2006) for existing foreign tax credit rules.

basket rules to achieve the goal of minimizing tax havens is not novel.²³⁴

The mechanics of using the basket rules to this end could be done by returning to a methodology formerly utilized by the United States—the per-country limitation. As discussed in Part II, the use of per-country basket limitations effectively prevent taxpayers from “blending” income from high-tax and low-tax countries as a means to “free up” excess foreign tax credits from wealthier countries. The limitations permit taxpayers to claim a credit for foreign taxes only against U.S. taxes owed on the same income, which is otherwise possible under the existing “income type” basket rules.²³⁵ By doing so, however, the per-country basket puts pressure on poorer countries to utilize loss or deduction rules to accomplish the same goal, that is, to use the tax laws to attract tax base.²³⁶ As a result, there is no one perfect basket rule in a nonharmonized international tax regime.²³⁷

Given this, one possibility could be to utilize the foreign tax credit baskets not solely within the context of the credit, but rather within the broader international tax laws of the United States as a whole. In particular, under the per-country basket system, the law could lift the cap on the ability to claim foreign tax credits for taxes paid to a list of certain less-developed countries. In this manner, rather than serve as an overall limit on the ability to claim foreign tax credits as a means to protect the U.S. fisc, the per-country basket would serve to make it relatively easier to use foreign tax credits generated in less-developed countries and relatively harder to use credits generated in developed countries.²³⁸ In effect, the United States would indirectly subsidize income taxes imposed in such

234. For example, adopting antiblending rules such as the per-country basket was one of the defensive measures recommended by the OECD. See OECD, HARMFUL TAX COMPETITION, *supra* note 10, at 40-43.

235. See *supra* Part II.C.2. It is for this reason that the basket rules have been the focus of many anti-tax-haven proposals as well. See JANE G. GRAVELLE, CONG. RESEARCH SERV., TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 26 (2009).

236. See *supra* Part II.C.2; see also Julie A. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Systems*, 81 VA. L. REV. 1753, 1768 n.53 (1995) [hereinafter Roin, *Rethinking Tax Treaties*] (“[O]ther source countries may find it beneficial to maintain low tax rates to attract investors who would otherwise find themselves in an ‘excess credit’ position.”).

237. See Roin, *Rethinking Tax Treaties*, *supra* note 236, at 1768-80.

238. See 26 U.S.C. § 904.

jurisdictions, while the overall limitation on foreign tax credits to “foreign source” income would remain,²³⁹ protecting the United States from unabated raiding of the fisc by other countries.²⁴⁰

For example, assume the United States permits a tax credit for taxes paid to a foreign country. NewCo, a U.S. corporation, sells software in Industria, a relatively wealthy nation, at a profit of \$200. The United States treats the \$200 as income subject to a U.S. tax of 35 percent for a total tax liability of \$70, less any available foreign tax credit. Industria imposes a tax of 40 percent on the \$200 profit, resulting in a total of \$80 in tax. Taken together, NewCo is left with \$10 of excess, useless foreign tax credit. As discussed above, the incentive of NewCo is to “free up” this credit by generating some profit in a low-tax country.²⁴¹ This in turn puts pressure on poorer countries to lower tax rates as a means to attract this investment. Thus, assume that in addition to Industria with a tax rate of 40 percent there was a third country, Island, with a tax rate of 30 percent. If NewCo could treat \$100 of income as arising in Island, it would now have a total \$200 of foreign source income but foreign tax of only \$70 (\$40 in Industria plus \$30 in Island), meaning that it could now fully utilize its foreign tax credit.

The per-country basket rules would prevent this type of blending of foreign income. Under the per-country basket, NewCo would have to make two separate calculations to determine its U.S. tax. First, it would calculate a total tentative tax liability in the United States of \$70. Second, with the per-country basket it could not necessarily claim all \$70 of foreign tax credit to reduce its U.S. tax to zero. Rather, it could only use the \$30 of Island credit against U.S. taxes on the \$100 of income earned in Island—that is, \$35 of taxes—and \$40 of credit against the \$35 of U.S. taxes on the \$100 earned in Industria. As a result, \$5 of the Industria credit would remain unused while NewCo would owe an additional \$5 of taxes on the Island income to the United States, for a total of \$75 in taxes and a \$5 “excess” foreign tax credit.

