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AND PUBLIC FINANCE

“HOW TO TAX GLOBAL CAPITAL”

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Week #2
SPRING 2017 SCHEDULE  
COLLOQUIUM NYU TAX POLICY  
(All sessions meet from 4:10-6:00 pm in Vanderbilt 208, NYU Law School)


5. Tuesday, February 21 – Jason Oh, UCLA Law School. ”Are the Rich Responsible for Progressive Marginal Rates?”


How to Tax Global Capital

Mark P. Gergen

I beg more the usual indulgences for a draft paper. This is roughly one-third of the paper I hoped to have written at this time. Materials in italics give you an idea of what I intend to say on some issues that I have not had time to address. And many of the points made in this draft need to be filled out. But what you have here sketches the core features of how the securities tax can be integrated into the existing international tax system. Part IV of the paper will cover cross-border direct investment.

I. Introduction

In an earlier paper I proposed a new approach to taxing capital owned by U.S. households and nonprofits. The heart of the new approach is a flat annual tax on the market value of publicly traded securities with a rate of around .8 percent (80 basis points) that is remitted by the issuer. A security issuer gets a credit for publicly traded securities it holds so that wealth that is represented by a string of publicly traded securities is taxed once. For example, a mutual fund remits the tax based on the market or redemption value of interests in the fund and gets a credit based on the market value of publicly traded securities it holds.

Income producing capital that is not subject to the securities tax, such as an interest in a closely held business or in a private equity fund, is covered by a complementary tax with the same rate as the securities tax. The complementary tax is paid on the estimated value of an asset. Asset value is estimated assuming all investments yield a normal return. An entity like a private equity fund is required to remit the tax on the estimated value of all interests in the entity that are held by any persons subject to the complementary tax, which include individuals, family trusts, nonprofits, and defined benefit pension funds. Importantly, an entity is required to revalue all interests of a type if any interest of a type is redeemed or sold in an arm’s-length exchange. The revaluation rule brings the expected tax burden of the securities tax and the complementary tax into line for assets like interests in hedge funds that are fairly liquid and so are likely to be revalued periodically. I estimate the securities tax will cover around 80 percent of the
income-producing wealth of U.S. households and nonprofits. The complementary tax will cover the rest.

The securities tax and the complementary tax are intended to replace the entire existing patchwork system for taxing capital income. This includes the corporate income tax; the individual income tax on all income from securities, including interest, dividends, and capital gains; and the individual income tax on all other investment or business income, including income from partnerships and sole proprietorships and income from real estate. The taxes are designed to work alongside a tax on labor income. Ideally this would be in the form of a cash-flow consumption tax or a value added tax, because these forms of a labor income tax largely eliminate the need to distinguish labor income and capital income, unlike a wage tax.

This paper addresses the treatment of cross-border investment under the two taxes in the existing international tax regime. Any tax on capital will distort savings choices and labor-leisure choices by making deferred consumption more expensive than current consumption. The goal in designing a tax on capital is to minimize other distortions. These include distortions in how capital is used, in the financial structure of business enterprises that use capital, in how capital is intermediated, and in the portfolio choices of wealth holders. The existing U.S. system for taxing capital income performs miserably in many of these respects. The securities tax and the complementary tax eliminate many of the distortionary features of the existing U.S. system for taxing capital income, including the realization requirement, the distinction between debt and equity, and the double-taxation of corporate income.

In the domestic context the principal distortion created by the two taxes is in the choice between liquid and illiquid assets held by persons who are subject to the complementary tax (e.g., individuals, nonprofits, and defined benefit pension plans) and in the management of illiquid investments. These distortions are a product of the under-valuation of illiquid assets under the complementary tax when an illiquid asset has a better than normal return. The timing option and the availability of value-erasing strategies create a small distortion in favor of illiquid assets over liquid assets. And there is a significant lock-in effect with respect to under-valued illiquid assets. An owner of an under-valued illiquid asset has a tax incentive to hang on to the asset. This is similar to the lock-in effect created by the realization requirement under existing tax law. I argue in the earlier paper that these distortions should create a relatively small deadweight loss given the nature of the tax, which is assessed at a low rate (essentially 80 basis points) on the estimated value of an asset.

The international dimension adds several new sources of potential distortion. Perhaps the most important new source of distortion involves the costs private parties will incur to comply with the rules on cross border investments. These compliance costs are a hidden tax on cross-border investment. Economies of scale in compliance create advantage for large financial intermediaries. In addition, the interaction of a U.S. tax on capital with a foreign tax on capital income inevitably will result in some types of cross-border investment bearing either a higher or a lower tax burden than would a comparable domestic investment. The taxes I propose will not achieve the ideals of capital export
neutrality, capital import neutrality, or capital ownership neutrality. This is not a reason to reject the proposals. As Michael Graetz and Daniel Shaviro have explained, the existing international tax regime falls well short of achieving these ideals, which are at odds in any event. The relevant questions are how the proposed taxes compare to the status quo, and to alternative tax regimes, as a matter of U.S. national and global welfare, both in the short run and in the long run, taking into account how other nations are likely to alter their tax systems in response to these taxes. I believe that the proposed taxes fare quite well in these respects. Certainly they are an improvement over the status quo, though this is a very low bar.

The existing system of international tax is based on a consensus “that active business income should be taxed in the country in which it originates (the source country) and passive income should be taxed in the country in which the recipient of the income resides (the residence country).” The distinction between active business income and passive income roughly corresponds with the distinction between foreign direct investment (which generates active income) and foreign portfolio investment (which generates passive income). An investment by a business entity in foreign real assets and operations is described as a direct investment. On the other hand, when an individual or a mutual fund acquires a relatively small interest in the equity or debt of a foreign business entity this is described as a portfolio investment. A tax on direct investment could also be described as a tax on a business enterprise that uses capital while a tax on portfolio investment could be described as a tax on the owner of capital. Ultimately all capital is owned by an individual, a nonprofit, or a government. Again the goal of the securities tax and the complementary tax is to tax capital used in business enterprises once at some point in the chain between the real and intangible assets used by a business enterprise to produce income and the household or nonprofit that stands at the end of the

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1 These ideals focus on the problem of taxing cross-border investment by business entities in real assets and operations to produce, distribute, and market commodities, goods, and services. Under the ideal of capital export neutrality a firm should face the same tax burden when it is comparing investment opportunities in its home nation and investment opportunities abroad. Under the ideal of capital import neutrality all inbound investments into a nation should bear the same tax burden. The concept of capital ownership neutrality comes from Mihir A. Desai and James R. Hines, Evaluating International Tax Reform, 56 National Tax J. 487 (2003). Under the ideal of capital ownership neutrality the international tax regime should not distort the ownership of capital assets.


5 Typically when a corporation in one nation holds real assets and conducts business operations in another nation it does so by establishing a corporate subsidiary. Thus the technical definition of direct investment is holding sufficient voting stock (or its equivalent) in a foreign business entity to be able to exercise substantial influence over the entity’s business decisions. In the US this is defined as at least 10% of the voting stock. See Graetz & Grinberg, 56 Tax L. Rev. at 538-539.
chain of financial assets that represent claims on the assets and income of a business enterprise. The securities tax collects the tax at this first point in the chain where capital is represented by a publicly traded security. The complementary tax collects the tax near the owner’s of chain from an entity in which an individual or nonprofit holds an interest that is not a publicly traded security.

