

exactly these structures in mind when severely tightening the anti-treaty-shopping rule in 2007. In order to receive any reimbursement of the retained withholding tax on the distribution of German dividends, the U.S. taxpayer has to comply in advance and deal readily with this new obstacle.

Furthermore, since the new unilateral anti-treaty-shopping rule reaches beyond the scope of the LoB clause in the Germany-U.S. treaty, in which both countries exhaustively define abusive behavior, the provision must be considered as an illegal treaty-override.

At the moment, the taxpayer has two options to deal with the anti-treaty-shopping rule: First, sit, wait, and hope that the ECJ will proclaim the new rule to violate EC law, or second, react by tax-planning.

Furthermore, the worldwide trend is to tighten anti-abuse rules from general anti-abuse rules (GAAR) over specific anti-treaty-shopping regimes (in particular in Germany) and CFC rules, to unilateral subject-to-tax provisions like the German § 50d(9) EStG.

The general anti-abuse rules focus on economic substance or the business purpose.

In international tax law there is a trend to tighten the deductibility of finance expenses by drafting and enacting more

restrictive thin cap rules. A good and recent example is the introduction of the German *Zinsschranke* that has tightened the deductibility of interest payments extensively. Instead of the formerly accepted debt-to-equity ratio of 1.5:1 (*Safe Haven*), the new rule provides for a deduction of only 30% of the EBITDA in excess of the net interest balance. Anything beyond is subject to three exceptions, of which the escape clause is the most likely option for MNCs. Yet, its complexity demands many efforts before U.S. MNCs can rely on the escape clause. Moreover, the *Zinsschranke* has a very detrimental effect on holding companies as their formerly granted specific *Safe Haven* has been abolished without any substitution. Hence, holding companies are virtually barred from taking advantage of the escape clause. In fact, holding companies are discriminated against since they cannot deduct the book value of their participations for purposes of calculating the debt-equity ratio.

## VI. Conclusion

At the end of the day, there is neither a perfect location for a holding company nor a perfect repatriation strategy. Yet, this account has to identify the legal framework including the obstacles, enabling each U.S. MNC to create and pursue an individual long-term repatriation strategy in an ever-changing tax world.

Stephen Utz\*

## Tax Reform in the Aftermath of the Financial Crisis

This article is based on my comments last May to a DAJV audience in Berlin about the prospects for US tax reform under President Barack Obama. To an earlier DAJV audience, also in Berlin, I had spoken on the same general subject during the 2008 presidential campaign. My predictions on the first occasion served as a starting point for a re-evaluation on the second, which I amend slightly here to take account of even recent developments.

I am a rather narrow tax specialist, neither a political commentator nor a sociologist, and like a good academic I live in the clouds. In the summer of 2008, despite these handicaps, I gave my best guesses about what Hillary Clinton or John McCain or the long-shot Barack Obama might do if they won the election. Now that the dust is well settled on President Obama's victory, some of my guesses are coming true. But the unfolding tax legislative process is of course shaped in part by the financial crisis, whose scale and severity were not at all obvious when I gazed into my crystal ball. Then as now, the best chance for principled tax reform is to bring everyone to the table at the same time: the more interest groups affected by the proposed reforms, the greater the chance that synthesis will actually occur. It seems that the Obama administration initially hoped to use the power of simultaneous pain to achieve a useful result; as the new president's first year in office comes to a close, that may no longer be as likely.

To set the stage, it may be worthwhile to dwell briefly on the legislative process in Washington. Each of the two houses of Congress has a tax-writing committee – the Finance Committee in the Senate, the Ways and Means Committee in the

House. The chairpersons of these committees have always been powerful. Charles Rangel, the current chair of the Ways and Means Committee, is on the left of the Democratic Party. He is associated with calls for broadening the corporate tax base, by eliminating tax deductions and other favorable adjustments, but he also represents Manhattan, and so he is a bomb-throwing anarchist with a surprising sympathy for the financial sector. By the way, he has recently admitted failing to pay income tax on rental income from property he owns in the Dominican Republic, and so I'm sure he can understand the tender consciences of those who use illegitimate tax shelters. Max Baucus, the chair of the Senate Finance Committee, is a Democrat from Montana and is considered a centrist. Both are likely to take prominent roles in writing new tax legislation and are at least superficially working for Obama's proposals.