But what if the tax credit for Island were unlimited? In such a case, NewCo would much prefer that Island taxes be 40 percent and

239. *Id.*

240. See Roin, *Rethinking Tax Treaties*, *supra* note 236, at 1768 n.53.

241. See *supra* notes 142-46 and accompanying text.

Industria taxes be 30 percent rather than the other way around. If NewCo paid \$30 to Industria subject to the basket, it would be able to claim all of the credit against \$35 of U.S. tax, while the \$40 of taxes paid to Island would be fully creditable against all the foreign income of NewCo. Since NewCo would still owe \$40 of U.S. tax on its \$200 of foreign income, it could use the foreign tax credit to offset all of the remaining U.S. tax, resulting in a total of \$70 in taxes and no “excess” foreign tax credit. In other words, such an approach would effectively permit a form of “one-way” or “reverse” blending of income for foreign tax credit purposes.

In this manner, by shifting the rules to adopt an unlimited basket for developing countries and a limited basket for developed countries, the incentives of U.S. taxpayers would shift from pressuring poorer countries to engage in tax competition under current law to one of pressuring wealthier countries to impose lower tax rates and, remarkably, for poorer countries to impose *higher* tax rates. Assuming there is a limit on the amount that developed countries can reduce their tax rates due to their spending commitments,²⁴² the pressure primarily will be on poorer countries to raise their rates from zero or near zero to positive, solely to free up tax credits.

As a result, by unilaterally amending the basketing rules for the foreign tax credit, the United States can dramatically change the incentives of U.S. capital, and consequently, tax competition for capital. This would reduce the incentives for poorer countries to engage in tax competition. Rather than serve to “reward” bad behavior, or insist on a harmonized world regime, or surrender to the inevitability of tax competition, the law in this manner could internally harmonize its moving parts solely on its own terms (with respect to the incentives it creates), regardless of how or whether other countries react.

Further, by using the foreign tax credit basket rules and maintaining the general limits on foreign tax credit, such as the foreign source income requirement, the total neutrality of the system as to capital between the United States on the one hand and foreign investment on the other would be no worse than under current

242. See Benshalom, *supra* note 96, at 647 (“While developed countries compete for capital investments by lowering taxes, they are limited in doing so by their need for revenues to cover governmental expenditures.”).

law.²⁴³ In other words, a partial unlimited foreign tax credit basket would not provide any incentive for more capital to leave the United States as a whole than already exists under current law, assuming taxpayers already maximize the ability to create foreign source income and blend income across jurisdictions under current law.²⁴⁴ Further, the existing limitations on abuse such as the anti-soak-up and other nondiscrimination rules would remain in place as well, meaning these methods would also be no worse under the basket proposal than under current law.²⁴⁵ Consequently, under these assumptions, amending the foreign tax credit basket in this manner should have little to no cost to the domestic tax base, but would ameliorate some of the incentives created within U.S. tax law toward tax competition. This makes intuitive sense as well—if tax havens continue to offer effectively zero tax rates after adopting this rule, allowing an unlimited foreign tax credit becomes irrelevant since they are charging no taxes. On the other hand, if tax havens effectively raise rates in response, the undesirable behavior would be mitigated.

Finally, the administration of such a rule should prove much simpler than other provisions targeted at developing countries because qualification for the foreign tax credit requires the provision of a receipt or comparable documentation from the foreign country proving actual payment of a tax upon request from the IRS,²⁴⁶ meaning the obligation is on the taxpayer to prove entitlement rather than on the government to trace and audit “abusive” behavior as with tax sparing, LDC Corporation provisions, and other similar provisions.²⁴⁷ If compliance was of a particular concern, however, receipts or other documentation could be required

243. *Id.* at 647-48.

244. *See, e.g.*, Rosenzweig, *supra* note 217, at 567 n.19. *See generally* Michael P. Devereux & Harold Freeman, *The Impact of Tax on Foreign Direct Investment: Empirical Evidence and the Implications for Tax Integration Schemes*, 2 INT'L TAX & PUB. FIN. 85 (1995) (concluding that taxation does affect the location of outward foreign direct investment); Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT'L TAX J. 825 (2000) (concluding that capital movement is very responsive to taxes).

245. *See supra* notes 186-90 and accompanying text.

246. *See* 26 U.S.C. § 905(b) (2006); 26 C.F.R. § 1.905-2(a)(2) (2010).