The securities tax and the complementary tax do not tax the income of a business enterprise. Instead they tax the value of an interest in a business enterprise. While this is a major change from the status quo the securities tax and the complementary tax are easily adapted to taxing cross-border portfolio investment, which typically involves a U.S. person holding a foreign security or other financial asset or a foreign person holding a U.S. security or other financial asset. The securities tax will tax the wealth of U.S. households and nonprofits that is invested abroad through U.S. mutual funds and other large U.S. financial intermediaries holding financial claims against foreign enterprises, individuals, or nations. Similarly the complementary tax will tax the wealth of U.S. households and nonprofits that is invested abroad through private entities such as U.S. hedge funds. Thus the securities tax and the complementary tax will cover the great majority of outbound portfolio investment without any special rules to deal with outbound portfolio investment.

Much of the remaining outbound portfolio investment consists of direct holdings by U.S. households and nonprofits of foreign securities. These holdings can be taxed by requiring financial intermediaries such as broker-dealers to remit the tax when an intermediary holds a foreign security on behalf of a U.S. individual, nonprofit, trust, or privately owned entity. Direct holdings of other foreign financial assets such as bank accounts or an interest in a foreign hedge fund can be dealt by requiring the foreign entity to remit the tax on the balance in an account or the estimated value of an interest in private equity fund. Unfortunately these mechanisms involve significant private compliance costs. I propose to deal with inbound portfolio investment in U.S. publicly traded securities by rebating all or a significant portion of the tax to a foreign holder of a U.S. security. This also involves significant private compliance costs because of the need for a mechanism to protect against U.S. wealth holders avoiding the tax by “round tripping” investments in U.S. assets through offshore intermediaries. In addition it may be in the interest of foreign nations for the U.S. to convert the rebate mechanism into a withholding mechanism to assist foreign nations in taxing the wealth of their residents that is represented by U.S. securities. This significantly increases private compliance costs.

I do not address cross border direct investment in this draft. I will briefly sketch how I propose to handle it. Outbound direct investment by a U.S. business entity raises the concern for double taxation. Capital invested abroad by a U.S. business entity will be subject to a foreign income tax on foreign earnings and to the U.S. tax on capital. A tax on capital is similar to a tax on imputed income so capital invested abroad is taxed twice. This potentially distorts investment by U.S. business entities to investment opportunities in the U.S. because investment in foreign opportunities entails the additional cost of a foreign income tax. It is possible to design a tax credit mechanism to
deal with this potential distortion that would work about as well as the existing credit mechanism (i.e., quite poorly).

Inbound direct investment by a foreign business entity in the U.S. raises the opposite concern. If an entity’s home nation does not tax an entity’s foreign source income, then a entity will bear a tax lower burden on capital invested in U.S. business opportunities because the U.S. does not tax business income. Consistent with the consensus view “that active business income should be taxed in the country in which it originates” the U.S. could tax inbound direct investment by subjecting it to the complementary tax, reducing this potential source of distortion. But this involves some complexity and invites foreign business entities that invest in the U.S. to structure their U.S. activities to minimize the apparent value of their interests.

I plan to propose a simpler solution to both of these problems: do nothing. Do not give a credit against the securities tax and the complementary tax for foreign taxes paid on outbound direct investment. And do not subject inbound direct investment to the complementary tax. Simplicity and the ability of a multinational enterprise (“MNE”) to structure its global operations to reduce source-based taxes justify a do-nothing solution. If an MNE can structure its global operations to reduce source-based taxes without altering fundamental business decisions, then the absence of a source-based tax on business enterprise income in the U.S. is not much of a reason for an MNE to divert investment to the U.S. Moreover, a foreign nation that is concerned that the U.S. has an advantage in attracting capital investment can eliminate this advantage by following the U.S. in replacing taxes on capital income with a tax on capital.

II. The landscape of U.S. cross-border investment

This Section provides a birds-eye view of the landscape of U.S. investment abroad and foreign investment in the U.S. The figures in Table 2.1 give a general sense of the scale and character of U.S. cross-border investment at the end of 2015. All figures are in billions. As a point of comparison, at the end of 2015 U.S. households were estimated to hold assets worth $101,696.8 billion and to have a net worth of $87,118 billion.

<table>
<thead>
<tr>
<th></th>
<th>Outbound</th>
<th>Inbound</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>$28,945</td>
<td>$28,283</td>
</tr>
<tr>
<td>Equity</td>
<td>$6,978</td>
<td>$6,544</td>
</tr>
<tr>
<td>Debt instruments</td>
<td>$5,811</td>
<td>$4,979</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>$1,167</td>
<td>$1,565</td>
</tr>
<tr>
<td></td>
<td>$9,606</td>
<td>$16,677</td>
</tr>
</tbody>
</table>

6 The data is from the Bureau of Economic Analysis report of the Net International Investment Position and are from the fourth quarter of 2015. The figures exclude financial derivatives. A significant part of foreign holdings of U.S. debt securities are in U.S. Treasury bills and certificates. Of $9,503 billion of foreign holdings in long-term U.S. debt securities $5,423 billion was in U.S. Treasury bills and certificates. The comparable figure for short term securities

Cross-border portfolio investment significantly exceeds cross-border direct investment. In 2015, 45.9% of foreign investment by U.S. persons was portfolio investment while 33.3% was direct investment. As for inbound investment, 59% of was portfolio investment while 23.1% was direct investment. The balance of cross-border investment (around 20% for both inbound and outbound) is currency, deposits, and loans. The dominance of portfolio investment over direct investment continues a trend observed by Michael Graetz and Itai Grinberg in 2003.8 Most cross-border portfolio investment is through financial intermediaries. Thus almost half of foreign portfolio investment by U.S. persons in 2015 was through mutual funds while 13 percent was through pension funds.9 Almost all of the wealth represented by claims against U.S. mutual funds and pension funds ultimately belongs to U.S. households and U.S. nonprofits.

The figures reported in Table 2.1 count an investment as cross border if a resident of one nation holds a financial claim against an entity organized under the laws of another nation. This can be misleading because an entity can be organized under the laws of a nation that is neither its principal base of operations nor its principle source of capital. The accounting for cross border investment involving a US MNE that undergoes a corporate inversion illustrates how this can create a misleading impression of the true scale of cross border investment. Prior to the inversion the US MNE’s investment in its foreign operations is accounted for as outbound direct investment. The inversion erases this outbound direct investment. After the inversion holdings by U.S. persons of the MNE’s debt and equity are accounted for as outbound portfolio investment while the investment by the MNE in its U.S. operations, which are conducted through a U.S. subsidiary of the newly formed foreign corporation, is accounted for as inbound direct investment. The inversion does not change who owns the capital in the MNE or the location of its real assets or operations, both of which are likely to be centered in the U.S. But the inversion makes the investment of U.S. wealth holders in the U.S. assets and operations of the MNE appear to be cross border investments.

