

**Stateless Income's Challenge to Tax Policy
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Summary

This Report considers the tax consequences and policy implications of the phenomenon of “stateless income.” It is a condensed, more accessible and slightly revised version of two more formal papers on the same topic referenced on page 1.

Stateless income comprises income 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 which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group’s parent company. Google Inc.’s “Double Irish Dutch Sandwich” structure is one example of stateless income tax planning in operation.

The Report first demonstrates that the current U.S. tax rules governing income from foreign direct investments often are misapprehended: in practice the U.S. tax rules do not operate as a “worldwide” system of taxation, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes. This claim holds whether one analyzes these rules as a cash tax matter, or through the lens of financial accounting standards. This paper rejects 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 firms over domestic ones by offering the former the prospect of capturing “tax rents” – low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important implications of stateless income include the dissolution of any coherence to the concept of geographic source, the systematic bias towards offshore rather than domestic investment, the more surprising bias in favor of *investment*

in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the 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 lock-out phenomenon, under which the price that U.S. firms pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (\$1 trillion or more, by the most recent estimates) and cash outside the United States.

The Report then demonstrates that economic policy conclusions that are logically coherent in a world without stateless income do not follow once the presence of stateless income tax planning is considered. More specifically, 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 why the United States ought to adopt a territorial tax system, and demonstrates how stateless income tax planning vitiates 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 imperfections of the latter can be mitigated through the choice of tax rate, the Report ultimately concludes by recommending a worldwide tax consolidation solution.

I. INTRODUCTION.

A. Scope of Paper.

This Report summarizes two longer papers that consider the design of tax systems that address the taxation of returns from corporate foreign direct investment. The first of these two papers, *Stateless Income*, will appear in *Florida Tax Review*.¹ The second, *The Lessons of Stateless Income*, will appear in *Tax Law Review*.² In order to keep this Report to a reasonable length, many of the subthemes developed in those papers have been excised, and footnotes have been kept to a minimum. Moreover, because many readers of *Tax Notes* are familiar with the relevant international tax rules, this Report does not summarize their operation. The longer papers supply more background.

¹ The current working version of this paper can be downloaded at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791769.

² The current working version of this paper can be downloaded at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791783.

Tax Notes has published many reports on subpart F, “territorial” tax systems, and large-scale proposals to change current U.S. tax law governing outbound foreign direct investment. The principal contributions of this Report are its development of the theme of “stateless income,” its analysis of the consequences of that phenomenon for standard policy prescriptions, and its attempt to combine practical insights with current economic efficiency theories for the design of international tax systems.

B. Overview of the Policy Challenges Posed by Stateless Income.

I employ the term “stateless income” to mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group’s ultimate parent company, but which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived, nor the domicile of the group’s parent company.³ Stateless income thus can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries *without* shifting the location of externally-supplied capital or activities involving third parties. Stateless persons wander a hostile globe, looking for asylum; by contrast, stateless income takes a bearing for any of a number of zero or low-tax jurisdictions, where it finds a ready welcome.

The techniques used to generate stateless income rely on norms woven deep into the warp and woof of virtually every tax system. As a result, the phenomenon is extremely difficult to curb. At the same time, its availability distorts U.S. firms’ investment decisions – such as the relative attractiveness of situating marginal investments in foreign jurisdictions or in the United States – and erodes the domestic U.S. tax base.

³ I first used this term in Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 114 TAX NOTES 548, 559 [hereinafter *Throw Territorial Taxation from the Train*] (February 5, 2007).

The domicile of a multinational enterprise’s ultimate parent company is referred to in the literature as the “residence” country. A country other than the residence country in which a multinational group derives business or investment income is referred to as the “source” country.

The fundamental and widely-shared international income tax norms that enable stateless income include the recognition of the separate tax personas of different juridical persons, even when commonly owned, the deductibility of intra-group interest, rents and royalties, the freedom of a multinational enterprise to deal with a subsidiary as an independent actor for “arm’s-length” contracting purposes, and the freedom to situate the economic rents attributable to unique business opportunities in a low-taxed affiliate. At the same time, stateless income also flourishes because of nations’ collective failure to develop robust source rules for income derived from intangible assets in particular.

Multinational firms get at least two bites at the stateless income generation apple. First, they can rely on the norms of freedom of contract within the group, the purportedly arm’s-length nature of arrangements reached by a parent company and its wholly-owned subsidiary (freshly capitalized by the parent), and ambiguities in the international consensus rules surrounding the source of returns to intangible assets to situate in a low-tax jurisdiction returns from factors most plausibly situated in high-tax countries (e.g., sales to local customers). Second, multinational firms can use “earnings stripping” strategies to move income tentatively situated in a jurisdiction with the most plausible claim to be the source of that income to another (low-tax) jurisdiction, typically through the creation of an item of intragroup deduction/income inclusion (e.g., intercompany interest, rents or royalties). That second stage earnings stripping strategy need not have any nexus to the generation of the income.

Stateless income thus comprises more than the problem of residence country base erosion through aggressive transfer pricing, although such behavior plainly exacerbates its magnitude in practice.⁴ As used in this Report, however, the term is reserved for strategies to reduce high-tax source country income. Nonetheless, the policy recommendations made by this Report respond

⁴ Examples of very recent papers emphasizing how current arm’s-length transfer pricing rules invite the erosion of residence country tax revenues include YarivBrauner, *Cost Sharing and the Acrobatics of Arm’s Length Taxation* (Univ. of Fl. Legal Studies Research Paper No. 2010-19, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1651334 and Harry Grubert, *Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren’t Being Globalized, Only Profits*, Available at http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert_March16.pdf [hereinafter, Grubert, “*Foreign Taxes and Domestic Income*”].

to both issues, for two reasons. First, the technologies employed in source and residence country base erosion overlap. Second, the Report’s ultimate goal of outlining a coherent approach to cross-border taxation in light of the stateless income phenomenon implicates the familiar question of whether that proposed approach distorts investment decisions as between source and residence countries.

The phenomenon of stateless income also is not the same as the phenomenon of “capital mobility.” As traditionally understood, capital mobility involves a person’s ability to locate real investments or third-party activity with a view to minimizing the tax burden imposed thereon; it is “the elasticity of supply of a location-denominated factor with respect to its net [after-tax] reward in that location.”⁵ The phenomenon of stateless income, by contrast, comprises the movement of taxable income within a multinational group without shifting any location-dependent factor supplied by third parties.

The straightforward application of optimal tax theory to the phenomenon of actual capital mobility leads, for example, to the policy recommendation that a small open economy should not impose any tax on returns to imported capital; this recommendation reflects a coherent theory in which efficient global markets lead to identical after-tax returns on business income, wherever situated.⁶ Stateless income tax planning, by contrast, is divorced from actual market transactions. Instead, it undercuts the functions of markets in setting market-clearing after-tax returns on capital investments. In brief, if one accepts the premise that after-tax returns on business income converge on a single worldwide level, then pretax returns must diverge, with commensurately higher pre-tax returns in high-tax countries. Stateless income tax planning permits advantageously-situated multinational firms to earn high-tax source country pretax returns and

⁵ Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility’s Place in Optimal Taxation*, 63 NATIONAL TAX J. 843 (2010). Slemrod points in the direction of stateless income with his concept of “tax mobility;” this Report argues that stateless income is an even more pervasive phenomenon than Slemrod’s paper might suggest.

⁶ George Zodrow, *Capital Mobility and Capital Tax Competition*, 63 NAT’L TAX J. 865, 881 (2010) [hereinafter Zodrow, *Capital Mobility and Capital Tax Competition*].

then to migrate those to a low-tax jurisdiction, thereby capturing low-risk supranormal returns, which this Report labels “tax rents.”

The ability of some multinational firms to earn tax rents from investments in high-tax foreign jurisdictions is one fundamental challenge that stateless income poses to the design of a foreign direct investment tax system, because if left unchecked a firm’s ability to capture tax rents can lead it systematically to prefer even marginal investment abroad when compared to a competing domestic marginal investment.⁷ But stateless income poses other important challenges for U.S. tax policy as well. Those implications include the dissolution of any coherence to the concept of geographic source, the systematic bias towards offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the 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 “lock-out” phenomenon, under which the price that U.S. firms pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (\$1 trillion or more, by the most recent estimates) and cash outside the United States.

As developed below, one policy implication that is simply inconsistent with the data is that current law disadvantages U.S. multinational firms in respect of the effective foreign tax rates they suffer, when compared with their territorial-based competitors. Whether those tax burdens are measured by reference to actual cash taxes paid, or to the financial accounting statements that are the lens through which shareholders and other stakeholders view publicly-held firms, many U.S. multinational firms today enjoy global effective tax rates closely comparable to those enjoyed by foreign-based competitors. Indeed, the most adroit U.S. firms have been so extraordinarily successful in stateless income tax planning that they have become

⁷ In general, the Report takes as a given that it is easier to migrate pretax income from a high-tax foreign country than from a high-tax residence country. So, for example, the Report assumes that it is easier for U.S. firms to move income economically earned in Germany to Ireland than it is to move income from sales to U.S. customers to Ireland. Aggressive transfer pricing strategies for intangibles might appear to be an exception, but that technique is at least valuable with respect to high-tax foreign countries as it for moving income out of the United States, and in any event is not implicated by a marginal investment. The allocation of global interest expense is a better counterexample.

hoist on their own petard. They have removed so much income from their tax bases, both in the United States and in high-tax foreign jurisdictions, that they now are running out of remotely feasible ways of reinvesting those huge sums accumulating in their low-tax subsidiaries.

The enjoyment of stateless income imposes substantial social costs in the form of the well-known “lock-out” effect, under which U.S. firms must leave earnings (and cash) in foreign subsidiaries to retain the benefits of stateless income. But it is not clear that these costs include any significant “competitiveness” problem for U.S. multinationals, or direct reductions in U.S. employment. Either of these hypotheses would require a showing that U.S. multinational firms are capital constrained in the United States, so that rational investment opportunities here cannot be pursued. But there is little evidence of this in the field. Instead, the principal social costs of lock-out seem to be that lock-out in practice functions as a kind of “lock-in,” in which shareholders cannot extract from firms the earnings and cash locked away to preserve the firms’ stateless income results.

