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Stateless Income's Challenge to Tax Policy, Part 2
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Stateless Income's Challenge to Tax Policy, Part 2

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This report considers the tax policy implications of the phenomenon of stateless income. Stateless income is income that is derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company but that is subject to tax only in a jurisdiction that is neither the source of the production factors through which it was derived nor the domicile of the group's parent company. Google Inc.'s "Double Irish Dutch Sandwich" structure is one familiar example.

Part 1 of this report, available at *Tax Notes*, Sept. 5, 2011, p. 1021, *Doc 2011-14206*, *2011 TNT 172-5*, showed that the U.S. tax rules governing income from foreign direct investments often are misapprehended: In practice they do not operate as a worldwide system of taxation, but as an ersatz variant on territorial systems, with hidden benefits and costs when compared with standard territorial regimes. That claim holds whether one analyzes these rules as a cash tax matter or through the lens of financial accounting standards. Part 1 of this report rejected as inconsistent with the data any suggestion that current U.S. law renders U.S. multinational firms less competitive when compared with their territorial-based competitors.

Stateless income privileges multinational corporations over domestic ones by offering the former the prospect of capturing "tax rents" — low-risk infra-marginal returns derived by moving income from

high-tax foreign countries to low-tax ones. Other important implications of stateless income include reduced coherence in the concept of geographic source; the systematic bias toward offshore rather than domestic investment; the more surprising bias in favor of *investment* in high-tax foreign countries to provide the feedstock for the generation of low-tax foreign *income* in other countries; erosion of the U.S. domestic tax base through debt-financed tax arbitrage; many instances of deadweight loss; and, essentially uniquely to the United States, the exacerbation of the lockout phenomenon, under which the price that U.S. corporations pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (\$1.4 trillion or more, by the most recent estimates) and cash outside the United States.

Part 2 of this report picks up at this point. It is adapted and condensed from Edward D. Kleinbard, "The Lessons of Stateless Income," 65 *Tax L. Rev.* 99 (2011).

Part 2 demonstrates that policy conclusions that are useful in a world without stateless income do not follow once its presence is considered. The report identifies and develops the significance of implicit taxation as an underappreciated assumption in the capital ownership neutrality model that has been advanced as an argument for why the United States should adopt a territorial tax system, and it shows how stateless income tax planning undermines this critical assumption.

The report concludes that policymakers face a Hobson's choice between the highly implausible (a territorial tax system with teeth) and the manifestly imperfect (worldwide tax consolidation). Because the former is so unrealistic, while the latter's imperfections can be reduced through the choice of tax rate, the report ultimately recommends a worldwide tax consolidation solution.

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Table of Contents

V. A World Imbued With Stateless Income . . . 1432
A. Overview 1432

B. Capital Ownership Neutrality 1432
C. An Implicit Tax Perspective 1434
D. Extending the Model for Stateless Income 1436

VI. Putting Teeth Into Territoriality 1438

 A. Overview 1438

 B. Cartoon Territoriality 1438

 C. Thin Capitalization 1439

 D. CFC Rules 1440

 E. Haircuts 1441

 F. Formulary Apportionment 1441

VII. Worldwide Tax Consolidation 1442

 A. Introduction 1442

 B. Elements of Worldwide Tax Consolidation 1443

 C. Competitiveness Concerns 1444

 D. Meaninglessness of Residence 1445

 E. Disincentivizing Foreign Tax Reduction 1446

VIII. Conclusion 1447

V. A World Imbued With Stateless Income

A. Overview

If stateless income tax planning were expunged, designing tax policy for foreign direct investment would become embarrassingly easy: Every country would adopt a territorial tax system and thus satisfy every known articulation of worldwide efficiency norms. The simple reason is that after-tax returns from marginal real investments would be the same around the world. In other words, every business would suffer the same tax burden when *implicit* as well as explicit taxes were considered. In this tax ecosystem, it would make no sense to add another layer of residence country tax. That would only drive down after-tax returns on investments for affected cross-border investors to levels below what they could obtain at home.

But stateless income fundamentally erodes this expectation. The whole point of stateless income tax planning is that it enables savvy multinational firms to capture tax rents by deflecting high-tax source country pretax returns to very low-tax jurisdictions and effectively doing the same with residence country pretax returns through interest expense arbitrage. Multinational firms can thereby capture a rate of return much higher than world after-tax norms, without incremental risk, as a result of planning opportunities available only to a few potential investors.

This section analyzes the problems that stateless income poses for standard efficiency benchmarks. It demonstrates that conclusions that are logical in a world without stateless income do not follow once the presence of stateless income tax planning is considered. The capital ownership neutrality standard has much to recommend it in theory. But it contains an underappreciated assumption that source country taxation is fully capitalized into the prices of firms operating in that source country.

Phrased alternatively, the capital ownership neutrality model assumes that multinational firms face a constant after-tax rate of return everywhere in the world and suffer the same tax burden everywhere, when “tax” for this purpose is defined to include both explicit and implicit taxes. This report argues that stateless income tax planning vitiates the plausibility of this critical assumption.

Without the full capitalization of source country taxes in firm valuations, recommendations that the United States adopt a territorial tax system reduce to pleas for a “competitive” international tax framework. But those pleas are little different in practice from a call for trade export subsidies or the like and strangely ignore the competitiveness of domestic operations.

B. Capital Ownership Neutrality

Consider the tax policies of plucky Freedonia and its neighbors. Freedonia imposes a 10 percent tax rate on domestic income. Sylvania taxes its multinational enterprises on a territorial basis, so that income earned outside it is taxed only by the source country. The Sylvanian tax rate on domestic income is 25 percent. Finally, Snowdonia has a territorial tax system like Sylvania’s but a domestic rate of 35 percent. In this restricted world, all firms face only source country taxes, including on domestic income, which is simply income sourced to the country where the firm is resident. For simplicity, assume that all taxes on firm income are imposed at the firm level, so that there are no shareholder taxes or withholding taxes on distributions to foreign owners to take into account.

Further assume that there is no such phenomenon as stateless income; net income from business operations is taxed only to the firm earning it and only in the source country — that is, where the factors of production that generate the income actually are located. Moreover, the identity of the source country is clear, which in practice today would exclude many cases involving returns to intangible assets or the location of pure business opportunities. Finally, capital is globally mobile, and capital markets are efficient.

Under those assumptions, all firms earn the same after-tax normal returns on their investments around the world, because that is the equilibrium price. If after-tax rates of return are higher in Freedonia than in Snowdonia, investment will leave the latter and flow to the former until equilibrium is achieved.⁸⁶ Assume that this global after-tax rate is

⁸⁶This is a standard assumption in economics presentations. See, e.g., Rosanne Altshuler, “Recent Developments in the Debate on Deferral,” *Tax Notes Int’l*, Apr. 3, 2000, p. 1579; Michael (Footnote continued on next page.)

5 percent. As previously pointed out, this implies that pretax normal corporate returns will vary from country to country to reflect differences in statutory tax burdens. Pretax corporate returns in Snowdonia will be 7.7 percent, while in Sylvania they will be 6.67 percent, and in Freedonia 5.56 percent.

A Freedonian domestic company that is a worldwide leader in basket-weaving designs and technology (Beweave Co.) earns \$556 in taxable income and clears \$500 after tax. That implies a market valuation of \$10,000 for Beweave ($\$10,000 \times 5 \text{ percent} = \500). Two multinational enterprises, one domiciled in Sylvania and the other in Snowdonia, each eager to expand its global presence in the basket-weaving sector, prepare bids to acquire Beweave from the Freedonian family that controls it. How will taxes influence the outcome? They won't, at least directly. The Sylvanian and Snowdonian firms face different tax rates on their domestic operations, but not for foreign direct investment in Freedonia, because under each jurisdiction's terri-

torial system the Freedonian net income tax is a final tax on Freedonian-source income.

Now introduce the United States into the mix. It taxes U.S. resident firms on their worldwide income (including income earned by foreign subsidiaries) and imposes a 35 percent tax rate. How would a potential U.S. acquirer fare in the bidding, assuming again that all firms are price takers in the auction (that is, they cannot individually determine the winning bid)? By virtue of the hypothesized genuine worldwide tax environment, U.S. firms face the same tax rate everywhere in the world (ignoring the possibility of excess FTCs) but do not have the same after-tax rate of return on investment as do their competitors in Sylvania and Snowdonia, because pretax rates of returns vary around the world. The result is that a U.S. firm cannot be competitive in bidding for an enterprise in a low-tax jurisdiction like Freedonia.⁸⁷ Ultimately, differences in the international tax systems used by Sylvania and the United States would lead to Beweave not being acquired by the company that could make the most productive use of it.

This is the dilemma envisioned by Mihir Desai and James Hines in their important article, "Evaluating International Tax Reform,"⁸⁸ and subsequent articles.⁸⁹ Desai and Hines argue that global welfare would suffer in this example if the United States

Devereux, "Taxation of Outbound Investment," 24 *Oxford Rev. Econ. Pol'y* 698 (2008) at 702; Zodrow, Part 1, *supra* note 6, at 881.

The standard view implicitly rests on the idea that multinational firms actually reside in territorial tax jurisdictions. This assumption in turn largely comports with reality because (1) in the world today there is no significant example of a true worldwide foreign direct investment income tax system (in which active business income of a foreign subsidiary is taxed immediately to the parent company); (2) portfolio investments in corporate firms (whether domestic or cross-border) are not taxed on a passthrough basis (and therefore the income of those firms is taxed only on a source basis); and (3) direct investments by individuals in domestic firms also generally are not taxed on a passthrough basis. In theory, withholding taxes also might be taken into account, but in practice, they often are eliminated or greatly reduced by treaties or tax planning (*e.g.*, the use of equity derivative contracts), and in any event are source rather than residence country burdens. As such, they simply add to the effective tax rate imposed by the source country.