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9 Department of Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, U.S. Portfolio Holdings of Foreign Securities as of December 31, 2015 (Oct. 2016), pp. 25-26: “As of December 2015, mutual funds were by far the largest holdings of foreign securities, at $4.4 trillion or nearly half of the total. The second largest U.S. holders of foreign assets were pension funds, with $1.3 trillion (13 percent of the total), followed by nonfinancial firms ($1.2 trillion or 12 percent). Investment funds, a group that consists mainly of hedge funds ... held $0.6 trillion, or 6 percent of total U.S. overseas securities holdings.”
The label cross-border investment can be misleading in another respect. Much foreign portfolio investment by U.S. persons is through securities that are listed and traded on U.S. exchanges and that are purchased and held through a U.S. securities intermediary, such as a U.S. broker-dealer or a U.S. bank. When a U.S. MNE undergoes a corporate inversion it is almost certain to list its new securities on a U.S. exchange. A foreign security can be listed on a U.S. exchange by placing the security in a foreign account of a U.S. bank and trust company, which will issue and list an American Depository Receipt (ADR) to be traded on a U.S. exchange. A foreign entity may also directly list a security on a U.S. exchange.

Mihir Desai puts these developments in a larger context. The legal home of an MNE used to be the same nation in which a firm’s headquarters were located and in which the firm’s core operations began and were located. MNEs replicated their operations in other nations through subsidiaries. The legal home of an MNE also was likely to be the firm’s financial home, meaning the nation in which the firm raised most of its capital and the nation in which most of the ultimate owners of this capital resided. This is ceasing to be true. An MNE may have a legal home in one nation, a managerial home in a second nation, and a financial home in a third nation.

Corporate inversions illustrate. A U.S. firm that wants to eliminate U.S. corporate income tax on its worldwide income can restructure so its U.S. operations are conducted through a U.S. subsidiary of a corporate parent with a legal home in Ireland. The firm’s managerial home may remain in the U.S. Or the managers may be moved to London. The firm’s financial home can remain in the U.S. for the firm may list the shares of the Irish parent on a U.S. stock exchange. The phenomenon is not limited to corporate inversions. Moreover a firm may list its shares in a nation that is not its legal home or its principal base of operations for non-tax reasons. Desai gives the example of Genpact, which was created by GE to outsource operations to India. When GE spun off Genpact its legal home was initially placed in Luxembourg and later moved to Bermuda while the firm’s financial home is the U.S. for its stock is listed on the NYSE. Some firms have multiple financial homes for they will list their shares on exchanges in multiple nations.

Desai explains the location of a firm’s financial home is important because “a financial home dictates who your owners are. Even though shareholder bases are becoming increasingly global, where a firm lists its shares does have a significant impact on who owns its shares.” In addition, the regulatory regime to which a security is subject, and so some of the legal rights of bondholders are stockholders, are determined by the nation in which a security is listed. Desai also observes that managers who

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10 Karolyi reports that “today about 12% (3.4%) of the average daily turnover on the NYSE (Nasdaq-Amex) is comprised of foreign listings.” G. Andrew Karolyi, Daimler-Chrysler AG, the first truly global share, 9 Journal of Corp. Finance 409, 414 (2003).
11 For an explanation of the regulation of ADRs and historical background see Guy B. Lander, American Depository Receipts, 29 International Lawyer 897 (1995).
13 Desai at 1276.
14 Desai at 1280.
15 Desai at 1279.
receive equity compensation may influence where a firm lists its shares. He gives as an example Alcon, a pharmaceutical company owned by Nestle (a Swiss firm). U.S. managers of Alcon who received equity compensation in Alcon demanded that the shares be listed on the NYSE.\footnote{16}{Desai at 1279.}

One upshot of these developments is that it not self-evident what should be treated as a U.S. security for purposes of the securities tax. It may be that the financial home of a firm is stickier than its legal home, which may be a reason to treat a firm’s financial home as its tax home. Section III-C addresses this issue. I conclude that an issuer should remit the securities tax if a security is listed on a U.S. exchange because this reduces compliance costs. When a security is listed on exchanges in multiple nations the issuer may elect whether to remit the tax.

When U.S wealth holders invest in securities listed on a foreign exchange it is likely to be through a closed-end country fund or a foreign index fund to get the benefit of diversification.\footnote{17}{Investment Company Institute. See also, Anita K. Pennathur, Natalya Delcoure, and Dwight Anderson, Diversification Benefits of iShares and Closed-End Country Funds, 25 Journal of Financial Research 541 (2002).} Most of these funds are established in the U.S. and their shares are listed and traded on U.S. exchanges. One upshot of this fact is that the securities tax will tax a large share of outbound portfolio investment as a matter of course without any special rule.

The Treasury International Capital (TIC) survey of U.S. portfolio holdings of foreign securities and foreign portfolio holdings of U.S. securities provides more granulated data on cross border portfolio investment between nations.\footnote{18}{If an entity holds 10% or more of the equity in an entity, then its holdings in the entity’s debt and equity are not accounted for as a portfolio investment.} Table 2.2 reports U.S. outbound portfolio investment in 2015 for the 20 nations with the greatest amount of such investment. The 20 nations account for 82% of total outbound portfolio investment ($9,454.8 billion). All figures are in billions.

| United Kingdom | $1,239.5 | 13.1% | Bermuda | $216.6 | 2.3% |
| Cayman Islands | $1,217.1 | 12.9% | Korea, South | $171.1 | 1.8% |
| Japan | $821.6 | 8.7% | Mexico | $147.6 | 1.6% |
| Canada | $705.3 | 7.5% | Sweden | $137.5 | 1.5% |
| Ireland | $498.3 | 5.3% | Hong Kong | $136.0 | 1.4% |
| France | $473.6 | 5.0% | India | $130.0 | 1.4% |
| Switzerland | $419.7 | 4.4% | Luxembourg | $127.6 | 1.3% |
| Netherlands | $404.1 | 4.3% | Brazil | $116.2 | 1.2% |
| Germany | $377.8 | 4.0% | Spain | $115.2 | 1.2% |

$6,756 billion of the outbound portfolio investment is in foreign equity, 85 percent of which is common stock, 9 percent is fund shares, and 6 percent is “other.”

\footnote{16}{Desai at 1279.}
\footnote{18}{If an entity holds 10% or more of the equity in an entity, then its holdings in the entity’s debt and equity are not accounted for as a portfolio investment.}
which includes limited partnership interests. Over 60 percent of the holdings in funds ($393.9 billion of $576 billion) are in funds established in the Cayman Islands. Much of this capital is in hedge funds and private equity funds, a type of funds in which the Cayman Islands specialize. A significant part of the capital invested through Cayman Island funds is owned by U.S. nonprofits, which channel hedge fund and private equity investments through offshore funds to avoid potential tax liability under the Unrelated Business Income Tax.

Table 2.3 reports U.S. inbound portfolio investment in 2015 for the 20 nations with the greatest amount of such investment. I exclude holdings in long-term Treasury securities and agency debt. The 20 nations account for 86.3% of total inbound portfolio investment, excluding government debt ($10,804.4 billion). All figures are in billions.