C. An Illustrative Example: The Double Irish Dutch Sandwich.

Recent news stories on the internal tax planning of U.S. firms like Microsoft, Forest Laboratories and Google have injected drama to the narrative, by providing useful insights into how firms generate stateless income in practice. This section uses Google Inc.’s “Double Irish Dutch Sandwich” structure to illustrate how stateless income tax planning relies on deeply embedded global tax norms, and how it operates to disassociate taxable income from any connection with any location in which the value-adding activities that generated that income could plausibly be said to lie.⁸ The same story (in a number of cases, literally so, because the

⁸ The facts that follow are drawn principally from Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, available at <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>, as supplemented by inferences drawn from Joseph S. Darby III and Kelsey Lemaster, *Double Irish More than Doubles the Tax Savings: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation*, 11 PRACTICAL U.S./INTERNATIONAL TAX STRATEGIES 2 (May 15, 2007) (hereinafter Darby and Lemaster, “*Double Irish More than Doubles the Tax Savings*”). Since Google’s tax planning is not transparent to outside observers, it is possible that there are some slight mischaracterizations of details in the text, but these would not change the thrust of the points made therein.

Double Irish Dutch Sandwich is an easily-replicable staple of current stateless income tax planning) could be told of many other U.S. multinational firms.⁹

In 2003, a few months before its initial public offering, Google Inc. entered into a cost sharing agreement with a newly-organized wholly-owned Irish subsidiary, Google Ireland Holdings (“Ireland Holdings”), under which Ireland Holdings acquired the rights to Google Inc.’s search and advertising technologies and other intangible property for the territory comprising Europe, the Middle East and Africa (“EMEA”). Google commenced its Irish operations in 2003 with five employees.¹⁰

Ireland Holdings made an undisclosed “buy-in” payment for rights to the technologies as they then existed, and further appears to have agreed pursuant to a “cost sharing agreement” to bear future development costs in proportion to the size that the EMEA market bore to the worldwide market for the Google technologies.¹¹ As a practical matter, that buy-in payment

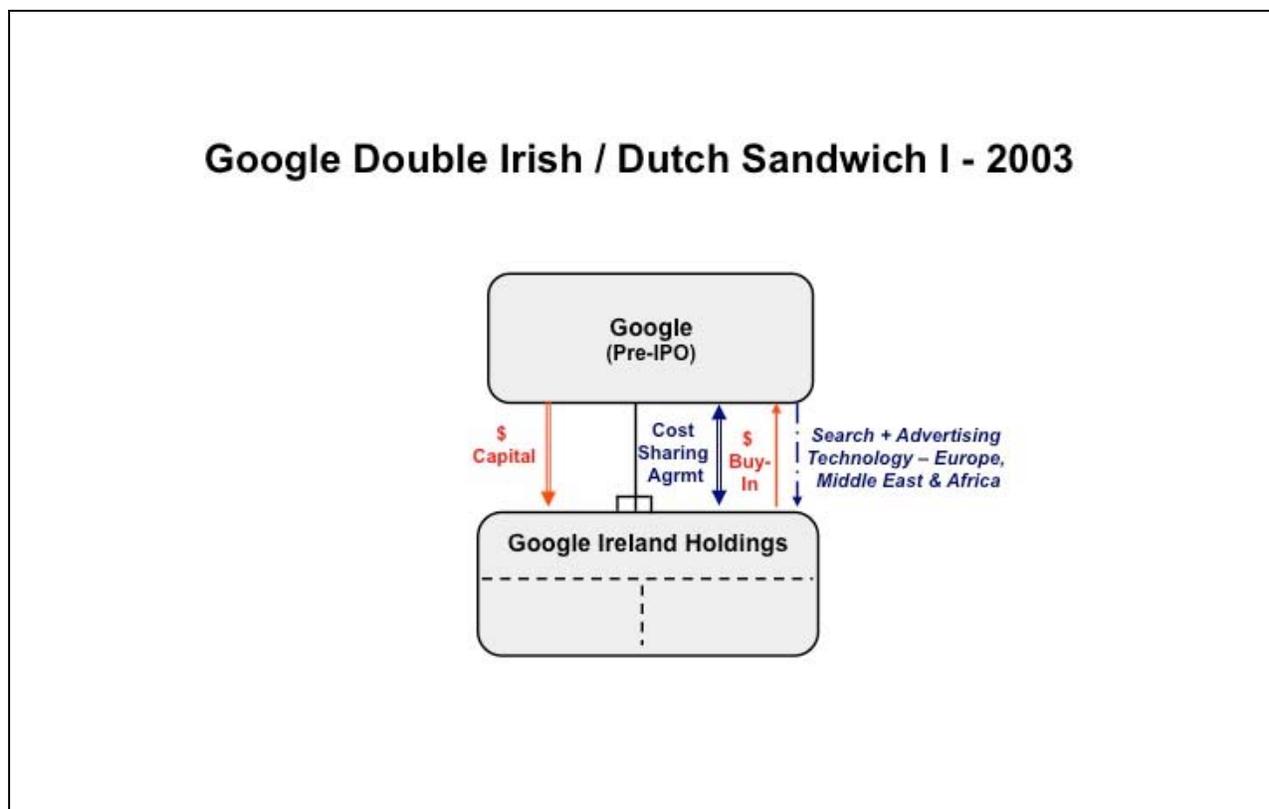
⁹ As one example roughly contemporaneous with Google’s Double Irish Dutch Sandwich, see Jeffrey L. Rubinger and William B. Sherman, *Holding Intangibles Offshore May Produce Tangible Tax Benefits*, 106 TAX NOTES 938 (February 21, 2005), proposing a complex structure involving Norwegian companies to achieve comparable results.

¹⁰ <http://googleblog.blogspot.com/2004/10/dublin-go-bragh.html>. (A Google blog post dated October 6, 2004) (“A year ago, Dublin became the first location for Google’s regional operations outside the U.S. We designed it to serve Google customers across multiple time zones and languages spanning Europe, the Middle East and Africa. There were just five of us in 2003. Today we’ve built a team of 150 . . .”)

¹¹ *Veritas Software Corp. et al. v. Commissioner (Symantec)*, 133 T.C. 297 (2009), offers an important window into how cost sharing agreements actually were constructed at times proximate to the formation of Ireland Holdings. In *Veritas*, the Tax Court accepted as correct the \$118 million dollar cost-sharing “buy-in” payments made by an Irish subsidiary of a U.S. parent company beginning in 1999 against a challenge by the Internal Revenue Service that the correct number for the buy-in payment was \$1.675 billion. For brief summaries, see, e.g., Kerwin Chung, Cindy Hustad, and Alan Shapiro, *Tax Court Rejects IRS’s Cost-Sharing Buy-In Analysis*, 125 TAX NOTES 1343 (December 21, 2009); Stephen Blough, Charles Cope, and Thomas Zollo, *Veritas Vincit*, 126 TAX NOTES 839 (Feb. 15, 2010). More recently the Internal Revenue Service announced that it would not appeal the *Veritas* decision. Cindy Hustad and Alan Shapiro, *IRS Decides Not to Appeal Veritas; Action on Decision Issued*, 129 TAX NOTES 1342 (Dec. 20, 2010). The relevant Treasury regulations covering cost sharing arrangements were revised in 2009; the new regulations arguably give the Internal Revenue Service more scope to insist that buy-in payments like those at issue in *Veritas* must take notice of the value of transferred “platform” intangibles as a long-lived continuing foundation that gives incremental value to subsequent research and development work.

likely reflected in part the then-market capitalization of Google (which in turn would have been a good proxy for the value of its intangible assets); that value in turn presumably was much smaller than the value that might have been inferred post-IPO.¹² Regardless, in 2006 Google eventually negotiated an Advance Pricing Agreement with the Internal Revenue Service that accepted the bona fides of the 2003 buy-in payments for the then-existing intangibles; the terms of the Advance Pricing Agreement (like all such Agreements) are not public.

The Google structure immediately after entering into the cost sharing agreement can be represented schematically as follows:



¹² There is no publicly-available information on the size or calculation of the buy-in payment or on the operations of Ireland Holdings before the cost sharing agreement was entered into; the text’s description relies on the author’s general experience and conversations with market professionals, and therefore may not strictly comport with Google’s actual case. The author believes, however, that the presentation is a fair summary of practice in this area in general.

In a sense, the most remarkable aspect of the entire structure is contained in this schematic. It is the ready acceptance by countries of the fantastic notions that (i) a wholly-owned subsidiary has a mind of its own with which to negotiate “arm’s-length” contractual terms with its parent, (ii) capital provided to the subsidiary by the parent somehow becomes the property of an independent actor (the subsidiary) with which it can take business risks that for tax purposes are not simply assimilated into those borne by the parent (as both provider of the capital and ultimate economic owner of the assets acquired therewith), and (iii) a multinational enterprise that exists as a global platform to exploit a core set of intangible assets best is analogized to wholly independent actors taking on limited and straightforward roles in a vertical chain of production or a horizontal array of distribution of a product. The second and third of these notions, in particular, transcend the question of transfer pricing – in the second case, because of the international tax norm that equity owners are not required to include in income any minimum current return on their investment, and in the third case because the global assets and synergies that a multinational group exploits are attributes of the group as whole, not any one member.

Within a few years, the structure had morphed. First, Ireland Holdings had become a dual resident company: that is, for U.S. tax purposes it remained an Irish corporation (because that is its place of incorporation), but for Irish tax purposes Ireland Holdings became a resident of Bermuda (because that is where its “mind and management” are centered). Second, Ireland Holdings had put the EMEA rights to the core technologies to work by licensing them to a subsidiary organized as a Dutch company (“Google BV”), which in turn had licensed the rights to a lower-tier subsidiary, Google Ireland Limited (“Ireland Limited”). Ireland Limited licenses the technologies throughout the EMEA territories, and collects billions of dollars of advertising revenues from the use of those technologies.

Presumably, each of Google BV and Ireland Limited has “checked the box”¹³ – that is, has made a special election relevant only for purposes of U.S. tax law not to be characterized as a

¹³ Treas. Reg. § 301.7701-3(a)(2). That is the structure proposed in Darby and Lemaster, *Double Irish More than Doubles the Tax Savings*, supra note 8 at 2. Like all federal income tax return materials, “check-the-box” filings are not publicly available.