"Writing new legislation" has a special meaning for Congress. It does not mean actually drafting the language of new tax provisions. Instead, it means brokering deals about very broad tax proposals coupled with revenue and cost projections from the Congressional Budget Office, a research service that is intended to be and usually is nonpartisan. In 1984-1986, when Congress passed the last big tax reform act and in 1997 when it cut the capital gains tax rate, the discussion was, to use the favorite word "conceptual," that is, framed entirely in general terms, without specific legislative language for the legislators to consider. The vote on the bill almost took place before anyone had seen the language. History is likely to repeat itself if and when Congress again takes up broad tax reform.

The starting point for the Obama administration was somewhat favorable to the prospects for principled tax reform. Just as the new president and new Congress settled into power, the

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financial crisis and the public outcry against “greed” strongly favored eliminating tax breaks. Despite or because of the government’s commitment to helping banks and auto makers survive, the public was unhappy with the rich and former rich, and this feeling seemed to extend to anything big and corporate. The administration seemed intent on harnessing the public mood for a variety of purposes, including a partial return to the pre-2000 Internal Revenue Code. This would have meant fewer breaks for high-income earners and big business but also possibly fewer “Christmas tree” ornaments for a wide range of special interests, not all of them commercial or well heeled. Did President Obama’s tax agenda look as if it would implement the public desire to clean house? Remember that his campaign promises were made *before* the crisis fully emerged.

Before the financial crisis and related public fallout, there had been ominous stock market declines and the credit market was already fragile, but no one yet expected half the big banks of the US and Europe to need bailouts, and hedge funds hadn’t yet had to de-leverage rapidly, although they had already begun quietly to withdraw from many acquisitions. Back then, however, federal budget deficits were attracting lots of attention. When I spoke to the DAJV in Berlin in 2008, I concluded that any Democratic or Republican White House-cum-Congress would strive to do something about them. It seemed to me very likely that whoever took office would begin taking the national debt seriously because the debt service was putting pressure on the US government’s ability to borrow. I expected other issues to influence the politics of taxation in the US, but this objective problem struck me as the most pressing.<sup>1</sup>

The national debt almost doubled during the eight years of President George W. Bush’s presidency. Neither party emphasized this during the 2008 campaign season. Perhaps even the Democrats had accepted the Bush administration’s bookkeeping trick of not counting the cost of the Iraq War as part of the national debt – the war accounted then for only about ¼ of the \$4.5 trillion increase in the debt but was expected to cost twice that much in the next few years – which still seems to be a fair prediction.<sup>2</sup> Actually, most of the debt increase resulted from Bush-era tax reductions and new spending programs. Some of these tax reductions had gone to the middle class and the poor, but the lion’s share – about 80% – had gone to the 2% of the country who report about 20% of the country’s income (I say “report” because it is a good guess that under-reporting and tax avoidance are very highly developed at this income level).

Other generous programs of the Bush era may have spread benefits more evenly, but it is impossible to tell. For example, the Bush Medical Modernization Act of 2002 gave elderly Americans a fairly generous prescription drug program – the first drug program. But much of the benefit of this program went to drug and insurance companies that were guaranteed a high profit margin for a larger market. The universal health legislation that Congress is likely to pass may eliminate some of this subsidy for insurance companies. Apart from this deficit-provoking feature of Medicare, the program as a whole was and remains fully funded by earmarked payroll and self-employment taxes.

Less conspicuous spending commitments of the last administration included military weapons development, privatized government operations, more generous tax benefits for real estate, heavy industry, and high income earners, but also an increased refundable income tax (the earned income tax credit) that has greatly expanded the country’s social safety net. Perhaps the greatest spending program of all was a budget *decrease* ... for tax auditing and collection. None of the spending was for infrastructure, either. The Obama administration has pushed for more tax audit and collection funding and for a broad plan of infrastructure improvements, the latter as part of the Obama stimulus package.

In response to the growing need for federal revenue, the Obama administration, as it took office, seemed likely to strive to eliminate loopholes. It is not surprising that during the long 2008 campaign, neither the future president nor any of his rivals sounded an alarm over the growth of the national debt. That would have been tantamount to threatening the public with an overall tax increase. Explicit increases in tax rates are very dangerous to the health of US politicians. George Bush Sr is thought to have been defeated in his second run for the presidency because he promised “no new taxes” but had to raise rates anyway. Since his loss in 1992, other US politicians have thought it wiser not to hint at adjusting tax burdens at all.