<table>
<thead>
<tr>
<th>Country</th>
<th>Investment (billion)</th>
<th>Percentage</th>
<th>Country</th>
<th>Investment (billion)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cayman Islands</td>
<td>$1,346.5</td>
<td>12.5%</td>
<td>Germany</td>
<td>$267.3</td>
<td>2.5%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>$1,267.4</td>
<td>11.7%</td>
<td>Norway</td>
<td>$243.2</td>
<td>2.3%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>$1,132.6</td>
<td>10.5%</td>
<td>Bermuda</td>
<td>$221.7</td>
<td>2.1%</td>
</tr>
<tr>
<td>Canada</td>
<td>$940.2</td>
<td>8.7%</td>
<td>France</td>
<td>$220.6</td>
<td>2.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>$627.1</td>
<td>5.8%</td>
<td>Australia</td>
<td>$215.9</td>
<td>2.0%</td>
</tr>
<tr>
<td>Ireland</td>
<td>$620.8</td>
<td>5.7%</td>
<td>Singapore</td>
<td>$214.8</td>
<td>2.0%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>$499.5</td>
<td>4.6%</td>
<td>Hong Kong</td>
<td>$160.7</td>
<td>1.5%</td>
</tr>
<tr>
<td>Belgium</td>
<td>$400.7</td>
<td>3.7%</td>
<td>Kuwait</td>
<td>$158.8</td>
<td>1.5%</td>
</tr>
<tr>
<td>China, mainland</td>
<td>$354.2</td>
<td>3.3%</td>
<td>British Virgin Islands</td>
<td>$154.8</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

As with the figures in 2.1, an outbound investment is considered to be in the nation in which the entity issuing a security is organized, which may not be the nation in which the capital is used or the nation in which a security is listed. Most of the outbound portfolio investment in the Cayman Islands represents capital that is ultimately used elsewhere, including capital that is used in the U.S. Inbound investment is considered to come from the nation in which the nominal holder of a security is organized, including an entity that holds a security in a custodial account on behalf of its beneficial owner. These figures do not show the nationality of the beneficial owner of a security. Thus much of the inbound portfolio investment from the Cayman Islands represents capital that

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20 Zucman at 26-27 (reporting most wealth is invested through "funds domiciled in Luxembourg, Ireland, and the Cayman Islands," with Luxembourg specializing in mutual funds, the Cayman Islands in hedge funds, and Ireland in money market funds).
21 I do not address Treasury securities in this draft. In the earlier paper I argued that a securities issuer in the U.S. should be given a credit against the securities tax for the value of Treasury securities it holds. The reasons that justify this rule might also justify the U.S. paying an amount equal to the rebate to a foreign person who holds a Treasury security.
22 Carol C. Bertaut, William L. Grievery, and Ralph W. Tryon, Understanding U.S. Cross-Border Securities Data, Federal Reserve Bulletin (2006), A60, A63, explain that the practice of collecting holder data from U.S. resident entities "tends to create a 'custodial bias' in the liabilities survey by attributing excessively large holdings to countries that are major custodial, investment management, or security depository centers, such as Belgium, the Cayman Islands, Luxembourg, and Switzerland."
is ultimately owned by residents of other nations, including U.S. residents. The upshot is that a significant share of cross-border portfolio investment is circular.

There is nothing wrong per se with circular investment flows. Sometimes a circular investment flow is a product of conventions of global financial accounting. As noted earlier, when a US MNC undergoes a corporate inversion this produces a circular investment flow because of the accounting convention that a firm is located in the nation in which it is organized. Investments by U.S. persons in the MNC’s securities are accounted for as out-bound portfolio investment while the MNC’s investment in its U.S. assets and operations are accounted for as in-bound direct investment. The inversion creates a large circular investment flow if the MNC’s ownership and assets and operations are centered in the U.S. But circular investment flows can be symptomatic of problematic behavior. In particular there is a concern when a flow is through a tax haven that an investment is being run through a tax haven to avoid paying taxes.

Gabriel Zucman has tried to estimate the amount of the world’s wealth that is held in tax havens by comparing national accounts of financial assets and liabilities. He uses Luxembourg as an example.23 At the beginning of 2015 the national accounts of Luxembourg reported that persons in other nations held $3.5 trillion in shares in mutual funds domiciled in Luxembourg while the national accounts of all other nations reported that persons in those nations held $2 trillion in Luxembourg mutual fund shares. Zucman surmises the imbalance is held through tax havens.24 While the shares appear as a liability on the national accounts of Luxembourg they do not appear as a corresponding asset on any other nation’s accounts. Zucman estimates that around 8 percent of the world’s wealth is invested in tax havens,25 including around 4 percent of the wealth of U.S. households.26 Most of this capital ultimately is invested in publicly traded stocks and bonds.27 And much of this investment is through offshore mutual and money market funds.

24 Zucman 38.
25 Zucman 34. This estimate includes only wealth represented by financial assets. It does not include wealth held in physical form, such as “bank notes held in vaults,” gold, chattels, or real estate. Id. 43-45. Zucman estimates that around 20 percent of the income on financial assets is declared for tax purposes. Id. 47.
26 Zucman 53. Zucman estimates that 10 percent of the wealth of Europe is held through tax havens, 22 percent of the wealth of Latin America, 30 percent of Africa, 52 percent of Russia, and 57 percent of the Gulf Countries. Id. M. Hanlon, E. Maydew, and J. Thornbeek, Taking the Long Way Home: U.S. Tax Evasion and Investments in U.S. Equity and Debt Markets, 70 Journal of Finance 257 (2015), find evidence of U.S. wealth holders evading U.S. tax by investing in U.S. securities through tax havens in the fact that flows of FPI from tax havens to the US increase when use capital gains and ordinary tax rates increase and in the fact flows of FPI from tax havens to the US decrease when the US signs a bilateral information sharing agreement with a tax haven.
27 Zucman 16-17. Zucman (at p. 31) estimates that in Spring 2015 of $2,300 billion held by banks domiciled in Switzerland belonging to nonresidents $750 billion was invested in Luxembourg mutual funds (which largely hold publicly traded equities), $200 billion was invested in Irish mutual funds (which largely hold debt instruments), $500 billion was directly invested in global equities, $600 billion was directly invested in global bonds, and $250 billion was in cash deposits or other types of assets. Zucman
Zucman proposes combatting the use by the wealthy of tax havens to avoid capital income and inheritance taxes by creating a global register that will identify the beneficial owner of every publicly traded security. A brief explanation of why this is possible is in order because the infrastructure of ownership of publicly traded securities is relevant to designing the securities tax to deal with cross-border investment. A global financial register would be ineffective in a world in which securities were often in the form of bearer certificates like bearer bonds. An individual can hide her wealth by holding it in the form of bearer certificates in the same way an individual can hide her wealth by holding it in the form of currency or gold.

In the modern world the wealthy hold only a trivial fraction of their wealth in the form of bearer certificates, currency, gold, or other physical forms. In particular securities in the form of bearer certificates are largely a thing of the past. In the modern world almost all publicly traded securities are held through a handful of central depositories, which maintain a registry of security ownership and serve as a central clearing house for securities transactions. A registry system might seem to make it possible to identify the owner of a security. But securities generally are held through securities intermediaries, such as banks and broker/dealers. Often a security is held through a chain of securities intermediaries. The beneficial owner of a security need only identify herself to the last securities intermediary in the chain. And a wealth holder may avoid identifying herself to the last securities intermediary in the chain by dealing through an agent or some other form of non-transparent intermediary such as a closely held corporation.