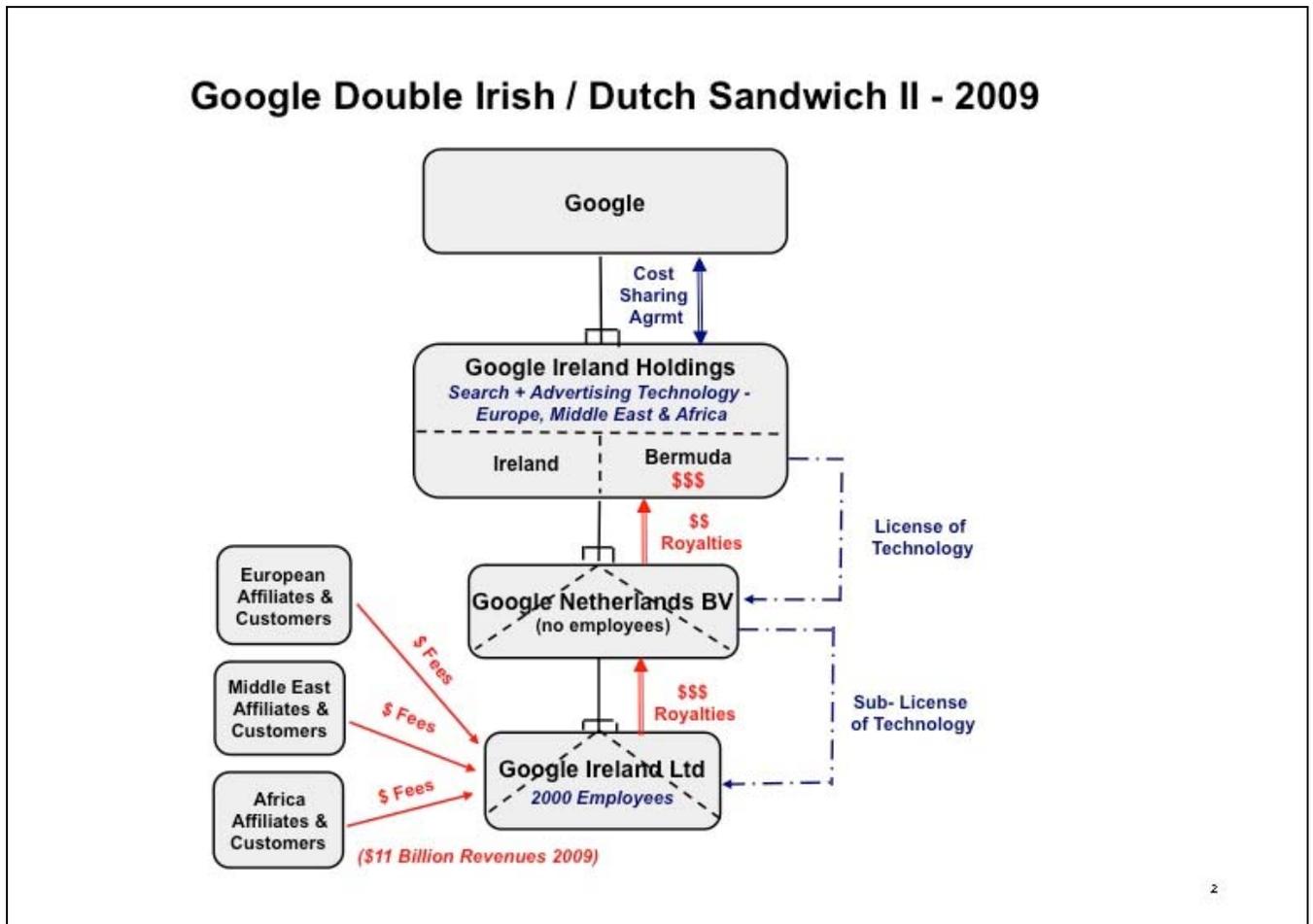
corporation. Because each has a single owner and has elected not to be regarded as a corporation for U.S. tax purposes, each is treated as a disregarded entity – a “tax nothing” – for U.S. purposes, but continues as a juridical person for all non-U.S. tax purposes. Here one can see another fantastic element of international tax planning. By virtue of a simple tax return election a company can disappear from view for purposes of U.S. law, in particular, while remaining relevant for purposes of all other fiscal systems, thereby facilitating a host of tax system arbitrage opportunities.

Ireland Limited today employs about 2,000 employees; it is not clear how many of them are engaged in the sale and marketing of Google products in the EMEA territory, and how many are working as engineers in the development of extensions of those technologies.¹⁴ Technically, it is possible for a foreign subsidiary to perform its obligations under a cost sharing agreement by hiring affiliates to do the actual work, using capital provided by the parent to pay those affiliates until it generates its own revenues. Again, one sees at work the fantastic idea that a subsidiary has both capital and an appetite for risk that can be separated from those of its parent.¹⁵

¹⁴ In a 2008 video interview, John Herlihy, the manager of Google Ireland, described Google’s Irish operations as the second largest Google office in the world. At the time, Google Ireland employed 1350 employees, of whom 900 worked in the “online [sales] team,” 250 “on the technology side” and 200 apparently in corporate support type functions for the EMEA operations. <http://www.youtube.com/watch?v=pYZsLLMQZxM&NR=1&feature=fvwp>. See also Google’s description of its Irish operations at <http://www.google.ie/intl/en/jobs/dublin/> (“What we do in Dublin is help millions of Google users and customers right across Europe, the Middle East, and Africa (EMEA) to get the most from our products. Google’s Dublin office is the EMEA Operations Headquarters. That means we support everyone who uses our products: the search engine that we are most known for, plus consumer products like [Gmail](#) and [Calendar](#), advertising products like [AdWords](#) and [AdSense](#), right through to business solutions for major corporations. In Dublin we also build on our existing products and create new ones, employing some of the finest engineering talent in the world. Many of the Dublin-based teams are engaged in supporting other Google offices across the EMEA region, working in areas like finance, payroll, legal, and HR.”)

¹⁵ Treasury regulations governing cost sharing agreements were revised in 2008 to adopt the “investor model” of arm’s length pricing. Treas. Reg. § 1.482-7, as amended by T.D. 9441, Dec. 31, 2008. This model emphasizes the idea that an affiliate that contributes only cash to a cost sharing agreement built around existing high-value intangible assets should make buy-in payments that leave the affiliate with only a normal return on its operations. Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), at 25-29, 111-14 (July 20, 2010). But the regulations do not reject the idea of a “cash box” subsidiary participating in a cost sharing

The structure now can be summarized in this illustration:



Now the full stateless income generation machine can be seen. Income earned from the use of the Google intangibles by customers (or, to the extent relevant, affiliates) in high-tax countries streams directly to Ireland Limited as a component of Ireland Limited’s advertising fees, without bearing source-country tax, because the fees paid are deductible in the source

agreement in the first instance, and might be expected only to lead to transfers of intangible assets at a somewhat earlier stage of development. Moreover, “cash box” subsidiaries can contract with and license intangible assets from their U.S. parent; those transactions are not ignored for U.S. tax purposes. *Id.* at 115-16.

country.¹⁶ While much of Ireland Limited's income presumably comes direct from third-party customers in the EMEA region, the same sort of structure can be used to strip out income from local affiliates that in turn serve local customers and then to move that income to Ireland. The net effect in either case is that income from the exploitation of the Google intangibles throughout the EMEA region is taxed only in Ireland.

Ireland imposes a 12.5 percent corporate income tax on Irish resident companies; Ireland Limited therefore is subject to that tax rate on its net income, but Ireland Limited makes very large deductible royalty payments to Google BV for the use of the core Google intangibles originally transferred in 2003 (and since extended by investments made under the internal cost sharing agreement). Google BV in turn makes royalty payments almost exactly as large to Ireland Holdings. The latter is a Bermuda company from an Irish perspective, and Bermuda has no corporate income tax.

Google BV exists because royalties paid directly from an Irish company to a Bermuda company (that is, from Ireland Limited to Ireland Holdings) would be subject to an Irish withholding tax.¹⁷ That tax does not apply to royalties paid to a company resident in an EU member state, even one that is an affiliate and that apparently serves no purpose but the elimination of Irish withholding tax. The Netherlands does not impose withholding tax on the outbound royalties paid to Ireland Holdings, and contents itself with collecting a small tax (essentially a fee for the use of its tax system) on the modest "spread" between the royalties Google BV receives and those it pays on to Ireland Holdings. (It is normal in Dutch tax practice to negotiate this sort of spread in advance with the Dutch tax authorities.)

¹⁶ Whether the fees are characterized as paid in respect of the provision of advertising services or as licensing fees for the use of the Google platform is a technical issue not really relevant to this simple narrative. Within the European Union, in particular, Member States cannot impose source-country withholding tax on royalties paid to a company resident in another State; moreover, Ireland has a good tax treaty network whose treaties often reduce the tax rate on royalties paid between firms in the two treaty countries to zero.

¹⁷ Darby and Lemaster, *Double Irish More than Doubles the Tax Savings*, supra note 8, does not discuss the role of the Dutch firm, either because the authors viewed it as a proprietary twist on the basic "Double Irish" idea or because it had not yet come into vogue. The article by Drucker, supra note 8, does discuss it.

Meanwhile, from a U.S. tax point of view, neither Ireland Limited nor Google BV exists at all. The United States sees only an Irish (not Bermuda) company (Irish Holdings) with a Bermuda branch, where most of its net income comes to rest. The end result is a near-zero rate of tax on income derived from customers in Europe, the Middle East and Africa that is attributable to the high-value intangibles that encompass the bulk of Google's economic factors of production, and a very low rate of tax on returns attributable to the services of Google's Irish-based sales force.

This stateless income generation machine is referred to as a "Double Irish" structure because of the use of the two Irish firms; the "Dutch Sandwich" sobriquet follows from the insertion of Google BV as a sort of tax filler between the two Irish firms. Importantly, the structure is easily replicable by others (and in fact has been reported to be in widespread use among U.S. technology firms¹⁸); there is nothing in the structure that relies on any unique business model or asset of Google's. From the point of view of sophisticated U.S. multinational firms, this arrangement is simply one tool among many in the stateless income planning toolkit.

II. THE CURRENT U.S. TAX SYSTEM IS AN ERSATZ TERRITORIAL REGIME.

A. The Current U.S. Tax System in Practice.

The U.S. tax system is conventionally described as employing a worldwide tax base, with the important exception that the net income, but not the net loss, of a foreign subsidiary is includible at some point in time in the taxable income of its U.S. parent company. (A true worldwide system would consolidate for tax purposes the operations of foreign subsidiaries with those of the parent company, so that (for example) foreign losses could offset domestic income.) This is a false picture of the U.S. tax system in operation.

