NEITHER RULES NOR STANDARDS

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Specifying the content of a requirement or a prohibition up front—e.g. replacing a "reasonable speed" requirement with a fifty-five miles per hour speed limit—can make life easier for enforcers and citizens alike. Recent efforts to substitute international tax rules for decades-old standards may do just the opposite, jeopardizing the "miracle" that is today's international tax regime. Enhanced information exchange and formulary apportionment will undermine the legitimacy that is essential to the success of any international legal regime. A better solution would overhaul the century-old benefits principle to weave enforcement deep into the fabric of the international tax regime. Only then will it meet today's tests as successfully as it once rose to the challenge of double taxation.

INTRODUCTION

H.L.A. Hart observed that the laws that govern our behavior draw strength from principles that operate unseen in the background. As he put it, the spark of "rules of recognition" can transform a lifeless "regime of primary rules" into a dynamic "legal system."[1] Without more than a mere collection of rules to guide them, he concluded that a community would stagnate, unable to shed outdated requirements or to embrace new constraints when needed.[2]

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1 H.L.A. HART, THE CONCEPT OF LAW 94 (2d ed. 1994).

2 For example, a town might agree on the need to impose speed limits, but not on the underlying rationale for them. Some might support the limits for environmental reasons while others do so out of safety concerns. Without a consensus principle, a subsequent call for carpooling would face an uncertain fate. The carpooling initiative might languish because of the lack of a shared principle to buoy it (if many in the town were environmental skeptics). Its momentum may be slowed still further

For international law, Hart concluded that his insight offered grounds for both optimism and pessimism. On the one hand, "the absence of an international legislature, courts with compulsory jurisdiction, and centrally organized sanctions" does not necessarily mean that international law cannot exist.[3] On the other, he suggests that crafting a principle—"a basic rule of recognition"—sufficient to assuage "doubts about the legal 'quality' of international law" would be tantamount to catching lightning in a bottle.[4]

International taxation demonstrates the truth of both perspectives. No World Tax Organization exists,[5] yet a skein of treaties and laws lays claim to the title of "international tax regime" and forms a bulwark against double taxation.[6] As a result, what should be an intractable problem—allocating global tax revenues among sovereign states—has been anything but.[7] The benefits principle[8] may not be the catalyst Hart believed capable of transforming an assemblage of international tax rules into a vital system of laws, but the success and stability of the international tax regime over nearly a century suggests that it comes close.[9]

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by the absence of the validation that accompanies widespread observance (if the requirement met with significant resistance). Put differently, the attitudes and behaviors of the townsfolk might render a carpooling requirement illegitimate. Conversely, if the town shared a commitment to environmental preservation, a law compelling carpooling might be superfluous.

3 HART, *supra* note 1, at 214.

4 *Id.* at 237.

5 *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1631 (2000) ("[I]t is not an authoritative 'world tax organization' that designs international tax rules, but each country acting separately with its own interests in mind.").

6 *See* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996) (arguing that a network of harmonized bilateral treaties forms a "coherent international tax regime . . . that enjoys nearly universal support").

7 *See id.* at 1305–08 (explaining allocation process that avoids double taxation of cross-border income).

8 *See* Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 509 (1997) ("The Benefits Principle assigns the right to tax active (business) income primarily to the source jurisdiction, while the right to tax passive (investment) income is assigned primarily to the residence jurisdiction."); Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 183–88 (1998) (exploring the relationship between benefit theory and international tax rules such as the source rules).

9 Avi-Yonah describes the international tax regime as a "flawed miracle." *See* Avi-Yonah, *supra* note 6, at 1303. David Rosenbloom takes a much dimmer view of the international tax regime. H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System"*, 53 TAX L. REV. 137, 166 (2000) (concluding that no such

Unfortunately, unlike a true basic rule of recognition, the benefits principle has not helped the international tax regime evolve over time.[10] The resulting mismatch between the demands made of the international tax regime and its capacity has rendered it impotent in the face of today's challenges.[11] The ongoing struggle to replace the international tax regime's standards with rules will only accelerate that failure.[12]

The international tax regime has no shortage of problems or proposed remedies.[13] Today, the solutions tend to bet on the precision of rules. Transnational enterprises remain square pegs to the round holes presented by national corporate taxes.[14] Formulary apportionment—the chief rival of the more established arm's length method of

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system exists). Rosenbloom reaches that conclusion in part because he sees no principle capable of filling that role. *See id.* at 137 ("The existence of overarching principles of international taxation into which U.S. law somehow fits, with which the U.S. Senate might be called upon to 'agree,' qualifies as news.").

10 *See* HART, *supra* note 1, at 91–99 (describing the three functions of a rule of recognition as making it possible to identify laws, adjudicating disputes, and facilitating changes in those laws over time).

11 *See infra* note 130 and accompanying text.

12 The rules versus standards debate has a long history and an impressive pedigree. *See* Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 71–76 (1983); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992); Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 959 (1995).

13 Michael Graetz has, for example, lamented that the international tax regime relies on outdated principles and inadequate concepts. *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1362 (2001). Diane Ring and Mitchell Kane describe the perils of international tax arbitrage. *See* Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 90–95 (2004); Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79. 79 (2002). It is also well recognized that traditional instruments of international tax policy do a poor job of advancing relations between rich and poor states. *See, e.g.*, Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639, 712 (2005) (examining implications of absence of treaties with African states). Scholars also offer advice to policymakers on a broad range of topics. *See, e.g.*, Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1582 (2009) (addressing implications of tax treaties on global labor mobility); Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555, 575–76 (2007) (offering a proposal to capitalize on international tax arbitrage to enhance international vertical equity).

14 *See* Elizabeth Chorvat, *Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory*, 54 ALA. L. REV. 1251, 1252 (2003) ("Perhaps the greatest problem facing the international tax system is the taxation of transfer pricing within related groups of corporations. By guaranteeing that the allocation of profits among

allocating corporate profits among jurisdictions—promises the clarity and ease of administration transfer pricing has long denied taxpayers and tax administrators.[15] Seeking to dispel the threat posed by tax havens, enhanced information exchange offers tax administrators hope that they may soon receive the same predictable diet of insight regarding the behavior of taxpayers from abroad that they obtain domestically.[16]

Although not characterized in such terms, both reforms seek to replace a standard (the arm's length method and treaty-based information exchange) with a rule (formulary apportionment and enhanced information exchange).[17] In theory, trading standards for rules has much to recommend it.[18] The classic illustration[19] of the ex ante clarity that rules offer is the contrast between a fifty-five miles per

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related parties reflects the economic reality . . . tax havens, tax competition, and corporate expatriations, would be greatly reduced or eliminated entirely.").

15 *See* Reuven S. Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, HAMILTON PROJECT, June 2007, at 14–16, *available at* http://www.brookings.edu/topics/taxes.aspx.

16 *See* ORG. FOR ECON. CO-OPERATION & DEV. (OECD), Promoting Transparency and Exchange of Information for Tax Purposes ¶ 4 (2010), *available at* http://www.oecd.org/dataoecd/26/28/44431965.pdf ("In 2009, more progress toward full effective exchange of information has been made than in the past decade.").

17 International tax scholars currently distinguish between features of the international tax regime as either "hard" law or "soft" law. *See, e.g.*, Allison Christians, *Networks, Norms, and National Tax Policy*, 9 WASH. U. GLOBAL STUD. L. REV. 1, 34 (2010) ("While scholars and policy-makers debate the relative merits of soft and hard coordinative methods, practitioners and administrators must navigate the uncertainties on a daily basis."); Diane Ring, *Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World*, 33 FORDHAM INT'L L.J. 649, 652 (2010) ("Thus, despite the formal, hard law power of the state over international tax policy, international organizations influence the actual design of international tax policy and tax rules in a variety of ways, up to and including the creation or exercise of 'soft law' power.").

18 *See* Sunstein, *supra* note 12, at 972. Sunstein enumerates the virtues of rules, identifying, among others, their "simplifying effects," *id.*, and their capacity to replace "ambiguous and conflicting guidelines" so that "government officials [and] affected citizens may reliably know their obligations in advance." *Id.* at 976. By specifying outcomes in advance in relatively straightforward terms, both information exchange agreements and formulary apportionment offer the appeal of greater simplicity and clarity and the promise of reduced enforcement costs. *See* Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 498 (2009) ("The U.S. [transfer pricing] system is also notoriously complex; observers are nearly unanimous in lamenting the heavy compliance burdens and the impracticality of coherent enforcement.").

19 *See* Kaplow, *supra* note 12, at 560. The quantitative limit leaves far less room for ambiguity and disputes than the standard.

hour speed limit and a standard that imposes a requirement of "reasonable and prudent" driving speeds.[20]

In the current international tax context, it is easy to conclude that both taxpayers and tax authorities would find a shift towards rules appealing.[21] Nevertheless, the pivotal role legitimacy plays in eliciting compliance from sovereign states makes such a transition treacherous. Apparent advantages could prove disastrous if the very clarity for which rules are prized exacts a high price in legitimacy.[22]

The allure of rules may merely draw states into legitimacy traps, sapping strength from—rather than lending strength to—the mechanisms that constitute the international tax regime.[23] For example, enhanced information exchange catalogues the information that states should be—but are not—providing to one another, casting a harsh light on the limits of states' commitment to international tax cooperation.[24] Memorializing largely aspirational information exchange requirements in a detailed legal document simultaneously reveals the potential of the international tax regime and exposes its shortcomings. Revealing precisely how far the regime's mechanisms fall from the ideal may do more to discourage states' compliance than improved clarity ever could to promote it.[25] As this Article shows, such legitimacy traps represent a grave threat to the continued vitality of the international tax regime.

The Article begins by describing the headwinds faced by tax authorities in enforcing the corporate and individual income taxes. Part I considers the impact of corporate income shifting and individual tax evasion and the trend towards addressing each with rules rather than standards. Part II shows why efforts to replace standards with rules are misguided. Both offer advantages, but neither rules nor standards can thrive without legitimacy.

Part III considers the importance of legitimacy—and its decline—for the international tax regime and describes the dynamic that produces legitimacy traps. Part IV proposes resolving those legiti-

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20 *See* Robert E. King & Cass R. Sunstein, *Doing Without Speed Limits*, 79 B.U. L. Rev. 155, 155–56 (1999).

21 The arm's length standard illustrates the problem quite clearly. *See* Avi-Yonah et al., *supra* note 18, at 506 (noting that since "neither taxpayers nor enforcement authorities typically have clear standards for judging compliance" with the arm's length standard, "issues involving very large amounts—billions of dollars—of federal revenue are resolved" through a variety of relatively informal administrative procedures).

22 *See infra* Part III.B–C.

23 *See infra* Part III.B.

24 *See infra* Part III.C.2.

25 *See infra* Part III.C.2.

macy traps by replacing the benefits principle with the benefits and burdens principle. As its name suggests, the benefits and burdens principle enriches the standard account of what entitles a state to a share of the global tax base.[26] The Article concludes by describing the transactional and aggregate methods of implementing the benefits and burdens principle.

I. Dominant Standards, Ascendant Rules

The international tax regime—if one exists at all—consists of a host of disparate elements.[27] Thousands of bilateral double tax treaties and countless provisions of national law that govern the treatment of international transactions can hardly form a seamless whole.[28] Nevertheless, important patterns emerge even in the midst of that diversity.

This Part highlights one trend notable for its familiarity to legal scholars of every stripe. Recent efforts to replace long-dominant standards with rules evoke a venerable scholarly debate.[29] Unfortunately, recognizing that proposals advancing formulary apportionment and enhanced information exchange tread this well-worn path suggests that they are less fruitful than they appear.[30] Indeed, if the primary

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26 In addition to allocating global tax revenues as a reward for doing what any good government does as a matter of course, the benefits and burdens principle would link each state's share to its efforts to address the rising threat of double nontaxation. Such an arrangement would be consistent with a normative conclusion that tax evasion and tax avoidance, referred to collectively as double nontaxation, is undesirable. Some might see such a conclusion as implicit in the benefits principle itself, so that a state's claim does not survive if it is not exercised. Making the benefits principle conditional in that way could moderate its tendency to produce double nontaxation. Unfortunately, it would not provide an affirmative incentive to provide enforcement assistance to other states.

27 Even the existence of an international tax system can be contentious. *See* Rosenbloom, *supra* note 9, at 166.

28 The OECD recently estimated the number of bilateral tax treaties in existence at 3,600. *See* OECD, *supra* note 16, ¶ 13. The U.S. statutory provisions that govern cross border transactions are numerous and varied. They govern everything from the treatment of U.S. investors in foreign investment funds to the treatment of cross-border social security payments. *See* I.R.C. §§ 1291–1297 (2006) (describing treatment of investments in Passive Foreign Investment Companies); I.R.C. § 871(a)(3) (2006) (specifying the treatment of U.S. social security benefits received by a nonresident alien).

29 *See supra* note 12.

30 The trend is sometimes framed as an evolution from "soft" to "hard" law. *See* Reuven S. Avi-Yonah, *International Tax as International Law*, 57 Tax L. Rev. 483, 496–97 (2004) (observing that features of the international tax regime are so widely observed that they may have evolved into customary international—or hard—law);

distinction between a rule and a standard is whether it "is given content ex ante or ex post," the shift towards rules in international taxation may be beside the point, or worse.[31]

A. *Income Taxes in a Global Economy*

Tax authorities must feel a bit like sea captains trying to navigate a round earth with only flat-earth maps to guide them. In both the corporate and individual context, the environment in which they operate bears little resemblance to the one in which the provisions they enforce took shape.[32] Even a conservative estimate might date the key features of the laws and treaties considered below as a half-century old.[33] The following discussion offers a brief overview of the challenges tax authorities face while administering that aging international tax regime.