A global financial register requires that the last securities intermediary in the chain determine who is the ultimate owner of wealth represented by a security and report this information back up the chain so that the information may be entered into the global financial register. In the last decade or so the U.S., the E.U., and the OECD have taken a few meaningful steps towards requiring tax havens to collect and to share information on the assets, income, and identity of foreign account holders. For example, in 2010 the U.S. adopted the Financial Account Tax Compliance Act ("FATCA"), which requires foreign financial institutions to collect and report to the I.R.S. information on financial accounts of U.S. persons and foreign entities with significant U.S. ownership or face a withholding tax on the gross amount of a broadly defined category of payments from U.S. sources and participating foreign financial institutions. Foreign governments have pushed back. Switzerland negotiated an arrangement under which Swiss financial institutions avoid the punitive withholding tax by agreeing to protect personally identifiable information on consenting U.S. account holders and aggregate information on non-consenting U.S. account holders. The Swiss response to FATCA is indicative of a general pattern. Financial institutions that offer account holders the benefits of anonymity

estimates U.S. households had $80 billion invested through Swiss bank accounts. Much of this capital was routed through offshore intermediaries in places like Panama.

28 Zucman 92 et seq.
29 Itai Grinberg, The Battle Over Taxing Offshore Accounts, 60 UCLA L. Rev. 304 (2012), is a good summary of developments through 2012.
30 Grinberg at 334-336.
31 Grinberg at 338.
have shown themselves to be willing to forego some of the benefits of being a tax haven if they can preserve the benefits of anonymity. Thus Austria and Luxembourg agreed to withhold and remit tax on interest paid to residents of other EU nations on an anonymous basis in return for being excused from an obligation under the EU Savings Tax Directive to share tax information. 32

One of the advantages of the securities tax is that the interests of the U.S. in taxing cross-border investment under the securities tax can be close to fully served by an anonymous withholding system and without a global financial registry of securities ownership. The non-transparency of securities ownership is a significant source of compliance costs under the securities tax but the penalty for non-compliance can be designed so that these costs are disproportionately borne by financial intermediaries who offer the benefit of anonymity and by wealth holders who use these financial intermediaries. This will enable wealth holders and financial intermediaries to reduce compliance costs by making securities ownership transparent. The enforcement mechanism would then push the international financial system in the direction of being more transparent.

The landscape of direct cross-border investment is complicated. 33 Happily the details can be ignored because the securities tax makes them irrelevant. Much of this complexity of the structure of cross border investment is tax driven and is a result of nations attempting to tax the income of MNEs while respecting each other’s tax sovereignty and trying to adhere to a principle that income should be taxed once. This has created an international tax system in which an MNE can significantly reduce its global taxes by structuring its operations so that a large share of its income is attributed to nations that impose little or no tax on income. The U.S. purports to tax the global income of U.S. MNEs. This complicates matters even further because a U.S. corporation can avoid the U.S. tax by keeping foreign earnings abroad in the accounts of a foreign subsidiary. The securities tax makes the complexities of cross-border direct investment irrelevant because the tax is based on the market value of an MNE’s debt and equity. From the perspective of the U.S. the only goal is to ensure that wealth of U.S. households and nonprofits represented by an MNE’s securities are taxed.

III. Cross-border portfolio investment

This Section addresses the taxation of cross-border portfolio investment. Under existing U.S. law, a U.S. resident is required to pay U.S. tax on her worldwide income,

32 Zucman 69-72 explains the holes in this arrangement. These include that it applies only to interest, and not dividends or gain on sale of a security, and the withholding tax can be avoided by changing the identity of an account owner from a resident of another EU nation to a entity such as a company in the Cayman Islands.

33 As explained earlier, direct investment generally equates with investment in active business operations abroad, and is typically made by MNEs. Technically an investment in a foreign entity is treated as a direct investment if a person (or related group of persons) owns 10% or more of the equity in the entity. More precisely, a financial claim is treated as a part of a direct investment relationship if one person, or an affiliated group of persons, own an interest of 10 percent or more of the voting stock of a corporation, or the equivalent of an unincorporated enterprise.
including dividends and interest paid with respect to a foreign security and capital gains realized on sale or exchange of a foreign security. A U.S. resident receives no tax credit for corporate taxes paid abroad by a foreign security issuer. A U.S. resident receives no tax credit for corporate taxes paid abroad by a foreign security issuer.\textsuperscript{34} Most of the major trading partners of the U.S. impose a withholding tax on dividends. When there is a tax treaty the usual withholding tax rate is 15 percent.\textsuperscript{35} The withholding tax is credited against any U.S. tax on dividends. Most of the major trading partners of the U.S. do not impose a withholding tax on interest. Nor do they tax capital gain on sale or exchange of a security by a foreign owner.\textsuperscript{36}

The existing treatment of foreign portfolio investment grounds on the premise "that passive income should be taxed in the country in which the recipient of the income resides (the residence country)." The rules developed in this Section accept this premise and further assume that the securities tax is analogous to a tax on passive investment income. While the tax is remitted by the issuer of a security this is for reasons of administrative convenience. This premise and assumption dictates that the securities tax be paid when a U.S. wealth holder holds a foreign security. Subsection A explains how this can be done. This premise and assumption also dictates that the securities tax be rebated when a foreign wealth holder holds a U.S. security on which the issuer remitted the tax. This is the subject of Subsection B. Subsection C addresses the question of when an issuer should be required to remit the tax on a security. Subsection D addresses cross-border portfolio investment involving financial assets other than publicly traded securities.

The securities tax could also be described as a wealth tax. The rules developed in this Section are consistent with the common premise that a wealth tax should be based on residency. There is something to be said for this premise. In a world in which much wealth is intangible and is represented by financial assets and/or is a product of intangible inputs (e.g., good will, trade marks, and intellectual property) it make sense to tax wealth based on the residence of a wealth holder because residence is visible and inelastic, which reduces administrative costs and the distortionary effect of the tax. Intangible wealth sometimes has no location. When wealth has a location its location tends to be a

\textsuperscript{34} Graetz and Grinburg, 56 Tax L. Rev. at 548. A U.S. corporation which owns 10 percent or more of the voting stock of from which it receives dividends gets a “deemed paid” tax credit under IRC § 902.

\textsuperscript{35} S.R. Callaghan and C.B. Barry, Tax-induced trading of equity securities: evidence from the ADR market, 58 Journal of Finance 1583 (2003). When stock on which a dividend is paid is held by a pension fund or in a tax-deferred account there is no tax benefit. This creates a conflict for a fund manager when the fund serves a mixed clientele and a potential arbitrage opportunity by moving shares back to the home country for the record dates of their dividends by a repo. S. Christoffersen, C. Geczy, D. Musto, and A. Reed, Crossborder Dividend Taxation and the Preferences of Taxable and Nontaxable Investors: Evidence from Canada, 78 Journal of Financial Economics 121 (2005), find that fund managers cannot exploit the arbitrage opportunity, and that they resolve the conflict by structuring the fund portfolio to serve the dominant clientele.