It is more accurate to say that, in practice, and in the hands of sophisticated multinational firms, the U.S. tax system today operates as an ersatz territorial tax regime, with two odd

¹⁸ Drucker, *supra* note 8.

twists.¹⁹ First, some extraordinary (that is, significantly larger than normal) repatriations of overseas profits to the U.S. parent are subject to U.S. taxation; as a result, the current system strongly discourages extraordinary repatriations. Second, untaxed foreign income paid to the U.S. parent in the form of interest or royalty payments can be sheltered from U.S. tax through the use of unrelated foreign tax credits (which would not be the case in a well-designed territorial regime).

The United States of course fundamentally deviates from a worldwide tax norm by offering U.S. firms the opportunity for “deferral,” under which the active business earnings of a U.S. company’s foreign subsidiary (but not a foreign branch) are not taxed in the United States until those earnings are in some fashion repatriated to the U.S. parent.²⁰ And as the next Section discusses, the actual residual tax collected by the United States on repatriated income is surprisingly small.

The practical consequences of the deferral principle are dramatic. The accumulated earnings of foreign subsidiaries of U.S. resident parent companies that have not been taxed by the United States today exceed \$1 trillion, after net extraordinary dividends in 2005 of about \$312 billion in response to the one-year repatriation tax holiday offered by Internal Revenue Code section 965.

¹⁹ See generally, Fleming, Peroni & Shay, *Worse Than Exemption*, 59 EMORY L. J. 79 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*] (concluding that the current U.S. international tax system can create a system that is as generous or more generous than a well-designed territorial system. *Id.* at 149). See also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Some Perspectives From the United States on the Worldwide Taxation vs. Territorial Taxation Debate*, 3 J. OF THE AUSTRAL. TAX TEACHERS ASS’N 35, 44 (2008); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837 (2000); Lawrence Lokken, *Does the U.S. Tax System Disadvantage U.S. Multinationals in the World Marketplace?* 4 J. OF THE TAX’N OF GLOBAL TRANSACTIONS 43 (Summer 2004).

²⁰ The United States taxes on a current basis certain categories of passive investment income or highly mobile income earned by foreign subsidiaries of U.S. firms (subpart F income). Over the last several years, the scope of the subpart F system has been cut back, so that increasing amounts of U.S. firms’ foreign earnings can qualify as active business income, and therefore are eligible for “deferral.” See Lawrence Lokken, *Whatever Happened to Subpart F - U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX REV. 185 (2005). This scale-back of the subpart F system in turn has greatly enhanced the ability of U.S. firms both to operate in a quasi-territorial environment and to generate stateless income.

As a result of deferral, the United States retains only a residual claim to tax the active business earnings of foreign subsidiaries, when that income in some fashion is made available to the U.S. parent, and then after allowable foreign tax credits are claimed. Interest expense incurred by a U.S. corporation is fully deductible, but to the extent the expense arises from debt that is deemed to support foreign assets, the interest expense is treated as derived from foreign sources.²¹ The net effect of these interest allocation rules is to reduce a U.S. firm's foreign income solely for U.S. tax purposes, while leaving unaffected its actual foreign tax liability; this result in turn is thought to limit a firm's willingness to incur debt in the United States to fund foreign equity investment.

In practice, however, so long as a U.S. firm does not drive its effective foreign tax rate above the U.S. statutory rate after taking these interest expense allocation rules into account, the rules have no impact on the U.S. firm's tax liability. As a result, firms that succeed through stateless income planning in driving down their foreign tax bills have substantial capacities to incur U.S. interest expense without adversely affecting their ability to utilize foreign tax credits.²²

The U.S. foreign tax credit, deferral and subpart F rules interact in complex ways that often are underappreciated by analysts of the current system. Critically, a U.S. firm can choose to defer or repatriate income from its foreign subsidiaries on a subsidiary-by-subsidary basis. The foreign tax credits that flow up to the U.S. parent in turn depend on the foreign tax burdens imposed on the specific subsidiary whose income is repatriated (which income in turn is calculated under U.S. principles). Moreover, foreign tax credits are not linked to a specific item of income. Thus, "excess" credits from one item of income (that is, foreign tax imposed at a rate

²¹ I.R.C. § 864(e); Treas. Reg. §1.861-9 and -9T.

²² More technically, by driving down its foreign effective tax rate before considering interest expense, a firm can incur more interest expense in the United States without bumping into the section 904 ceiling on foreign tax credit utilization. The lower effective foreign tax rate (pre-U.S. interest expense) creates more capacity to absorb without adverse consequences the fraction of U.S. interest expense that is allocated against foreign source income.

greater than the U.S. tax rate on that item of income) can be redeployed to offset tentative U.S. tax on unrelated low-taxed foreign-source income.

A sophisticated U.S. firm manages the residual U.S. tax on repatriated foreign earnings by manipulating the complex interactions between the U.S. deferral and foreign tax credit rules in a manner that can be analogized to a tax distillery. The firm's tax director functions as the master distiller, confronted by hundreds of casks of foreign income, one cask for each category of income earned by each foreign subsidiary. Each cask sits waiting to be tapped by the master distiller as needed, and each dram of foreign income drawn from a cask brings with it a different quantum of foreign tax credits. The master distiller takes instructions from the Chief Financial Officer as to how much cash must be repatriated to the United States each year, and then sets about perfecting a blend of income and credits so that the residual U.S. tax on the resulting liqueur is as small as possible.

Through adroit tax planning the tax director can replenish the casks of high-tax and low-tax foreign income, while keeping untapped income offshore and waiting to be drawn down as needed. The aggregate result, as summarized above, is a very low effective U.S. residual tax rate on regular repatriations to the United States. At the same time, the operation of the distillery tends to drive down the effective foreign tax rate associated with *unrepatriated* foreign earnings, because the purpose of the distillery is to strip out from indefinitely-deferred foreign earnings all the foreign tax credits that are needed to offset current repatriations of zero-taxed or low-taxed foreign income.

The typical corporate tax distillery is built to handle a certain maximum annual throughput of foreign income and associated foreign tax credits. If business exigencies were to call for a very large repatriation in one year, the tax director's intricate distillation apparatus would be overwhelmed, and a substantial residual U.S. tax liability incurred. It is for this reason that the right way to see the U.S. rules for taxing income from foreign direct investment as they apply to ordinary course operations is as a *de facto* territorial tax system, with a contingent (and firm-specific) residual tax liability associated with large-scale repatriations.

B. Revenue Collections Under the Current System.

As a result of the interactions of the complex rules summarized above, the United States today imposes a very small cash tax burden on foreign income that actually is repatriated to the United States. In 2004, for example, the United States collected \$18.4 billion in tax from the foreign operations of U.S. multinationals; this figure includes not only taxes on dividends paid by foreign subsidiaries, but also subpart F income and interest and royalty income paid from controlled foreign corporations to U.S. affiliates.²³ Yet in 2004 foreign subsidiaries paid \$47 billion in dividends to their U.S. parents, generated \$48 billion in subpart F income taxable to U.S. owners, paid another \$59 billion in royalties to U.S. affiliates, and \$12 billion in interest – altogether, some \$166 billion in total repatriations out of foreign earnings.²⁴ The \$18.4 billion in U.S. tax collections represents a U.S. tax rate of about 11 percent on that repatriated income.

At the same time, profitable foreign subsidiaries of U.S. firms (that is, those subsidiaries that reported positive income for the year) retained outside the reach of the U.S. tax system \$270 billion of after-foreign tax (and after dividends to the United States) net earnings for the year.²⁵

²³ The figure represents the 35 percent U.S. statutory tax rate applied to the aggregate “excess limitation” income reported by those U.S. firms in excess limitation for the year. (Personal correspondence with Dr. Harry Grubert, U.S. Treasury Department.) Grubert & Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS, 319, 331-333 (John W. Diamond and George R. Zodrow eds., 2008) [hereinafter Grubert and Altshuler, *Corporate Taxes in the World Economy*] at 326-27 identifies several shortcomings with this approach to measuring the effective tax burden on foreign income; since these shortcomings point in opposite directions, and since no better data exist, it is necessary to use this measure. Those authors also analyze in detail the components of the U.S. residual tax on foreign income for 2000, when that tax totaled \$12.7 billion.

²⁴ For the first two figures, see IRS SOI data for controlled foreign corporations for 2004, available at <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html>. The data are measured employing U.S. tax principles, rather than U.S. GAAP. The last two figures are the result of the author’s request for information from the IRS Statistics of Information Division.

²⁵ The data in the text assume that dividends are paid first out of current earnings, so that dividends paid in 2004 can be presented as distributed out of 2004 earnings. The data do not show how much cash was retained by foreign subsidiaries of U.S. firms, in part because controlled foreign corporations can distribute cash out of “previously taxed income” (basically, subsidiary income previously taxed to the U.S. parent under subpart F); such distributions are excludible from the U.S. parent company’s taxable

As described below, the average effective foreign tax rate on those retained earnings was roughly 16 percent.

One important consequence of the design of the U.S. foreign tax credit rules is that royalty and interest payments received by U.S. affiliates from foreign subsidiaries today are both significant in amount and partially tax-free *everywhere* in the world, which is not the case in properly constructed territorial tax systems. These items bear little tax when they are received in the United States because they generally are deductible in the source country, and are in turn sheltered from tax in the United States through the blending of high-tax foreign income from other sources to shelter these zero-taxed items.²⁶

For example, if the United States had employed a standard territorial tax system in 2004, it would have collected a modest amount of tax on the \$95 billion of dividend and subpart F income actually or constructively repatriated in that year.²⁷ It would, however, have collected roughly \$25 billion (35 percent of \$71 billion) on the royalty and interest income received by U.S. firms from their foreign subsidiaries – some \$6.6 billion *more* than it actually collected under the entire current “worldwide” system.

C. Arbitrage and Domestic Base Erosion.

The current U.S. regime for the taxation of foreign direct investment not only collects very small revenues (as suggested above, arguably smaller than those that would be collected

income. I.R.C. §959(a). In 2004 controlled foreign corporations distributed \$43.8 billion of previously taxed income.

²⁶ Fleming Peroni and Shay, *Worse than Exemption*, supra note 19; Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less than Enthusiastic about the Idea (and Some Ideas They Really Dislike)*, 59 SMU LAW REV. 751, 759- 770 (2006).