1. Corporate Taxation

Today's transnational businesses scarcely resemble their predecessors of thirty years ago, let alone what passed for a multinational enterprise in the 1960s.[34] Spanning the globe, they defy the notion

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Allison Christians, *Hard Law, Soft Law, and International Taxation*, 25 Wis. Int'l L.J. 325, 332 (2007) (examining the use of the concepts of hard and soft law in international taxation and questioning whether hard law should be viewed as superior to soft law).

31 Kaplow, *supra* note 12, at 559.

32 *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021, 1041 (1997) (describing evolution of the international tax regime in the early twentieth century).

33 Transfer pricing rules, for example, were first introduced in 1917. *See* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation* 4 (Univ. of Mich. Pub. Law & Legal Theory Working Paper Series, Working Paper No. 92; John M. Olin Ctr. for Law & Econ., Working Paper No. 07-017, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017524. The arm's length standard arrived with regulations introduced in 1935. *See id.* The modern transfer pricing regime took shape in the 1960s. *See* James P. Fuller, *Section 482 Revisited*, 31 Tax L. Rev. 475, 476 (1976) (describing circumstances that led to the promulgation of the "far reaching" 1968 regulations, stating that "[t]he most significant period in section 482's history started during 1961 when the Treasury Department urged congress to make numerous changes affecting U.S. taxpayers with foreign affiliates").

34 *See* Mihir A. Desai & Dhammika Dharmapala, An Alternative Transfer Pricing Norm 6 (June 2011) (unpublished manuscript), *available at* http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/Dharmapala%20final.pdf ("The last thirty years have witnessed a transformation in the scope of multinational firm activity.").

that they belong to any particular jurisdiction in a meaningful way.[35] With fundamentally rootless intellectual property making up an increasing proportion of their value, associating their profit with a specific location becomes more difficult.[36]

It is in that context that tax authorities attempt to regulate the process known as transfer pricing.[37] Transfer pricing involves the allocation of taxable profits among the many jurisdictions in which transnational businesses create, manufacture, and sell.[38] Although the context makes it seem exotic, transfer pricing is no different than a small business owner putting her son on the payroll to take advantage of his lower marginal tax rates.[39]

The term transfer pricing derives from the process that related entities undertake when they set a price on goods or services that they transfer to one another.[40] For example, take a business that makes and sells contact lenses. If it manufactures and sells all of its products in the same jurisdiction, there will be no international transfer pricing problem. However, if it manufactures the lenses in Ireland and sells them in the United States, tax authorities are left with the puzzle of determining how much of the profit on each lens is U.S. profit and how much is Irish profit.[41]

Transnational businesses have developed many techniques for maneuvering profit into jurisdictions with relatively low tax rates. A business might take the dramatic step of moving all of its sales, its entire staff and all of its productive assets from a jurisdiction with a fifty percent tax rate to one with a ten percent rate. Doing so would

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35 *See* Avi-Yonah, *supra* note 5, at 1589–90 (using Intel and General Motors as examples of how transnational enterprises are distributed across the globe, partly in response to taxation).

36 *See id.* at 1590 (suggesting that the increasing importance of intellectual property will make it easier for transnational enterprises to shift their operations to reduce global tax burdens).

37 *See id.* at 1591 (describing transfer pricing).

38 *See* Avi-Yonah, *supra* note 33, at 2.

39 Such intra-familial income-shifting strategies were once so popular that Congress requires the unearned income of minor children to be taxed at the (higher) marginal tax rate the child's parents would have paid if they had received the unearned income. *See* I.R.C. § 1(g) (2006).

40 *See* Avi-Yonah, *supra* note 33, at 2 (offering the example of a related manufacturer and reseller of computers).

41 They cannot rely on market forces to provide an allocation since the buyer and seller are related. *See* Avi-Yonah, *supra* note 33, at 2 ("[T]he affiliated parties do not care what the transfer price is, since it merely re-allocates profits within the affiliated group.").

allow its future profits to be taxed in the low-rate jurisdiction.[42] The objective of transfer pricing planning is to achieve the tax results such a relocation would produce without the necessity of relocating.

A perfect example of a successful transfer pricing strategy involves Bausch & Lomb's contact lens manufacturing business.[43] Bausch & Lomb, a U.S. corporation, established an Irish subsidiary and in 1981 granted that subsidiary a license to manufacture the lenses in exchange for a modest royalty.[44] Bausch & Lomb then purchased the majority of the lenses produced by its Irish subsidiary.[45]

The result of that series of transactions was that much of the profit produced by Bausch & Lomb's industry-leading technology remained in Ireland. Faced with a challenge by U.S. tax authorities, Bausch & Lomb prevailed by demonstrating that the price charged by its Irish affiliate was comparable to prices charged by other producers.[46] Bausch & Lomb's victory—shifting income from a high-tax to a low-tax jurisdiction merely by transferring intangible assets to a related party—reveals the depth of the challenge national tax authorities face in today's global, technology-driven economy.[47]

2. Taxation of Individuals

For national tax authorities, the threat posed by individuals is not that they will report a disproportionate amount of their income in a low-tax jurisdiction, but that they will not report their income any-

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42 If the high-rate jurisdiction were the United States, the asset transfer itself might be subject to tax toll charge of sorts on its exit. *See* I.R.C. § 367 (2006) (imposing tax on certain "outbound" corporate reorganizations). Of course, even if such a transaction made sense from a tax perspective, business exigencies might interfere.

43 *See* Bausch & Lomb Inc. v. Comm'r, 933 F.2d 1084 (2d Cir. 1991).

44 *See id.* at 1087.

45 *See id.*

46 *See id.* at 1090–91. The Tax Court did, however, increase the royalty rate paid by the Irish subsidiary to Bausch & Lomb. *See id.* at 1092.

47 The nature of the problem could also be presented differently, so that the struggles of the arm's length method of transfer pricing flow primarily from theoretical deficiencies rather than practical challenges. *See* Desai & Dharmapala, *supra* note 34 (manuscript at 12) ("[T]he premise of ALP—that unrelated party transactions serve as reasonable comparisons for intrafirm transactions—is inconsistent with the modern theory of multinational firms."). Ultimately, the practical and theoretical limitations reinforce one another. The increased importance of intellectual property produces greater cross-border integration, exacerbating the administrative challenges presented by the arm's length method. *See id.* at 11–12 ("In those areas of business in which these ownership advantages are important (such as those in which intangible assets are crucial), cross-border transactions will come to be dominated by MNCs, with no arm's-length transactions between unrelated parties that can serve as a standard of comparison.").

where.[48] By routing their investments through a tax haven jurisdiction, it can be remarkably easy for individuals to neutralize the structural safeguards that have been so successful in encouraging tax compliance domestically.[49]

When, for example, an individual considers whether to pay tax on interest income she receives from a bank, she is far more likely to do so if she can be certain that the bank has already alerted authorities to its existence.[50] Such third-party reporting is routine within the United States.[51] When a transaction crosses one or more borders, the situation is quite different.

Even transactions involving only developed countries with cooperative tax authorities can quickly become anonymous. Assume a French bank reports an interest payment paid to a U.S. resident to French tax authorities who in turn notify U.S. authorities. Unless that information is accompanied by a U.S. social security number, it cannot automatically be linked to a particular taxpayer.[52] Such information may be useful in the course of an active investigation of a taxpayer, but given the rarity with which taxpayers are audited, our hypothetical taxpayer might well decide not to report the French interest on her U.S. tax return.[53]

When an investment travels through a jurisdiction in which the tax authority is uncooperative, ill-equipped, or both, the odds of detection fall further.[54] The potential for evasion in these circum-

48 "[M]uch of the income from overseas portfolio investments escapes income taxation by either source or residence countries." Avi-Yonah, *supra* note 5, at 1584 (attributing that compliance failure to the lack of information reporting and withholding in the cross-border context).

49 *See* Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 677 (2006) ("The use of structure to encourage tax compliance has been an unqualified success.").

50 *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 697–700 (2007) (exploring the importance of third-party information reporting and withholding for domestic tax compliance).

51 *See* Cheng, *supra* note 49, at 675–76.

52 *See* Avi-Yonah, *supra* note 5, at 1584 (lamenting absence of "uniform, worldwide system of tax identification numbers").

53 Domestic cash-based businesses and others not subject to information reporting or withholding often make the same calculation, contributing to disproportionately low rates of compliance among those taxpayers. *See* Lederman, *supra* note 50, at 698 (explaining that compliance rates fall nearly in half when neither information reporting nor withholding apply).

54 *See* Avi-Yonah, *supra* note 5, at 1584 (describing the impact of a Mexican taxpayer investing through the Cayman islands in a U.S. bank).

stances can be significant.[55] Anecdotal evidence supports the conclusion that U.S. taxpayers exploit such flaws in the structural enforcement network. One Cayman bank that came under investigation by the Justice Department turned out to primarily house U.S. investments by U.S. investors.[56] The bank served only as a means of encrypting individuals' financial information. Decrypting that information requires far more than a typical taxpayer audit.[57]

B. *Rules and Standards*

The primary tools tax authorities use to combat abusive transfer pricing and international tax evasion have not changed much over the past fifty years. Transfer pricing continues to rely on the arm's length method to allocate profit among jurisdictions.[58] Likewise, the bulk of the taxpayer information that is exchanged between national tax authorities changes hands pursuant to the information exchange articles of double tax treaties, just as it has since the World War II era.[59]

1. The Dominance of Standards

The arm's length method of transfer pricing does not specify a precise technique transnational businesses must use to associate its profit with individual jurisdictions. Rather than providing a uniform quantitative formula for all businesses (the equivalent of a numerical

55 Staff of S. Permanent Subcomm. on Investigations, S. Comm. on Homeland Sec. & Governmental Affairs, 109th Cong., U.S. Tax Haven Abuses 1 (Comm. Print 2006), *available at* http://hsgac.senate.gov/public/_files/TAXHAVENABUSES REPORT107.pdf (estimating U.S. revenue losses attributable to tax havens at between forty and seventy billion per year).

56 Joseph Guttentag & Reuven S. Avi-Yonah, *Closing the International Tax Gap*, *in* Bridging the Tax Gap 100 (Max B. Sawicky ed., 2005).

57 One means governments have increasingly come to use is purchasing data stolen from banks located in tax havens. *See* Matthew Saltmarsh, *Imminent End of Secrecy to Shake Up Swiss Banking*, N.Y. Times, May 14, 2010, at B7 (describing the sale of such stolen tax information as "something of a cottage industry").

58 Avi-Yonah describes the significant, but incremental changes Congress and the Treasury have made to the arm's length standard over the past four decades. *See* Avi-Yonah, *supra* note 33, at 18–25. He views the changes as an implicit rejection of "the traditional and narrow ALS for the vast majority of [transfer pricing] cases." *Id.* at 18. Nevertheless, the arm's length standard, as reinterpreted by Congress and the Treasury, remains intact.

59 An information exchange article was first included in the U.S.-Sweden treaty in 1939 and has remained the predominant means of extraterritorial tax information acquisition. *See* Steven A. Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. Rev. 605, 644–49 (2008).

speed limit) the arm's length method provides a flexible standard.[60] Employing the international tax version of a "reasonable speeds" standard, it simply calls for integrated elements of a single enterprise to behave as though they were unrelated.[61] In other words, it mandates that transactions between commonly controlled entities be conducted as though they were occurring at arm's length between independent parties.[62]

This approach leaves businesses with a great deal of responsibility—and authority—to determine what represents an arm's length price.[63] While their discretion is cabined by the statutory and regulatory framework tax authorities employ to gauge taxpayer compliance, the use of a standard inevitably means that much of its content is only specified when it is applied to a particular set of circumstances.[64] For example, U.S. regulations specify an array of methods taxpayers may use to demonstrate the compatibility of their transfer pricing methods with the arm's length standard and encourage taxpayers to choose the "best" method.[65] Businesses can even use a method other than one

60 Formulary apportionment sits at the opposite end of the spectrum, with a one-size-fits-all rule for all transnational businesses. *See* Avi-Yonah & Clausing, *supra* note 15, at 2 (describing application of formulary apportionment).

61 The premise of the arm's length method has become increasingly problematic as firms become increasingly global and integrated. *See* Desai & Dharmapala, *supra* note 34, at 11 ("The ALP envisages a world in which both related and unrelated parties engage in economically similar transactions across national borders. However, the modern theory of the multinational enterprise suggests that the *raison d'etre* of these firms is that ownership confers various advantages in terms of productivity and the avoidance of opportunistic behavior.").

62 The arm's length standard contemplates a wide range of approaches in setting transfer prices. *See* Avi-Yonah, *supra* note 33, at 4 ("'[A]rm's length' refers to methods of determining transfer prices by using comparables . . . . [but] can also be used to refer to any method of determining transfer prices that reaches results (i.e., a profit allocation) that are the same as those that would have been reached between unrelated parties.").

63 The regulations specify a range of methods to be used in different circumstances. *See* Treas. Reg. § 1.482-3(a) (2011).