If one were to imagine a world in which net business income was taxed in all events immediately to ultimate individual owners, whether domestic or foreign, one would expect *pretax* returns to be equated around the world (and the world's economies to operate in an environment best described as approximating capital export neutrality). This essentially is the case today for interest income, because portfolio interest income generally is deductible in source countries, taxed in residence countries, and exempt from withholding tax in source countries. Since a portfolio investor resident in any given country faces the same tax rate on interest from any source, tax is irrelevant to the decision as to which debt instrument to acquire (although it is of course relevant to the fundamental decision to invest rather than to consume). Equilibrium prices therefore will correspond to pretax returns. Investors resident in different countries with different tax rates will have different after-tax returns, but each will capture the same after-tax return on otherwise identical debt instruments issued by issuers in different jurisdictions. Differences in tax rates will affect the propensity to invest and private after-tax wealth, but not prices.

⁸⁷Imagine that both Sylvania Co. and US Co. want to acquire Beweave Co. Ignoring firm-specific synergies and the like, Sylvania Co. (or a competing domestic Freedonian firm) will be able to bid up to \$10,000 for Beweave Co., because Sylvania Co. incurs no additional tax burden on its investment in Beweave as a consequence of the territorial tax system adopted by the Sylvanian legislature. US Co. cannot afford to bid that much. If it did, it would earn the same \$556 before tax that Sylvania Co. would, but only $\$556 \times 0.65$, or \$361, after tax, as a result of the imposition of U.S. corporate income tax on top of the Freedonian 10 percent. (The US Co. group would still bear \$56 in Freedonian tax but would obtain a U.S. FTC for that cost, so that its total tax liability for the Freedonian investment would remain a constant 35 percent rate, or \$195 — \$56 paid to Freedonia and \$139 to the United States.) That implies a valuation of the business of only \$7,220 in the hands of US Co. Even if US Co. were uniquely able to raise Beweave's pretax returns by \$200 a year, to \$756, because of US Co.'s superior operational skills or better synergies with the target company, Sylvania Co. still would be able to outbid US Co. for the company.

⁸⁸Mihir A. Desai and James R. Hines Jr., "Evaluating International Tax Reform," 56 *Nat'l Tax J.* 487 (2003). Under the Desai and Hines framework, the inability of US Co. to acquire Beweave is the measure of the potential economic inefficiency that arises from ownership distortions. Under the authors' theory, tax systems that ensure the identities of capital owners are unaffected by differences in residence country tax rates that permit the market to allocate ownership rights where they are most productive. *Id.* at 499.

⁸⁹Subsequent articles include the following, cited in Part 1: Desai and Hines, "Old Rules and New Realities," *supra* note 66;

(Footnote continued on next page.)

were to use a worldwide tax system that was consistent with the capital export neutrality paradigm while other jurisdictions relied on territorial tax systems. A U.S. multinational firm's investment priorities would be unaffected by taxes, because it would face a constant (35 percent) burden wherever its proposed investments were located. But the Sylvanian multinational firm would be able to outbid the U.S. firm for a Freedomian domestic company, even when the target company would be more productive in the U.S. firm's hands, simply because the Sylvanian company would face only the (10 percent) Freedomian tax rate on the returns earned by that target company rather than its higher home country rates.

In response, Desai and Hines develop a new benchmark for measuring whether a country's tax policies governing foreign direct investment advance worldwide welfare, which standard they term "capital ownership neutrality."⁹⁰ In their article, Desai and Hines argue that the benchmark of capital ownership neutrality dominates the standard of capital export neutrality, which had previously been the consensus measure of worldwide efficiency in this area.⁹¹

Desai, "New Foundations for Taxing Multinational Corporations," *Taxes* (Mar. 2004); Hines, "Foreign Income and Domestic Deductions," *supra* note 53; and Hines, "Reconsidering the Taxation of Foreign Income," *supra* note 50.

⁹⁰Desai and Hines define capital ownership neutrality as the principle that worldwide welfare is maximized if the identities of the owners of capital are unaffected by tax rate differences. Desai and Hines, "Evaluating International Tax Reform," *supra* Part 1, note 76, at 488. The term appears to have been coined by British economist Michael Devereux in "Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality, and All That," Institute for Fiscal Studies working paper (June 11, 1990).

⁹¹Capital export neutrality takes as its fundamental economic premise the goal of enhancing worldwide welfare by ensuring production efficiency, which is achieved when the reallocation of production factors from one country to another would not lead to greater output. Devereux, "Taxation of Outbound Direct Investment," *supra* note 86, at 701 ("CEN implies that (a) the international tax system will not distort the location decisions of any individual investor, (b) the pre-tax rate of return in all jurisdictions will be the same (production will be efficiently organized), but (c) investors in different jurisdictions may face different post-tax rates of return on their investment, and hence different incentives to save"). A state of global production efficiency implies that pretax normal returns are consistent throughout the global economy. *Id.* See also Altshuler, "Recent Developments in the Debate on Deferral," *supra* note 86.

Looking at the investment decisions of a U.S. multinational firm from this perspective, Peggy Musgrave, who developed much of the original analysis, concluded that production efficiency could be furthered by taxing all returns earned by a U.S. company, whether directly or through foreign subsidiaries, at the same (U.S.) rate. In that way, the U.S. parent company would make the same after-tax decisions on where to situate a

(Footnote continued in next column.)

Capital ownership neutrality in turn is seen as leading to a policy recommendation that the United States adopt a territorial tax system. The recommendations include not only the exclusion of foreign income from a U.S. multinational firm's tax base, but also the decision not to deny or otherwise limit deductions incurred by the U.S. parent company that might be thought to support the generation of that foreign income.⁹²

These points can be summarized with a simple metaphor.⁹³ As a principle of tax policy design, the benchmark of capital export neutrality contemplates that when a U.S. multinational draws up its list of new investment opportunities both inside and outside the United States, that firm's priorities remain unchanged once tax consequences are considered. Desai and Hines extend the principle by requiring that when an auction is held for a firm (or, following Devereux, any asset) located, for example, in a low-tax country, the winner of that auction would be the same in a world with income taxes as it would have been in a world without them. Leaving the U.S. firm's shopping priorities unaffected would satisfy capital export neutrality but might not satisfy the test proposed by Desai and Hines. That is because even if the rank ordering of its preferences were unaffected by taxes, the U.S. firm might be unable to bid as much as another high-tax jurisdiction resident company that faces only host country taxes on third-country investments.

C. An Implicit Tax Perspective

The goals contemplated by Desai and Hines could be implemented through a territorial tax system if the quotidian world even roughly corresponded to the conditions developed in the model laid out above: The geographic source of business income (that is, the country to which it appertains) is unambiguous, those returns are taxed only in the

new investment as it would make in the absence of taxes (subject, of course, to any wealth effect of the tax burden itself). Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax L. Rev.* 261, 284-294, 285 (2001). Thus, capital export neutrality is usually advanced as the justification for tax systems that impose "worldwide" taxation on resident companies (however defined) and that pair that worldwide taxation with an FTC.

⁹²On this last point, see Hines, "Reconsidering the Taxation of Foreign Income," *supra* Part 1, note 50; and Hines, "Foreign Income and Domestic Deductions," *supra* Part 1, note 53.

⁹³See also Mitchell A. Kane, "Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks," 26 *Va. Tax R.* 53, 59 (2006) (offering what he describes as a revised version of ownership neutrality, under which "ownership neutrality will hold where the potential acquirer with the greatest productivity advantage will be able to offer the highest bid for the target").

source country where they are earned, and after-tax corporate normal returns throughout the world are therefore the same. Desai and Hines appear to have relied on those assumptions in developing their policy recommendation that the United States adopt a territorial tax system.⁹⁴ The resulting problem is not with this logic, but with the fact that stateless income vitiates the existence of uniform market clearing prices for firms or for business investments.

In other words, the capital ownership neutrality model assumes a world of perfect “tax capitalization” — one where different tax burdens on different investments are reflected in prices, so that all instruments yield the same after-tax risk-adjusted returns. Tax capitalization also is described through the language of “implicit taxation.”⁹⁵ For example, imagine that U.S. fully taxable normal returns are 10 percent, and a high-grade tax-exempt municipal bond yields 6.5 percent, so that both a \$1,000 principal amount taxable bond with a 10 percent coupon and a \$1,000 principal amount tax-exempt municipal bond with the same maturity and a 6.5 percent coupon trade for \$1,000. In this case one can say that the different tax burdens have been capitalized into prices, or that the municipal bond’s owner bears an implicit tax of 35 percent, because she accepts a 6.5 percent rather than 10 percent coupon.

Implicit taxes are not collected by a government, but they are reflected in an investor’s yield. In this sense, the capital ownership neutrality model can be described as assuming that all businesses, wherever located in the world, earn the same after-tax normal rate of return and suffer the same tax burden, where “tax” for this purpose is understood to include both explicit and implicit taxes.

The capital ownership neutrality model assumes that from the perspective of a U.S. multinational firm, an investment in a foreign target company functions exactly like a municipal bond in the U.S. domestic market with perfect tax capitalization.

⁹⁴For example, in a recent article, Hines responds to criticism that his proposals would be unfair to U.S. domestic firms by arguing that it is fair that the United States not tax the income of a U.S. firm’s foreign subsidiary that does business in a zero-tax jurisdiction, while fully taxing the U.S. parent’s domestic income, because competition will drive down the after-tax yield in the first jurisdiction to the same level as that of wholly domestic U.S. companies. Hines, “Reconsidering the Taxation of Foreign Income,” *supra* Part 1, note 50, at 292-293 (“The zero tax rate in the foreign jurisdiction unleashes foreign competition that reduces the returns that investors can earn locally.” *Id.* at 293).

⁹⁵Myron S. Scholes et al., *Taxes and Business Strategy: A Planning Approach*, ch. 5 (2009); Stanley Koppelman, “Tax Arbitrage and Interest Deduction,” 61 *S. Cal. L. Rev.* 1143, 1172-1173 (1988).

Without this assumption, Desai and Hines cannot conclude that a territorial tax regime can satisfy capital ownership neutrality.