\textsuperscript{36} Foreign persons, including foreign companies, generally are not subject to information reporting requirements under U.S. law, including the requirement to file Form 1099 when interest or dividend is paid. When a foreign security is held through a U.S. intermediary, such as fund or a broker, then it is required to file an information return with respect to a foreign security. Foreign Financial Institutions are subject to special reporting requirements under the Foreign Account Tax Compliance Act (“FATCA”).
matter of form or is quite elastic, which increases the administrative cost and distortionary effect of the tax.

The securities tax and the complementary tax are not well suited for taxing all forms of wealth. In particular, they are ill suited for taxing wealth held in the form of real estate. A wealthy U.S. individual can avoid U.S. taxes on capital by holding real estate in London. The best way to deal with this problem is to rely on the nation, state, or local government in which real estate is located to levy a tax on real estate. Similarly, wealth represented by natural resources can be taxed by the nation in which the resource is located.

A) Foreign security held by a U.S. person

Often when a U.S. wealth holder invests in a foreign security it will be through a U.S. mutual fund. No special rule is needed to deal with this case. There is no need for anyone to remit the tax on a foreign security that is held by a U.S. mutual fund because the mutual fund will remit the tax on the value of interests in the fund. Similarly when a foreign security is held by a U.S. corporation or by a U.S. financial institution that is subject to the securities tax there is no need for anyone to remit the tax on the foreign security. The wealth represented by the foreign security will be taxed when the entity remits the tax on the value of its publicly traded securities. The same is true when a foreign security is held by a privately owned entity like a hedge fund that remits the complementary tax on the estimated value of interests in the fund that are held by U.S. households, nonprofits, and pension funds. The wealth represented by a foreign security is taxed by the complementary tax.

A special mechanism is needed to deal with the case in which a foreign security is held by a U.S. wealth holder through a custodial account with a U.S. or foreign securities intermediary such as a bank or a broker-dealer. I propose imposing a remittance obligation on a securities intermediary. An alternative is to impose a reporting obligation on a U.S. or foreign securities intermediary and then to require the U.S. wealth holder to pay the tax. A reason to impose a remittance obligation on a securities intermediary is that third party withholding of taxes has been shown to improve compliance over third party reporting without withholding. It also makes it possible to preserve anonymity. When a U.S. individual holds a foreign security through a Swiss depository account the Swiss institution can satisfy its obligation by remitting the tax. It need not report the identity of the account holder to the U.S. tax authority.

An initial question is the types of account holders that should trigger the remittance obligation. At a minimum this should cover a U.S. individual, nonprofit, and trust (other than a business trust). It also should cover a closely held U.S. entity, such as a partnership, LLC, or closely held corporation. And the remittance obligation should cover a closely held foreign entity that is owned by a U.S. individual, nonprofit, trust, or closely held U.S. entity. The remittance obligation must cover certain closely held foreign entities to prevent wealthy individuals from avoiding the tax by holding foreign securities through an offshore company, like an LLC established in Panama. I will come back to how this is likely to work in practice at this end of this Section.
The remittance obligation for a closely held U.S. entity and for certain closely held foreign entities are prophylactic rules. An entity is required to remit the complementary tax on the estimated value of an interest in the entity if the interest is held by a person for which there is a remittance obligation. If an entity satisfies its remittance obligation it will take a credit for the tax remitted by the intermediary. Imposing the remittance obligation on an intermediary is a prophylactic against a closely held entity not satisfying its remittance obligation. It also is a prophylactic against interests in a closely held entity being under-valued.

A second question is the character of an intermediary’s liability for failure to remit the tax in a case in which it is due. Possibilities include strict liability, negligence-based liability, and knowledge-based liability. A third question is the extent of an intermediary’s penalty for failure to remit. Should the penalty be for a fraction or multiple of the amount the intermediary failed to remit? A fourth question is whether the liability for failure the remit the tax should extend up the chain of securities intermediaries. For example, a Detroit resident who purchases Daimler-Benz shares may hold a securities entitlement on the shares against small local broker-dealer, who holds a securities entitlement against a regional broker-dealer, who holds a securities entitlement against a national bank and trust company, who holds a securities entitlement against the central depository in New York. The liability could be limited to the local broker-dealer or it could be extended up the chain.

I do not have strong views on the specific answers to some of these questions. As a general matter liability should be strict with safe harbors. Liability should run up the chain to a point short of the central depository. Liability running up the chain should be joint and several. Liability should be strict because it reduces public enforcement costs. There should be safe harbors because they reduce private compliance costs. Liability should run up the chain of securities intermediaries to induce large regional, national, and global securities intermediaries to monitor local broker-dealers. Liability should be joint and several so the length of the chain does not alter the liability exposure. The size of the penalty—i.e. what is the appropriate fraction or multiple—depends on the balance one strikes between deterring tax avoidance and compliance costs. I will briefly explain how policy-makers should think about the size of the penalty and the design of safe harbors.

The remittance mechanism involves significant private compliance costs. These include the cost to a securities intermediary of determining when it has a remittance obligation with respect to a security, the cost of remitting the tax, and the cost of informing a U.S. wealth holder and other intermediaries who potentially are under a remittance obligation with respect to a security that the tax has been remitted. The function of a safe harbor is to enable an intermediary to easily determine the absence of a liability risk with certainty. If the liability risk runs up the chain, then financial intermediaries up the chain will incur compliance costs to monitor down-chain financial intermediaries to assess and regulate the liability risk.

A major source of compliance costs is the requirement that the tax be remitted by a securities intermediary in certain cases in which the owner of a record of a security is a non-U.S. entity. This is necessary to prevent a U.S. individual from avoiding the tax by
holding foreign securities through an offshore company, such as a Panama LLC. The obligation to remit the tax when a U.S. individual holds foreign securities through a Panama LLC must cover a foreign securities intermediary as well as a U.S. securities intermediary otherwise a U.S. individual could avoid the tax by using a foreign securities intermediary. One benefit a Panama LLC offers an owner is anonymity, which makes it impossible for a securities intermediary to determine if it is under a remittance obligation when the record owner of a foreign security is a Panama LLC. Strict liability creates a liability risk that runs up the chain of securities intermediaries.

The goal in setting the size of the penalty and in designing safe harbors is to make wealth holders who seek anonymity and financial intermediaries who provide anonymity bear a disproportionate share of private compliance costs that are created by ownership of securities being non-transparent. Obviously I need to say more about this. The basic idea is to design a system in which central players in the securities intermediation system pass some of the cost of their liability risk in intermediating securities held through non-transparent entities to local broker-dealers who deal with these clients directly. The local broker-dealers will then pass these costs on. More generally, the goal is separate the market so that wealth holders who do not try to avoid the securities tax invest in foreign securities through intermediaries with low compliance costs, such as country funds.

B) U.S. security held by a foreign person

All or a substantial portion of the securities tax should be rebated to a foreign person who holds a U.S. security on which the tax has been remitted. The rebate mechanism can be fairly simple in many cases. The U.S. often need not concern itself with the identity of the ultimate owner of capital that is represented by a security that is held by a foreign person. For example, if a U.S. security is held by a Luxembourg mutual fund the tax can be rebated to the mutual fund. Similarly, the tax can be rebated to a Swiss bank if it holds a U.S. security in a depository account. The U.S. can leave it to foreign parties to make arrangements to ensure that the value of the rebate flows to the foreign wealth holder who owns the wealth represented by the security.