64 In other words, the content is specified on an ex post basis when a particular allocation method is chosen. *See supra* note 31 and accompanying text.

65 *See* Robert G. Clark, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures From Multinational Cacophony*, 42 AM. U. L. REV. 1155, 1191–92 (1993) ("[T]he IRS acknowledged that problems exist with imposing a rigid hierarchy for applying valuation methods and therefore promulgated the 'best method rule.'").

the regulations describe if they can demonstrate that it is superior to the enumerated methods.[66]

Cross-border tax information exchange takes place pursuant to a different type of standard. Like arm's length, it provides only a broad sketch of the obligations it imposes.[67] For example, the U.S. model double tax treaty provides that the "Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes."[68] What that means in any particular circumstance is left to the judgment of the tax authorities that are tasked with the responsibility of providing and procuring that information.

At one extreme, the tax authorities charged with implementing that standard might negotiate for the right to receive comprehensive, automatic flows of information. In theory, that information could play the same structural enforcement role as the information tax authorities receive from private parties pursuant to domestic laws.[69] More likely, the ad hoc flows of information contemplated by the prevailing standard merely facilitate investigations into the affairs of particular taxpayers.

The U.S. stance on cross-border information exchange underscores its shortcomings as a structural enforcement mechanism. The official U.S. interpretation of its own model information exchange language specifies that it does not even permit tax authorities to request information on par with that it receives routinely from domestic sources.[70] While that would be easy to dismiss as an historical legacy of a disregard for extraterritorial tax information, today's

66 *See* Treas. Reg. § 1.482-3(e) (2011) ("Methods not specified in paragraphs (a)(1), (2), (3), (4), and (5) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length.")

67 In this case, the obligations fall on tax authorities themselves. This is different than the process by which a tax authority receives information domestically. Domestic information reporting typically involves reporting by private entities. There are, however, some circumstances in which federal authorities report information to states and local governments and vice versa. *See, e.g.*, I.R.S., Rev. Proc. 2010-26, 2010-30 I.R.B. 10 (describing the Combined Federal/State Filing Program).

68 U.S. Treasury Dep't, United States Model Income Tax Convention of November 15, 2006, at art. 26(1) (2006).

69 *See supra* notes 49–50 and accompanying text.

70 *See* U.S. Treasury Dep't, United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, at 86 (2006) ("[T]he language 'may be' would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.").

dominant information exchange mechanism also falls far short of the earliest information exchange provisions.[71] More than seventy years ago, the United States and Sweden obligated themselves to make annual, exhaustive exchanges of extraterritorial tax information to facilitate enforcement.[72]

2. The Rise of Rules

While standards continue to play a central role in the international tax regime, rules have gained a new prominence in recent years. The two most visible initiatives of the past decade to modernize the tools available to tax authorities have aimed to replace standards with rules.[73] Formulary apportionment offers an alternative to the arm's length method that provides the ex ante content the prevailing standard does not.[74] Likewise, the effort to create a more effective instrument for promoting cross-border information exchange has emphasized the up-front specification of the rights and obligations of national tax authorities.[75]

Formulary apportionment accomplishes the same allocative task as the arm's length method.[76] Unlike arm's length, it does so by identifying a set of readily observable criteria correlated with each jurisdiction's share of global economic activity.[77] Once the metric is selected,

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71 *See* Dean, *supra* note 59, at 647–48. Early information exchange provisions called for automatic exchanges of information that today's information exchange provisions would not permit even upon request. *See id.* at 648.

72 Convention Respecting Double Taxation, U.S.-Swed., Mar. 23, 1939, 54 Stat. 1759.

73 *See* Avi-Yonah & Clausing, *supra* note 15, at 2 (proposing the substitution of formulary apportionment for the present arm's length based regime); ORG. FOR ECON. CO-OPERATION & DEV. (OECD), HARMFUL TAX COMPETITION 46–47 (1998) (launching the anti-tax haven effort that culminated in a wave of information exchange agreements).

74 *See* Avi-Yonah et al., *supra* note 18, at 500 ("[T]here is universal agreement that [the arm's length] standard leaves substantial room for uncertainty as to the 'correct' transfer pricing . . . .").

75 *See generally* Org. for Econ. Co-operation & Dev. (OECD), Agreement on Exchange of Information on Tax Matters (2002), *available at* http://www.oecd.org/dataoecd/15/43/2082215.pdf (providing considerably more specificity than prevailing double tax treaty information exchange provisions).

76 Avi-Yonah concludes the two approaches appear quite different but "despite the common practice of contrasting the ALS and the formulary methods of dealing with the transfer pricing problem, they are actually not dichotomous." *See* Avi-Yonah, *supra* note 33, at 3.

77 *See* Avi-Yonah et al., *supra* note 18, at 508 (under formulary apportionment "net income is apportioned among taxing jurisdictions based on a formula that takes into account various factors").

allocating the tax base becomes mechanical.[78] Unlike the arm's length standard, it does not require transnational enterprises and tax authorities to determine how to employ it in any particular case.[79]

The significance of formulary apportionment's pragmatic approach to the problem can be best appreciated by making an analogy to a more familiar regime. An income tax dispenses with the pretense that it can measure a taxpayer's "ability to pay" by focusing instead on the amount of "income" earned in a given year.[80] In much the same way, formulary apportionment dispenses with the preliminary step of constructing a hypothetical world in which each business exists only within a single jurisdiction in order to then allocate profit according to the benefits principle.[81] It chooses a measure of a global firm's presence in a given jurisdiction to serve as a proxy for the benefits that jurisdiction provides to that firm.[82] Accepting sales, for exam-

78 *See* Avi-Yonah & Clausing, *supra* note 15, at 2 ("Under our proposal, the U.S. tax base for multinational corporations would be calculated based on a fraction of their worldwide income. This fraction would simply be the share of their worldwide sales that are destined for customers in the United States.").

79 Under the best method rule, the determination of the arm's length price is established under a "facts and circumstances" test. Treas. Reg. § 1.482-1(c) (2011) ("The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods . . . ."). The task is complicated by the fact that the standard calls for the implementation of a standard that is fundamentally at odds with economic reality. In particular, its assumption that integrated transnational companies can be disaggregated for tax purposes is highly problematic. *See* Avi-Yonah et al., *supra* note 18, at 501 ("[T]he assumption that each affiliated company within the group transacts with the other members of the group in the same way that it would transact if the members were unrelated. . . . defies reality.").

80 Section 61 of the Internal Revenue Code provides a very broad definition of income. That definition is not so broad that it includes every item that would be considered economic income. For example, the income tax considers only that economic income which has been realized. *See, e.g.*, I.R.C. § 1001 (2011) (specifying the calculation of gain on the sale of property). That means that except to the extent that Bill Gates has sold shares of Microsoft stock or received a dividend on those shares, his investment in the corporation has produced no taxable income.

81 By contrast, the arm's length method calls for taxpayers and tax authorities to disaggregate fully integrated transnational businesses, a task that brings to mind putting toothpaste back in a tube. *See* Avi-Yonah et al., *supra* note 18, at 501 ("[F]or firms that are truly integrated across borders, holding related entities within the commonly controlled group to an 'arms-length' standard for the pricing of intracompany transactions does not make sense, nor does allocating income and expenses on a country-by-country basis.").

82 The formula often used in the U.S. domestic context—referred to as the "Massachusetts formula"—combines sales, assets, and employees. *See id.* at 509.

ple, as a robust measure of a jurisdiction's entitlement would make it quite easy to calculate each state's share of the global tax base.[83]

The debate between proponents of formulary apportionment and arm's length is not new.[84] One of the most recent salvos in that debate is also one of the most thought provoking. Several years ago, Reuven Avi-Yonah and Kimberly Clausing offered a detailed exploration of the costs and benefits of a switch from arm's length to formulary apportionment.[85] After considering the implications of such a change—including efficiency, complexity, and distributional concerns—Avi-Yonah and Clausing judge formulary apportionment to be superior to arm's length. They note that such a switch will inevitably create winners and losers, but "despite concerns about systematic revenue losses in some countries" formulary apportionment "would eventually help many governments by eliminating incentives for tax competition."[86]

The Organisation for Economic Co-operation and Development (OECD) provided the catalyst for modernizing the global information exchange architecture.[87] In a 1998 report, it decried the state of the international tax regime and, in particular, the growing freedom of taxpayers to hide income from tax authorities.[88] Over the next decade, the OECD promoted the notion of enhanced information exchange as the preferred response to the corrosive threat of tax evasion.[89] Relatively unstructured cooperation has long been the norm.[90] The OECD advocates a very different approach. It envisions

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83 *See supra* note 78.

84 *See* Avi-Yonah, *supra* note 6, at 1339 ("[T]here are two approaches to this problem, which has been the subject of heated debate in the past thirty years. One approach is the arm's-length method . . . and the other is the unitary or formulary apportionment method . . . .").

85 *See* Avi-Yonah & Clausing, *supra* note 15.

86 *See id.* at 25.

87 Describing the transformation of the information exchange architecture as a modernization may strike those familiar with the early history of information exchange as ironic. The first information exchange provisions were every bit as precise as those currently being put into place. That precision was quickly lost as the still-dominant information exchange standard took hold. *See* Dean, *supra* note 59, at 644–49 (describing the dramatic decline in the precision of information exchange agreements from the model information exchange agreements developed in the 1920s and included in the earliest U.S. double tax treaties).

88 *See generally* OECD, *supra* note 73 (identifying the existence of tax havens as a major threat to global welfare).

89 *See* OECD, *supra* note 16, ¶ 2 (summarizing OECD progress towards the elimination of tax evasion and avoidance).

90 *See supra* note 68 and accompanying text.

automatic, highly specified exchanges of standardized "'bulk' taxpayer information."[91]

Replacing a standards-based information exchange apparatus with a more precise rule could create cross-border structural enforcement mechanisms comparable to those that produce remarkably high rates of compliance in the domestic context.[92] Ideally, taxpayers would come to assume that tax authorities know as much about their offshore income and activities as they do about their domestic income. Rather than adopting a defiant attitude towards tax authorities, taxpayers would volunteer information about their cross-border activities.[93] That transformation would be the result of replacing a standard (producing ad hoc information flows) with a rule (providing a steady, predetermined stream of data).

In both the corporate and individual contexts, replacing standards with rules promises clear benefits. At a minimum, by providing the ex ante content standards necessarily lack, taxpayers and tax authorities would engage in fewer disputes. Both taxpayers and tax authorities would be able to redeploy the vast resources that would otherwise be devoted to their game of cat-and-mouse, increasing the collective welfare. Of course, the story of rules and standards is not nearly so simple.

II. Rules, Standards, and Principles

Choosing between rules and standards is never easy.[94] That observation clashes starkly with the apparent international tax policy consensus that progress demands more rules and fewer standards. This Part first considers the conceptual framework frequently applied to the international tax regime and explains why the more focused lens of rules versus standards may, in this instance, be more useful. It

91 Org. for Econ. Co-operation & Dev. (OECD), Manual on the Implementation of Exchange of Information Provisions for Tax Purposes 3 (2006).

92 *See supra* notes 49–51 and accompanying text.

93 Like Foucault's panopticon, that transparency would persuade taxpayers that noncompliance will inevitably be discovered and punished. Michel Foucault, Discipline and Punish 201–02 (Alan Sheridan trans., Vintage Books 2d ed. 1995) (1978) (explaining that once they accept that authorities have the capacity to monitor their activities "it is not necessary to use force to constrain the convict to good behavior, the madman to calm, the worker to work, the schoolboy to application, the patient to the observation of the regulations").

94 *See* Sunstein, *supra* note 12, at 956–57 (observing that "[i]t would be hard to overstate the importance of the controversy between" advocates for "clear, abstract rules laid down in advance of actual application" and "law-making at the point of application" (emphasis omitted)).

then explores the insights of scholars regarding the factors to be weighed when deciding between rules and standards in the domestic context. Combining these insights with those of international law scholars suggests that a switch from standards to rules will do little more than exchange one set of challenges for another, still more daunting, obstacle.

A. *Rules vs. Standards*

Rather than a contest between rules and standards, the dynamics of the international tax regime tend to be viewed in terms of hard and soft law.[95] That distinction can be quite useful.[96] It illuminates the different mechanisms through which the two types of international law influence the behavior of states[97] and provides a useful vocabulary for distinguishing between fundamentally different types of legal instruments.[98]

Hard and soft law can be distinguished across three dimensions: precision, obligation, and delegation.[99] In matters of taxation, the sovereignty-driven questions of obligation and delegation tend to steal the limelight.[100] Considered alongside such dramatic contests for

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95 *See* Christians, *supra* note 30, at 325 ("Discussion in international tax literature is increasingly using terms such as *hard law*, *customary law*, and *soft law* . . . .").

96 *See* Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT'L ORG. 421, 421 (2000) (concluding that the dichotomy of hard and soft law allows commentators to "analyze the benefits and costs of different types of legalization and suggest hypotheses regarding the circumstances that lead actors to select specific forms").

97 Referring to international law as "soft" does not mean that it has no capacity to influence state action. It may merely influence states through non-legal channels. For example, Hathaway identifies the formal and informal mechanisms that influence state action as "transnational legal enforcement" and "transnational collateral consequences." Oona A. Hathaway, *Between Power and Principle: An Integrated Theory of International Law*, 72 U. CHI. L. REV. 469, 497–512 (2005).

