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March 2007

**Cross-Border Arbitrage:
The Good, the Bad and the Ugly**

By H. David Rosenbloom

It certainly is tempting to think of international taxation as a closed system, in which cross-border income is invariably subject to tax in one country or another. The recognized bases for jurisdiction to impose tax on cross-border income, residence and source, are complements. The general expectation is that countries will invoke both of these jurisdictional grounds, that all income will be subject to taxation on one or the other or both grounds, and that the basic task of the international tax rules will be to provide relief for any double taxation that results. That is what the foreign tax credit system and the exemption system are all about. Less obviously, it is also what the source rules and rules of taxation of foreign persons are largely about, since they are normally drafted with an eye to the likely assertion of tax jurisdiction in other countries.

There is, in short, something deeply satisfying about the "single tax principle" identified by Professor Avi-Yonah: "[I]ncome from cross-border transactions should be subject to tax once (that is, neither more nor less than once)."[1] This is the way the world ought to work. If there is an "international tax regime," as Professor Avi-Yonah maintains there is, the single tax principle deserves to be its linchpin.

But is there really such a regime, and is there really a single tax principle? That is the—or, at least, a—core question. Professor Avi-Yonah finds that "a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based and customary)." The "norms" of that regime are, in his view, the single tax principle and "the benefits principle (*i.e.*, that active business income should be taxed primarily at source, and passive investment income primarily at residence)."

I do not dispute the proposition that something—call it an international tax regime if you will—of the kind described by Professor Avi-Yonah is real. Yes, there is a large network of tax treaties of generally similar nature and yes, there is a kinship in the domestic laws of many countries pertaining to international taxation and yes, a developing country (*viz.*, Brazil) adopting idiosyncratic principles of international taxation will pay a price with respect to its trading partners and its taxpayers for its disinclination to adopt widely accepted norms.

At the level of specific rules, however, there is no mechanism for enforcing, or even attempting to enforce, either the benefits principle or the single tax principle, the two "definable principles" that Professor Avi-Yonah sees as embodying the international tax regime. At the level of individual transactions, in fact, it is hard to discern the existence of any international tax regime at all.

Let us focus on the single tax principle because it is that principle, more than the benefits principle, that pertains directly to the subject of cross-border tax arbitrage. The treaties do not seem to be good candidates for establishing a single tax principle. They are largely aimed at supplementing domestic laws in the task of eliminating, or at least mitigating, double taxation. When it comes to ensuring that cross-border income is taxed at least once, the treaties have little to say.

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