Even if President Obama, before or shortly after the election, had wished to raise taxes, the existence of a number of tax rate provisions that contain “sunset” provisions would have complicated his prospects for doing so. (If a legislative act provides for its own expiration on a certain future date, it is said to contain a “sunset” provision.) Unless Congress acts, in 2009 the top tax rate on dividends will increase from 15 percent to 35 percent. The principal capital gain rate will rise from 15 percent to 20 percent. And in 2010, the Bush tax cuts of 2003 – which reduced the tax rates applicable to taxable income by about 5% each from earlier rates (from 15%, 28%, 31%, 36%, and 39.5% to 10%, 25%, 28%, 33% and 35%), estate tax repeal, marriage penalty relief, and many other tax reductions of the Bush era will expire. Thus, if Obama and his party’s majority in Congress wanted to raise rates by allowing the Bush tax cuts to expire, they need not lift a finger, because this will happen without new legislation. But low and middle-income taxpayers will also face higher tax rates, if the Bush tax cuts are allowed to expire – not so appetizing for the new incumbents.

When the economic downturn is taken into account, the chances of passive across-the-board tax rate increases fall to zero, at least in the short term. So let’s assume that open rate increases for the mass of the public are out of the question. What else can happen?

Consider the “tax gap.” This often-mentioned “dark hole” is the difference between government estimates of the total amount of US income that is legally subject to the income tax and the amount – smaller by about one-fifth – that is actually reported. About \$290 billion in income is annually escaping US tax, by latest estimate, or roughly \$90 billion in income tax revenue.<sup>3</sup> Whose money is it? The Treasury Department

1 Martin A. Sullivan, a reporter for Tax Analysts, has recently blogged his horror at the Obama underestimation of future deficits. Martin A. Sullivan, *Goofy Responses to a Gloomy Budget*, May. 12, 2009, at [www.tax.com](http://www.tax.com). The tone of Sullivan’s blog comments was less restrained than that of his analyses of falling effective corporate tax rates worldwide. I rely below on his research. See note 5 *infra*.

2 See Joseph E. Stiglitz & Linda J. Bilmes, *The Three Trillion Dollar War: The True Cost of the Iraq Conflict* (2008).

3 “In 2005, the IRS estimated this gross tax gap to be approximately \$345 billion. After subtracting revenue obtained through enforcement actions and other late payments, the IRS estimated the net tax gap to be approximately \$290 billion. These estimates, which remain the most recent estimates available, were conducted using data collected in tax year 2001 and before.” U.S. Dept. of Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* (July 8, 2009), page 2. According to a Cato Institute Report, the US tax gap is actually small in comparison to

guesses that about half of this untaxed money is earned by small businesses that are simply committing fraud by not reporting it or by claiming undeserved deductions. The other half is individual and corporate income that is hidden illegitimately offshore. If all this income had been properly taxed, most of the deficits the government was running before 2008, apart from the Iraq War, would have disappeared. (They had in fact disappeared at the end of the Clinton administration, even *with* the tax gap.) No one really believes that *all* the fraud and noncompliance with tax laws could be eliminated, but perhaps a significant part, perhaps half, might be.<sup>4</sup>

Until recently, the extent to which US citizens were concealing their wealth and its income offshore was known neither to the public nor to most tax professionals in the US. The IRS certainly suspected that the amount was large, because it organized a special team of investigators to track down the money. After my talk to the DAJV in summer 2009, the story was released to the press generally that the US government had reached an agreement with the Swiss bank UBS, in accordance with which the bank would release information about 4,450 accounts belonging to US citizens, plead guilty to criminal wrongdoing under US laws, and pay an \$870 million fine. Along with the news, the government announced a limited amnesty program, inviting US citizens to disclose previously secret offshore accounts in exchange for limited tax and penalties. The response has been so overwhelming that the IRS has scarcely been able to deal with the rush of applicants.<sup>5</sup> Congress is now contemplating a new law that would give banks outside US jurisdiction certain advantages in exchange for entering into reporting agreements that would reveal certain information about US citizens' accounts in these banks.<sup>6</sup>

What about corporate wealth and income concealed offshore? The offshore corporate part of the tax gap is money sheltered illegally, not by taking advantage of the generous policy of deferral but by secretive strategies that are *not* among those contemplated by the legislature. The US has a funny rule concerning the income of controlled foreign corporations or CFCs, the more-than-80%-controlled foreign subsidiaries of US corporations. By long established common-law tradition, US tax law treats foreign subs as separate from their parents, so that their offshore income is not US income until it is "repatriated" or returned to the parent corporations by voluntary dividends or liquidation of these foreign subs. The resultant "deferral" of tax on income the US could, like many other countries, legally and providently tax, costs the US a lot in lost revenue. But that is not the money I am referring to as the offshore corporate part of the tax gap.