98 Abbott and Snidal, for example, distinguish between hard and soft law by reference to three criteria, "obligation, precision, and delegation." Abbott & Snidal, *supra* note 96, at 422.

99 *See generally* Kenneth W. Abbott et al., *The Concept of Legalization*, 54 INT'L ORG. 401 (2000) (providing a detailed analysis of each of the three characteristics).

100 *See* Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155, 156 (2008) ("No significant issue in international tax can be discussed without raising the question of sovereignty. Does a particular outcome or position harm or infringe upon a nation's sovereignty? Is sovereignty advanced by the proposed tax plan? Should a sovereign nation participate in multilateral tax cooperation to solve shared problems?"). Interestingly, the preoccupation that states have with tax sovereignty does not always lead in the same direction on the question of obligation and delegation. The European Union currently struggles with

power, the more technical question of precision tends to be an afterthought.[101] The rules versus standards literature provides a rich set of tools that brings precision into focus. No less important, it does so without implying any inherent hierarchy.[102]

To describe the "optimal precision" of legal requirements as falling somewhere between "administrative underprecision" and "exces-

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a situation in which they have obligated themselves without delegating. The result is a situation in which the European Court of Justice continues to strike down national tax laws (and the states act as though they are bound to respect those decisions) but the European Parliament cannot pass laws to solve the problem without the unanimous agreement of E.U. member states (because they have not delegated authority). *See* Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1253 (2006); Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. REV. 1277, 1278–82 (2008).

101 States bridle at suggestions that they shape their tax policies for the benefit of others and display skepticism towards efforts to delegate authority to resolve intergovernmental tax disputes. States tend to be very reluctant to consider commitments binding. *See generally*, Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71, 82–116 (1995) (providing the history of U.S. tax treaty overrides). States are even less willing to delegate authority to third parties. *See* Abbott et al., *supra* note 99, at 415 ("The characteristic forms of legal delegation are third-party dispute settlement mechanisms authorized to interpret rules and apply them to particular facts (and therefore in effect to make new rules, at least interstitially) under established doctrines of international law."). With the exception of the recent advent of a limited amount of binding arbitration in the double tax treaty context, states simply do not delegate the interpretation or adjudication of international tax rules. *See* Diane Ring, *Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World*, 33 FORDHAM INT'L L.J. 649, 689–99 (2010) (tracing the history of the inclusion of binding arbitration features in the OECD model double tax treaty). The binding arbitration was carefully designed to "to assuage countries' sovereignty concerns . . . ." Hugh J. Ault, *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOK. J. INT'L L. 757, 775 (2009); *see* Hugh J. Ault, *Improving the Resolution of International Tax Disputes*, 7 FLA. TAX REV. 137, 139 (2005) (noting that most international tax disputes are resolved pursuant to Mutual Agreement Procedures and that "the individual case is not considered on its merits but [as] part of a larger tradeoff between the countries").

102 By contrast, viewing legal regimes through the lens of hard and soft law can create an expectation that soft law will—or should—blossom into hard law. *See* Abbott & Snidal, *supra* note 96, at 422–23 ("Others justify soft law only as an interim step toward harder and therefore more satisfactory legalization."). As a result, through the hard versus soft law prism, the arm's length standard may seem like little more than "a way station to harder legalization" such as formulary apportionment. *Id.* at 423. The soft law label itself can become a liability. *See id.* ("The implication is that soft law—law that 'falls short' on one or more of the three dimensions of legalization—is a failure."). The rules versus standards framework, by contrast, does not suggest a comparable hierarchy as between rules and standards. Each offers advantages and disadvantages and neither is viewed as inferior to the other.

sive regulatory rigidity" suggests both the importance of striving for that goal and the impossibility of achieving it.[103] No matter how well tailored to a particular context, a highly specified rule is likely to be perceived as unduly rigid in at least some cases. By the same token, even the most elegant standard will fail to provide adequate guidance in others.

The fundamental difference between rules and standards is the point at which each is given content.[104] A numerical speed limit embodies up-front content specification, while a "reasonable" speed requirement demands a case-by-case determination.[105] In that sense a rule is a mass-produced legal instrument while a standard serves as a skilled craftsman. A rule—by providing "an advance determination of what conduct is permissible" that may apply to hundreds or thousands of events—creates the potential for economies of scale.[106] Of course, like any other mass-production process, creating a rule entails significant up-front costs.

The two primary costs are "the cost of obtaining and analyzing information about the rule's probable impact, and the cost of securing agreement among participants in the rulemaking process."[107] A standard minimizes lawmakers' initial outlay by, for instance, deferring difficult decisions.[108] Nevertheless, it offers no guarantee of lower overall costs. Given a large number of instances in which a standard applies, the need for private parties and authorities to repeatedly implement the standard could make it more costly over time.[109]

Moreover, the economies of scale that a rule offers do not come without risk. One of the "conventional arguments against precise statutory guidelines . . . stress[es] the need for flexibility for responding

103 Diver, *supra* note 12, at 65.

104 *See supra* note 31 and accompanying text.

105 *See* Kaplow, *supra* note 12, at 560.

106 *Id.* at 560, 583.

107 Diver, *supra* note 12, at 73.

108 The parallels between the hard/soft law and the rules/standards distinctions are particularly apparent when we focus on the nature of the costs they entail. *See* Abbott & Snidal, *supra* note 96, at 434 ("A major advantage of softer forms of legalization is their lower contracting costs. Hard legalization reduces the post-agreement costs of managing and enforcing commitments, but adoption of a highly legalized agreement entails significant contracting costs.").

109 An imprecise standard could, for example, spawn a large number of disputes. *See* Diver, *supra* note 12, at 95 (offering the "staggering" number of cases challenging INS's exercise of its discretion to adjust the status of aliens to permanent residence pursuant to the Immigration and Nationality Act of 1952 as an example of the impact of a lack of precision).

to changed circumstances . . . ."[110] In other words, not even the most efficient production process can compensate for a change in technology or tastes that renders a product—or a law—obsolete. In such cases, lawmakers' up-front investment may, in retrospect, appear foolish.

B. Rules and Standards in International Taxation

The intuitive appeal of rules is not difficult to understand. One need only compare the indeterminacy of the arm's length standard to the refreshing clarity of formulary apportionment to appreciate why rules seem to be an important part of the international tax regime's future.[111] Rather than asking transnational businesses and national tax authorities to craft bespoke solutions to increasingly common allocative problems, formulary apportionment promises a dependable off-the-rack alternative.

1. Formulary Apportionment and the Costs of Consensus

Bausch & Lomb paints a compelling picture of the limits of the arm's length standard.[112] The long, expensive fight over allocating the profits derived from a product as prosaic as a contact lens does not inspire great confidence in the arm's length standard's capacity to address disputes regarding more complex products and services. The opacity of the operations of financial firms, for example, has long taxed the capacity of the extant regime.[113] It seems safe to conclude that the future holds more, not less, of that sort of complexity.

Against that backdrop, formulary apportionment's rule—dispensing with the need to delve too deeply into the nature of an organization's idiosyncratic technologies and structures—seems almost

110 Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 481 (1987).

111 Of course, the clarity rules provide does not come without costs. If substituting rules for standards were an easy cure for chronic ailments like those that afflict the international tax regime, the rules versus standards debate would hardly have been the subject of decades of sustained scholarly attention. Choosing between rules and standards is never easy. Similar contests between rules and standards persist in all sorts of settings. One particularly heated and long-running debate focuses on the appropriate way of policing the behavior of public companies. *See generally* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007) (contrasting "principles-based" and "rules-based" securities law enforcement actions).

112 *See supra* notes 43–46 and accompanying text.

113 *See* Lisa M. Nadal, *Reproposed Global Dealing Regs Similar to 1998 Regs*, 117 TAX NOTES 307 (2007) (describing what is now a more-than-decade-long effort to create regulations governing the allocation of profits of financial firms).

inevitable. Unfortunately, embracing a rule such as formulary apportionment can create as many problems as it solves. As in any other context, while it might significantly lower post-implementation costs, those savings could be dwarfed by increased rulemaking costs.

Even assuming the costs of designing the rule are modest, forging consensus among states with differing interests and capacities may be extremely difficult.[114] The growth of cross-border commerce undoubtedly makes the notion of economies of scale appealing, but the increasing interconnectedness that accompanies that growth also makes achieving consensus more costly.[115] As Cass Sunstein succinctly put it, "[s]ometimes people can agree on a standard when they cannot agree on its specification. An incompletely specified provision may be the best the political (or judicial) system can do."[116] The indeterminacy of the arm's length standard may indicate its status not merely as a lowest-common denominator but also as a high-water mark in political terms.[117]

2. Information Exchange and the Rigidity of Rules

The mechanisms through which information is exchanged among national tax authorities provide another illustration of the extent to which the international tax regime defers the specification of content.[118] It also illustrates a second pitfall of a switch from standards to rules.[119] Not only are rules costly to construct, once brought

114 *See* Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 611 (1994) (arguing that structural differences among countries make it "seem very unlikely that a consensus would develop in the foreseeable future" regarding an appropriate formula by which to apportion income). Some commentators argue that a high level of coordination is not necessary, but concede that some coordination would be required. *See, e.g.*, Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment—Myths and Prospects: Promoting Better International Tax Policy by Utilizing the Misunderstood and Under-theorized Formulary Alternative* 22 (Univ. of Mich. Pub. Law and Legal Theory Working Paper Series, Working Paper No. 221; Empirical Legal Studies Ctr., Working Paper No. 10-029, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1693105.

115 More transactions involving more firms in more jurisdictions inevitably means higher rule implementation costs.

116 Sunstein, *supra* note 12, at 965 (emphasis omitted).

117 *See* William J. Wilkins & Kenneth W. Gideon, *Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment*, 65 TAX NOTES 1259, 1261 (1994) (contrasting the "difficulty in achieving international agreement on formula apportionment and its details" against "the arm's length approach, which is capable of brief and noncontroversial treaty expression").

118 The deferral of content specification is the hallmark of a standard. *See supra* note 104 and accompanying text.

119 *See supra* note 111 and accompanying text.

into existence they face the constant threat of obsolescence. Investing heavily in a production process (i.e. a rule) may not be prudent if the product in question is one that may soon fall out of fashion.

It is difficult to contemplate the current double-tax-treaty-based information exchange infrastructure without acknowledging the inadequacy of the ad hoc information flows it generates.[120] Still, it embodies the flexibility that is so prized in a standard.[121] Even though national income taxes and the global economic landscape have changed dramatically over the last few decades, the information exchange provisions of treaties have not.[122]

Had they been more precisely specified, those treaty-based mechanisms might now be obsolete as well as ineffective.[123] Today, it would be short sighted to discount the possibility that wholesale changes in the domestic laws of states currently heavily reliant on income taxes might hobble a highly specified, rules-based information exchange regime.[124] After all, the same organization that leads the charge for

120 That is particularly true when today's standards are compared to those that existed in the earliest days of the international tax regime. *See* Dean, *supra* note 59, at 638–44.

121 The information exchange articles themselves change little over time. The commentaries provide more flexibility. *See, e.g.*, ORG. FOR ECON. CO-OPERATION & DEV. (OECD), MODEL TAX CONVENTION ON INCOME AND ON CAPITAL—CONDENSED VERSION, at art. 26 (2010) (presenting both a relatively short information exchange article (Article 26) in which a handful of words are altered and the much lengthier commentaries on that article in which those changes, along with changes not reflected in the article itself are described in detail). The same is true of the arm's length standard. The standard itself has changed very little, but its interpretation has. *See supra* note 33 (describing evolution of the standard over several decades).

122 *Compare* U.S. TREASURY DEP'T, *supra* note 68, at art. 26 *with* U.S. TREASURY DEP'T, UNITED STATES MODEL INCOME TAX CONVENTION, at art. 26 (1976). Arguably, the biggest change is the switch from the "is necessary" threshold to the newer "may be relevant" standard. Footnote 70, *supra*, provides a portion of the official U.S. commentary on that change, suggesting that the new language may not be as expansive as it appears.

123 For example, U.S. tax authorities require borrowers to report not only the cash interest they pay to lenders, but also interest that economically accrues without being paid in cash. *See* I.R.S., Form 1099-OID (2011). The highly specified information exchange provisions created during the first half of the century did not require reporting of that deferred interest, referred to as Original Issue Discount. As a result, even if those early agreements had not been supplanted by the modern information exchange standard, they would not have provided today's authorities with information comparable to the information they receive from domestic sources.

124 *See* STAFF OF J. COMM. ON TAXATION, 104TH CONG., IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX 96–114 (Comm. Print 1996), *available at* http://www.house.gov/jct/s-5-96.pdf (addressing international implications of dramatic changes in the U.S. tax system). Of course, some of the

rules-based information exchange also extols the advantages of consumption taxes over the very income taxes that the new information exchange infrastructure would serve.[125]

Even if change were to continue to come gradually to the world's income taxes, the impact on the proposed information exchange architecture could be disruptive.[126] In the context of domestic tax information acquisition, administrators find themselves in a constant battle to keep pace with changes in taxpayer behavior.[127] It is not difficult to understand that the more highly specified a rule becomes, the more vulnerable it would be to even incremental changes in the needs of participating states.[128] In other words, the switch from a standard to a rule might merely replace the ex post costs of providing content for a standard with the not inconsiderable costs of constant modernization.