This may appear to open doors to U.S. wealth holders avoiding U.S. taxes on capital by “round-tripping” an investment in U.S. securities through a Luxembourg mutual fund or a depository account in a Swiss bank. But such doors can be closed by requiring the tax to be remitted on financial assets held by U.S. wealth holders that represent claims against a foreign person. For example, if a U.S. individual holds shares in a Luxembourg mutual fund through a foreign securities intermediary the foreign intermediary will be required to remit the tax on the shares under the rules covered in Subsection II-A. In principle international balance sheets should balance. When a U.S. individual invests in U.S. securities through an offshore entity the liability represented by the security in a foreign entity’s hand should be offset by an asset in the hand of the U.S. individual against a foreign entity. So long as the tax is remitted on the asset held by the U.S. individual there is no need to tax the liability.
In practice international balance sheets do not balance. Gabriel Zucman has examined the national accounts of Luxembourg and found that around $1.5 trillion in shares of mutual funds domiciled in Luxembourg do not appear in the accounts of other nations. He infers the imbalance is held through tax havens. A general solution to this problem is to pressure financial intermediaries in tax havens to remit the tax on financial assets held by U.S. wealth holders through the tax haven. The U.S. could refuse to rebate the securities tax to a financial intermediary (or to a tax haven) that does not comply with its remittance obligation with respect to financial assets held by U.S. wealth holders to apply pressure on a financial intermediary to comply. But it is a mistake to use the rebate mechanism for this purpose. There is no reason to think that loss of the rebate is an adequate or appropriate penalty to encourage a financial intermediary to comply with its remittance obligation with respect to financial assets held by U.S. wealth holders. It is best to keep the problem of collecting the tax on out-bound portfolio investment and rebating the tax on in-bound portfolio investment separate for they are separate problems.

The problems converge in one case: a U.S. wealth holder may avoid the securities tax by holding U.S. securities through a foreign entity such as a Panama LLC in order to collect the refund. This is similar to the problem of a U.S. wealth holder avoiding the securities tax by holding foreign securities through a Panama LLC. The problems are similar because a U.S. wealth holder will try to disguise the fact a Panama LLC is claiming the rebate by having a securities intermediary claim the rebate on behalf of an account holder. The solution is the same: impose a third-party penalty on the broker and up-chain securities intermediaries. The fact that the broker must affirmatively claim the rebate increases the effectiveness of the third-party penalty because it increases the probability that a sham will be detected. From this perspective the rebate is in the nature of bait to induce shady brokers to reveal themselves. Another way to think about this is that brokers who cater to U.S. wealth holders who avoid tax on holdings of foreign securities will avoid U.S. wealth holders who want to use their services to claim a rebate on holdings of U.S. securities.

The remittance and rebate mechanisms make it possible for a tax haven financial intermediary to preserve anonymity for its clients while satisfying the interests of the U.S. with respect to the tax on capital. The interests of the U.S. with respect to taxing capital are satisfied so long as capital owned by a U.S. household or nonprofit is taxed at some point and investments by foreign wealth holders in U.S. securities do not bear a tax. The ability to preserve to anonymity lowers the cost to a tax haven financial intermediary of satisfying the interests of the U.S. with respect to the tax on capital because its clients often value anonymity for reasons apart from avoiding taxes. Basically the remittance and rebate mechanisms make it marginally easier to solve “the scourge of tax havens” by unbundling anonymity and tax avoidance.

Itai Grinberg has argued that it is a mistake to accept a solution to the problem of tax havens that collects taxes on wealth held through tax havens while preserving the

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37 Zucman 38.
anonymity of wealth holders. Grinberg frames the choice as being between “an information reporting model” and an “anonymous withholding model.” One of his arguments is that an information-reporting model “preserves sovereign political autonomy” better than an anonymous-withholding model. This has to be right in a general sense. An information-reporting model can provide a nation’s tax authority information to assess a tax on a wealth holder in whatever way it chooses and verification that the tax is paid. An anonymous-withholding model only provides a nation a revenue stream and some confidence that the revenue was extracted from wealth of its citizens held through foreign accounts. Grinberg also argues that there is value in people knowing that the wealthy are being made to pay their fair share of taxes, which anonymous withholding sacrifices.

The character of the securities tax and the complementary tax as indirect wealth taxes moots these concerns with respect to the U.S. But this does not respond to what I take to be Grinberg’s objection, which is that if the U.S. agrees to anonymous-withholding because it satisfies its national interests with respect to taxing capital, this will prevent other nations that have different interests with respect to taxing capital from satisfying those national interests. Grinberg is particularly concerned that an anonymous-withholding system will evolve so that the interests of economically powerful nations are protected while the interests of less powerful nations are not protected.

The rebate mechanism can be changed to a withholding tax mechanism to address some of these concerns though this involves a significant increase in compliance costs. A withholding tax mechanism works in a fairly straightforward way when the beneficial owner of a U.S. security is an identifiable foreign individual or foreign corporation who reports and pays tax on the income from the U.S. securities in their home nation. Rather than rebating the securities tax to the individual or corporation the U.S. would remit the tax to the nation in which the individual or corporation reports and pays tax on income from U.S. securities. The home nation could decide whether and how to apply the amount remitted against the home nation tax liability of the individual or corporation. Even this fairly straightforward mechanism involves significant public administrative and private compliance costs. Information identifying the beneficial owner of a security and his or her home nation must be collected and transmitted to the U.S. tax authority. The U.S. tax authority must process this information and remit the tax and relevant information concerning the beneficial owner to the home nation tax authority. There are further costs if the home nation credits the tax against the home nation tax liability of the beneficial owner.

38 Itai Grinberg, The Battle Over Taxing Offshore Accounts, 60 UCLA L. Rev. 304, 347-371 (2012). The concern that the withholding model does not reach “untaxed principal” is eliminated by a capital tax.
39 It is possible to design an anonymous-withholding model to address some of Grinberg’s specific political autonomy concerns. For example, one concern is that withholding rates, which are a matter of bilateral agreement, will not adjust with domestic rates. Id. at 361. This can be addressed by providing for an adjustable withholding rate in a bilateral agreement. Another concern is that anonymous-withholding “is not compatible with a progressive income tax and benefits system.” Id. at 362. Anonymous-withholding can be made compatible with progressive tax rates by withholding at the highest tax rate. An individual who wants the benefit of a lower tax rate must forego the benefit of anonymity.
40 Id. at 358-359.
A withholding tax is not easily adapted to deal with U.S. securities held by a foreign fund such as a Luxembourg mutual fund, an Irish money market fund, or a Cayman Islands hedge fund. The problem is that funds usually are structured so that the fund does not pay tax on income earned through a fund. This requires a mechanism to allocate the rebate to owners of interests in the fund. This requires identifying owners of beneficial interests in a fund, determining the share of the rebate to which each is entitled, determining their home nations, and remitting the rebate to their respective home nations. Another fund may be a beneficial owner of an interest in a fund, adding another level of complexity. Similar problems arise with respect to any multi-member pass through entity that holds the beneficial interest in a U.S. security.