The US has over the last 20 years been slowly winning a war against these tax shelters. In fact, one of the only reasons the

budget deficits aren't so bad at the moment is that recent tax collections from the shutdown of bad shelters has been rolling in rather nicely. But the shelters are still big business, and again based on estimate from the government, it looks as if there is a lot more tax to be collected from this source.

Thus, fraud accounts for much of the tax gap. Some of that fraud is politically vulnerable – the offshore corporate part. One part used to be politically off limits – the onshore small business part. Things may have changed. The attitude of the US public at large has especially changed. In the last month of the presidential campaign, a plumber had an apparently spontaneous chat with Barack Obama after one of his public appearances. This man – afterwards known as Joe the Plumber – protested that Obama's plan to repeal the upper level of the Bush tax breaks would especially hurt *him*, and he claimed he was an ordinary and typical small businessman. This looked as if it might be very bad publicity for Obama, and McCain promptly invited Joe the Plumber to appear on the same platform with him in a number of places. But Joe the Plumber didn't attract much favorable attention. Already the public had begun to be skeptical, it seems, of the traditional view that we are all about to get rich quick. The recession was already beginning to be felt, and the financial crisis had definitely begun.

In May 2008 the three presidential candidates all proposed tax relief for the "middle class".<sup>7</sup> Clinton and Obama proposed no new business tax breaks, but Obama did promise that, at least for individual taxpayers with annual net taxable income of more than \$250,000, that is roughly the top 2% of US taxpayers.

It seemed a year ago that if Obama won, he could not easily deliver on this promise. It did not seem at all likely that the election would give the Democrats a strong enough majority to do this – assuming that the Democrats would back Obama's proposal. Now the majority is almost strong enough and it does seem possible that they will fulfill this campaign promise of the new president. But so much else has changed.

The US government, under calmer and more competent management, said nothing about tax law refurbishment until April 2009. Then it suddenly launched a campaign to change public opinion. On May 5, the New York Times carried a front-page story based on government releases in which the falling effective tax rate on overseas income of US corporations was dramatically illustrated by charts for specific corporate giants – GE, Pfizer, Exxon Mobil, Citigroup, Chevron and Merck.<sup>8</sup> Now the most striking aspect of this government announcement is the "spin" that blames the use of tax havens for the falling effective tax rate on US MNCs. Elsewhere in the government's announcement – and President Obama has used this factoid himself in several speeches – it is stated that US MNCs paid an effective rate of tax of only 2.3% on offshore

that of other advanced industrial countries. Daniel Mitchell, *The Tax Gap Mirage*, 44 *Cato Institute Tax & Budget Bulletin*, March 2007, page 1. International comparisons, however, are unreliable in some respects, because different countries maintain tax statistics. OECD efforts to compile comparative statistics are not yet fully developed. See *A Progress Report on the Jurisdictions Surveyed by The OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (September 9, 2009), at [http://www.oecd.org/document/21/0,3343,en\\_2649\\_33745\\_42344853\\_1\\_1\\_1\\_37427\\_0.html](http://www.oecd.org/document/21/0,3343,en_2649_33745_42344853_1_1_1_37427_0.html).

4 Joel S. Slemrod & Jon Bakija, *Taxing Ourselves* (2d ed. 2009).

5 Department of Justice, *News Release: Justice Department & IRS Announce Results of UBS Settlement & Unprecedented Response in Voluntary Tax Disclosure Program*, November 17, 2009; Lynnley Browning, *14,700 Disclosed Offshore Accounts*, *N.Y. Times*, November 17, 2009, p C1.

6 This legislative scheme would extend an existing administrative one that has similar features but requires less of foreign banks and puts less pressure on foreign banks to participate. *Rev. Proc. 2003-64, Appendix 3, I.R.B. 2003-32*.