There is extensive domestic literature that explores the twin concepts of tax capitalization and implicit taxation. In particular, the existence in the capital markets of tax-exempt municipal bonds alongside otherwise comparable taxable ones offers a perfect opportunity to explore the practical aspects of tax capitalization theory.⁹⁶ Also, the capitalization of tax benefits into prices received much attention during the heyday of individual tax shelters. Some argued that the after-tax yields on tax shelter investments necessarily would fall to the same yields as otherwise comparable taxable investments, leaving the system (in the words of Boris Bittker) with inefficiencies (more office towers in Houston than might be the case in a world of constant burdens on capital investments) but no inequities (no taxpayers — or at most, only the very earliest movers — would capture inframarginal yields on their tax shelter investments).⁹⁷

The literature reflects the consensus that tax capitalization does not function as perfectly as theory would predict.⁹⁸ For example, municipal bond yields are higher than would be expected in a

⁹⁶See Merle Erickson, Austan Goolsbee, and Edward Maydew, “How Prevalent Is Tax Arbitrage? Evidence From the Market for Municipal Bonds,” 56 *Nat’l Tax J.* 259 (2003). Erickson, Goolsbee, and Maydew find few firms engaging in municipal bond tax arbitrage and conclude that there must be significant (broadly defined) transaction costs associated with this type of arbitrage. *Id.* at 268.

⁹⁷Bittker, “Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities?” 16 *San Diego L. Rev.* 735 (1979); Bittker, “Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?” 28 *Nat’l Tax J.* 416 (1975).

⁹⁸David Weisbach, “Implications of Implicit Taxes: Commentary on Crane’s ‘Some Explicit Thinking About Implicit Taxes,’” 52 *SMU L. Rev.* 373, 380 (1999) (“Reliance on full capitalization is utopian. Full capitalization has never happened and is unlikely to ever happen”); Calvin H. Johnson, “Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters,” *Tax Notes*, Apr. 15, 1996, p. 377, *Doc 96-11398*, 96 *TNT* 78-28 (“Equilibrium between the returns from tax-favored investments and from debt has never happened and cannot be expected to happen. The supply of tax-favored investments is too large and too elastic. In absence of equilibrium, the interest deduction on debt-financed investments in tax-favored assets does not work right. In absence of equilibrium, debt-financed, high-bracket investors bid up the price of tax-favored investments and drive out all lower-bracket competitors. In absence of equilibrium, debt can become cost-free after tax: the tax savings generated by the debt is more valuable than the debt itself costs in real or present value terms”); Scholes et al., *supra* note 95, at 143-145, review economic literature finding evidence that tax capitalization occurs in general, but they also point out that in light of different clienteles, “market frictions or tax-rule restrictions are required to prevent arbitrage opportunities.”

world of perfect capitalization.⁹⁹ Indeed, Hines recognizes in his most recent article that municipal bonds are an example of a tax capitalization market failure, which he attributes “insufficient demand” (for which one could also write “oversupply”).¹⁰⁰ But Hines does not then consider the possibility that multinational groups can defeat the mechanism of tax capitalization themselves, through stateless income tax planning.

D. Extending the Model for Stateless Income

One could develop strong arguments why it would be implausible to assume the existence of perfect tax capitalization in the returns on business investments across different countries. Critically, however, it is unnecessary to do so.

Tax capitalization cannot work in the international context to ensure that all firms face the same after-tax returns on foreign direct investment by virtue of the distinction between what Prof. Stanley Koppelman termed “status” tax arbitrage and “asset” tax arbitrage.¹⁰¹ Municipal bonds are an example of asset arbitrage — the asset itself carries the special tax preference. In theory, it would be possible to describe circumstances (efficient markets, no limits on debt incurred for arbitrage activities, and a supply curve for tax-favored assets identical to that for otherwise comparable tax-unfavored ones) under which full tax capitalization would be achieved for those assets.

By contrast, status tax arbitrage is personal to the taxpayer, not a characteristic of the asset. The fully taxable bond that becomes tax exempt when held by a Roth IRA or a university endowment is an example. Tax capitalization cannot gain even a toehold when the after-tax return on the same asset varies from the pretax return (that is, a zero tax burden) to the maximum statutory marginal rate, depending on the taxpayer’s status.

⁹⁹Koppelman, *supra* note 95, at 1176-1185; Erickson, Goolsbee, and Maydew, *supra* note 96, at 267-268 (finding that there may be costs that raise the costs of borrowing for firms, thereby making arbitrage unprofitable); Johnson, “Inefficiency Does Not Drive Out Inequity,” *supra* note 98, at 381-386.

¹⁰⁰Hines, “Reconsidering the Taxation of Foreign Income,” *supra* Part 1, note 50, at 293.

¹⁰¹Koppelman, *supra* note 95, at 1175-1176. Asset tax benefits attach to specific assets and are subject to market forces. Prices of these assets will rise relative to other assets to reflect the tax benefit. *Id.* Status tax benefits result from the status of the taxpayer or the status of the intermediary through which the taxpayer invests rather than the type of asset purchased (e.g., bonds that yield nontaxable income because the taxpayer is exempt from tax). *Id.* Status tax benefits are not capitalized and can present opportunities for status tax arbitrage. Eugene Steurele used the terms “normal” and “pure” to make the same point. Eugene Steurele, *Taxes, Loans, and Inflation*, at 59-60, n.4 (1985).

Even if asset tax arbitrage theory worked perfectly in practice, the problem that capital ownership neutrality model ignores is that multinational enterprises can engage in status arbitrage. A multinational firm’s income from foreign direct investment is not invariably taxed in the source country in an economic sense. Instead, stateless income tax planning enables multinational firms to capture high-tax-country pretax yields on which those firms pay tax only at low rates in other countries.

To see this, return to the model described above and introduce the concept of stateless income. For simplicity, assume that a multinational firm (but not a local domestic one) can arbitrarily move income from high-tax jurisdictions (including the multinational’s home country) to low-tax ones while retaining ownership of the income stream. (The simplest example would be interest paid within the multinational enterprise’s group, from a high-tax subsidiary to a low-tax one.) Further assume that the United States has implemented a territorial tax system as the basis for taxing foreign direct investment by U.S. multinational firms. As a result, no U.S. tax is imposed on a foreign subsidiary’s earnings.¹⁰² Moreover, the United States has followed the Hines recommendation not to limit in any way the deductibility of U.S. domestic expenses, even when those expenses are directly incurred to finance foreign direct investments. How do these new assumptions change the capital ownership neutrality analysis, as summarized in the preceding subsection?

The analysis changes fundamentally, not for a prospective investment in a real business in Freedonia or any other low-tax jurisdiction, but for prospective investments in Sylvania or other *high-tax* countries. If one accepts the original model’s assumption that after-tax (and before stateless income tax planning) rates of return are constant around the world, the injection of stateless income into the model means that a multinational enterprise, but not a wholly domestic firm, can capture the higher pretax normal returns found in high-tax countries, but pay low taxes on them, by shifting the locus of taxation of those high pretax returns to a low-tax jurisdiction — what this report terms tax rents.

¹⁰²Technically, territorial tax systems also retain residence country taxation for some categories of passive or mobile income (termed subpart F income in the United States). The text assumes that the stateless income strategies used here would not trigger those rules.

In effect, as long as stateless income tax planning is available, investments in high-tax countries become opportunities to capture supernormal after-tax returns, but only for multinational firms that can exploit those planning opportunities. Only multinational enterprises can acquire stateless income, because to generate it requires affiliates in both low-tax and high-tax jurisdictions.

As an illustration, recall that in the original example normal pretax returns in Sylvania, with its 25 percent tax rate, are 6.67 percent (thus yielding 5 percent after tax), while normal pretax returns in Freedonia are 5.56 percent (also yielding a 5 percent after-tax return). Now inject stateless income tax planning into a U.S. multinational firm's corporate acquisition strategy.

If a U.S. multinational were to acquire a Sylvanian target company and divert some of the target's income to Freedonia, the U.S. firm would have an after-tax return of 6 percent on that diverted income, not the global after-tax normal return of 5 percent (6.67 percent pretax return minus a Freedonian 10 percent tax). Moreover, the U.S. firm could further turbocharge its returns by financing the deal with debt at the U.S. parent level. The net effect would be to convert 35 percent taxed domestic income into 10 percent taxed foreign income. And this opportunity would exist only through strategies available because of the U.S. firm's status as a multinational enterprise.

As this example illustrates, a U.S. (or foreign) multinational enterprise's shopping list for the global auctions that Desai and Hines envision will be fundamentally rearranged once the firm's stateless income planning opportunities are considered. Ironically, rearranging priorities will not directly affect the multinational firm's interest in enterprises in low-tax jurisdictions. Those target companies presumably already are priced to reflect the low-tax environment in which they operate. Tax capitalization should work in those cases.

The multinational enterprise's priorities that will change are its appetites for acquiring target companies in high-tax countries. They will become much more attractive to the multinational firm than to domestic bidders to the extent that under the tax law of the jurisdiction, stateless income planning strategies are easily implemented. And in turn, U.S. domestic leverage exacerbates the resulting policy problem (or business opportunity).

Stateless income tax planning thus also undermines Hines's arguments that the domestic U.S. expenses of a U.S. multinational firm should be fully deductible in the territorial tax system, regardless of whether those expenses directly support

foreign income not subject to U.S. tax.¹⁰³ In a world where stateless income can be earned, the result would be a zeroing out of the firm's domestic tax base.¹⁰⁴

In other words, permitting a deduction for U.S. expenses that are directly allocable to earning foreign income would be tantamount to offering U.S. individuals unlimited IRA accounts and full deductibility of interest expense on all borrowings. Rational individual taxpayers would borrow in their personal capacity and invest in low-risk assets through their IRAs. They would capture a positive arbitrage profit not because of a market failure in tax capitalization, but rather because of their status (the IRA), which enables them to hold otherwise taxable financial assets without paying tax.¹⁰⁵ The same would apply — indeed, to a large extent does apply today — to a U.S. multinational firm that can use its status to transmute high-tax jurisdiction pretax normal returns into low-taxed income.