One solution to these problems is to pay the rebate through the withholding tax mechanism only when the person who is entitled to the rebate can be readily identified. This would create an incentive for a foreign investor in U.S. securities who wants the benefit of the rebate to arrange an investment so ownership is transparent. A foreign investor who wants anonymity would forego the rebate.

C) Definition of a U.S. security

This Section addresses the question of who should be treated as an issuer of a U.S. security for purposes of the obligation to remit the securities tax. There are three feasible rules. One rule bases the remittance obligation on the U.S. being an issuer’s legal home. The second rule requires that the issuer of a security remit the tax on a security listed on a U.S. exchange. I will call these two options the legal home rule and the listing rule. The third option is to allow a security issuer to elect whether to remit the tax. I will call this the election rule. I propose the listing rule with an election if a security is listed on the exchanges of multiple nations.

Under the listing rule a foreign company that deposits a security with a U.S. bank and trust company to list an ADR on a U.S. exchange will be required to remit the tax on the market value of the ADR. Under the legal home rule the foreign company would not be required to remit the tax on an ADR. Under the listing rule a U.S. company could not avoid the remittance obligation by undergoing a inversion, making its U.S. company a subsidiary to a parent company established abroad, if the shares of the parent company remain listing on a U.S. exchange. Under the legal home rule the inversion would eliminate the remittance obligation. Conversely, under the listing rule a company established in the U.S. would not be required to remit the tax on securities the company issues abroad and lists on a foreign exchange, or on shares it deposits in European bank and trust to list an EDR on a European exchange. The company would be required to remit the tax on securities listed abroad under the legal home rule. Under the election rule the company issuing the security gets to elect whether it remits the tax in every case.

It is vital that whichever rule is chosen make it possible for all parties concerned to determine with certainty and minimal effort whether tax has been remitted on a

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41 If the ADR is created by a bank and trust company by acquiring securities listed on a foreign exchange, then the bank and trust company will be obligated to remit the tax and not the foreign issuer of the security.
security. All three rules pass this test. Indeed practice should coalesce around an issuer denoting that a security is or is not “US tax paid,” whichever rule is chosen.

All three rules give an issuer the power to determine whether it is under a remittance obligation. This is a feature and not a bug. An issuer’s principal concern in choosing a security’s tax home should be reducing compliance costs and not minimizing the burden of the securities tax. The basic point I want to make here is that it is difficult for an issuer to capture whatever tax benefit there may be in choosing a tax home that enables some holders of its securities to avoid the securities tax. The effects on compliance costs are spread more widely and so are more likely to be reflected in the price of a security. The intuition is straightforward if you imagine an MNC considering whether to make its tax home in the U.S. or a foreign nation. This decision should be made based on who it expects to be the dominant clientele for its shares. If the dominant clientele is U.S. investors, then it should select a U.S. tax home for its shares because this reduces their compliance costs.

The legal home rule has several advantages. It is consistent with the existing practice of identifying the residence of a company by its legal home. The other advantages of the rule are in comparison with the listing rule. A company can have only one legal home while a security can be listed on exchanges in multiple nations. The listing rule requires additional rules to determine the remittance obligation when a security is listed on exchanges in multiple nations. The legal home rule also raises no legal issues under existing U.S. tax treaties. The status of the listing rule under the treaties is not clear.\(^4^2\)

The listing rule has the major advantage over the legal home rule that it more closely aligns the remittance obligation with the pattern of national ownership of securities. This is because of a strong home bias in securities investment.\(^4^3\) Most of the

\(^{42}\) I will use the text of the current U.S. Model Income Tax Treaty to explain the legal issue. The securities tax should be covered by the language in Article 2, section 4, stating that in addition to Federal income taxes the treaty “also shall apply to any identical or substantially similar taxes that are imposed . . . in addition to, or in place of, the existing taxes.” An argument that requiring a company established abroad to remit the securities tax violates the treaty grounds on Article 7, section 1, which provides “Profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.” (A permanent establishment is a “fixed place of business through which the business of an enterprise is wholly or partly carried on.” Article 5, section 1.) A contrary argument that the tax does not violate the treaty is that it is not a tax on the profits of an enterprise, but instead is a tax on dividends, interest, and gains with respect to a security, which may be imposed by the state in which the beneficial owner of the security resides under Article 10, Article 11, and Article 13, section 6.

\(^{43}\) A leading article is K. French and J. Poterba, Investor Diversification and International Equity Markets, 81 Amer. Econ. Rev. 222 (1991), which finds that 93.8% of the portfolio equity holdings of U.S. investors was in U.S. equities. This understates the bias towards purchasing and selling securities that are listed on a home exchange because securities listed on U.S. exchanges that are issued by foreign companies are treated as foreign securities. The bias is observed in the investment behavior of sophisticated investors, such as fund managers, as well as individual investors. Possible explanations for the bias include informational advantages and over-optimism regarding the home equity market. See, e.g., A.G. Ahearne, W.L. Griever, and F.E. Warnock, Information Costs and Home Bias: An Analysis of U.S. Holdings of Foreign Equities, 62 Journal of Int’l Econ. 313 (2004)(exploring information cost explanation); N. Strong and X. Xu,
wealth of U.S. households and nonprofits that is represented by publicly traded securities is represented by securities that are traded on U.S. exchanges. And most of the wealth that is represented by securities that are traded on U.S. exchanges ultimately belongs to U.S. households and nonprofits. Thus a listing rule generates fewer false negatives (i.e., securities ultimately owned by U.S. wealth holders on which the issuer does not remit the tax) and fewer false positives (i.e., securities ultimately owned by foreign wealth holders on which issue the issuer does remit the tax). This reduces public administrative and private compliance costs.

For example, typically when a U.S. MNC undergoes an inversion holders of the company’s securities will receive securities issued by the foreign parent. The new securities will be listed on a U.S. exchange. Under the legal home rule the inversion will eliminate the company’s obligation to remit the tax but it will shift the remittance obligation to persons who hold the MNC’s securities. There will be a small increase in compliance costs with respect to securities held by large U.S. institutional investors. But there will be a material increase in compliance costs with respect to securities held by U.S. individual investors. These costs will be borne by securities intermediaries.

A potential advantage of the election rule over the other two rules is that unbundling the remittance obligation from an issuer’s choice of a legal home and an issuer’s choice of where to list a security may result in issuers electing to remit the tax when it reduces overall private compliance costs. The election rule also eliminates any potential distortionary effects the legal home rule and listing rule might have on an issuer’s choice of a legal home and an issuer’s choice of where to list a security. This is a small advantage for these distortionary effects are likely to be small. The election rule also provides a simple basis for determining whether an issuer has a remittance obligation when a security is listed on exchanges in multiple nations.

I come down in favor of the listing rule because of the home equity bias. When a company lists a security on a U.S. exchange it is likely to be because it wants to reach U.S. investors. Thus the listing rule is likely to reduce compliance costs. But I think a security issuer should be able to choose another tax home for a security. The way this is written now I propose to limit the election to a security that is listed on the exchanges of multiple nations. It is difficult for me to imagine why an issuer might want to choose a tax home that is not a nation of an exchange on which a security is listed.