7 McCain's also included a substantial additional tax break for business: he would have indefinitely extended the "expensing" (that is, immediate deduction instead of gradual write-off) of new purchases of tangible personal property (Mobilien) to be used in business operations. The estimated cost of this extension would have been about \$60 billion a year. He would also have reduced middle and upper-middle class income taxes by repealing the Alternative Minimum Tax (AMT), which is really a disguised reduction of the personal deductions available to these taxpayers. This would have cost an estimated \$60 billion a year as well. The total of his proposals would have increased the then anticipated annual budget deficit by about 1/3, although the stimulative effect of these proposals might have reduced the deficit. The net effect was impossible to predict, especially with the real estate bubble and rising fuel prices that were signs of economic instability ahead.

8 *Obama Asks Curb on Havens' Use to Limit Taxes*, *NY Times*, May 5, 2009, at page 1A, col. 6.

income for 2004, the most recent year for which data are available – that is, they paid about \$16 billion in US income taxes on offshore economic income estimated to be \$700 billion. As I explained in my talk here a year ago, effective tax rates on MNC income are falling everywhere in the world,<sup>9</sup> and the explanation is at least in part that much of the money is being earned by operations in low-tax countries – some developing countries, certainly, but also wealthy developing countries, and countries like Ireland that have deliberately low rates of taxation on inbound investment.

#### Corporate Tax Preferences and Projected Revenue Costs, FY2008-2017

Preference	Revenue Cost (\$ Billions)
Expensing and accelerated depreciation	410
Deduction for U.S. production activities	210
Exclusion of interest on state and local debt	135
Research and experimentation (R&E) credit	132
Deferral of income of controlled foreign corporations	120
Low income housing credit	55
Exclusion of interest on life insurance savings	30
Inventory property sales source rule	29
Deductibility of charitable contributions	28
Special Employee Stock Ownership Plan (ESOP) rules	23
Exemption of credit union income	19
New technology credit	8
Special Blue Cross/Blue Shield Deduction	8
Excess of percentage over cost depletion	7
Other corporate preferences	27

Source: Treasury Report, reprinted in CRS, Corporate Tax Reform: Issues for Congress, Oct. 31, 2007.

The Obama administration has now associated itself with taxing offshore corporate income, and the chair of the House Ways and Means Committee Charles Rangel is a strong advocate of broadening the corporate tax base. One of my predictions was that the government would try to tax this MNC income more heavily, probably by weakening the traditional US tax rule that treats a corporation's distinctness from another corporation as absolute, a rule that makes it possible for a single group of corporations to be taxed on only part of its worldwide income. The income of foreign subsidiaries of US parent corporations is not attributed to the parents, whether the foreign subsidiaries have permanent establishments abroad or not.<sup>10</sup>

Discussions of international tax design usually refer to several broad goals – capital import and export neutrality, national neutrality, and sometimes capital owner equity – and experts have already begun to debate how the US tax laws should be

modified to meet these goals better. Briefly, it can be argued plausibly that a change in the definition of corporate residence and perhaps the repeal of “deferral” altogether would improve the capital export neutrality of US tax law. But it would also modestly raise the effective rate of the corporate tax overall. The argument would of course be made that this is a terrible thing to do at any time, but especially so in a financial crisis. The effective rate might be kept the same or even lowered if corporate tax preferences – deductions, credits and sheer exemptions – were curtailed, and this would in theory make the corporate tax fairer without driving away investors.

This possible change in the residence rules for corporations is best understood in a broader context. Three goals of international tax policy are often singled out: *capital export neutrality* (tax-neutral treatment of invested capital of a country's own residents, no matter where it is invested), *capital import neutrality* (tax-neutral treatment of investment in the taxing country, no matter whether the investors are resident or non-resident), and *national neutrality* (equal return on investment, requiring foreign-source income to be taxed with a credit for foreign taxes paid). To achieve these goals, two broad types of taxing strategy that may be used, more or less faithfully in practice, are *residence-based* taxation (tax only your own residents without regard to where they earn their income) and *source-based* taxation (tax only the income arising within your borders, regardless of whether those whose income it is are resident or not).