In response, it might be argued that, although the existence of stateless income invalidates the tax capitalization story, if every other country has adopted a territorial tax system and broadly countenances the existence of stateless income tax planning, the United States should too in order to create a level playing field for U.S. multinational firms. This argument is not an economic welfare argument. It is in practice a simple call for corporate "competitiveness" and at most an incomplete national welfare argument, but one of uncertain merit. The urge to cheer for the home team is understandable, but the intuitive sports metaphor does not necessarily hold.

In effect this argument is indistinguishable from a call for export subsidies on the grounds that other countries offer them. If U.S. tax revenues are kept constant, those de facto subsidies must be borne by other Americans. The positive externalities to the United States of fielding a team of successful U.S.

¹⁰³Hines, "Foreign Income and Domestic Deductions," *supra* Part 1, note 53, at 463-465. Hines argues that not allowing for these deductions distorts the behavior of U.S. multinational firms and encourages them to increase foreign rather than domestic investment.

¹⁰⁴Kane, "Considering 'Reconsidering the Taxation of Foreign Income,'" 62 *Tax L. Rev.* 299, 314 (2008) ("With arbitrage the concern is that the U.S. taxpayer could zero out tax liabilities on the income from the domestic deployment of capital").

¹⁰⁵*Compare* Scholes et al., *supra* note 95, at 155-156 (the elimination of tax liability through leverage-based tax arbitrage when the implicit tax burden is lower than explicit taxes saved).

multinationals (complementarily in U.S. job creation, for example) must be weighed against the costs of funding the subsidy and the social costs of distorted investment decisions.¹⁰⁶ This is an entirely different analysis from that undertaken in advancing capital ownership neutrality as a policy prescription for the United States.

VI. Putting Teeth Into Territoriality

A. Overview

Every country that is the residence of major multinational enterprises, other than the United States, has adopted some form of territorial tax system. But stateless income distorts the implicit tax mechanism that lies at the core of the most cogent theoretical case for territorial taxation, and it compounds the meaninglessness of the entire concept of the source of income. The economic case for territorial taxation therefore compels a correlative campaign to eradicate stateless income tax planning opportunities of every form.

This section considers how countries might respond to the phenomenon of stateless income within the context of territorial tax systems. Territorial tax systems and worldwide tax consolidation, of course, are polar opposite approaches from which to address the phenomenon of stateless income. From the unique perspective of U.S. law, however, both territorial tax systems and a worldwide tax consolidation regime share an immediate welfare-enhancing aspect, which is the elimination of the lockout effect. The huge amount of locked-out earnings (more than \$1.4 trillion) and their accelerating growth argue strongly for a decisive move in either direction and away from the status quo.

B. Cartoon Territoriality

In light of the debate over the future direction of U.S. corporate tax policies regarding foreign direct investment, it is important to begin the discussion of territorial tax responses to the stateless income phenomenon by clarifying the current state of the art in territorial tax design. Recent speeches,¹⁰⁷

¹⁰⁶To suggest that U.S. multinationals are primarily owned by U.S. persons (which is true) and therefore that higher U.S. multinational profits justify “pro-competitive” international tax policies looks at one side of the picture but overlooks that those higher profits are being funded through subsidies provided by other U.S. persons (for example, domestic businesses).

¹⁰⁷Amy S. Elliott, “GE Executive Criticizes Possible U.S. Territorial System,” *Tax Notes*, Feb. 28, 2011, p. 998, *Doc 2011-3673*, 2011 *TNT* 35-5 (remarks of John M. Samuels, GE vice president and senior counsel for tax policy and planning).

testimony,¹⁰⁸ and articles¹⁰⁹ by representatives of U.S. multinational firms and their advisers paint consistent pictures of both the current U.S. tax system in operation and the current state of development of territorial tax systems.

In the standard version of this presentation, every major country that uses a territorial tax system does so with at most inconsequential restrictions (such as a blanket inclusion in taxable income of 5 percent of otherwise exempt dividends from foreign subsidiaries). Expenses incurred in the residence country are not allocated against tax-exempt (territorial) income or otherwise limited or disallowed (beyond the 5 percent sort of haircut referenced above). Further, those presentations imply that these systems are static in design and that there is no pressure to reform them to address the stateless income problems identified in this report.

This is incomplete and misleading, to the point where it fairly can be labeled a cartoon version of the territorial tax policies that should be adopted if the United States were to move in this direction. Foreign policymakers are highly concerned about the tax avoidance issues implicit in the stateless income phenomenon,¹¹⁰ international tax design is a subject of political controversy in other countries,¹¹¹ non-U.S. analysts have recently focused closely on the problem,¹¹² and many natural experiments are underway in different countries to address these concerns.

¹⁰⁸Testimony of Robert A. McDonald, chair, Fiscal Policy Initiative Business Roundtable, before the House Ways and Means Committee hearing on tax reform, Jan. 20, 2011 (Jan. 24, 2011), *Doc 2011-1279*, 2011 *TNT* 14-42 (testimony of president and CEO of Procter & Gamble).

¹⁰⁹Philip R. West, “Across the Great Divide: A Centrist Tax Reform Proposal,” *Tax Notes*, Feb. 28, 2011, p. 1025, *Doc 2011-2086*, 2011 *TNT* 40-7; Barbara Angus et al., “The U.S. International Tax System at a Crossroads,” *Tax Notes*, Apr. 5, 2010, p. 45, *Doc 2010-4430*, 2010 *TNT* 64-4; John M. Samuels, “American Tax Isolationism,” *Tax Notes*, June 29, 2009, p. 1593, *Doc 2009-14174*, 2009 *TNT* 122-11.

¹¹⁰Thomas Rixen and Markus Leibrecht, “Double Tax Avoidance and Tax Competition for Mobile Capital,” ch. 4 in Martin Zagler (ed.), *International Tax Coordination: An Interdisciplinary Perspective on Virtues and Pitfalls* 70-71 (2010) (identifying government responses to stateless income planning and further speculating that the breadth of these responses to date may have been limited by international tax competition among nations, at the behest of multinational firms).

¹¹¹Kristen A. Parillo, “Activists Protest Vodafone’s Alleged ‘Tax Dodge,’” *Tax Notes Int’l.*, Nov. 8, 2010, p. 392, *Doc 2010-23589* (reporting on activist groups’ demonstrations against international tax planning activities of U.K. firm Vodafone).

¹¹²Wolfgang Schoen, “International Tax Coordination for a Second-Best World,” 1 *World Tax J.* 67 (2009) (Part I), 2 *World Tax J.* 65 (2010) (Part II), and 2 *World Tax J.* 227 (2010) (Part III) (casting taxation of foreign direct investment as an exercise in intersovereign coordination, urging an incremental continuity approach, and ultimately recommending allocation of taxing

(Footnote continued on next page.)

One final important overarching theme for U.S. policymakers is that the rationales that other countries use in adopting territorial systems extend beyond economic efficiency arguments. Within the EU, territorial tax systems are easier to implement than are worldwide tax consolidation regimes in a manner consistent with the tightly integrated nature of the European market and with European Court of Justice jurisprudence interpreting Treaty of European Union constitutional principles governing freedom of establishment.¹¹³ And some countries (for example, Canada¹¹⁴) have adopted relatively toothless territorial tax systems as conscious subsidies for their corporate national champions. This is an economic *inefficiency* argument at work, and one that hardly should be cited as precedent for the United States, any more than one would cite export trade subsidies by another country as a principled reason for the United States to adopt tax expensing of capital investment.

To that end, policymakers should reflect on the fact that the United States, which today remains the largest economy in the world, operates an ersatz sort of territorial tax regime that in many respects — for example, its sheltering of interest and royalty income repatriated to the United States, or the costless tax system arbitrage abetted by the check-the-box regulations — is more conducive to stateless income tax planning than are more coherent territorial tax regimes. It is not surprising that other countries find it so difficult to deflect the pressures

rights and income on a sales and services basis); Maarten F. de Wilde, "Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy," 38 *Intertax* 281 (2010); and de Wilde, "A Step Towards a Fair Corporate Taxation of Groups in the Emerging Global Market," 39 *Intertax* 62 (2011) (analyzing tax-induced distortions of economic behavior arising in cross-border contexts and recommending the development of worldwide tax consolidation solutions to reflect a unitary business approach, eliminating intragroup interest expense in consolidation but ultimately allocating income from real investments following OECD transfer pricing guidelines for permanent establishments); Vann, *supra* Part 1, note 46 (focusing on transfer pricing as the core stateless income tax avoidance problem, rejecting current practice as based on inappropriate market analogies that ignore the theory of the firm, and encouraging both limits on intragroup contractual freedoms and the wider use of profit-split methods).

¹¹³EU constitutional concerns plainly limit the ability of one member state to restrict a company's ability to re-domicile in another member state. Carsten Gerner-Beuerle and Michael Schilling, "The Mysteries of Freedom of Establishment After Cartesio," available at <http://ssrn.com/abstract=1340964>. De Wilde at least believes that constitutional concerns would not prohibit the adoption of unilateral mandatory worldwide tax consolidation by an EU member state. De Wilde, "A Step Towards a Fair Corporate Taxation of Groups in the Emerging Global Market," *supra* note 112, at 75-76.

¹¹⁴Samuels, *supra* note 109, at 1595.

of their national champions to countenance tax competition through weak implementation of limits on territorial tax rules when those national champions can persuasively argue that the largest stateless income abusers of current law, ironically enough, hail from the United States, the last redoubt of putative worldwide taxation. It is the United States that needs to make the first move if the stateless income problem is to be addressed.

The remainder of this section considers some of the efforts in territorial tax countries to address the stateless income problem.

C. Thin Capitalization

It is true that no major jurisdiction that uses a territorial tax system disallows interest expense incurred in the parent company's domicile on the theory that it has been incurred for the purpose of earning tax-exempt foreign dividends. But to make that assertion without qualification paints a misleading picture. In fact, several major economies reach this result through another means — thin capitalization statutes.¹¹⁵

Thin capitalization statutes traditionally were understood as source country rules that limited earnings stripping from the source country to a low-tax affiliate by limiting the introduction of excessive internal leverage within a multinational group.¹¹⁶ More recent and sophisticated thin capitalization statutes go much further by limiting the amount of interest deductions allowable to the parent company of a multinational group in its country of domicile.