²⁷ If one imagines that subpart F income would be defined in a territorial tax system comparably to its current definition, then even under such a hypothetical territorial tax regime U.S. tax would be owed on the \$48 billion of subpart F income includible in the income of U.S. shareholders, after taking into account foreign tax credits attributable to that income. If one assumes that the \$48 billion in subpart F income brought with it foreign tax credits at the global average of 16 percent, then the residual U.S. tax would be in the neighborhood of \$11 billion.

under some scenarios if the United States were to switch to a well-designed territorial system), but also exposes the U.S. corporate tax on the *domestic* tax base of U.S. multinationals to systematic erosion through straightforward tax arbitrage strategies.

Current law has the pernicious effect of implicitly encouraging domestic leverage to fund a firm's domestic cash needs, while leaving low-taxed foreign earnings abroad. This strategy allows U.S. multinational firms to operate in a quasi-territorial tax environment, by supplying the U.S. parent company with cash to fund its domestic operations from two sources: the low-taxed stream of regular course foreign operations (as described above) and domestic borrowings. The attendant increase in domestic interest expense in turn is allocated in part against foreign operations for purposes of the foreign tax credit limitation rules described earlier. Nonetheless, so long as the firm's foreign earnings are sufficiently low-taxed before taking into account the increase in the firm's foreign effective tax rate from the application of those expense allocation rules, the limit is simply not binding.

A U.S. multinational firm's systematic use of domestic borrowing to replicate the cash flow advantages enjoyed by other firms in territorial regimes (where foreign earnings can costlessly be repatriated) erodes the U.S. corporate tax base, because the firm's interest expense is deductible in the United States, while the foreign earnings are not included. The combination of "deferral," as turbocharged by stateless income planning, and incomplete domestic expense allocation rules, which often are not binding, thus lead to classic tax arbitrage, no different in character than if taxpayers could incur tax-deductible interest to invest in uncapped IRA accounts.

III. HOW LARGE IS STATELESS INCOME?

There is strong evidence that multinational firms substantially reduce their aggregate worldwide tax burdens – and thereby increase their incentives to retain earnings outside the United States – through stateless income planning. In light of the obviousness of the assertion to anyone working in the field, this subsection only briefly reviews some of that evidence, looking at both "cash" tax liabilities (that is, the tax liabilities shown as due on the taxpayer's actual tax

returns) and financial accounting data. The evidence strongly implies that U.S. firms are operating in a tax environment not very different from that of foreign competitors in territorial tax systems.

A. Cash Tax Liabilities.

The actual tax liabilities of U.S. multinational firms are confidential, because corporate tax returns, like individual ones, are not released to the public. Fortunately, the Internal Revenue Service Statistics of Information Division publishes tax data on controlled foreign corporations biennially; the presentation includes the aggregate “earnings and profits” of all controlled foreign corporations having positive earnings and profits for the year in question, and the foreign income taxes paid or accrued by these profitable foreign companies in respect of that year.²⁸

In 2006 (the most recent year for which such data have been released), the Internal Revenue Service Statistics of Information public data show that controlled foreign corporations with positive earnings in that year had earnings and profits (before taxes) of \$587.8 billion. Those firms paid or accrued foreign income taxes of \$96.6 billion in respect of that year.²⁹ These data therefore suggest that U.S.-controlled foreign corporations actually paid or accrued foreign taxes in respect of their 2006 economic income at an effective rate of 16.4 percent. The same figure for 2004 was comparable, at 15.7 percent. To put that 15.7 percent effective foreign tax rate in context, the General Accountability Office calculated that for 2004 the weighted average

²⁸ For greater detail on the calculation of this information, see Lee Mahoney and Randy Miller, *Controlled Foreign Corporations, 2004*, IRS Statistics of Information Bulletin, Summer 2008, 49, 58-59. (The biennial article for 2006 has not yet been published, but the data have been posted to the Statistics of Information’s website.)

The term “earnings and profits” is a technical tax term of art, and for this purpose can be understood as a measure of income calculated using fundamental tax norms like the realization principle, but with more economic measures of key items (such as depreciation) than would apply for purposes of calculating taxable income for a domestic income tax return.

²⁹ Technically, these taxes include taxes paid to U.S. possessions. *Id.* at 59.

U.S. domestic effective tax rate for large profitable U.S. corporations was 25.1 percent; the median stood at 31.8 percent.³⁰

Some U.S. multinationals are fortunate enough to enjoy foreign tax rates materially lower than the 16 percent average effective tax rate. For example, Microsoft Corporation's Financial Statements in its 2010 Annual Report indicated that the company has \$29.5 billion in "permanently reinvested earnings" outside the United States (that is, after foreign-tax earnings of foreign subsidiaries that Microsoft does not currently intend to repatriate to the United States).³¹ Microsoft also noted that the tax cost of repatriating those earnings to the United States would be \$9.2 billion.³² These numbers suggest that Microsoft's permanently reinvested foreign earnings enjoyed an effective foreign income tax rate in the neighborhood of 4 percent.³³

Extraordinarily low *effective* foreign income tax rates like those enjoyed by Microsoft theoretically could be explained if most countries had commensurately low *statutory* corporate income tax rates. But that is a false hypothesis. Working with firm-specific confidential U.S. Treasury data, Treasury Department economist Harry Grubert and Professor Rosanne Altshuler calculated that for the year 2002 U.S. multinational firms faced an average foreign *statutory* tax rate of 29 percent, weighted by the firms' foreign incomes.³⁴ As another example, Koninklijke Philips Electronics N.V (Philips), a major Dutch multinational industrial group, reported in its

³⁰ General Accountability Office, *Effective Tax Rates Are Correlated with Where Income Is Reported* at 12 (August 2008).

³¹ Microsoft Corporation 2010 Annual Report, Financial Statements, Note 13. The next subsection describes the concept of "permanently reinvested earnings" in more detail.

³² Some of this \$9.2 billion repatriation tax cost might be attributable to foreign withholding taxes, but those taxes in turn ordinarily are fully creditable in the United States; as a result, the division of the repatriation tax cost between foreign withholding tax and U.S. residual income tax does not affect the calculation summarized in the following sentence in the text.

³³ $9.2/29.5 = 31$ percent, implying that foreign tax credits associated with the repatriation of all permanently reinvested earnings would amount to only about 4 percentage points.

³⁴ Grubert and Altshuler, *Corporate Taxes in the World Economy*, supra note 23 at 322 -23 (29 percent effective statutory rate for foreign subsidiaries in 2003). By contrast, Grubert and Altshuler concluded that in 2002 U.S. manufacturing firms' average effective foreign tax rate stood at 16 percent. Id.

2007 annual report that the weighted average statutory tax rate of all the jurisdictions in which it did business was 26.9 percent.³⁵

There is strong circumstantial evidence of stateless income tax planning in the extraordinary magnitude of interest and royalty payments made by U.S. firms' foreign subsidiaries (technically, controlled foreign corporations) to other foreign subsidiaries. Table 1 sets out the relevant data for 2004 and 2006 (the most recent year for which data are available), as prepared by the Internal Revenue Service Statistics of Information Division:

Table 1: Royalty and Interest Paid by Controlled Foreign Corporations³⁶

Rents, Royalties & License Fees			Interest	
Year	Paid to US Related Parties	Paid CFC to CFC	Paid to US Related Parties	Paid CFC to CFC
2004	\$59,275,141,484	\$13,489,657,755	\$12,419,547,764	\$42,039,808,030
2006	\$66,719,388,821	\$12,659,524,687	\$25,139,162,746	\$67,012,282,063

As can be seen, in 2006 controlled foreign corporations of U.S. parent firms made some \$80 billion in (presumptively) deductible royalty and interest payments *to other controlled foreign corporations*. And this sum in turn vastly understates the actual quantity of such payments, because it completely ignores payments by a “disregarded entity” – a subsidiary of a controlled foreign corporation that for U.S. tax purposes is treated as having no separate juridical existence, but which is very much alive and counted as a company for local tax purposes. The Google facts described earlier are a real life example of enormous (presumably, multi-billion

³⁵ Philips 2007 Annual Report, Note 6 to US GAAP Financial Statements and Note 42 to IFRS Financial Statements.

³⁶ Source: U.S. Internal Revenue Service, Statistics of Information Division, by electronic communication with the author in response to a request for information.

dollar) royalty streams among foreign affiliates of a U.S. multinational group that work to accomplish stateless income goals but that are invisible for U.S. tax purposes.

Another factor pointing to widespread stateless income tax planning is the often-observed importance of a handful of very low-tax jurisdictions, such as Ireland, Singapore, Switzerland, Bermuda and the Cayman Islands in explaining the foreign effective corporate income tax rates of U.S. firms.³⁷ This concentration of U.S. multinational firms' reported incomes in a handful of relatively small foreign economies whose only common feature is their low tax rates belies the notion that U.S. firms' low effective foreign tax rates in the 2002-06 period were attributable simply to tax preferences that were generally available in countries with high nominal rates.

The fruits of stateless income tax planning are that the foreign subsidiaries of U.S. firms held at the end of 2008 more than \$1 trillion in retained low-taxed earnings (net of the \$312 billion in special dividends that qualified for the one-year repatriation holiday afforded by section 965 of the Internal Revenue Code). To the same effect, Harry Grubert found in a recent study that from 1996 to 2004 (i.e., in the period immediately preceding the one-time repatriation tax holiday) the share of U.S. firms' worldwide income that was retained by foreign subsidiaries each year climbed from 17.4 percent to 31.4 percent.³⁸

³⁷ Kimberly Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 57 NAT'L. TAX J. 703, 714 (2009) (showing importance of Ireland, Luxembourg, Bermuda, Switzerland and other low-tax countries as the situs of U.S.-domiciled multinational firms' profits); Martin Sullivan, *Extraordinary Profitability in Low-Tax Countries*, 120 TAX NOTES 724 (August 25, 2008) ("Low-tax Ireland is particularly prone to high profitability."); Martin Sullivan, *U.S. Multinationals Shifting Profits Out of the United States*, TAX NOTES, March 10, 2008; Martin Sullivan, *A Challenge to Conventional Tax Wisdom*, 44 TAX NOTES INT'L 841 (Dec. 11 2006) (30 percent of the pre-tax profits of foreign affiliates of U.S. firms were located in very low-tax countries, a figure greatly disproportionate to employment or physical capital there); Altshuler & Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 FLA. TAX L. REV. 153, 170, 182 (2005) (finding that from 1997 to 2002 there was almost 100 percent growth in the income of foreign affiliates of U.S. parent companies in seven major low-tax countries (Bermuda, Cayman Islands, Ireland, Singapore, the Netherlands, Luxembourg and Switzerland), and that this income represented roughly 40 percent of worldwide income from equity investments).