247. *See, e.g.*, McDaniel, *supra* note 217, at 267-73.

to be submitted to the IRS by the taxpayer in advance as a prerequisite to granting the unlimited foreign tax credit basket.²⁴⁸

Lastly, to effectuate the “punishment plus” theory, the basketing approach should be combined with an anti-tax-haven effort of some sort. In other words, to ensure that countries eligible for the unlimited basket provisions would not continue to engage in harmful tax competition, ceasing or modifying tax haven behavior could be a prerequisite for a country to be included on the eligible list. For example, eligibility for the list could be conditioned upon a jurisdiction not engaging in bank secrecy or other forms of support for money laundering or tax evasion. Taken together, adoption of the unlimited basket provisions would serve to offset the incentive currently built into U.S. law for poorer countries to engage in tax haven behavior, while punishment in the form of ineligibility for continued tax competition would weed out jurisdictions that might continue their harmful tax haven behavior notwithstanding the removal of the incentive due to path dependence,²⁴⁹ institutionalization of tax competition, domestic political economy reasons, or other reasons. Regardless, since the punishment would be integrated with the basketing proposal, the punishment paradox would be mitigated because the incentives created by both the baseline rules and the punishment rules under U.S. law would, for the first time, be unified toward cooperation.

This is not to say that such a basketing proposal is the only or even the best approach to mitigating the capital neutrality paradox or deterring countries from acting as tax havens. For example, a similar rule could be implemented by adopting a per-country basket and permitting zero-sourcing of deductions to the eligible countries.²⁵⁰ Rather, the basketing proposal is an example of how rethinking the manner in which seemingly disparate provisions of the international tax laws might work together to create perverse incentives can lead to dramatically different ways to thinking about

248. This was in fact proposed by the Treasury Department for foreign tax credits generally, but was withdrawn as overbroad. See T.D. 8759, 1998-13 I.R.B. 19-20; see also I.R.S. Notice 88-65, 1988-1 C.B. 552.

249. See, e.g., Rosenzweig, *supra* note 217, at 567 n.18.

250. This would effectively create more foreign tax credit capacity in the poorer countries and less in the wealthier countries, similar to the basketing proposal. For the current rules on sourcing of deductions, see 26 C.F.R. § 1.861-8.

other areas such as Subpart F to create unified incentives. By approaching international tax law in this manner, the law could move closer to breaking the seemingly never ending cycle of combating tax havens once and for all.

CONCLUSION

This Article directly addresses the question, “why are there tax havens?” Surprisingly, although there has been a fair amount of literature on why tax havens are harmful to the modern international tax regime, which countries become tax havens, and what means are available to combat tax havens, there has been little written specifically on this underlying theoretical question. Although at first this seems like an exceedingly obvious question—tax havens exist because countries use their tax laws to attract business—the literature has fairly well established that this must be either incorrect or irrational. So are tax havens merely acting contrary to their own long-term economic and fiscal interests, possibly captured by special interest groups who are indifferent to the harms they are imposing on the world, or is some other underlying phenomenon at play?

This Article contends that the inability to answer this question can be attributed to the failure to identify the hidden underlying principle of international tax law: the “capital neutrality paradox.” Under the capital neutrality paradox, it is precisely the focus of modern international tax laws in wealthier countries such as the United States on increasing the mobility of capital across borders that creates or exacerbates the conditions necessary for tax havens to arise and persist within the international regime. The capital neutrality paradox arises because of the empirical reality that capital flows disproportionately away from poorer countries to wealthier countries. Taking this fact into consideration, a world that encourages capital to flow freely across borders would result in poorer countries with scarce domestic tax bases having little choice but to engage in tax competition to meet their minimum revenue needs. To the extent this is the case, punishing such countries would almost always prove counterproductive because it would only exacerbate this need to engage in tax competition. Understanding

the “punishment paradox” in connection with the “capital neutrality paradox” together can fundamentally alter the way in which the law conceptualizes and responds to the issue of tax havens.

Confronting the issue of tax competition from this combined perspective, it is the focus on neutrality and punishment in international tax law that comes into question. Consequently, contrary to the punishment trend embraced both in the United States and through organizations such as the OECD and G20, when faced with a particular tax haven problem the best solution may well be to first look inward to harmonize the tax laws of countries such as the United States and the incentives they create to poorer countries, and only then pursue punishment as an option. In effect, rather than ask the question “why are there tax havens?” the question would become “why pursue capital neutrality?” Rather than ask “what can we do to punish tax havens?” the question would become “would punishment be effective?” Such an approach could not only lead to a more efficient international tax regime for all countries involved, but could be the first step to finally answering the question of why there are tax havens as well.