The German thin capitalization regime is a good example of this more sophisticated approach.¹¹⁷ As applied to a German parent of a multinational group, the German thin capitalization rules impose a hard cap on interest deductions of 30 percent of

¹¹⁵In 2008 an International Fiscal Association study concluded that 18 out of 34 countries examined had adopted thin capitalization statutes. See Alfred Storck, "The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements," 65 *Bull. for Int'l Tax.* 27, 36 (2011). For a comprehensive and recent overview, see Tim Edgar, Jonathan Farrar, and Amin Mawani, "Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis," 56 *Can. Tax J.* 803 (2008). See also Stuart Webber, "Thin Capitalization and Interest Deduction Rules: A Worldwide Survey," *Tax Notes Int'l*, Nov. 29, 2010, p. 683, *Doc 2010-23763*.

¹¹⁶Section 163(j) is an example of a source country thin capitalization statute, in this case designed to protect the United States as a source country.

¹¹⁷Wolfgang Kessler and Rolf Eicke, "Germany's Growth Acceleration Act — Taming the Sunshine Tax Legislation," *Tax Notes Int'l*, Apr. 12, 2010, p. 127, *Doc 2010-6751*, summarizes current German law. The text's description of the relevant German rules is drawn primarily from this article.

the firm's earnings before interest, taxes, depreciation, and amortization. If a German firm were to borrow extensively to invest in the equity of foreign subsidiaries (the dividends from which would be exempt), the German parent company would run into the hard cap on interest deductibility. The same rule applies to German firms as source country taxpayers.

There is only one escape clause from this outright limit on tax-advantaged leverage: A German parent company can deduct interest without limitation if its German equity-to-debt ratio (looking only at German business assets, not equity in foreign subsidiaries) is no less than 2 percentage points lower than its worldwide equity-to-debt ratio. In other words, interest expense incurred by the German parent in Germany is fully deductible only if the German parent on a stand-alone basis is no more than immaterially more highly leveraged than its non-German operations. Australia's rule is similar,¹¹⁸ and Sweden recently introduced innovative debt push-down legislation.¹¹⁹

Thin capitalization statutes are growing in importance and sophistication precisely because countries that use territorial tax regimes understand how easy it is to game their tax bases in the absence of those rules through the location of external or internal debt.¹²⁰ The Council of the European Union in 2010 published a resolution on the design of European Constitution-compliant thin capitalization and CFC¹²¹ laws.¹²² This resolution recommends a very narrow scope for intra-EU CFC laws to reflect ECJ jurisprudence on the constitutional freedoms of establishment and movement of capital. But it suggests essentially no EU constitutionally-mandated restrictions on thin capitalization statutes, beyond the observation that they should reach genuine instances of thin capi-

talization. This resolution plainly augurs further thin capitalization statutes along the German lines in the years to come.

D. CFC Rules

Many jurisdictions use the term "CFC" to refer to a foreign subsidiary whose income for some reason is disqualified from eligibility for that jurisdiction's territorial exemption rules. In those jurisdictions, to refer to CFC rules is to refer to antiabuse rules of one stripe or another.

In effect, when a territorial tax system adopts CFC rules, it abandons the territorial principle in favor of residence-based taxation for activities within the scope of those rules. Countries that have adopted territorial tax regimes have looked to CFC rules to limit the sorts of tax avoidance that this report describes under the rubric of stateless income.¹²³

As noted in the previous subsection, far-reaching CFC rules are difficult to reconcile with EU constitutional law guarantees of freedom of establishment and movement of capital, and they hence occupy a narrower role within the European Union than might otherwise be the case.¹²⁴ Nonetheless, EU member states are reviewing their CFC rules with a view to addressing tax avoidance concerns of the same nature as those developed in this report and its predecessor, to the extent permitted by EU constitutional law.¹²⁵ In March 2011, in connection with its proposal for an EU-wide common consolidated corporate tax base (CCCTB), the European Commission recommended the adoption of a European-wide CFC rule applicable to subsidiaries outside the European Union.¹²⁶ And outside the European Union, CFC rules can play a much larger role in limiting stateless income tax planning in a territorial tax regime.

For example, in 2009 Japan abandoned a deferral and FTC regime roughly similar to U.S. law for the

¹¹⁸Edgar et al., *supra* note 115, at 840-841. Australian thin capitalization rules deny the deduction of interest on debt of an Australian resident corporation controlled by a nonresident, if the amount of that debt exceeds a 75 percent debt-to-asset ratio. The Australian rules effectively limit the amount of debt that can be sourced domestically for interest deductibility purposes to the greater of (1) 75 percent of Australian assets and (2) 120 percent of the leverage of worldwide corporate group.

Cf. reg. section 1.861-10T(e) (imposing limitations for FTC purposes on interest arising on U.S. parent company debt that is disproportionately large compared with the indebtedness of its CFCs).

¹¹⁹Storck, *supra* note 115, at 35.

¹²⁰*Id.* at 29 ("Following this trend, it can be expected that intra-group financing and leverage in general will in the future be scrutinized to a much greater extent than in the past").

¹²¹CFC has a different meaning outside the United States. See the discussion in Section VI.D., *infra*.

¹²²Resolution of the Council of the European Union C 156/1, *Doc 2010-13338*.

¹²³Nicolas Garfunkel, "Are All CFC Regimes the Same? The Impact of the Income Attribution Method," *Tax Notes Int'l*, July 5, 2010, p. 53, *Doc 2010-9471*.

¹²⁴See *supra* text accompanying note 115.

¹²⁵See, e.g., Bill Dodwell et al., "U.K. Begins Corporate Tax Reform Discussion," *Tax Notes Int'l*, Dec. 6, 2010, p. 723 (discussing U.K. review of its CFC rules).

¹²⁶European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base," COM/2011/121, at 47 (Article 82), available at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm. The CFC rule would be triggered if the statutory tax rate in the non-EU country was less than 40 percent of the average EU rate and the subsidiary located there derived primarily passive or mobile income of the sort that U.S. readers might associate with foreign personal holding company income (section 954). Most important, tainted income includes royalties from intangible assets and interest income.

taxation of income derived from foreign direct investment, and it instead adopted a territorial tax system under which a Japanese parent company can exclude from its income 95 percent of the dividends it receives on substantial investments (25 percent or more) of the stock of a foreign corporation.¹²⁷ That change has been much discussed by proponents urging the United States to adopt what this report earlier described as cartoon territoriality.

Less frequently observed is that Japan also uses a stringent CFC rule. Under it, a foreign subsidiary of a Japanese firm that has an effective tax rate of less than 20 percent (ignoring dividends from substantial participations in other foreign affiliates in the income calculation) or whose head office is in a jurisdiction that has no income tax is presumptively ineligible for the new dividend exemption regime.¹²⁸ As a result, this income is immediately taxed in the hands of the Japanese parent company.¹²⁹

If the United States were to adopt a territorial tax system with a CFC rule similar to Japan's, income derived from an arrangement like the Google Double Irish Dutch Sandwich (described in Part 1 of this report) presumably would fail to qualify for the exemption. As the example suggests, CFC rules like Japan's thus could serve as an important constraint on stateless income tax planning in a U.S. territorial tax system.¹³⁰

E. Haircuts

The parent company of a multinational group typically incurs unreimbursed expenses that benefit the whole worldwide group. Groupwide external debt that is concentrated at the parent company is the most dramatic example. As discussed above, sophisticated thin capitalization statutes are a direct response to this case. However, a typical parent company will also incur many other unreimbursed groupwide expenses. In the absence of countervailing tax rules, a territorial tax jurisdiction that is the domicile of a multinational firm will find that its tax revenues are reduced by these expenses incurred to support income that is sourced to other countries and therefore exempt in the parent company's country of residence.

Many territorial regimes for the taxation of foreign direct investment address this problem through an arbitrary inclusion in the parent compa-

ny's income of a fraction — often 5 percent — of otherwise exempt dividends that the parent receives from its participations in foreign operations. Japan is one example; France, Germany, and Italy are others.¹³¹ These haircuts are administratively useful tax solutions, but they address only a small part of the stateless income problem — as demonstrated by the eagerness of U.S. corporate proponents of cartoon territoriality to offer them up.

F. Formulary Apportionment

The fundamental crisis confronting all territorial tax systems today is that they allocate taxing rights among nations solely by reference to the geographic source of a firm's profits, but there is a strong consensus that the existing source rules are unimplementable in practice and conceptually bankrupt. As a result, many observers have agreed that a world in which territorial taxation is the model for taxing foreign direct investment requires the adoption of some sort of (ideally coordinated) formulary apportionment of income method as the mechanism for allocating a multinational enterprise's global income to source countries.¹³² That method in turn could be applied to all group activities on a consolidated basis (a unitary approach) or to a subset of activities in which arm's-length pricing methods appear particularly deficient as a conceptual and administrative matter.¹³³

In short, a powerful case can be made that a well-ordered territorial tax system necessarily implies the systematic application of formulary apportionment rules for at least some of a multinational group's activities in order to add some economic foundation and consistency to the concept of source. The European Union in March 2011 took a major step in that direction when the European Commission released a detailed proposal for a pan-EU CCCTB.¹³⁴ It was the culmination of a project begun 10 years earlier.

If approved by the European Parliament and agreed to unanimously by the European Union's member states, the CCCTB would permit a firm with operations in the European Union to elect to

¹³¹Samuels, *supra* note 109, at 1595.

¹³²See, e.g., Reuven S. Avi-Yonah and Ilan Benshalom, "Formulary Apportionment — Myths and Prospects" (Oct. 16, 2010), available at <http://ssrn.com/abstract=1693105>; Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *U. Fla. Tax. Rev.* 497 (2009); Reuven A. Avi-Yonah and Kimberly Clausing, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," in *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* 319-344 (2008).