³⁸ Grubert, *Foreign Taxes, Domestic Income*, supra note 4 at 2.

B. Financial Accounting Evidence.

In a very real sense, current cash tax liabilities are not as important to a firm as are its audited financial accounting statement provisions for taxes, because U.S. Generally Accepted Accounting Principles (GAAP) are the lens through which investors judge public firms.³⁹ Indeed, investors have little choice in the matter: a firm's U.S. corporate income tax return is confidential, while GAAP financial statements of publicly-held firms of course are not. And here again one sees evidence that U.S. multinational firms enjoy very low effective foreign tax rates that can logically be explained only through stateless income tax planning.

U.S. GAAP accounting for taxes is an odd mixture of different concepts. Very generally, the idea behind the tax reconciliation table in a firm's tax footnote to its financial statement is to calculate a hypothetical tax burden equal to the statutory rate (35 percent) applied to the GAAP (not tax) measure of income. Differences between the actual U.S. tax burden and this hypothetical figure must then be accounted for, either as temporary differences (e.g., differences in depreciation accounting conventions) or as permanent differences (e.g., irreversible differences between the GAAP and tax accounting measures of income, such as tax-exempt bond interest income). Temporary differences are reflected on the financial statements as deferred tax liabilities (when tax deductions run ahead of the corresponding GAAP measure of an expense) or deferred tax assets (the converse). Permanent differences, however, are reflected simply as a reduction in the firm's tax expense, and therefore its effective tax rate.

³⁹ John R. Graham, Michelle Hanlon and Terry Shevlin, *Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions* (Nov. 2010), at 6, available at <http://ssrn.com/abstract=1389731> [hereinafter Graham, Hanlon and Shevlin, *Real Effects of Accounting Rules*]. This Report argues that GAAP accounting for taxes in fact dominate cash tax costs.

GAAP accounting now requires firms to set out their cash tax payments for a year. This category is not the same as the tax liabilities shown as due on the firm's tax returns for the year, because the financial accounting category is a simple record of cash flows: tax payments in respect of prior years are conflated, for example, with estimated payments in respect of the current year. As previously noted, this Article uses the phrase "cash" taxes to mean the tax liabilities shown as due on the taxpayer's tax returns for the year in question.

Examples of material permanent differences are relatively scarce, with one principal exception: U.S. GAAP does not require any deferred tax liability to be established for the contingent residual U.S. tax liability that might be incurred on the repatriation of “permanently reinvested” low-tax foreign earnings.⁴⁰ A better term for this might be “indefinitely reinvested:” so long as a firm can demonstrate that it has no current plan to repatriate foreign income and does not have an identified need to do so, it need not provide for the potential liability for doing so on its GAAP financial statements.⁴¹ The permanently reinvestment decision can be made on a subsidiary-by-subsiary basis, and this decision to treat accumulated foreign earnings as not permanently reinvested can be reversed (and an accounting benefit booked) in appropriate circumstances.

These rules mean that low-taxed “permanently reinvested” earnings bring down a firm’s GAAP tax expense. They also mean that firms that defer the repatriation of active foreign earnings are not penalized relative to competitors in territorial systems, when viewed through the lens through which investment decisions ordinarily are made.

Two recent complementary empirical studies confirm the intuitive heuristic that GAAP accounting for taxes on foreign earnings dramatically affects the repatriation decision. In one, Blouin, Krull and Robinson, working with confidential Bureau of Economic Analysis data, conclude that “our empirical tests tell a consistent story; [GAAP] reporting incentives [for permanently reinvested earnings] deter the repatriation of foreign earnings.”⁴² In the other, Graham, Hanlon and Shevlin report the results of an extensive survey of firm tax executives; the

⁴⁰ Other, much smaller examples are the section 199 domestic production deduction and the R&D credit.

⁴¹ A more technical description would be that the facts drive a required financial accounting result, but that the company controls the relevant facts, including those relating to its future plans.

⁴² Jennifer L. Blouin, Linda K. Krull and Leslie A. Robinson, *Is U.S. Multinational Intra-Firm Dividend Policy Influenced by Reporting Incentives?* (Feb. 2011), at 6, available at <http://ssrn.com/abstract=1468135>. The authors also find that public companies are more sensitive to the accounting benefits of permanently reinvested earnings than are private firms, which is consistent with the point made earlier in the text that financial accounting is the lens through which stakeholders view public firms.

authors conclude that “the ability to not recognize the U.S. income tax expense on foreign earning in financial statements . . . is an important consideration in real corporate investment decisions regarding location of operations and whether to repatriate foreign earnings to the U.S. or reinvest the foreign earnings overseas.”⁴³

Some studies have suggested that the market in fact discounts stock prices for the U.S. residual tax that firms actually disclose in their financial statements as estimates of the cost of repatriating their permanently reinvested earnings.⁴⁴ Even if the market does discount these stocks, recent corporate practice seems to tilt in favor of not quantifying estimated repatriation tax costs. For example, out of the thirty constituent members of the 2010 Dow Jones Industrial Average, only three disclosed their 2007 estimated tax costs to repatriate their permanently reinvested earnings.

In sum, from the perspective of investors, the U.S. global tax regime often operates much like a territorial system. For example, in 2007 (chosen as the last year before the current financial crisis) the effective U.S. GAAP tax rate for the *global* operations of General Electric Company

⁴³ Graham, Hanlon and Shevlin, *Real Effects of Accounting Rules*, supra note 40 at 3.

⁴⁴ See Mark Bauman & Ken Shaw, *The Usefulness of Disclosures on Untaxed Foreign Earnings in Firm Valuation*, 30 J. AM. TAX. ASSOC. 53 (2008) (“This result is due to estimated repatriation tax amounts exhibiting downward bias, and less accuracy for actual repatriation tax effects, relative to firm-disclosed repatriation tax amounts”); Julie H. Collins, John R.M. Hand & Douglas A. Shackelford, *Valuing Deferral: The Effect of Permanently Reinvested Foreign Earnings on Stock Prices*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 143 (James R. Hines, Jr. ed. 2000). Bryant-Kutcher, Eiler, and Guenther also found evidence that firms’ stock prices were discounted for *disclosed* repatriation tax costs, but only if those firms also had accumulated high levels of excess foreign cash—presumably in an effort to avoid repatriation taxes. See Lisa Bryant-Kutcher, Lisa Eiler & David A. Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Foreign Earnings*, 61 NAT’L TAX J. 699, 701 (2008) [hereinafter Bryant-Kutcher, Eiler & Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Foreign Earnings*].

By contrast, at least one study concludes that the market does not discount stock prices for the *unreported* tax liability from permanently reinvested earnings. Dan Dhaliwal & Linda Krull, *Permanently Reinvested Earnings and the Valuation of Foreign Subsidiary Earnings* (unpublished, 2006). Also, while the Collins, Hand, and Shackelford model, for example, concludes that stock prices are negatively affected by disclosed but unquantified tax liabilities, it does not estimate with statistical significance the size of this effect. See Collins, Hand & Shackelford, supra note 45, at 155–56.

(GE) and its GAAP-consolidated subsidiaries was 15.1 percent.⁴⁵ (This means, of course, that GE's effective foreign income tax rate for the year was far lower, as the 15.1 percent figure represents an average of foreign and U.S. income tax rates on their respective proportions of firm income.) The non-inclusion of any GAAP liability for U.S. taxes on foreign operations accounted for 15.2 percentage points of the difference between the statutory rate of 35 percent and the reported global tax rate of 15.1 percent.⁴⁶

IV. POLICY IMPLICATIONS OF STATELESS INCOME TODAY.

A. The Fruitless Search for Source.

The artificiality of the global norms that define the source of income is a well-known problem, for which solutions are not obvious.⁴⁷ But territorial tax solutions require their resolution, because the source rules that are adopted determine the jurisdiction with the right to tax the income in question. Source rules thus are central to the entire operation of territorial tax systems. Source rules also are somewhat important for the current U.S. tax system, although they do not play quite the same central role as they do in territorial regimes, because source rules drive the ability of a U.S. taxpayer to claim foreign tax credits.

Stateless income tax planning compounds the meaninglessness of income tax source rules. Even if a multinational enterprise's income is sourced in the first instance by every country

⁴⁵ GE 2009 Annual Report, Note 14 to Consolidated Financial Statements, p. 93 (showing 2007 as well as 2009 effective tax rate data). Available at <http://www.ge.com/ar2009>.

⁴⁶ Id.

⁴⁷ See, e.g., Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 1 WORLD TAX J. 291, 305-343 (2010) [hereinafter Vann, *Taxing International Business Income*]. Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. FOR INT'L TAX. 486 (2008) eloquently describes the artificiality of source rules applicable to locating the includibility or deductibility of interest, and then recommends in effect a global multilateral treaty to apportion interest expense on pure fungibility of assets principles to all members of an affiliated group of companies, without regard to the identity of the particular affiliate that actually borrowed the funds. Another way of looking at this is that Graetz proposes the worldwide adoption of a formulary income standard, but applied only to interest expense.

according to some economically rational set of agreed principles, stateless income tax planning simply extracts the income from the source country (for example, through deductible interest, royalty, or fee payments) and deposits it in a tax-friendlier locale. For example, Google's income from sales to German advertisers is deducted from German income tax returns, while Google Ireland has no permanent establishment in Germany to which that income is attributable. As a result, Google's income derived from providing advertising services in Germany effectively is untaxed in Germany.. That income is sourced in the first instance to Ireland, as the domicile of the putative owner of the intangible assets that give rise to the advertising income. But then, in a *second* step unrelated to the wisdom of the first-level source rule, that income migrates to Bermuda, via the Double Irish Dutch Sandwich mechanism described earlier.

The result is that in a world imbued with stateless income tax planning, there can be no meaning at all to source, because transactions one or more steps removed from a firm's original value-adding operation serve to redirect that income to friendlier locales. The efforts to date devoted to clarifying source rules largely overlook how these second or third step internal transactions – all perfectly consistent with arm's-length standards and other bedrock global tax norms – completely erode the value of that work.

B. Capture of “Tax Rents.”

Global capital markets are liquid and efficient, and many countries have eliminated or greatly scaled back barriers to foreign investment in their local economies. Moreover, for most direct and portfolio investment, source country net income tax effectively is the final tax on cross-border investment income. As a result, economists generally expect that global after-tax returns on corporate marginal investments will converge, because foreign and local investors will provide capital to those jurisdictions where after-tax marginal returns exceed world norms, and withdrawing capital from those where returns are below normal.⁴⁸ But corporate income tax

⁴⁸ This is the standard view in economics presentations. See Note 75, *infra*.

rates differ around the world, which means that pre-tax marginal returns necessarily must differ if after-tax returns do not.