C. Rules, Standards, and Legitimacy

In the international context, the potency of both rules and standards derives from the push and pull generated by the principles that underlie them.[129] The international tax regime relies on one princi-

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investment in information technology infrastructure could be salvaged and repurposed to create a new information exchange regime. By the same token, the cooperative relationships among participating states would survive that switch.

125 *See* Org. for Econ. Co-operation & Dev. (OECD), Consumption Taxes 5 (2007), *available at* http://www.oecd.org/dataoecd/45/6/39495382.pdf (finding "strong support for the view that a move in the balance of taxation towards taxes on consumption would be likely to improve economic efficiency and increase growth"). The OECD is far from alone in advocating in favor of consumption taxes. *See* Warren, *supra*, note 114, at 610 ("Some analysts have argued that income taxation should be replaced by cash flow [consumption] taxation, for both individuals and corporations . . . even apart from international considerations.").

126 The same would be true if a formulary apportionment regime were introduced. *See* Julie Roin, *Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 174 (2008) ("[R]eplacing the current international tax rules with a system of formulary taxation would entail tremendous institutional and transition costs in the United States and elsewhere. Further, achieving and maintaining the degree of legal uniformity necessary for such a system to operate to its full potential would have its own costs." (footnote omitted)).

127 *See* Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1632 (2009) (showing that the IRS tax shelter reporting requirement has had a hard time striking a balance between underdisclosure and overdisclosure by taxpayers).

128 *See* Sunstein, *supra* note 12, at 994 ("[R]ules may badly misfire under new conditions.").

129 Without Hart's rules of recognition, a set of obligations will not develop into a "legal system." *See supra* note 1 and accompanying text. Franck echoes the impor-

ple in particular, the benefits principle, as its primary source of legitimacy.[130]

Because there is no central transnational tax authority with the capacity to enforce either standards or rules nothing compels obedience by individual states.[131] States participate in the international tax regime because they choose to do so, not because they must. Of the two reasons that states comply with international legal regimes, the first is the more obvious. States can be expected to comply with legal regimes when that compliance is perceived to be in their own national interest, however that is understood.[132] More difficult to understand is why states comply even against their own apparent interests.

One solution to that puzzle is "compliance pull."[133] Compliance pull refers to the capacity of a regime to "secure compliance when, as in the international system, there are no other compliance-inducing mechanisms."[134] Why, for instance, does a state accept an adverse ruling of an international body? There may be circumstances in which it is clear that the short-term burden of doing so will be more than offset

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tance of such "secondary" rules to the success of international law. *See* Thomas M. Franck, *Legitimacy in the International System*, 82 AM. J. INT'L L. 705, 752 (1988) ("Primary rules of obligation that lack adherence to a system of secondary rules of process are mere ad hoc reciprocal arrangements."). Franck and Sunstein both make the observation that rules divorced from principles are less likely to be successful. Sound principles provide the foundation that makes rules—and standards—strong. *See* Sunstein, *supra* note 12, at 966 ("[R]ules are justified by principles, usually political or moral in character"). Posner and Ehrlich make a similar observation about the relationship between rules and principles. *See* Ehrlich & Posner, *supra* note 12, at 260 ("Properly understood, 'principles' are simply the considerations that are relevant in determining the content of a rule.").

130 The benefits principle plays a critical role in persuading states to comply with international tax rules. In other words, it represents a means by which "other rules of the system" can be "assessed, and in virtue of which the rules constitute a single system." HART, *supra* note 1, at 233.

131 The OECD comes closest to playing the role of a World Tax Organization. To the extent it influences state action, it does so by generating international norms. *See* Christians, *supra* note 17, at 4 ("The OECD describes itself as a 'market leader in developing standards and guidelines,' and policy norms it develops have worldwide impact.").

132 *See* Claire R. Kelly, *Realist Theory and Real Constraints*, 44 VA. J. INT'L L. 545, 547 (2004) (observing that states will abide by rules that do them a short-term disservice in order to secure greater long-term benefits). Such incentives are the explanation typically offered for the remarkable success of the double tax treaty network. *See supra* note 28. States offer concessions with regard to their taxation of foreign residents in order to secure equivalent benefits for their own residents. *See infra* note 169.

133 Franck, *supra* note 129, at 713.

134 *Id.* at 706.

by long-term benefits of membership in that body.[135] In other cases, legitimacy may play the more important role in cultivating commitment to a regime.[136] Simply put, regimes that are perceived to be legitimate elicit more compliance than those that are not.

Legitimacy can be disaggregated into input and output legitimacy.[137] Thomas Franck identifies input legitimacy as "that quality of a rule which derives from a perception on the part of those to whom it is addressed that it has come into being in accordance with right process."[138] In the absence of a global legislature with the capacity to supply its imprimatur, perhaps the best means of satisfying Franck's procedural threshold—thereby generating input legitimacy—is to anchor a rule or standard in a principle that itself possesses legitimacy.[139] Conversely, even the most finely wrought rules or protean standards can lose the benefit of the pull provided by that borrowed legitimacy if they fail to "adhere" to their host principle.[140]

Congruence between a regime's objective and its real-world impact generates a second type of legitimacy referred to as output legitimacy. If a law succeeds in meeting its objectives—whether limiting noise pollution, reducing crime or promoting investment—it may command a respect that is independent of its origins. International legal regimes and institutions can acquire legitimacy in the same way. For example, the perceived success or failure of International Monetary Fund efforts to resolve financial crises will either burnish or detract from its output legitimacy.[141]

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135 *See supra* note 132.

136 *See infra* note 137.

137 *See* FRITZ SCHARPF, GOVERNING IN EUROPE 2 (1999) (distinguishing "input-oriented authenticity" and "output-oriented authenticity" as two distinct sources of legitimacy); Robert O. Keohane & Joseph S. Nye, Jr., *The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy*, *in* EFFICIENCY EQUITY AND LEGITIMACY 265 (Roger B. Porter ed., 2001) ("The legitimacy of institutions is affected both on the 'input' side—in particular, through procedures for accountability—and on the 'output' side, in terms of effectiveness.").

138 Franck, *supra* note 129, at 706 (emphasis omitted). Although Franck uses the concept of "input legitimacy," he does not use that label.

139 Franck describes an important role for what he sees as the international equivalent of H.L.A. Hart's secondary rules of recognition. He argues that such rules can help lend legitimacy to international legal regimes while "[p]rimary rules of obligation that lack adherence to a system of secondary rules of process are mere ad hoc reciprocal arrangements." Franck, *supra* note 129, at 752.

140 Franck uses the term "adherence" to describe phenomenon of a legal provision being firmly rooted in an underlying principle. *See* Franck, *supra* note 129, at 751–52.

141 *See* Keohane & Nye, *supra* note 137, at 286.

For the international tax regime, the switch from standards to rules will generate neither type of legitimacy. Instead, as described in Part III, that shift threatens to diminish the international tax regime's legitimacy. Formulary apportionment and enhanced information exchange both sacrifice adherence to the benefits principle—the bedrock principle of the international tax regime—in a misguided pursuit of greater output legitimacy. Unfortunately, as described below, the rise of rules is more likely to reduce than increase the output legitimacy of the international tax regime.

III. The Power of Legitimacy

On its own, transforming a standards-based international tax regime into one that relies more heavily on rules will accomplish little. More urgent is closing the growing gap between the architecture of the international tax regime and its basic norm. That hardly seems possible so long as those rules continue to rely on a principle designed to solve the quaintly outdated problem of double taxation.[142] This Part begins by tracing the benefits principle's roots and then explores its role in producing legitimacy traps.

A. *The Benefits Principle*

The embarrassment of riches that governments once struggled to tame no longer exists.[143] Today, states find themselves in a world turned upside down. Too little tax revenue, not too much, leaves governments at a loss. While it would be difficult to overstate the historical significance of the improbable compromise embodied in the benefits principle—that states will refrain from asserting claims to tax revenues that another state earns—"nowadays the decisive issue is . . . the enforcement problem inherent in double non-taxation."[144]

Simply put, collecting taxes is now the challenge states face, not *refraining* from collecting them. Fabricating a solution to this fundamentally different problem demands an equally unorthodox approach to allocating tax revenues. As detailed in Part IV, if a state contributes to a solution it should be rewarded; if it exacerbates the problem, it should suffer.[145]

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142 *See infra* note 144 and accompanying text.

143 *See* Avi-Yonah, *supra* note 5, at 1631–48 (describing consequences of declining taxing capability of developed countries).

144 Thomas Rixen, The Political Economy of International Tax Governance 200 (2008).

145 In other words, a state's investment in a modern tax infrastructure must be given its due alongside its investments in railroads.

1. Legitimacy and the International Tax Regime

The benefits principle dates to the origins of the modern international tax regime and represents the key compromise that has propelled its success for so many years.[146] Like relative newcomers such as capital export neutrality and capital import neutrality, the benefits principle seeks to avoid disproportionate burdens on cross-border economic activity.[147] Unlike those esoteric concepts, the benefits principle delivers a message that is easy to understand and that has been widely embraced.[148]

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146 The benefits principle emerged in a world that bears little resemblance to one in which even the most readily identifiable of national businesses could change passports not once, but twice in little more than a decade. *See* Chris V. Nicholson, *Chinese Carmaker Geely Completes Acquisition of Volvo from Ford*, N.Y. TIMES, Aug. 3, 2010, at B3 (noting that Ford bought Volvo in 1999 and then sold it to a Chinese competitor in 2010). The birth of the modern benefits-principle-based international tax regime could be dated to the issuance of a report published under the auspices of the League of Nations. *See* COMM. OF TECHNICAL EXPERTS ON DOUBLE TAXATION & TAX EVASION, LEAGUE OF NATIONS, DOUBLE TAXATION AND TAX EVASION 5–9 (1927), *available at* www.law.wayne.edu/tad/Documents/League/League_Tech_Experts.pdf. That report contained four model conventions, including the Convention for the Prevention of Double Taxation. *See id.* at 10. In the post–World War I environment, international trade was important enough to support the creation of the generous cross-border investment subsidy known as the foreign tax credit. *See* Graetz & O'Hear, *supra* note 32, at 1046–47 (describing the reasons for the "generosity" embodied in the foreign tax credit). Nevertheless, cross-border transactions were limited to the purchase of goods rather than the companies that produced them.

147 The benefits principle might be thought of as a forerunner of the later neutralities. While those neutrality principles draw subtle distinctions among the ways in which cross-border activity may be disadvantaged over purely domestic activity, the benefits principle seeks only to avoid double (or triple) taxation by the jurisdictions that host, facilitate, and generate cross-border investments. The neutrality principles emerged much later. *See* Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203, 205 (2007) (describing the emergence of an array of international tax neutrality principles beginning in the 1960s).

148 Shaheen describes the lack of consensus that prevails even among specialists regarding the five international tax neutrality principles. *See id.* at 207–08. His analysis also demonstrates that the principles do not appear to be particularly well understood. *See id.* at 239 (questioning the view of "CEN as a doctrine that requires the return on capital to be subject to the same total tax rate regardless of the location of the investment (residence-based taxation)"). Michael Knoll reaches a similarly pessimistic conclusion regarding the failure of international tax commentators to fully grasp the significance of the neutrality principles. *See* Michael Knoll, *Reconsidering International Tax Neutrality* 42 (Univ. of Pa. Law Sch. Inst. for Law & Econ., Working Paper No. 09-16, 2009), *available at* http://ssrn/abstract=1407198.

The benefits principle operates by allocating taxing jurisdiction to the state that fosters the economic activity giving rise to the tax.[149] It provides that states "earn" tax revenues by, for example, building roads, providing schools, or nurturing capital formation.[150] The benefits principle offered a robust solution to the "original problem of international taxation—double taxation" which amounted to "the distributive problem of sharing the international tax base . . . ."[151]

The benefits principle, or the "economic allegiance" principle as experts of the day sometimes referred to it, reflected its era.[152] It envisions a clear link between the services states provide and the economic activity that occurs within its borders that would seem "delusional" today.[153] The benefits principle presupposes that by providing "infrastructure or education, as well as more specific government policies such as keeping the exchange rate stable or interest rates low" a jurisdiction hosting foreign investment becomes entitled to collect tax "in the sense that the host country's government bears some of the costs of providing the benefits that are necessary for earning the income."[154]

When the international tax regime focused on curbing double taxation, the benefits principle provided both output and input legitimacy. Just as the World Health Organization accrues legitimacy by successfully addressing global health issues, the success of the international tax regime in eradicating double taxation endowed it with output legitimacy.[155] At the same time, the seamless link between the benefits principle and the regime's allocation of revenues provided

149 The assumption is that "the taxpayer has an obligation founded on ethical principles to pay for the benefits conferred by the host country" or that "the obligation to pay income tax at the source arises under an implied contract between the taxpayer and the host country imposing the tax." Kaufman, *supra* note 8, at 184.

150 *See id.* at 185 ("Under a strict benefit rule, the country in which a product is produced could impose a charge for the governmental goods and services benefiting the producer . . . .").

151 Rixen, *supra* note 144, at 200.

152 *See* Kaufman, *supra* note 8, at 196 (explaining "economic allegiance" concept).

153 William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!*, 29 U. Pa. J. Int'l L. 349, 370 (2007) (referring to a modern "system defined by territorial principles of source").