¹³³Avi-Yonah and Benshalom, *supra* note 132.

¹³⁴European Commission, *supra* note 126.

¹²⁷Lawrence Lokken and Yoshimi Kitamura, "Credit vs. Exemption: A Comparative Study of Double Tax Relief in the United States and Japan," 30 *Nw. J. Int'l L. & Bus.* 621, 628 (2010).

¹²⁸*Id.* at 641-642.

¹²⁹*Id.*

¹³⁰This also is Lokken and Kitamura's conclusion, *id.* at 643-645.

consolidate its EU operations and then to apportion its consolidated net EU income among the members of the group (and member states) in accordance with a formula. The commission summarized that formula as follows:

The formula for apportioning the consolidated tax base should comprise three equally weighted factors (labour, assets and sales). The labour factor should be computed on the basis of payroll and the number of employees (each item counting for half). The asset factor should consist of all fixed tangible assets. Intangibles and financial assets should be excluded from the formula due to their mobile nature and the risks of circumventing the system. The use of these factors gives appropriate weight to the interests of the Member State of origin. Finally, sales should be taken into account in order to ensure fair participation of the Member State of destination. Those factors and weightings should ensure that profits are taxed where they are earned. As an exception to the general principle, where the outcome of the apportionment does not fairly represent the extent of business activity, a safeguard clause provides for an alternative method.¹³⁵

The proposal does not seek to harmonize tax rates, which would be left to each member state.

In light of the administrative failures and conceptual bankruptcy of the arm's-length standard, some sort of formulary apportionment may be necessary for any well-ordered territorial tax system. But formulary apportionment is not a panacea, and it brings with it its own implementation and abuse problems.¹³⁶ The system can be gamed through the relocation of relatively fungible real assets or personnel to low-tax jurisdictions (to attract a disproportionate amount of groupwide net profits) or by the acquisition of low-value-added but high-volume businesses (for example, a grocery store chain) in a low-tax jurisdiction to augment the sales factor in that jurisdiction.¹³⁷ This in turn requires responses such as authorizing tax administrators to divide firms into different subgroups when necessary to prevent abuse. In the absence of a multilateral implementation along the lines contemplated by the European Union, formulary apportionment also has been criticized as likely to lead to under- or

¹³⁵*Id.* at 14, para. (21).

¹³⁶Compare Altshuler and Grubert, "Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives?" 63 *Nat'l Tax J.* 1145 (2010), with Avi-Yonah and Benschalom, *supra* note 132.

¹³⁷Altshuler and Grubert, *supra* note 136.

overtaxation because its goals of taxing income where earned will be defeated by the competing measurement systems.

VII. Worldwide Tax Consolidation

A. Introduction

The logical alternative to a territorial tax system is a worldwide global tax consolidation (or full-inclusion) model.¹³⁸ Again, this is not the same as the current U.S. system for taxing foreign direct investment. A genuine worldwide tax model would effectively consolidate the operations of foreign subsidiaries with those of the parent company for tax purposes, just as they today are consolidated for financial accounting purposes, and it would impose residual U.S. tax, net of an FTC, on a current basis, regardless of where the income is retained as a cash matter.¹³⁹

A worldwide tax consolidation system has some important advantages over the current U.S. rules applicable to foreign direct investment. First, it removes the lockout constraint on repatriations of foreign earnings. Territorial tax solutions address the problem by never taxing foreign earnings, and a true worldwide tax consolidation system does so by always taxing them, so that there is no incremental cost to repatriation.

Second, a worldwide tax consolidation solution treats losses symmetrically with income. Symmetry in the taxation of losses and income is critical to accurately taxing capital income.¹⁴⁰ Current law is asymmetrical in that a foreign subsidiary's losses do not directly give rise to reductions in U.S. tax,

¹³⁸A worldwide imputation system was recommended in Samuel C. Thompson Jr., "An Imputation System for Taxing Foreign-Source Income," *Tax Notes*, Jan. 31, 2011, p. 567, *Doc 2011-94*, or *2011 TNT 21-6*. That paper reviews some of the same issues considered here but is ambiguous as to whether the system the author contemplates would be tantamount to complete tax consolidation, in which net losses and net income of foreign subsidiaries would be includable in a U.S. parent company's tax return.

¹³⁹The ownership threshold for consolidation of foreign subsidiaries should be the direct or indirect ownership of stock comprising more than 50 percent by vote or value of the stock of the foreign corporation. Consolidation would be mandatory in these circumstances. For a conflict between two U.S. shareholders, one of which owns more than 50 percent of a domestic firm's voting stock and the other more than 50 percent of the value of that firm's stock, an arbitrary tiebreaker rule would be required.

It also may be necessary to retain current-law principles to address companies that today are CFCs but that have no U.S. shareholder with enough control to consolidate that company. These cases are rare.

¹⁴⁰Edward D. Kleinbard, "Designing an Income Tax on Capital," in Henry J. Aaron et al., *Taxing Capital Income* 168-169 (2007).

while foreign income ultimately is includable in the U.S. tax base if and when repatriated. Both territorial and worldwide tax consolidation systems eliminate this distortion. In the territorial case, that is because foreign operating earnings are taxed by the residence country at a zero rate, and conversely no deductions are available in the residence country for foreign losses. In the worldwide tax consolidation case, that result follows from the extension of tax consolidation to foreign operations, so that foreign operating losses (including losses incurred by a foreign subsidiary) are fully available to offset domestic income.

Third, a worldwide tax consolidation system by definition satisfies the traditional capital export neutrality benchmark. This is not the only relevant goal in designing an international tax system, but it is not a bad thing if it can be obtained without introducing other major distortions in taxpayer behavior.

More generally, a worldwide tax consolidation system focuses policymaker attention on domestic productivity and competitiveness, as well as on international business competitiveness, because the tax system links the two. Territorial tax systems do not implement neutrality in investment location decisions in a world imbued with stateless income.

Fourth, and most critically for the themes developed in this report, a worldwide tax consolidation system directly addresses the problem of stateless income. Under such a regime, a multinational business enterprise obtains no advantage from generating stateless income if its average effective foreign tax rate before taking stateless income into account is no higher than the residence jurisdiction tax rate.¹⁴¹ The reason is that income moved to a low-tax foreign jurisdiction is still taxed in the residence country at the latter's rates.

A worldwide tax consolidation system thus is a unilateral response to stateless income tax planning that is still highly effective at curbing the problem. By contrast, territorial tax systems have only limited tools available to protect the income base in source countries short of hypothesizing multilateral coordinated solutions involving novel implementations of universal formulary apportionment rules.

Fifth, a worldwide tax consolidation system resolves two specific large and otherwise intractable administrative problems embedded in stateless income tax planning. Worldwide tax consolidation

¹⁴¹The text here assumes an FTC mechanism that permits some amount of cross-crediting, as does the current U.S. system. It is a fair question, however, whether current law or the law of cross-crediting circa 1986 would better implement that mechanism, particularly considering the need to encourage U.S. taxpayers to minimize foreign tax liabilities.

substantially aids transfer pricing enforcement, because again there is no advantage to using aggressive transfer pricing strategies to move income from the residence country to a low-tax foreign affiliate or even from one foreign affiliate to another (provided that the average effective foreign income tax rate does not exceed the residence country rate).¹⁴²

Worldwide tax consolidation also simplifies the problem of expense allocations. In a worldwide tax consolidation system, expense allocation rules are not a critical component of the allocation of taxing rights, because every item of global income and expense is reflected currently on the parent company's tax return. If firms were tax-indifferent across this dimension, one would expect that expenses generally would be booked in the jurisdictions to which they have the strongest commercial nexus.¹⁴³

Nonetheless, as described below, thin capitalization statutes may be necessary even to worldwide tax consolidation regimes. Without a thin capitalization statute, U.S. firms might otherwise be indifferent to the magnitude of their foreign tax liabilities, because of the FTC.¹⁴⁴

B. Elements of Worldwide Tax Consolidation

It is useful to summarize the contours of a system that could be proposed as an alternative to territorial taxation. As applied to the United States, a worldwide tax consolidation regime for taxing foreign direct investment that is incremental to current law would contain the following elements:

- Reduce the U.S. corporate tax rate significantly (to bring it into conformity with evolving world norms and improve the competitiveness of the U.S. domestic economy) and eliminate current corporate tax expenditures such as accelerated depreciation. The rate necessary to achieve the international conformity goals might fall in the range of 25 to 27 percent.
- Tax the worldwide income of U.S.-domiciled firms on a current basis by bringing foreign affiliates into the U.S. consolidated group (to

¹⁴²This is the theme of Kleinbard, "Throw Territorial Taxation From the Train," *Tax Notes*, Feb. 5, 2007, p. 547, *Doc 2007-416*, or *2007 TNT 25-65*.

¹⁴³Of course, source countries have reason to police the expense allocations to subsidiaries operating in their jurisdictions, because as to them there is no residual tax fallback.

¹⁴⁴This is consistent with the concerns expressed by Daniel Shaviro in three papers. See Daniel Shaviro, "The Case Against Foreign Tax Credits," NYU Law & Economics Research Paper Series Working Paper No. 10-09 (Mar. 2010); Shaviro, "Rethinking Foreign Tax Creditability," NYU Law & Economics Research Paper Series Working Paper No. 10-30 (July 2010); Kimberly A. Clausing and Daniel Shaviro, "A Burden-Neutral Shift From Foreign Tax Creditability to Deductibility?" NYU Law & Economics Research Paper Series Working Paper No. 10-39 (Aug. 2010).

remove the attribute of stateless income and to protect the domestic tax base from earnings stripping by U.S. firms).¹⁴⁵

- Retain the existing FTC system in general.
- Revise the definition of U.S. corporate residence to reflect the mind and management of a company, not simply its place of incorporation.
- Abandon existing interest expense allocation rules for purposes of calculating the FTC, because they are unnecessary in an environment of current worldwide taxation (and thereby reduce the total tax burden on foreign direct investment that might result for companies whose operations are predominantly in foreign jurisdictions with relatively high tax rates).
- Adopt thin capitalization rules that protect the U.S. base both as to parent companies of multinational groups that are resident in the United States and as to U.S. subsidiaries of multinational groups whose parent companies are foreign residents.