Stateless income tax planning offers multinational firms, but not wholly domestic ones, the opportunity to convert high-tax country pre-tax marginal returns into low-tax country inframarginal (supranormal) returns, by redirecting pretax income from the high-tax country to the low-tax one. By doing so, multinational firms can be said to capture “tax rents.”⁴⁹ Their inframarginal returns stem not from some unique high-value asset, but rather from their unique status as structurally able to move pretax income across national borders.

For example, assume that the United States has a corporate tax rate of 35 percent, Sylvania’s tax rate on domestic income is 25 percent, and Freedonia imposes a 10 percent tax rate on domestic income. Moreover, because capital is globally mobile, and capital markets are efficient, *after-tax* normal returns on capital invested in business firms are the same around the world. Assume that this global after-tax rate is 5 percent. What this implies is that *pre-tax* normal corporate returns will vary from country to country, to reflect differences in tax burdens. Pre-tax corporate returns in the United States will be 7.7 percent, while in Sylvania those returns will be

⁴⁹ It might be argued that multinational firms are so successful in generating stateless income that their investment behavior changes global asset prices, by bidding up prices for high-tax country assets. If multinational firms were the price setters in corporate investments around the world, and they in turn paid no tax anywhere (or conversely, paid residence-country tax on everything), then one might see convergence in pre-tax rather than after-tax risk-adjusted corporate net incomes (just as should be true for interest income today).

This scenario seems implausible, for several reasons. First, all domestic investors and all portfolio investors (whether domestic or cross-border) are post-corporate tax investors. See note 49, *supra*. Moreover, since much crossborder investment today is portfolio investment, there is no particular reason to assume that direct investment by multinational firms sets asset prices. Second, not even this paper and its companion argue that all multinational firms convert 100 percent of cross-border investment income into zero-taxed returns. Third, as developed in Section V, the ability to generate stateless income is a form of “status” tax arbitrage, which means that it is an attribute available only to some investors competing for a particular investment. (Indeed, as effective tax rate studies show, it is not even a status equally distributed among all multinational firms.) Fourth, investment opportunities that yield normal returns often are relatively fungible, or can be replicated through greenfield construction. As in the domestic market for municipal bonds, or tax shelters (see Section V), it seems implausible to think that market forces by themselves would be sufficient to vitiate the “tax rents” story developed in the text.

6.67 percent, and in Freedonia 5.56 percent. A U.S. firm, confronted with earning a 5 percent after-tax return on a marginal investment, will opt instead to invest, not in low-tax Freedonia, but rather in high-tax Sylvania, and then through stateless income tax planning move the Sylvanian pre-tax 6.67 percent return to Freedonia. After Freedonian income taxes on that 6.67 percent marginal return, the U.S. firm will enjoy an after-tax marginal return of 6 percent, rather than the global prevailing 5 percent rate. The incremental 1 percent return that comes without any incremental risk is an instance of “tax rents.”

At least as applied to U.S.-domiciled companies, tax rents are easier to harvest from foreign jurisdictions than they are from a multinational firm’s own country of residence.⁵⁰ U.S. firms prefer marginal investments in foreign high-tax countries to investments in the United States because the former are more easily employed in stateless income planning. The income is already foreign source, and straightforward earnings stripping technologies can be used to move that income to a low-tax affiliate that are not available with respect to domestic income.

The best counterargument is that capital, like nature, abhors a vacuum, and that foreign investors will replace domestic firms as investors in the U.S. domestic markets.⁵¹ But this argument confuses U.S. investment with U.S. taxable income.⁵² To a foreign-domiciled

⁵⁰ For example, if a U.S. domestic affiliate of a U.S. multinational group pays interest to a foreign affiliate, that income will constitute subpart F income. 26 U.S.C. §954(a)(1) and §954(c)(1)(A). When a foreign affiliate in a high-tax jurisdiction pays interest out of active business earnings to an affiliate in a low-tax jurisdiction, that interest income is not subpart F income, by virtue of the look-through rules of I.R.C. §954(c)(6).

The §954(c)(6) look-through provision is a temporary provision that recently was extended by Congress.

⁵¹ James R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 280 (2008) [hereinafter, Hines, *Reconsidering the Taxation of Foreign Income*] summarizes the research underlying this counterargument.

⁵² *Id.* at 278 (“To a first approximation there is little effect of additional foreign investment on domestic tax revenue.”) Hines offers no evidence in support of this assertion. It may be that he assumes that investment and taxable income generally are closely positively correlated. A principal theme of this Article, by contrast, is that stateless income tax planning and analogous strategies employed by U.S.-domiciled multinational groups in respect of the U.S. tax base have substantially disassociated investment from taxable income.

multinational firm, the United States is just another source country, and a particularly high-tax one at that. Thus, it may be that foreign multinational firms replace any missing U.S. investment, but the empirical issue goes beyond that question, and must consider as well whether foreign firms are themselves wholly unschooled in the arts of stateless income planning when it is the United States that is the source country. Notwithstanding the existence of some statutory protections against earnings stripping, there thus are good reasons to believe that the United States is a net loser when its tax system encourages domestic firms to invest disproportionately outside the United States, and (as the next subsection discusses) to finance domestic cash flow needs through U.S. borrowings that erode the U.S. tax base.

In sum, the net effect of the tax rents phenomenon is an odd incentive for U.S. firms to invest in *high-tax foreign* countries, to provide the raw feedstock for the stateless income generation machine to process into low-taxed permanently reinvested earnings. The tax rents that are thereby generated are retained outside the United States, to preserve their value.

This last point, when combined with the arbitrage possibilities described in the next subsection, effectively answers the question often posed by the private sector as to why the

In one fairly recent study on the earnings stripping rules of section 163(j) the U.S. Treasury Department concluded that the evidence for the proposition that foreign-controlled domestic firms systematically stripped income out of the United States was ambiguous. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007 at 3. (“As discussed below, it is not possible to quantify with precision the extent of earnings stripping by foreign-controlled domestic corporations generally. However, there is strong evidence of earnings stripping by the subset of foreign-controlled domestic corporations consisting of inverted corporations (i.e., former U.S.-based multinationals that have undergone inversion transactions).”).

The Treasury Department study has been treated skeptically. See, e.g., Stephen E. Shay, *Ownership Neutrality and Practical Complications*, 62 TAX L. REV. 317, 322 (2009). Its conclusions also appear to be at least partially inconsistent with those reached in a contemporaneous report by the General Accountability Office, *Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations 1998-2005* (2008), available at <http://www.gao.gov/new.items/d08957.pdf>. (“FCDCs reported lower tax liabilities than USCCs by most measures shown in this report.” Id. at 3.) The GAO report acknowledges, however, that there are several non-tax related factors, such as the average age of foreign and domestic-controlled domestic corporations, that might explain some of the differences in results.

United States should care if U.S.-domiciled multinational firms minimize their foreign income tax liabilities. The simple answer is that the pursuit of tax rents, combined with the erosion of the domestic tax base through leverage, leads to both distorted investment decisions by domestic firms and sharply reduced domestic tax revenue collections.

C. Domestic Base Erosion through Tax Arbitrage.

At the same time that they capture tax rents through stateless income tax planning, U.S. firms finance much of their funding needs (including dividends and stock repurchases) through domestic U.S. borrowing. The resulting interest deductions erode the U.S. corporate tax base through a classic tax arbitrage operation, in which the inframarginal returns on offshore investments fall outside the U.S. tax net, while interest expense is deducted on debt that arguably would not be incurred if those returns were repatriated (and the income included in the U.S. tax base. The U.S. tax base is shifted outside the United States through domestic leverage incurred to support foreign earnings, genuine foreign earnings in turn migrate to low-tax locales, and those low-taxed foreign earnings are allowed to compound U.S.-tax free indefinitely.

This arbitrage operation is not a theoretical abstraction. At the end of its fiscal quarter ending December 31, 2010, Microsoft Corporation had \$29.5 billion in permanently reinvested earnings, and worldwide held \$41 billion in cash and short-term investments. In February 2011, Microsoft borrowed \$2.25 billion in the U.S. capital markets. A recent news report in the financial press has asserted that Microsoft sold these debt obligations to fund dividends and stock buy-backs, because 80 to 90 percent of its cash and short-term investments are held outside the United States, in order to avoid any repatriation tax.⁵³ Moreover, the article suggests that this pattern is becoming more common among U.S. technology companies generally.

⁵³ Richard Waters, *Tax Drives US Tech Groups to Tap Debt*, FINANCIAL TIMES, February 7, 2011, p. 15 Col. 6. In the same vein, Microsoft's very recent announcement of plans to acquire Skype Software S.a.r.l. (a Luxembourg-based company) has been explained as a tax-efficient use of the firm's vast hoard of offshore cash. *Microsoft Structured Acquisition Of Skype To Avoid U.S. Taxes*, <http://thinkprogress.org/2011/05/13/microsoft-skype-tax-havens/>.

As previously mentioned, the Code contains a few special rules – in particular, the foreign tax credit interest expense rules – whose nominal purpose it is to limit this arbitrage. In practice, however, these limitations often do not constrain the full deductibility of U.S. interest expenses, again in part because of the work of the tax director as master blender of the tax distillery, in this case by bringing back enough very low-taxed foreign income (including interest and royalty income) to offset the allocation of U.S. expense.⁵⁴ Given that the United States has high corporate statutory tax rates compared to world norms, it would be extraordinary to think that U.S. firms, having successfully captured tax rents through the operation of their stateless income mechanisms, would not complete the tax minimization circle by funding their global cash needs through U.S. domestic borrowings. The net effect is to turbocharge the benefits of stateless income tax planning by migrating (through domestic interest deductions) what would have been U.S. taxable income to stateless status.

D. Competitiveness of U.S. Firms: Statutory and Effective Tax Rates.

The United States today has the highest federal statutory corporate tax rate of any of the world's largest economies.⁵⁵ Relying in part on this fact, and in part on their assertion that the United States imposes a worldwide tax on the income of U.S. multinational firms, many such enterprises have argued that the current U.S. tax system makes them “uncompetitive” against foreign multinationals operating with territorial tax regimes.⁵⁶ The data point in a different direction.