Capital export neutrality requires a country to apply the same tax rate to firms' investments in or out of the country and would be a straightforward consequence of a residence-based tax system. Capital import neutrality requires that tax burdens on firms of different national residence that invest in the same country should be the same, and a territorial or source-based tax would straightforwardly accomplish neutrality in this respect. National neutrality requires that the nation's total return on investment, the sum of national tax revenue and domestic firms' profits, should be the same wherever it is earned, in the country or abroad. This form of neutrality is obtained by taxing foreign-source income and allowing a deduction for foreign taxes.<sup>11</sup>

In terms of these theoretical goals, it seems that changing the US residence rules may improve the capital export neutrality of the US tax system, by causing more investment abroad to face the same rate of tax investment at home faces. It should have no effect on capital import neutrality. And it may increase the national neutrality of the current system. So two out of three goals would be better served.

The US now uses a hybrid residence and source-based approach. It does not tax nonresident corporate income, even if the nonresident corporation is controlled by a US parent. This seems faithful to the goal of capital export neutrality. But it also credits foreign taxes paid, if foreign subsidiaries send their earnings back to their US parents. This seems to accord with national neutrality. And it taxes US-source income of nonresi-

9 Martin A. Sullivan, Reported Corporate Effective Tax Rates Down Since Late 1990s, Tax Notes, 118 Tax Notes 882 (Feb. 25, 2008); Why Reported Effective Corporate Tax Rates Are Falling, 118 Tax Notes 977 (Mar. 3, 2008).

10 German tax law, I believe, does not tax any income from a foreign Betriebsstätte. By contrast, a corporate group that has its central management in the US is treated as having a non-US parent, if the parent was not formed and is not now recognized under the law of the US or one of its member states. Corporate residence has always been analyzed in a purely formal way for US income tax purposes. Under German law, if Germany is the situs, in this sense, of a corporation or the place where its Geschäftsleitung is located, the corporation is liable for German income tax on its worldwide income, with a credit for taxes paid abroad, and with certain exceptions, such as that for income from permanent establishments abroad. Most countries approach the corporate income measurement in this or a similar way; the US is alone, as far as I can tell, in adherence to the formal understanding of corporate residence.

11 Other concerns may be peculiar to the economic predicament of advanced industrial nations. When capital is plentiful within a national economy, to discourage in-bound investment may promote national welfare, by encouraging the use of domestic labor instead of foreign capital (all this assumes that capital and labor are in relevant measure interchangeable within the economy as a whole). Fending off foreign capital, if this reasoning is sound, hurts foreign labor, by leaving more capital to be invested in the foreign country itself. A policy that serves to balance the use of capital and labor within a country, sometimes called national neutrality, is at odds with capital import neutrality. See David L. Brumbaugh, International Taxation and Competitiveness, Congressional Research Service Report, May 19, 2006, page 5.

dents in a selective way (selective because the US source rules could be very different than they are, especially, the portfolio interest exemption and the exemption of capital gains of non-residents), which partly accords with capital import neutrality. Actually, the US is extremely non-neutral vis-à-vis inbound passive investment.

When you look at it at this general level, relaxing the distinction between US parent corporations and their non-US subsidiaries – which is what the Obama administration may now want to do, and which is what I predicted any new president might have to do – might make the US less neutral on capital export. Capital export non-neutrality can lead to capital export retaliation. It would also, in the case of the US, lead to a very different treatment of developed and developing countries, because our treaties would still prevent the US from taking permanent establishments in treaty-partner countries. This would be a dangerous strategy at a time when the lists of developed and developing countries may be changing rapidly.

There are, however, other tax goals that are not particularly concerned with international tax neutrality. Taxing CFCs more heavily raises the effective rate of the corporate tax, if we regard all the relevant corporations as properly comparable to corporations that are exclusively active in the US. International corporate tax is after all a small part of the corporate tax as a whole, in terms of the amount of US foreign outbound investment as a share of overall corporate investment.<sup>12</sup> Critics of the corporate income tax have long argued that it burdens domestic investment, by lowering the effective rate of return on invested capital. Increasing the effective rate of tax on multinational corporations is, from that perspective, a bad thing, because it will increase the effective rate of tax on US corporations generally. Several economists have therefore argued that instead of increasing the tax at the corporate level, the tax system should be adjusted to tax distributions to shareholders more heavily. By increasing the rate of tax on dividends, the overall design might buy a lower rate of tax on corporate income as such.<sup>13</sup>

Economists' view that corporate tax must distort investment incentives is all about the return on investment in the corporate sector as a whole. Corporations in the US have conspicuously expressed almost no interest in efforts to eliminate the distortion resulting from the double corporate tax. Instead, they have been happy to "game the system" by striving for the competitive advantage of a lower rate of tax than the rate faced by rival US corporations. (In 1991, on leaving office, George Bush Sr. had his Treasury Department publish a report calling for elimination of the double corporate tax, and the National Association of Manufacturers, the biggest corporate trade association, openly said it had little interest in that goal.)