C. Competitiveness Concerns

Worldwide tax consolidation is unpopular among multinational companies, which enjoy the freedom under current law to reduce their effective tax burdens to a small fraction of weighted average statutory rates, and among many scholars, who rightly see it as in theory distorting investment decisions when compared with an ideal (and unobtainable) territorial tax. Those are important concerns. That many multinational companies overstate their case does not mean there is no case to be made. But there is a reasonably satisfactory response, which is the coupling of worldwide tax consolidation with tax rates comparable to a relevant global median rate.

The operation of tax capitalization into prices in low-tax jurisdictions in fact may mean that U.S. firms are not competitive in bidding to own or hold real factors of production there. Nonetheless, the United States ought not to be held hostage in its tax system design to the existence of low-tax locales, for the simple reason that they are such a small fraction of the world's real economy that the deadweight loss associated with imperfect rules as applied to them is insignificant when compared with the deadweight and revenue losses associated with stateless income gone wild.

Many low-tax jurisdictions are the depositories of enormous amounts of multinational firm taxable income from both U.S. and foreign corporations.

¹⁴⁵See *supra* note 139, for a description of the modifications that would need to be made to current law's definition of the ownership requirements that would trigger consolidation.

But when presented as a competitiveness argument, this is not a tax capitalization or capital ownership neutrality story. Rather, it is akin to a competition in export subsidies. That is, because some countries have poorly implemented territorial tax systems, thereby enabling their national champions to funnel income from high-tax to low-tax countries through stateless income tax planning, the United States should do so as well.

As in the competition among nations to outdo each other in export subsidies, the economically rational behavior here is to abstain. Moreover, in light of the leading role the United States plays as an abettor of stateless income tax planning by its national champions, there is reason to believe that more balanced U.S. rules will enable other sovereigns to address weaknesses in their policing of aggressive stateless income generation by their own national champions. Finally, confusing tax subsidies with tax policies ignores the steps that many major jurisdictions already have taken to strengthen their territorial tax systems.

The genuine competitiveness and capital ownership neutrality issue for U.S. firms on the adoption of worldwide tax consolidation would be to ensure their competitiveness regarding the location of actual factors of production in the world's major economies. If the U.S. worldwide consolidated tax rate is comparable to world norms looking at relevant other economies, legitimate competitiveness concerns are addressed in relation to foreign local competitors in particular and also to multinational competitors domiciled in jurisdictions that take territorial tax system design seriously.

The tax rate data summarized earlier in Part 1 imply that a worldwide consolidated tax rate in the neighborhood of 25 to 27 percent would satisfy both genuine competitiveness concerns and the capital ownership neutrality benchmark for the world's major economies — in the latter case, not because a worldwide consolidated tax regime was the theoretically correct design, but because the rate actually used by the United States on worldwide income would correspond to the range of tax rates reflected in the tax capitalization of asset prices in the relevant countries. The United States does not need to compete with the tax rates available to domestic firms in the Slovak Republic (19 percent, as it happens) for U.S. firms to be globally competitive.

Just as important, those lower U.S. rates make the domestic operations of U.S. firms more competitive in the world as well. Given the size of the U.S. economy and the dominant role therein of U.S.-based firms, this is an important issue, even if it is largely unaddressed in recent tax policy debates designed to influence the decisions of policymakers.

D. Meaninglessness of Residence

The second problem associated with a worldwide tax consolidation regime is that, like territorial systems, it is vulnerable to the criticism that it relies on an artificial conceptual foundation. For territorial systems, that artificiality lies in the definition of source, which operates to allocate among jurisdictions the right to tax the item of income. For worldwide tax consolidation systems, the artificiality lies in the concept of corporate residence.¹⁴⁶

Certainly it is true that the most sophisticated multinational enterprises can be described as having transcended ordinary concepts of citizenship in only one state. And of course the current U.S. definition of corporate tax residence (which looks solely to the place of incorporation) is artificial. But it is difficult to think of many significant examples of firms that in the popular imagination are U.S.-domiciled but that as a tax matter are not. In many cases the practical tax categorization of the residence of a parent firm of a multinational group is easier than theory might suggest.¹⁴⁷

There are more national ties between U.S. firms and their owners than one might expect. For example, in 2004 U.S. investors owned 87 percent of the aggregate value of firms traded on U.S. stock markets (overwhelmingly firms treated as U.S. residents).¹⁴⁸

The strongest justification for the existence of a corporate income tax is that it serves as a substitute for the imposition of current tax on the firm's owners. When (as in small open economies) there is only a partial correspondence between the residence of a firm and the residences of its owners, the

case for a worldwide tax consolidation system that elevates the consequences to nonresident investors of the parent company's domicile is proportionately weakened, and a territorial tax system is closest to implementing economic neutrality, given the portfolio investment options of nonresident shareholders.

But as applied to the United States, whose resident companies are overwhelmingly owned by U.S. investors, the rationale for worldwide taxation along this margin is strong. In other words, if the U.S. corporate income tax is best justified as a substitute tax on U.S. individual owners when the corporation is both domestically owned and operated, and if it also is accepted that taxing U.S. individuals on their worldwide income is an appropriate exercise of U.S. taxing power from an economic perspective (again accepting as a given a tax system that burdens capital income), then it must follow that imposing U.S. corporate income tax on the worldwide income of firms that are overwhelmingly ultimately owned by U.S. persons also is theoretically sound.

In short, U.S. firms (however defined) are overwhelmingly owned by U.S. persons, treating them as U.S. persons is a fair first-order approximation of a more sophisticated answer. And the artificial current statutory definition of corporate residence in turn can be modernized to look to a company's mind and management (the U.K. concept) rather than simply its place of incorporation. As so modified, the rule might retain some artificiality, but the consequences of the application of that artificial rule do not seem hugely distortive.

Modernizing the technical definition of corporate residence is a partial answer to something that in practice is more a political talking point than an urgent matter of tax policy. That is the concern that if the United States were to adopt a worldwide tax consolidation regime, U.S. firms would re-domicile outside the United States or offer themselves up for acquisition by non-U.S. enterprises, all to escape the burdens of the new U.S. system, and newly created U.S. businesses would incorporate outside the United States.

The first response to this concern, of course, is that developed in the preceding subsection: A tax burden squarely in the median of other major relevant economies' (that is, ranging from 25 to 27 percent) is not much of a competitive burden at all, except if one believes that all those other economies will continue to countenance unlimited stateless income tax planning by their national champions. But as noted, this is at best an argument for matching other countries' government subsidies, not a

¹⁴⁶See, e.g., Shaviro, "The Rising Tax-Electivity of Corporate Residence," NYU Law and Economics Research Paper No. 10-45 (Oct. 1, 2010), at 70, available at <http://ssrn.com/abstract=1683642>. ("In an increasingly integrated global economy, with rising cross-border stock listing and share ownership, it is plausible that U.S. corporate residence for income tax purposes, with its reliance on one's place of incorporation, will become increasingly elective for taxpayers at low cost. This trend is potentially fatal over time to worldwide residence-based corporate taxation, which will be wholly ineffective if its intended targets can simply opt out").

¹⁴⁷Vann, *supra* Part 1, note 48, at 307-308 (in practice, "the test of corporate residence generally is robust for the parent in an MNE group," but not for its foreign subsidiaries).

¹⁴⁸Philip R. Lane and Gian Maria Milesi-Ferretti, "International Investment Patterns," Int'l Monetary Fund Working Paper WP/04/134 (2004), at 31. The U.S. domestic stock market capitalization represented 49 percent of the world's stock market capitalization in that year. *Id.* See also Anil V. Mishra, "International Investors' Home Bias in Portfolio Equity Investment," available at http://www.eprints.usq.edu.au/2176/2/Mishra_2007_International_investors.pdf (2007) (analyzing some of the factors that explain investors' marked bias in favor of investing in companies they identify as resident in their home countries).

genuine competitiveness argument, and one that in any event is not relevant to foreign competitors in their domestic markets.

Second, the United States today has an anti-inversion statute that prevents a U.S. firm from simply situating a foreign holding company on top of it.¹⁴⁹ That statute is imperfect in its reach,¹⁵⁰ but those imperfections reflect a political judgment, not the existence of irresolvable technical difficulties in broadening its application.

Third, a more modern definition of corporate residence responds to the claim that in a worldwide tax consolidation system, simply organizing a U.S. business as a foreign corporation will lead to tax savings. If U.S. individuals are the mind and management of an organization, it will be a U.S. firm, regardless of its place of incorporation.¹⁵¹

Fourth, existing law imposes a prohibitive toll charge on the transfer of U.S. business assets to a foreign firm in a tax-free incorporation or reorganization transaction.¹⁵² Those rules can also apply to tax-free stock acquisitions in which the stock of a U.S. firm is acquired by a foreign company and U.S. shareholders control the combined enterprise.¹⁵³ Again, these rules might not be watertight, but if there is still a bona fide competitiveness concern regarding tax-free acquisitions, any remaining gaps can readily be closed.

Finally, it is useful to compare the definitional problems that must be solved in implementing a successful territorial tax regime with the different definitional issues raised by a worldwide tax consolidation system. As described above, territorial tax systems satisfy coherent economic norms only when used in a world where source rules for both

income and expenses are transparent, comprehensive, and non-distortionary. To accomplish this requires the efforts of many sovereigns to introduce effective thin capitalization and other anti-base-erosion legislation, as well as agreement among those sovereigns on novel source rules on matters like the situs of income earned from the use of intangible assets. For the reasons explained earlier, it is likely that those source rules will require the multilateral adoption of formulary apportionment principles covering significant swaths of firms' incomes.