154 Avi-Yonah, *supra* note 8, at 521.

155 *See* Keohane & Nye, *supra* note 137, at 286 ("The World Health Organization's eradication of smallpox gave the WHO substantial legitimacy for being effective in dealing with global health problems, whereas its slowness in focusing on AIDs may have had the opposite effect.").

the international tax regime with a high level of derivative input legitimacy.[156]

2. Legitimacy's Decline

In the many decades since their introduction, a long list of contemporary phenomena such as electronic commerce "have helped to render archaic . . . international . . . tax arrangements and policies."[157] The benefits principle is certainly one of the casualties of that disruption. As a descriptive matter, when "multinational firms . . . shift nominal income to low tax jurisdictions while still reaping the benefits of . . . jurisdictions where the business is headquartered" the already fragile link between public services and tax revenues that animates the benefits principle may be severed.[158] Unable to enjoy the fruits of their efforts, states lash out, responding by departing from "traditional tax policy principles."[159]

The product of that cycle of private behavior and public response is a legitimacy trap. States struggle to nurture a vital international tax regime, but succeed only in accelerating a decline in input and output legitimacy. Output legitimacy declines even as states labor to plug holes in the regime.[160] Responding to crises by departing from the benefits principle script, states sacrifice input legitimacy in the pursuit

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156 *See supra* notes 138–140 and accompanying text.

157 Graetz, *supra* note 13, at 1417 (listing e-commerce, derivatives, e-money and tax havens as part of the new reality that challenges the capacity of the international tax regime).

158 Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws*, 34 CONN. L. REV. 333, 380 (2002).

159 *See id.* at 390–95 ("[T]he United States and other OECD member States have, despite assertions that traditional tax policy principles must be preserved, moved toward an economic presence test for cross-border e-commerce income tax purposes, a significant departure from traditional international tax principles that focused on the need for a physical presence . . . ."). Cockfield concludes that this change contributes to a dynamic in which "profits are diverted away from the countries that have a meaningful connection to the profit-making activities (i.e., the country where an e-commerce business is based, the country where the intangible assets were developed or the country where the e-commerce good or service is purchased)." *Id.* at 395.

160 *See* Avi-Yonah, *supra* note 5, at 1579–86 (describing impact of U.S. decision to forgo the taxation of portfolio interest earned by nonresident investors on capacity of other states to impose such a tax). For those who view the benefits principle as mandatory rather than permissive—i.e. a state must, rather than may—collect the revenues allocated to it, the magnitude of the output legitimacy decline is particularly stark. The U.S. decision to repeal its tax on portfolio interest was not consistent with a mandatory view of the benefits principle.

of output legitimacy. They run a grave risk of winding up with neither.[161]

B. Legitimacy Traps and Hypocrisy

The harm done by the persistence of "outdated" or "inadequate" principles can be significant without being apparent.[162] If a provision of international law fails to adhere to a legitimate basic norm while also failing to be effective, it will enjoy neither input nor output legitimacy. The result can all too easily be a downward spiral in which a dearth of legitimacy (specifically, input legitimacy) elicits only insincere acceptance from states, further diminishing the regime's legitimacy (particularly its output legitimacy).[163]

The problem could also be described more succinctly: the tension created by an inadequate principle makes hypocrites of even the most stalwart supporters of the international tax regime. A cynic might, for instance, dismiss the OECD's success in persuading tax havens to sign information exchange agreements as the sort of hollow victory one must expect when dealing with rogue states.[164] Unfortunately, a similarly shallow commitment can be observed in even those most dedicated to information exchange.[165]

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161 Even if those new features allow states to collect additional revenues, the negative impact their departure from traditional tax policy principles may mean no net gain in legitimacy.

162 *See* Graetz, *supra* note 13, at 1362.

163 *See* Hathaway, *supra* note 97, at 517–19 (noting that when the costs of noncompliance are low states may willingly commit to an international regime with no intention of complying). A particularly jarring example of the perils of that type of insincerity is the tendency of regimes with poor human rights and environmental track records to commit to human rights and environmental treaties as a means of camouflaging their lack of actual compliance. *See id.* at 514–19.

164 *See* Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 147–49 (2009) (doubting the capacity of the OECD effort to transform commitment into full-fledged cooperation); Michael J. McIntyre, *How to End the Charade of Information Exchange*, 56 TAX NOTES INT'L 255, 255 (2009) ("Tax haven countries that agree to this ineffective TIEA are provided with an undeserved patina of respectability. They have been eager to sign up, and most have done so."); Lee A. Sheppard, *Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, 53 TAX NOTES INT'L 1139, 1140 (2009) ("Overall, the agreement is more a public relations document than a tool of tax administration. It allows banking havens to make a show of cooperation while going about their essential business of selling tax evasion services to residents of rich countries.").

165 *See* McIntyre, *supra* note 164, at 259 (concluding that at the same time it pursues bilateral information exchange to curb offshore tax evasion, "it has an active program encouraging foreign tax cheats to invest in the United States").

The United States has long been a strong supporter of the international regime in general and of information exchange in particular.[166] In the wake of the UBS tax evasion scandal, for instance, the United States has strenuously bargained for improved information exchange with Switzerland.[167] At the same time, the United States has assertively broken with the cooperative inter-state ethos of the benefits principle. Instead of observing the benefits-driven notion of information reciprocity, U.S. authorities have embraced a new, unilateral approach.

Over the past decade, the United States has increasingly come to rely on qualified intermediaries for the collection of extraterritorial tax information. A qualified intermediary is a private firm deputized by U.S. tax authorities to collect taxes imposed on U.S. income earned by foreign individuals and businesses.[168] It is a quirk of the international tax regime that relatively few cross-border payments are taxed at the statutory tax rate.[169] As a result, the qualified intermediary rou-

166 The United States set the cornerstone of the international tax regime in place by enacting the foreign tax credit. *See supra* note 146. It stood at the vanguard of the spread of the double tax treaty. Britain concluded its first comprehensive double tax treaty with the United States in 1945. *See* John F. Avery Jones, *Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 2 (1999). The United States also laid the groundwork for the current wave of information exchange agreements by reviving the concept in the 1980s. *See* Dean, *supra* note 59, at 650–53.

167 The United States and Switzerland recently entered into a protocol to their bilateral double tax treaty that provides for expanded information exchange. *See* Press Release, Treasury Dep't, United States, Switzerland Sign Agreement to Bolster Tax Information Exchange (Sept. 23, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg297.aspx ("The protocol revises the existing U.S.-Switzerland income tax treaty to allow for the exchange of information for income tax purposes to the full extent permitted by Article 26 of the Organisation for Economic Co-operation and Development (OECD) Model Income Tax Convention.").

168 A qualified intermediary is defined under the regulations as a "foreign financial institution" or a similar entity "that is a party to a withholding agreement with the IRS." Treas. Reg. § 1.1441-1(e)(5)(ii) (as amended in 2007).

169 The high statutory rate serves merely as a penalty default encouraging taxpayers to identify themselves in order to qualify for a lower rate. *See* Jones, *supra* note 166, at 3 (concluding that the "high withholding taxes on nonresidents" are intended to make those nonresidents, and by extension their states of residence, to "want treaties" to reduce those rates). In the United States that nominal rate on dividends, interest, and similar periodic payments is thirty percent. I.R.C. §§ 1441–42 (2006). Historically, one benefit of the scheme is that in order to secure the lower nonstatutory rate, a nonresident must generally provide documentation establishing his or her entitlement to that rate. Tax authorities can provide that information—specifying the taxpayer's identity and residence—to tax authorities in the recipient's residence jurisdiction. Having received information about the income of one of its residents in this roundabout manner, that jurisdiction may then impose a tax on the investment

tinely assesses the eligibility of foreign taxpayers receiving interest or dividends from within the United States for rates below that statutory thirty percent withholding tax rate.[170] Only after it examines the documentation proving that a French recipient is eligible for the reduced rates provided by the double tax treaty between the United States and France, for instance, will it ensure that the appropriate amount of tax is remitted to U.S. authorities.[171]

Privatizing a process that had previously been carried out directly by U.S. tax authorities has distinct advantages for the United States. As is often true, privatization offers the possibility of significant operational savings. Here, the savings may be more substantial than in a typical privatization scenario.[172] That is because qualified intermediaries not only perform a complex, labor-intensive task on behalf of U.S. tax authorities, they do so without compensation.[173]

Although uncompensated, those services are nonetheless remunerative.[174] Clients of qualified intermediaries gain the benefit of access to U.S. financial markets without sacrificing their anonymity.[175]

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income of its resident. The rise of qualified intermediaries disrupts the flow of information from nonresident taxpayers to their home jurisdiction.

170 The specific obligations of the qualified intermediary are specified by each intermediary's withholding agreement. *See* Treas. Reg. § 1.1441-1(e)(5)(iii)(B) (as amended in 2007) ("[T]he agreement shall specify the type of certifications and documentation upon which the qualified intermediary may rely to ascertain the classification . . . and status . . . of beneficial owners and payees who receive payments collected by the qualified intermediary and, if necessary, entitlement to the benefits of a reduced rate under an income tax treaty.").

171 *See id.*

172 Privatization can enhance economic efficiency by imposing market discipline on decision makers. *See* Mary M. Shirley, *The What, Why, and How of Privatization: A World Bank Perspective*, 60 FORDHAM L. REV. S23, S25–27 (1992).

173 Rather than receiving information with respect to individual taxpayers, qualified intermediary withholding agreements may provide for the qualified intermediary to provide aggregate, rather than individualized information regarding nonresident taxpayers. *See* Treas. Reg. § 1.1441-1(e)(5)(iii)(B) (as amended in 2007). In effect, U.S. tax authorities receive a convenient summary, sparing them the burden of processing the information themselves.

174 As Michael McIntyre puts it, being a qualified intermediary benefits financial intermediaries by making it possible for them to "handle anonymously the investments in the United States by foreign tax cheats." McIntyre, *supra* note 164, at 259 ("Hundreds of billions of dollars flow into the United States under this system.").

175 Qualified intermediaries need not "disclose the identity of beneficial owners and payees" when those payees are nonresidents. Treas. Reg. § 1.1441-1(e)(5)(iii)(B) (as amended in 2007). As a result, U.S. tax authorities do not receive that information and cannot exchange that information with their foreign counterparts. To some, the simultaneous rise of the qualified intermediary and enhanced information exchange smacks of "brazen hypocrisy." *See* McIntyre, *supra* note 164, at 255. At a

That irresistible combination generates business for qualified intermediaries while producing more privacy and higher returns for foreign investors and more foreign investment and tax revenues along with lower administrative costs for the United States.

The result appears to be a win-win-win for the United States, qualified intermediaries, and their clients. The primary losers are those states that have agreed to exchange information with the United States. Because the qualified intermediary receives and reviews the documentation that entitles our hypothetical French taxpayer to a low treaty withholding rate, the United States does not possess and cannot provide that documentation to France.[176] In a desperate bid to bolster compliance (output legitimacy) the United States sacrificed a measure of adherence to the benefits principle (input legitimacy) by creating a unilateral extraterritorial information acquisition mechanism.[177]

The UBS scandal that followed may represent the nadir of the resulting legitimacy trap.[178] As a participant in the qualified intermediary program, UBS assumed the role once filled by states bound by information exchange obligations.[179] As has become clear, UBS breached those obligations in spectacular fashion.[180] Without the derivative input legitimacy supplied by the benefits principle the risks of such failures increase.[181]

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minimum, the rise of the qualified intermediary has had a pernicious effect on its ability to satisfy its information exchange obligations.

176 Whether intentional or the result of an oversight, that result is starkly at odds with the U.S. commitment to information exchange.

177 The benefits principle encourages unilateral extraterritorial information acquisition, but such unilateral efforts clash with the universal nature of the claim to extraterritorial tax information that is implicit in the benefits principle. *See infra* text accompanying note 208.

178 *See* Statement of Facts at 3, United States v. Birkenfeld, No. 08-CR-60099-ZLOCH (S.D. Fla. June 19, 2008), *available at* http://www.justice.gov/usao/fls/PressReleases/Attachments/080619-01.StatementofFacts.pdf (describing efforts of UBS employees to assist wealthy clients in circumventing the qualified intermediary regime to evade U.S. income taxes).

179 *See id.* at 1 (describing obligations of UBS under qualified intermediary program).

180 *See id.* at 4.

181 The United States has worked to compensate for the absence of compliance pull by introducing additional incentives to ensure foreign financial firms provide U.S. authorities with extraterritorial tax information. *See* Niels Jensen, Note, *How to Kill the Scapegoat: Addressing Offshore Tax Evasion with a Special View to Switzerland*, 63 VAND. L. REV. 1823, 1849–52 (2010) (describing the new U.S. withholding tax introduced in 2010 as a lever to extract extraterritorial tax information for U.S. tax authorities).

However profound the weaknesses of the aging information exchange standard, they nevertheless draw less attention than a scandal involving smuggling diamonds into the United States in a toothpaste tube.[182] Few appreciate the degree to which reliance on qualified intermediaries compromises U.S. information exchange obligations, but anyone can understand such malfeasance on the part of a U.S. private (fiscal) contractor. As a result, even if reliance on qualified intermediaries manages to boost U.S. tax revenues, it tarnishes the international tax regime's output legitimacy. The result is a vicious circle of declining input and output legitimacy.