It therefore seems that the double corporate tax, beloved of corporations, is a doubly bad thing. Not only does it distort investment incentives for investors in the corporate sector as a whole, it also distorts business practices of US corporations, inspiring them to shape their business decisions to achieve tax advantages over their rivals.

If this is a correct diagnosis of the problem as a whole, the Obama administration should *both* eliminate tax deferral and broaden the corporate tax base. Unfortunately, the principal corporate tax preferences seem to be the very ones, apart from

the tax benefit of deferral, that are always boosted in an economic downturn: enhanced write-offs for depreciable property and R&D. Some of the others have been mentioned by Treasury Secretary Geithner as among the administration's tax reform measures: elimination of LIFO inventory accounting (an easy thing to do in deflationary times) and the exclusion of corporate owned life insurance (COLI) benefits.

The correspondence between the tax reform measures theorists have identified and those for which the Obama administration has released trial balloons is impressive. This suggests that the current government is at least looking for objectively reasonable reform strategies, not just serving as a mouthpiece for lobbyists. But is theory right?

Perhaps the most important proposal so far is the Obama administration's demand for better tax enforcement. This means requiring that a wider range of intermediaries disclose the income of US taxpayers and related information, as well as giving the IRS more money for enforcing the tax law. At present the percentage of US tax returns that are audited is less than 2%. It would be easy to audit more if intermediaries gave the IRS more information – computers could then match the disclosed information with tax returns, as they already do for most taxpayers who are employees.

Better tax enforcement is not a new theme for presidents, but it is possible that the less friendly attitude of the public towards financial institutions and big corporations may result in a major increase in tax revenue. Some types of enforcement do not require congressional approval. For example: In April 2009 the IRS offered "qualified intermediaries" – primarily foreign banks and other financial institutions – a choice of voluntarily disclosing more information or facing closer scrutiny from the IRS. This choice takes the form of "allowing" foreign institutions to apply for the benefits – less stringent reporting of their own proprietary information – in exchange for greater disclosure of their US clients' tax-sensitive information to the IRS.

Conspicuously absent from the White House Green Book on Revenue Raising Tax Proposals, May 11, 2009, is any hint at reducing corporate tax "expensing" or raising tax rates on individuals with taxable incomes of less than \$250,000. Both would be enormous revenue raisers, but both would be (or be perceived as) restraining rather than stimulating the economy.

What specific changes in the tax rules has the Obama administration proposed? The idea of taxing offshore corporate earnings has *not* yet been explained in detail. On the following list, some have been explained and others have not:

- (1) Limit the benefit of personal deductions for high-income taxpayers by limiting them to the 28% rate. A taxpayer in the 35% tax bracket can save \$35,000 by deducting mortgage interest of \$100,000, but under this proposal, he/she would save only \$28,000. The estimated 10-year tax revenue is \$267 billion.
- (2) Change the "check-the-box" rules for entity recognition as they apply to entities involved in cross-border transactions. Many tax shelters use the formal recognition for US tax purposes of entities specially formed to absorb income or generate losses for US corporate and sometimes individual taxpayers. The purpose would be to curtail this. Details are not known. Could require deep changes in the partnership tax rules.
- (3) Re-characterize "carried interest" income as ordinary income instead of capital gain -- \$24 billion. Just how this would work has not been explained, but we know

12 "Despite increasing globalization of the U.S. economy, foreign direct investment remains a small share of the U.S.-owned capital stock." David L. Brumbaugh & Jane Gravelle, Reform of International Taxation: Alternatives, Congressional Research Service Report, July 31, 2007, at page 21.

13 *Id.* at pages 21-23.

it would not be easy as a technical matter. Also change partnership tax rules.