By contrast, a worldwide tax consolidation system can be implemented unilaterally, but is vulnerable to the risk that its definition of a corporate resident will prove to be overinclusive in some instances and underinclusive in others. The key difference is that the consequences of an imperfect definition of corporate residence will affect only those firms at the margin of whatever definition is adopted. In a territorial tax world, every multinational firm will be able to exploit weaknesses in different (or for that matter, identical) definitions of source or the decision by one or more countries not to join the new world order. Each approach to the taxation of foreign direct investment is vulnerable to definitional imprecision, but the aggregate consequences of those failings for neutrality in economic decision-making would not appear to be comparable at all.

E. Disincentivizing Foreign Tax Reduction

A third concern that would be raised on the adoption of a worldwide tax consolidation system would be that resident multinational firms would have no incentive to reduce their foreign tax burdens, at least as long as their average effective foreign tax rate was below the residence country rate.

A partial answer, of course, lies in choosing the right residence country rate. The lower it is, the more aggressively firms will be required to pursue local source country tax minimization strategies. A more complete answer would be that when placed in an environment of worldwide tax consolidation, firms generally can be expected to site their income where their business operations are located, because tax results will then comport with the firm's real factors of production and with how income is recorded for management purposes.

There is little reason for a U.S. firm deliberately to overpay a foreign source country just to spite the United States. And of course if it did, the resulting taxes would not be creditable, because current law provides that taxes are creditable only to the extent

¹⁴⁹Section 7874.

¹⁵⁰West, *supra* note 109, at 1025, n.112.

¹⁵¹Almost all of the enormously successful "new economy" firms created in the last few years that were organized by U.S. entrepreneurs were formed as U.S. corporations. Facebook, Google, and Amazon are three examples. It might be argued that the stakes will be raised once worldwide tax consolidation is introduced, but the counterpoint is that today it is virtually costless to organize as a foreign firm while in the future it will require relocating senior management and board of directors supervision outside the United States. Yet despite the clear tax advantages to organizing as a foreign firm (*e.g.*, never dealing with subpart F and avoiding the lockout price that must be paid for stateless income tax planning) and the ease of doing so, real-life examples of successful new public firms that have organized as foreign firms are hard to find. (Some years ago several new enterprises organized as offshore companies from the start, but some of those (*e.g.*, Global Crossing) have since collapsed.)

¹⁵²Section 367(a). Essentially, such a transfer is treated as wholly taxable, so that gain is recognized on the entire value of transferred assets (less their tax basis) at the time of transfer.

¹⁵³Section 367(b).

of the legal minimum due.¹⁵⁴ It seems much more probable that the United States would collect residual tax not collected today from operations in low-tax countries than it is that all this potential residual tax will be secretly bargained away by firms looking to curry favor with source country tax administrations.

Admittedly, a problem exists in worldwide tax consolidation regimes regarding the siting of indirect expenses, particularly interest expense. Current practice and financial markets behavior show that in the absence of any countervailing rule, parent companies would likely undertake nearly all group external debt funding. Capital markets ordinarily prefer parent-level financing because all the group's operations then support the loan and because the agency costs associated with policing parent-subsidiary transfer pricing and transactions are irrelevant.

A parent company would have no incentive to fund foreign subsidiaries with anything other than equity, the result would be residence country base erosion. The resulting foreign operating income would be includable in the parent's worldwide consolidated tax return but would be sheltered by FTCs. As U.S. firm's aggregate worldwide tax burden would be the same as if the group's external debt were distributed throughout the group's member companies, but the United States as residence country would be a revenue loser and source countries' revenue would be winners. Because the United States is still a private direct investment net investor,¹⁵⁵ this suggests that U.S. revenues could be at risk.

This problem can be addressed by a well-designed thin capitalization statute like the German rules described earlier. A well-designed thin capitalization statute functions in practice as a form of worldwide interest apportionment, after firms apply straightforward internal financing decisions as a kind of self-help mechanism. What is more, it does so without requiring the tracing of proceeds by taxpayers or multilateral agreements among countries.¹⁵⁶

A final problem with worldwide tax consolidation is that it limits a sovereign's flexibility in

setting corporate income tax rates. For the reasons described earlier in this subsection, a sensible worldwide tax consolidation system requires that a country's corporate tax rates be comparable to world median rates. Because these rates would apply to domestic as well as to international operations,¹⁵⁷ the result would be a circumscribed range of plausible corporate tax rates that a country might adopt. The only answer to this is that in a global economy, the tax rates imposed on domestic capital income (as well as on income from foreign investments) are an important part of the overall competitiveness of local firms. It may be that the tail (the taxation of foreign direct investment) should not wag the dog, but if one consequence of adopting an otherwise useful scheme for the taxation of foreign direct investment is that the dog is nudged closer to world norms, that is not an undesirable outcome.

VIII. Conclusion

We live, and design tax systems, in a world imbued with stateless income and with dramatically different national corporate income tax rates. Territorial tax solutions are vulnerable to the former condition, and worldwide tax systems to the latter. There is no approach that is optimal everywhere. All that we can do is to consider which system is likely to create the fewest distortions in corporate behavior while raising adequate revenues.¹⁵⁸

As applied to the United States, both territorial and full inclusion tax systems resolve the distortions attendant on the lockout phenomenon and introduce symmetry in the treatment of offshore losses. These are substantial steps forward. But in a world imbued with stateless income, a territorial tax system like that proposed by some U.S. multinational firms will lead to large systematic preferences for investing outside the United States to obtain an all-in lower effective tax burden on income, even when "tax" is understood to include implicit as well as explicit taxes. As a result, corporate investment and ownership decisions will be systematically distorted.

¹⁵⁷It is possible to imagine split tax rates, with different rates imposed on domestic and foreign income, but that would import many of the weaknesses of current law (transfer pricing disputes, stateless income tax planning more generally, importance of the definition of source of income, allocations of expenses, and so on). On balance, a split rate approach would seem to be too complex and insufficiently ungrounded in principle to be useful.

¹⁵⁸*Cf.* Grubert and Altshuler, "Corporate Taxes in the World Economy," *supra* Part 1, note 23, at 320 ("it [is] clear that no one-dimensional criterion is useful and that a complete evaluation of any reform proposal is probably not feasible. . . . Nonetheless, it is clear that progress can be made along a number of decision margins").

¹⁵⁴Reg. section 1.901-2(e).

¹⁵⁵*See* JCT, "Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States," JCX-49-08 (June 17, 2008), at 16-17, *Doc 2008-13379, 2008 TNT 118-13* (in 2006 foreign direct investment by U.S. persons outweighed direct investment into the United States by foreign persons by roughly \$800 billion, measured at cost).

¹⁵⁶*Compare* Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," *supra* Part 1, note 46 (urging a multilateral solution).

Moreover, a poorly implemented territorial tax system will greatly compound existing problems in enforcing transfer pricing rules necessary to protect the domestic tax base, and unless accompanied by strict expense allocation rules not currently contemplated by territorial tax advocates, that system will expose the domestic tax base to losses through straightforward arbitrage. In the absence of vigorous (and perhaps untested) rules to address these problems, a territorial tax solution will lead to large-scale incremental domestic tax base erosion.

Unless the stateless income phenomenon is eradicated, the United States' adoption of a territorial tax system would distort corporate investment behavior and deplete domestic tax revenues. And in turn, eradicating stateless income would require unprecedented levels of international cooperation and substantive agreement on novel tax norms. It is easy to understand the appeal of such a system to U.S. multinational firms, and even to understand why an ideal territorial tax system is the better economic answer in a Panglossian world, but it is less obvious why a territorial system should be the preferred outcome from a practical policy perspective in light of the substantial risks it poses.

A worldwide tax consolidation system coupled with a corporate tax rate in the range of the world median for comparable economies, when combined with a thin capitalization regime, addresses transfer pricing gaming and tax arbitrage strategies. It can be implemented unilaterally and does not depend heavily on parsing the mysteries of expense allocation rules. It authentically embraces capital export neutrality (except in the unlikely scenario in which U.S. corporate tax rates are materially lower than the world median), which may not be everything, but at least is something. It effectively creates results consistent with capital ownership neutrality principles in most cases if one corrects for actual subsidies that some sovereigns may run through their tax systems.

There are two irreducible costs to be paid for the benefits of a full inclusion system. U.S. firms will not be tax competitive in bidding for real assets (or companies) in genuinely low-tax jurisdictions, and U.S. firms will not receive the de facto subsidies that stateless income tax planning offers foreign com-

petitors in jurisdictions with poorly implemented territorial systems for investments in high-tax third countries. As to the first cost, most genuinely low-tax jurisdictions are small economies, and if the protection of the domestic tax base and the removal of systematic incentives for U.S. firms to invest outside the United States require that U.S. firms be somewhat disadvantaged in this one dimension, that would appear to be a fair trade-off.

As to the second cost, it is difficult to see why the United States should respond to systematic tax subsidies offered by other countries for their resident firms to invest offshore by mimicking that behavior, any more than it is thought to be efficient for one country to respond to another's trade subsidies by implementing comparable subsidies.¹⁵⁹ Moreover, as the erosion of domestic source country tax revenues through stateless income becomes better appreciated throughout the world's major economies, one can expect increased focus on developing stronger domestic earnings stripping rules. As source countries slowly become more adept at designing earnings stripping rules, any remaining gap in competitiveness between U.S. and foreign firms will narrow.

The United States today faces a Hobson's choice between the highly implausible (a territorial tax system with teeth) and the manifestly imperfect (worldwide tax consolidation). Because the former is so unrealistic, while the imperfections of the latter can be mitigated through the choice of tax rate, the worldwide tax consolidation solution, coupled with a much lower corporate income tax rate, is the more productive approach that the United States should take.

¹⁵⁹*Id.* at 342 (“the case of intangible assets is identical to the case of exports because it is simply the export of U.S. created services. They are intellectual property that was created in the United States, the value of which has not been included in the U.S. tax base. It is in principle possible that selective export subsidies would improve U.S. welfare, but this would require information about market behavior which is unlikely to be available, apart from any World Trade Organization (WTO) concerns. The same argument would apply to exports of intellectual property”).