C. *Neither Rules nor Standards*

The simplest conclusion that can be drawn from the UBS episode is that replacing standards with rules is no silver bullet for the international tax regime's input and output legitimacy deficit. Even without scandalous headlines, the qualified intermediary mechanism combines greater precision with less legitimacy. Ultimately, neither rules nor standards address the root problem: the benefits principle invites the United States to prioritize its own collection efforts over cooperative enforcement.[183] Pursuant to that principle, the U.S. share of tax revenues is merely a function of its contribution to global economic growth, not its contribution to global tax cooperation.

1. Into the Legitimacy Trap

The benefits principle does not encourage states to cooperate by investing in extraterritorial enforcement assistance.[184] Instead, states treat the lost input legitimacy that comes with the embrace of unilateral enforcement efforts as a cost of boosting output legitimacy. Unfortunately, the dearly bought output legitimacy often turns out to be illusory.[185] Formulary apportionment illustrates the way in which the benefits principle creates those legitimacy traps. Simply put, it forces states to choose between input and output legitimacy, ultimately leaving them with neither.

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182 *See* Statement of Facts, *supra* note 178, at 4.

183 The qualified intermediary strategy does precisely this. It maximizes compliance with U.S. tax rules by sacrificing U.S. capacity to provide extraterritorial tax information to its information exchange partners. *See* McIntyre, *supra* note 164, at 258–59. Faced with budget shortfalls and forced to choose between its domestic spending priorities and a desire to be a good citizen by embracing the spirit (as well as the letter) of its information exchange commitments, how could it do otherwise?

184 *See infra* note 206 and accompanying text.

185 *See infra* note 201 and accompanying text.

Implicitly acknowledging states' reluctance to invest in extraterritorial enforcement assistance, the Avi-Yonah and Clausing formulary apportionment proposal emphasizes the virtues of its relatively parsimonious consumption of information.[186] Particularly under the single factor variant they identify as most desirable—sales serving as that single factor[187]—formulary apportionment consumes a remarkably small amount of extraterritorial tax information.[188] That feature would make it relatively straightforward for a committed state to comply with—and for other states to assist and monitor compliance with—such a rule.[189]

To appreciate the risks and benefits of this approach, it is helpful to compare it to an earlier Avi-Yonah proposal.[190] Like the 2007 proposal, its predecessor offers greater precision as compared to the prevailing arm's length standard.[191] Nevertheless, the 1994 rule is quite different from its 2007 counterpart.[192] Where possible, it calls for profits to be allocated in accordance with arm's length prices, determined by reference to transactions between wholly unrelated par-

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186 *See supra* note 78. Given the difficulty the United States and other developed countries have had acquiring tax information from abroad, efficient use of information is important. *See* Dean, *supra* note 59, at 663–64 (suggesting that reducing U.S. dependence on extraterritorial tax information might provide an alternative solution to the U.S. extraterritorial tax information deficit).

187 *See* Avi-Yonah & Clausing, *supra* note 15, at 12 ("Sales would be determined on a destination basis: that is, they would be based on the location of the customer rather than the location of production.").

188 *See supra* note 78.

189 As long as it is possible to determine the location of each multinational's sales, allocating global tax revenues becomes child's play. Of course, its simplicity could provide wayward states with a roadmap to manipulating the system's results.

190 In 1994, Avi-Yonah published a proposal for the simplification of the international tax system that suggested replacing the corporate arm's length regime with a formulary approach. *See* Avi-Yonah, *supra* note 6, at 1347–48.

191 Since "[r]ules may be simple or complex," both the 1994 and 2007 proposals may fairly be described as rules. Sunstein, *supra* note 12, at 962.

> A law could say, for example, that no one under eighteen may drive. It could be somewhat more complex, saying that people under eighteen may not drive unless they pass certain special tests. Or it could be quite complex, creating a formula for deciding who may drive. It might look, for example, to age, performance on a written examination, and performance on a driving test.

Id. (emphasis omitted).

192 Avi-Yonah is careful to describe his 1994 formulary apportionment proposal as a close analogue of the existing arm's length standard. *See* Avi-Yonah, *supra* note 6, at 1346–49. Formulary apportionment could be said to elevate a particular expression of the arm's length standard to become a substitute for that standard. *See id.*

ties.[193] Next, it allocates a portion of global tax revenues in accordance with the unique economic functions performed by each subdivision of the multinational[194] and then divides the balance among jurisdictions according to a multi-factor formula.[195]

The 1994 proposal adheres more closely to the contours of the benefits principle.[196] For example, the 1994 rule allocates revenues in accordance with the unique economic rents attributable to each jurisdiction.[197] That feature makes it a far better embodiment of the benefits principle[198] than any formula based entirely on surrogate measures of a state's economic contribution such as sales.[199]

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193 *See id.* at 1341 (concluding that "it has become increasingly clear that in a large number of cases involving MNEs, it is not possible to find even the roughly comparable transactions required to apply" those techniques).

194 *See id.* at 1347–48 ("[A] functional analysis of the portions of the MNE in each jurisdiction should be made, and returns should be allocated to each function . . . . The functional analysis should include the allocation of rents to the jurisdiction furnishing the basis for such rents (e.g., natural resources or a cheap labor pool).").

195 *See id.* at 1348 ("[T]he most likely solution in the case of manufacturing MNEs would appear to be a division of the residual among all of the jurisdictions in which the MNE operates . . . based equally on the MNE's tangible assets and sales . . . .").

196 Unfortunately, that adherence—and the input legitimacy it generates—comes at a price. Quite simply, it asks more of participating states. While locating economic rents within particular jurisdictions would obviously provide a more accurate assessment of economic allegiance than merely identifying the location of customers, it would also be more difficult. Advances in technology make the process called for by the 1994 proposal—allocating economic rents and so on—increasingly difficult. *See* Jack M. Mintz, *National Tax Policy and Global Competition*, 26 BROOK. J. INT'L L. 1285, 1289 (2001) ("[E]conomic rents increasingly are related to services and technological innovation that is not tied to a location.").

197 *See supra* note 194.

198 *See* Barker, *supra* note 153, at 377 (concluding that allocating jurisdiction to tax in accordance with locational economic rents is "consistent with the just allocation of the income tax base among nations. The origin of the income is the country that produced the value that gave rise to the income").

199 It is not difficult to link a factor such as sales to the economic benefit concept. Sales simply becomes a proxy for the jurisdiction's contribution to global economic activity and for the governmental efforts underlying them. *See* Avi-Yonah & Clausing, *supra* note 15, at 13 ("Under an FA system . . . the share that is taxed by the national jurisdiction depends on the fraction of a firm's economic activity that occurs in a particular country. In the case of a sales-based definition, the measure of economic activity . . . focuses on the demand side of market value."). Nevertheless, relative sales can be determined by a host of factors unrelated to a jurisdiction's contributions to productive economic activity. For example, a state that spends beyond its means by running a current-account deficit (as the United States has for the past forty years) would a collect disproportionate share of global tax revenues in a manner wholly incompatible with the benefits principle. *See* David Stockman, *Four Deformations of the Apocalypse*, N.Y. TIMES, Aug. 1, 2010, at WK9. Avi-Yonah and Clausing respond to assertions that formulary apportionment is arbitrary by noting that the current regime

Formulary apportionment's precision brings the risk of a legitimacy trap into stark relief. Particularly in its purest form, formulary apportionment would adhere only loosely to the benefits principle, producing a dearth of input legitimacy. Output legitimacy might increase along with precision, but, as the UBS scandal illustrates, it might just as easily fall.[200] Trading input legitimacy for the mere hope of output legitimacy is no way to break free of a legitimacy trap.

2. Precision Without Legitimacy

Formulary apportionment remains, as yet, just a proposal. By contrast, over the past decade, enhanced information exchange has become a prominent feature of the international tax regime. Unsurprisingly, enhanced information exchange has failed to provide the legitimacy the international tax regime increasingly lacks.

The recent spate of information exchange agreements appears to represent an improvement over the existing information exchange infrastructure, but on closer scrutiny that superiority dissipates.[201] Compared with the information exchange provision included in a typical double tax treaty, information exchange agreements articulate the rights and obligations of each party with greater precision.[202] Unfortunately, that increased precision generates neither input nor output legitimacy.[203]

The OECD model information exchange agreement specifies that one party may request "information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees" from its counterparty.[204]

is equally arbitrary. *See* Avi-Yonah & Clausing, *supra* note 15, at 19. They concede, however, that the arbitrariness of the current regime is a flaw of execution rather than design. *See id.*

200 The precision offered by rules may merely provide private actors with the tools to exploit the regime. To the extent that they know precisely which questions authorities will ask, they can more easily mold their behavior to produce favorable results.

201 The apparent superiority is partly a function of the tendency to distinguish among international rules as hard or soft law and to view hard law as superior to soft law. *See* Christians, *supra* note 30, at 332.

202 Underscoring the confusion that exists regarding rules and standards in the international tax regime, the OECD refers to the enhanced precision produced by the new wave of information agreements as "standards on transparency and exchange of information." OECD, *supra* note 16, ¶ 11.

203 The OECD has made an effort to enhance the input legitimacy of its information exchange initiative that is attributable to its narrow membership by working with nonmembers. Its model information exchange agreement was produced in conjunction with eleven nonmember states. *See* OECD, *supra* note 75, ¶ 2.

204 *Id.* at art. 5(4)(a).

From the point of view of a tax administrator seeking extraterritorial tax information, the specificity of that language has an understandable appeal.[205] It provides a clear contrast with the vague double tax treaty alternative.[206] Rather than a standard that leaves open the question of exactly what information each party may request from the other, it specifically identifies the information held by banks and other financial institutions that falls within its scope.

Of course, the apparent advantages of the rule over the standard mean little without the output or input legitimacy needed to give it life. Indeed, enhanced information exchange has elicited the same insincerity from tax havens that the United States exhibited with the qualified intermediary mechanism.[207] The problem again lies not in the rule itself, but in the relationship between the rule and the benefits principle.

The benefits principle ensures that states' commitment to satisfying their information exchange obligations will not affect the rewards allocated to them.[208] As a result neither those states at the center of the international tax regime (here, the United States) nor those on

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205 Even the fortified language of the new information exchange agreements does not rival that of the information exchange mechanisms initially advanced by the League of Nations. *See* Dean, *supra* note 59, at 637–49.

206 *See supra* text accompanying note 68.

207 Assuming that tax havens do not have a genuine desire to shed their tax haven status, there are two ways to explain the willingness of tax havens to embrace information exchange agreements. The first is that they have done so strategically in order to gain a veneer of respectability. *See supra* notes 163–164. Alternatively, information exchange agreements may be little more than cross-border contracts of adhesion. The power imbalance between tax havens and OECD member states may induce tax havens to agree to terms that they do not have the technical wherewithal to satisfy. *See infra* note 213. The result in each case is that relatively strong parties manage to secure the existence of a rule in spite of the existence of a determined, but overmatched, opposition. Sunstein describes a similar phenomenon in the legislative context, in which a pronounced power imbalance makes the creation of a rule more rather than less likely. *See* Sunstein, *supra* note 12, at 1013 ("It follows that we are likely to find rules when one group of interests is well-organized or otherwise powerful and when its adversaries are not.").

208 The benefits principle does not link a state's entitlement to a portion of global tax revenues to its extrajurisdictional enforcement expenditures. Accordingly, the model information exchange agreement makes no connection between the duties it imposes and a state's share of global tax revenues. The model agreement does provide for the possibility of the reimbursement of incidental costs, but it does nothing close to elevating a state's enforcement efforts to the same status as its contribution to generating economic income. *See* OECD, *supra* note 75, at art. 9.

the periphery (tax havens) feel much of a push to live up to their information exchange obligations.[209]

The resulting insincerity—and the inevitable contrast between the information each state is nominally entitled to receive and will actually consume—reduces output legitimacy. Similarly, the extent to which information acquisition has become a unilateral, rather than reciprocal, exercise gives the lie to enhanced information exchange's claim of derivative input legitimacy.[210] The benefits principle presupposes that the U.S. right to collect and consume extraterritorial tax information is universal, a corollary of each state's right to collect the taxes that flow from the benefits it provides. By highlighting the extent to which information exchange is a one way street, enhanced information exchange merely underscores the distance between the benefits principle and today's extraterritorial tax information acquisition infrastructure.

IV. Overhauling the Basic Rule

Neither rules nor standards can free the international tax regime from the legitimacy trap created by the benefits principle. Without first transforming the benefits principle, rules such as formulary apportionment and enhanced information exchange will not find sustained success. Whatever degree of precision best suits particular features of the international tax regime, its success hinges on legitimacy. Without a modern international tax principle, that legitimacy will remain elusive, no matter how creative the architects of international tax policy prove to be.

A. *Benefits and Burdens*

The benefits principle does not clearly articulate the obligations that states owe one another.[211] Instead, the benefits principle focuses on each state's entitlements, only implicitly recognizing a state's obli-

209 *See* McIntyre, *supra* note 164, at 255–56 (concluding that both the U.S. and tax havens affirmatively choose to flout their information exchange obligations).

210 The profound differences between the tax systems employed by states that seek extraterritorial tax information from tax havens and those employed by the havens themselves reinforce the input legitimacy problem illustrated by the qualified intermediary mechanism. Simply put, even if the United States had access to the information now kept at bay by qualified intermediaries, havens often have no use for it. A state with no comprehensive income tax will have no use for much of the information generated by enhanced information exchange. *See* Marshall J. Langer, *The Case for Limited Revenue-Sharing Tax Arrangements*, 40 Tax Notes Int'l 641, 648–49 (2005).