- (4) Repeal the exclusion of employer-provided health insurance above a certain value -- \$120 billion (*1-year*).
- (5) Repeal the exclusion of life insurance benefits that flow to corporations (COLI benefits) -- \$12 billion (10-year).
- (6) Repeal LIFO accounting -- \$61 billion (10-year).
- (7) Keep the federal estate tax with a \$1.2 million estate exemption -- \$24.5 billion (10-year).
- (8) Reduce real estate tax preferences, including the exclusion for gain on principal residence and passive loss rule exemption for real estate developers.
- (9) Reduce oil and gas tax preferences -- \$31.5 billion (10-year).
- (10) Codify the "economic substance" doctrine, a standard for disallowing claimed tax advantages on the grounds that the underlying nature of the transactions involved does not qualify for those advantages -- \$4.7 billion (10-year).

The total is only about \$700 billion, or \$70 billion a year.

One further item, not covered in the Green Book: The Obama administration has of course also strongly advocated universal health coverage, with a permanent research and development expense deduction that will benefit big pharmaceutical companies, but the insurance companies have just as strenuously resisted the idea that government-sponsored insurance should

be offered to everyone.<sup>14</sup> White House and Congress are now considering taxing employer-provided health care benefits, to fund health care for all.<sup>15</sup> The amount of tax forgone is roughly \$130 billion for 2008, and will rise to about \$200 billion by 2014, if the current exclusion from employees' income continues.<sup>16</sup> Current proposals that form part of congressional bills for health care reform would tax only part of the value of employer-provided health insurance above certain dollar value thresholds.

Is the Obama administration only re-arranging the deck chairs on the Titanic? The revenue raised by these proposals isn't enough to deal with the long-term problem deficits caused by the current financial crisis and bailout efforts. A modest tax increase across the board might finance the debt service on the increased national debt, but increased debt may pose other problems.<sup>17</sup> The future could be more difficult to predict, but I think tax increases for the Middle Class are coming. Probably only after the economic downturn – if we can wait that long.

<sup>14</sup> Robert Pear, *Health Care Leaders Say Obama Overstated Their Promise to Control Costs*, N.Y. Times, May 14, 2009; Paul Krugman, *Blue Double Cross*, May 21, 2009.

<sup>15</sup> Janet Adamy, *New Taxes Loom to Fund Health Care*, W. St. J. 5/18/09 (discussing an interview with the Office of Management and Budget Director Peter Orszag).

<sup>16</sup> The Brookings Institution estimates, which are likely to be even-handed, are given at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=375> (Stand: ...).

<sup>17</sup> Paul Krugman, *State of Paralysis*, N.Y. Times, May 25, 2009.

Harry R. Dammer\*

## The Crime of Human Trafficking

This is a summary of the presentation given by Harry Dammer\* to the DAJV and graduate students at Bonn University on June 4<sup>th</sup>, 2009.

I am grateful for the invitation to speak to the DAJV and visit this prestigious University. And, special thanks to Prof. Bose and his staff for organizing my trip to Bonn. Today I speak to you about a crime problem that has been a major concern of law enforcement personal across the globe for the past decade or so...the problem of human trafficking (HT). More specifically, I will try to answer four questions about HT. The first is, what is HT or how is it defined in the international community? Second, what is the extent of the global problem of HT? Third, how does HT happen? Fourth and finally, what can we do about this serious crime problem?

### What is human trafficking?

Although there are different definitions of HT in different countries and within various international documents a good starting point for a formal definition of HT is as follows: Human trafficking is the recruitment, transportation, transfer, harboring or receipt of persons by use of force, threat, fraud,

or coercion for the purpose of exploitation (most often sexual exploitation or forced labor).

Before proceeding about the extent of the problem let us talk a little about why the HT is something that we should be concerned with at this point in history. Most obvious, HT is a transnational crime. Less obvious may be that HT problematic because it is a modern form of slavery-moving vulnerable populations (from poor areas) to serve the labor needs of others. And HT can also lead to other forms of social problems/crimes. Each of these are self explanatory so I will not linger on each but this gives someone who was previously unaware of the reach of HT some idea how extensive the problem can be.

- Illegal adoptions/sale of babies
- Child pornography
- Trading in body parts
- Murder of prostitutes
- Domestic abuse of mail order brides
- Street prostitution

### What is the extent of human trafficking in the world today?

It is difficult to measure the extent of this international crime scourge but some indicators are the following data. In 2006 the U.S. Government reported 800,000 were trafficked across borders with over 80% being females. Recent UN reports estimate that the problem to be far greater with reports of 12.3

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