211 Specifically, the benefits principle tells states what share of global tax revenues they may collect. It does not tell states what they should and should not do to help

gations as a corollary of its rights. One consequence is that the benefits principle provides no direct incentive for states—the United States being no exception—to operationalize the ideals embodied in a commitment to information exchange.[212]

The benefits and burdens principle offers an alternative to the benefits principle that explicitly recognizes states' obligation to support extrajurisdictional enforcement. By doing so, it aligns the interests of states as producers and consumers of extrajurisdictional enforcement assistance. It balances the traditional emphasis on the allocation of the global tax base with the modern challenge of collecting tax, providing an escape from the legitimacy traps that plague today's international tax regime. In the simplest terms, it would reward states not only for their role in supporting productive economic activity but also for their efforts to combat failures such as corporate income shifting and individual tax evasion.[213]

The benefits and burdens principle would supplement the extant allocative norm by introducing a compliance element. Now, treaties and domestic law allocate taxing jurisdiction solely according to the taxpayer's residence and the source of the investment.[214] Assigning revenue partly to reflect a state's enforcement contribution would promote both input and output legitimacy, providing a possible escape from a legitimacy trap.

In addition to alleviating the pressure to sacrifice input legitimacy, the benefits and burdens principle would affirmatively encourage states to embrace extrajurisdictional enforcement obligations. For example, information exchange agreements presume that tax havens—often the sort of small, developing countries least likely to have the necessary administrative capacity[215]—will devote scarce

them enforce their taxes (or to help other states enforce their own taxes). *See* Dean, *supra* note 164, at 161–62.

212 *See supra* note 209 and accompanying text.

213 It is at least theoretically possible to balance enforcement needs alongside the traditional emphasis on allocation. *See* Dean, *supra* note 59, at 605 (suggesting that a more complete market for extraterritorial tax information might encourage states to augment their enforcement capacity); Dean, *supra* note 164, at 127 (concluding that encouraging states to play complementary roles would permit states to capitalize on relative strengths, including enforcement).

214 *See supra* note 8.

215 It is viewed as "unlikely that a developing country can actually administer a broad-based, 'global' individual income tax . . . ." James Alm & Sally Wallace, *Can Developing Countries Impose an Individual Income Tax? in* THE CHALLENGES OF TAX REFORM IN A GLOBAL ECONOMY 221, 221 (James Alm et al. eds., 2006). The OECD recently highlighted the same point. *See* ORG. FOR ECON. CO-OPERATION & DEV. (OECD), DOMESTIC RESOURCE MOBILISATION FOR DEVELOPMENT 1 (2010), *available at*

resources to extrajursidictional enforcement.[216] Reallocating revenues to reflect a state's extrajurisdictional enforcement efforts would give those states an opportunity to earn a share of global revenues by taking extrajurisdictional enforcement seriously.[217]

As described below, the benefits and burdens approach can be operationalized on a transactional basis or at an aggregate level. The next subpart offers illustrations of both types of arrangement. Each would force states to bear part of the burden of transnational tax enforcement, either by affirmatively embracing that burden or by sacrificing revenues it might otherwise collect.

B. Implementing the Benefits and Burdens Principle

Insisting that states shoulder the burden of extrajurisdictional tax enforcement would require an unambiguous change in the behavior of states of all kinds. Tax havens could not feign commitment to curbing tax evasion without putting their fiscal stability in jeopardy.[218] No less important, the damage done by the systematic pruning of U.S. extraterritorial tax information acquisition capacity would be more likely to decrease, rather than increase, U.S. tax revenues.

Weaving a rule or a standard out of that balanced principle would serve both as a guide and a goad for states. Such a mechanism would divide global tax revenues according to multiple factors. For example, it might look not only to the proportion of the world's sales that occur in a particular jurisdiction but also to a measure of the enforcement assistance it provides to other states.

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http://www.oecd.org/dataoecd/23/62/44465017.pdf (noting that developing countries "often lack the resources and capacity to build effective tax administration"); OECD, *supra* note 16, ¶ 22 (describing efforts to promote conclusion of exchange of information arrangements with small states).

216 *See* Richard M. Bird & Eric M. Zolt, *Technology and Taxation in Developing Countries: From Hand to Mouse*, 61 NAT'L TAX J. 791, 791–93 (2008) (describing challenges developing countries face in administering modern tax regimes under severe resource constraints). Ensuring that resources flow to states in proportion to their willingness to shoulder that burden would align the interests of tax havens with those of other states and bolster the integrity of the global tax base. *See* 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, 958–59 (2007) (proposing paying tax havens a percentage of additional revenues generated by their cooperation).

217 *See infra* note 224 and accompanying text.

218 *See supra* note 164 and accompanying text.

1. The Transactional Approach

Under the benefits and burdens principle, if one state were to adopt policies that made it more difficult for other states to enforce their taxes, that action would be reflected in their share of global revenues. As a result, such behavior would not only have an adverse effect on the integrity of the international tax regime but would also hurt the wayward state's own bottom line. Conversely, remedying such a failure would not merely bolster enforcement in an abstract sense, but would also enhance that state's fiscal well-being.

A transactional approach to implementing the benefits and burdens principle might require only incremental changes to benefits principle-based approaches. For example, take Avi-Yonah's multi-lateral withholding tax.[219] His proposal envisioned that OECD states would participate to gain access to information about their residents. Under a pure benefits regime, the administrative burden of imposing a fully refundable withholding tax on payments to foreign investors would not be a means of directly generating revenue.[220] Instead it would represent an indirect cost of collecting taxes tied to its contribution to the global economy.

A transactional implementation of the benefits and burdens principle might provide only a partial refund of the tax withheld by the host jurisdiction.[221] Avi-Yonah suggests a more modest refinement, permitting host jurisdictions to retain "a small percentage of the tax as a fee for its collection assistance."[222] By going further, providing them with a share of revenues that reflects a return on—rather than a reimbursement of—their enforcement contribution, host jurisdictions

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219 *See* Avi-Yonah, *supra* note 5, at 1669–70 (proposing a fully refundable withholding tax to encourage taxpayers to report offshore income to their residence jurisdictions).

220 By bartering information with other states, the host jurisdiction would be better able to tax its own residents, but would not tax the foreign investors. *See id.*

221 The European Union Savings Directive that inspired Avi-Yonah's proposals ultimately did something quite similar. It provided that certain jurisdictions could, for a limited time, collect a withholding tax, transferring "the greater part of their revenue of this withholding tax" to the residence jurisdiction. *See* Council Directive 2003/48, arts. 17–19, 2003 O.J. (L 157) 38 (EC) arts. 17–19.

222 Avi-Yonah, *supra* note 5, at 1669 n.457. The precedent he cites for such an arrangement provides for a fee of twenty-five percent of the amount collected, but it is not clear whether this represents the "small percentage" his proposal indicates. Similar proposals have suggested different splits. Even those proposals that create incentives for cooperation tend to adhere to the benefits principle. *See, e.g.*, Langer, *supra* note 210, at 648 (envisioning tax havens agreeing to provide extrajurisdictional enforcement assistance of fifty percent of taxes withheld on payments to tax haven residents).

would acquire a direct stake in the success of another jurisdiction's tax. Revenue generated by each transaction would be allocated in part in response to the creation of the underlying income (as the benefits principle requires) and in part in response to a state's willingness to bear the burden of providing extrajurisdictional enforcement assistance.

Such an arrangement would appropriately acknowledge the significance of the role played by the host in forcing the disclosure of information to the residence jurisdiction. The allocation of a meaningful portion of the tax to the host jurisdiction would increase output legitimacy by encouraging extrajurisdictional enforcement assistance. In a benefits-only world that bifurcation would undoubtedly decrease input legitimacy. The benefits principle requires revenues to be allocated exclusively to the jurisdictions that help to produce economic income, but a benefits and burdens approach would not. In benefits principle terms, the payment to the jurisdiction providing enforcement assistance would be an illicit windfall.[223]

2. The Aggregate Approach

Rather than focusing on efforts to collect tax on particular transactions or from particular taxpayers, an aggregate approach would adopt a broader perspective. It might, for instance, rely on a mutually agreed-upon benchmark such as the quantity and quality of information made available to other jurisdictions to trigger allocations of revenue.[224] For instance, tax havens providing information on par with the reports U.S. authorities receive from domestic sources might receive a percentage of the seventy billion of U.S. revenues estimated to be lost to offshore tax evasion each year.[225]

One could imagine an international tax regime that allocates tax revenues along two dimensions. In addition to a traditional benefits allocation, it could also employ a second element. Allocations according to that second, burdens-oriented metric would encourage states to devote the resources needed to address the vulnerabilities that plague

223 Even when such "side-payments" are possible and result in an efficient exchange of assistance for cash, they remain beyond conventional benefits principle boundaries on state behavior, uncomfortably like paying a bribe or blackmail. *See* Rosenzweig, *supra* note 13, at 584 ("[S]tates can share information and as a result make side-payments or other bargains to mitigate the potential sucker payoff described in the bilateral one-time prisoner's dilemma situation.").

224 *See* Dean, *supra* note 216, at 963–64 (describing operation of tax flight treaties that call for states to pay a percentage of the revenues preserved through the cooperation of former tax havens to those former havens).

225 *See supra* note 55.

today's international tax regime. For example, the extant transfer pricing regime does a poor job of evaluating the risk borne by related parties. Without understanding those risks it is impossible to accurately estimate the relative return that each party should earn from a particular transaction.[226] Providing states with an incentive to develop techniques to measure that risk and, no less important, to implement those techniques would produce a system that is more legitimate than today's transfer pricing mechanisms.

A stylized numerical example can illustrate the operation of an aggregate approach. Such a system might compare the resources states devote to promoting extrajurisdictional enforcement—measured as the amounts each state spends to assist other states in enforcing their taxes—and divide a predetermined share of collective revenues accordingly.[227] For example, assume there are two states: Big and Small. They agree to pool ten percent of their revenues, with each state receiving a share of that pool proportionate to their relative expenditures on extrajurisdictional enforcement.

	Big	**Small**
Post-cooperation Revenues	$100	$20
Pooling Contribution	$10	$2
Extrajurisdictional Enforcement Expenses	$2	$1
Share of Pooled Revenues	$8	$4
Revenues after Pooling	$98	$22

Big collects taxes of one hundred, contributing ten, while Small collects twenty, contributing two. Big spends two to help Small

226 I am grateful to Erika Nijenhuis for this insight.

227 Allocating a percentage of transactional revenues to cooperating jurisdictions might be viewed as a modest step beyond the types of cost-reimbursement provisions that could be viewed as consistent with the benefits principle. Even the OECD model tax information provides for the possibility of cost-reimbursement. *See* OECD, *supra* note 75, at art. 9 (providing that states should specify the "[i]ncidence of costs incurred in providing assistance"). For one jurisdiction to effectively pay another a percentage of its general revenues would be another matter. Even if it would produce an increase in compliance large enough to ensure that all jurisdictions received increased revenues, it would clearly conflict with the benefits principle and would today be illegitimate.

enforce its taxes while Small spends one to help Big.[228] As a result, Big will pay in ten and collect eight (a net contribution of two). By contrast, Small will pay in two and collect four (a net receipt of two).

C. *Push and Pull*

Whether it follows the aggregate or the transactional path, it would be hard not to conclude that the distance from the benefits principle to the benefits and burdens principle is even greater than that from standards to rules.[229] Persuading policymakers—and those with influence over them—to retire a principle with a pedigree as distinguished as the benefits principle would be a daunting task. Nevertheless, if a better principle could make meaningful inroads against the enforcement failures that threaten to swamp tax authorities, the potential gains could be correspondingly large. An international tax regime capable once again of generating the push and pull of input and output legitimacy could help to turn the tide in their—and, by extension, our—favor.

Conclusion

The international tax regime has begun to reject standards in favor of rules. That trend is understandable, but misguided. No rule or standard can overcome the deeper weakness that threatens the long-term viability of the international tax regime. To solve today's international tax problems as well as the benefits principle tamed those faced by the international tax regime a century ago, that principle needs an overhaul. Unless the international tax regime's focus on enforcement is reflected in the principle from which it draws strength, the international tax regime will remain mired in a legitimacy trap. A

228 Small's costs will not be one-fifth the size of Big's since it must match much of the administrative infrastructure that Big puts in place.

229 Any such arrangement would represent a radical departure from existing practice. In the above illustration, each state contributes ten percent of its overall tax revenues and receives a percentage of the total determined according to its relative extrajurisdictional enforcement expenditures. That percentage could fall over time so that after, for example, thirty years, the contribution might represent one percent of overall revenues. These numbers are purely hypothetical, but the costs of cooperation presumably will fall over time. The decline would also encourage the most marginal states—those with the least motivation and/or resources—to participate immediately. Since those extrajurisdictional enforcement expenditures are not merely a function of a state's revenues, states will inevitably receive more or less than they contribute. States that are small, poor, or both would tend to benefit under such an arrangement. On the other hand, jurisdictions that express only an insincere commitment to cooperate will collect a correspondingly smaller share.

new principle—the benefits and burdens principle—could support rules and standards that promote enforcement without sacrificing legitimacy.