⁵⁴ James R. Hines, Jr., *Foreign Income and Domestic Deductions*, 61 NAT'L TAX J. 461, 463-64 (2008). (“Taxpayers whose foreign income is lightly taxed by foreign governments, and who, therefore, owe residual U.S. tax on that income, receive the benefit of full domestic deductibility of expenses incurred in the United States.”).

⁵⁵ The government of the previous record holder, Japan, reduced its national total (central and sub-central government) corporate tax rate to 34.5 percent on April 1, 2011.

⁵⁶ “Competitiveness” is not a concept that is well developed in the economic literature. For two recent efforts to situate the term more firmly in economic analysis, see Eckhard Siggel, *International Competitiveness and Comparative Advantage: A Survey and a Proposal for Measurement*, 6 J IND

As a preliminary matter, the gap between U.S. and world corporate tax rate norms is sometimes overstated. Many analysts find it convenient to rely on an annual OECD dataset for this purpose;⁵⁷ using this source, the simple unweighted average of 2010 corporate tax rates among the 30 OECD countries excluding the United States was 25.6 percent. (In 2006 it was about 28 percent.⁵⁸) This dataset must be applied with caution in three respects.

First, the dataset includes sub-central government taxes on corporate income; this explains why the U.S. rate is described as 39.2 percent. It is appropriate to include sub-central government taxes when comparing the competitive tax environment of U.S. *domestic* firms to foreign domestic firms, or when measuring the *foreign* tax burden on inbound investment in a particular country, but it is not appropriate to include U.S. sub-central government taxes when measuring an actual or hypothetical U.S. statutory tax burden on U.S.-domiciled multinational firms contemplating an outbound investment, because as a general matter foreign income is not taxed by the states of the United States.⁵⁹ The right statutory rate comparison in that case is the total (central and sub-central) foreign tax rate to the federal U.S. statutory rate (35 percent).

COMPETITION TRADE 137 (2006); Michael Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771 (2009).

U.S. multinational firms can fairly be said not to be deeply troubled by any terminological ambiguity. To such a firm, an “anticompetitive” measure is any cost that along any dimension might be greater than the comparable cost faced by a firm not domiciled in the United States. As an anecdotal matter, it has been this author’s experience that within this framework no quantum of pro-competitive factors can ever outweigh the damage imagined to be done by a single anti-competitive one.

⁵⁷ See <http://www.oecd.org/dataoecd/26/56/33717459.xls> for 2010 data.

⁵⁸ OECD, *OECD in Figures, 2009 Edition*, at 58, Table of 2006 Comparative Income Tax Rates (28.1 percent OECD simple average of maximum corporate statutory rates, including subnational taxes on corporate income).

⁵⁹ No state directly taxes foreign income under its general corporate income or franchise tax. Three states (Idaho, Montana and North Dakota) require global consolidation and apportionment of income; if firms report consistently higher profits on a separate company basis outside the United States than they do inside, the effect of this rule may be to increase firms’ tax liabilities in those states. Finally, three states (California, Utah and West Virginia) permit worldwide consolidation and apportionment at the taxpayer’s election.

Second, the simple unweighted average of OECD statutory rates mixes rates imposed by economies of greatly disparate size; in general, however, there is an inverse relationship between the size of an economy and its corporate tax rate. In 2010, for example, the unweighted average of the five largest OECD economies other than the United States was roughly 32 percent, and the unweighted average of the next six economies was 28 percent.⁶⁰ Giving equal weight to the smallest 19 economies (where U.S. firms by definition face smaller markets) misstates the tax burdens fairly attributable to a multinational firm’s global economic opportunities (if undistorted by stateless income planning).

Finally, the OECD dataset does not include non-OECD countries, in particular, the “BRICs” – Brazil, Russia, India and the People’s Republic of China. These are very important markets, of course. Their 2010 unweighted average corporate tax rate was 28.25 percent.⁶¹

More fundamental to the thrust of this Report, U.S.-domiciled multinational firms do not in fact bear a 35 percent tax burden in respect of their non-U.S. income. The data summarized earlier demonstrate that residual U.S. tax today on actual repatriations is a small fraction of total foreign earnings. At the same time, U.S. multinational firms are able to employ stateless income tax planning techniques to drive down their cash foreign tax liabilities and their GAAP financial accounting effective foreign tax rates on unrepatriated earnings to levels far below the foreign tax statutory average.

Taken together, these facts point to many U.S. firms operating in an environment much closer in practice to territorial systems – indeed, superior to them in respect of intragroup

⁶⁰ Author’s calculations. The five largest economies ex-USA comprise: Japan, Germany, the United Kingdom, France and Italy. The next six comprise: Canada, Spain, Korea, Mexico, Australia and the Netherlands. See Christopher Heady, *Directions in Overseas Tax Policy*, in MELBOURNE INSTITUTE – AUSTRALIA’S FUTURE TAX AND TRANSFER POLICY CONFERENCE, ch. 2, at 8. available at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference_report.htm.

⁶¹ Author’s calculation from data in KPMG Corporate and Indirect Tax Survey 2010, available at: <http://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Pages/KPMG%27sCorporateandIndirectTaxRateSurvey2010.aspx>. The author’s calculation employs the standard (nonpreferential regime) maximum corporate income tax rate, which is consistent with the OECD methodology.

interest, royalties and license fee income. In the same vein, the recent study by Harry Grubert previously mentioned concludes that from 1996 to 2004 there was no meaningful correlation between lower foreign tax rates and the growth rate of U.S. firms.⁶² From this he concludes that “The importance of low taxes on foreign income for U.S. ‘competitiveness’ does not, at least on this evidence, have much empirical support.”⁶³

E. Lock-Out.

The lock-out effect refers to the fact that a firm’s benefits from stateless income planning are contingent upon the firm not repatriating more foreign earnings than its tax distillery can process. Because so many U.S. firms have been so successful in developing multibillion dollar pools of low-taxed foreign permanently reinvested earnings, those firms in turn are compelled as a practical matter to keep a large percentage of their foreign earnings and cash outside the United States solely to avoid this residual tax.

For the reasons described in the preceding subsection, the real tax issue for the managers of U.S. multinational firms that are able to engage in widespread stateless income tax planning is not any U.S. tax burden on retained foreign earnings (whether measured by cash tax liability or financial accounting presentation), or even significant current U.S. taxation of ordinary course cash repatriations of low-taxed foreign source income. Instead, it is the extraordinary accumulation of profits *and cash* in foreign subsidiaries, and the inability of most firms’ tax distilleries to absorb a very large repatriation dividend.⁶⁴ This distorts behavior (for example, by encouraging firms to borrow in the United States or to make relatively unproductive investments outside the United States), and leads to deadweight loss.

⁶² Harry Grubert, *Foreign Taxes, Domestic Income*, supra note 4 at 19.

⁶³ Id.

⁶⁴ Fritz Foley, Jay C. Hartzell, Sheridan Titman & Garry Twite, *Why Do Firms Hold So Much Cash? A Tax-Based Explanation*, 86 J. OF FIN. ECON. 579 (2007) (U.S. tax rules for foreign direct investment induce U.S. firms to accumulate excessive cash) [hereinafter Foley, et.al., *Why Do Firms Hold So Much Cash?*].

Two recent business news stories illustrate the problem. After suggesting (plausibly, in the experience of this author) that the lock-out effect drives U.S. firms to make foreign acquisitions, simply because they need some use for the cash they have accumulated outside the United States, one story quotes the Chief Executive Officer of Cisco Systems to the effect that “Cisco has \$30 billion of its \$38 billion in cash parked abroad because of higher U.S. taxes.”⁶⁵ The other describes how eBay “has 70 percent of its cash outside the US and [as a result] is hunting for acquisitions in Europe.”⁶⁶

The magnitude of the lock-out effect’s deadweight losses has been the subject of spirited debate.⁶⁷ As a practical matter, those losses no doubt increase disproportionately to the amount of a firm’s low-taxed permanently reinvested earnings.⁶⁸ Nonetheless, it might be helpful, particularly when the “competitiveness” banners are unfurled in policy debates, to distinguish between the deadweight losses to firm managers in respect of their ongoing business activities, and the deadweight losses to investors in those firms.

⁶⁵ Serena Saito, *U.S. Technology Companies Go Shopping Abroad to Avoid Taxes*, BLOOMBERG BUSINESSWEEK, September 2, 2010, available at http://www.businessweek.com/magazine/content/10_37/b4194031986280.htm.

⁶⁶ Richard Waters, *Tax Drives US Tech Groups to Tap Debt*, FINANCIAL TIMES, February 7, 2011 at 15, Col. 6.

⁶⁷ See Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 Nat’l. Tax J. 937, 957 (2004) [hereinafter Desai & Hines, *Old Rules and New Realities*] (Desai and Hines estimate \$10 billion in indirect efficiency losses due to retained earnings due to residual tax on dividends.); Harry Grubert, *Comment on Desai and Hines, “Old Rules and New Realities: Corporate Tax Policies in a Global Setting”* 58 NAT’L. TAX J. 263 (2005) (rejecting Desai and Hines’ proposition because dividends account for a relatively small amount of revenue); Mihir A. Desai, *Reply to Grubert*, 58 NAT’L. TAX J. 275 (2005); Harry Grubert, *MNC Dividends, Tax Holidays and the Burden of the Repatriation Tax: Recent Evidence*, (Oxford University Center For Business Taxation, Working Paper, 2009).

⁶⁸ Bryant-Kutcher, Eiler & Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Earnings*, supra note 45 at 702-03 (“Since U.S. tax law provides an incentive for foreign subsidiaries to defer repatriation of cash, managers must trade off the negative impact of U.S. repatriation taxes on firm value with the lower benefits that come from reinvesting foreign earnings in financial assets”).

One way to focus on the first question is to ask whether U.S. firms are capital constrained, by virtue of needing to satisfy their funding needs by particularly costly borrowing in the United States, rather than repatriating cash from abroad. There is little statistical or anecdotal evidence to support such a capital constraint story for the major U.S. multinational firms that account for the bulk of U.S. firms' income from foreign direct investment.⁶⁹ Many large firms with low effective foreign tax rates in fact have very low debt-to-assets ratios, or do not need to borrow at all.⁷⁰ When such firms do borrow domestically, there is scant evidence that they suffer punitively high borrowing costs.⁷¹

The 2004 section 965 repatriation experience implicitly supports the idea that large U.S. multinational firms with substantial "permanently reinvested" earnings are not capital-constrained in the United States. In response to the one-year repatriation tax holiday, U.S. firms repatriated \$312 billion in cash dividends in excess of their normal aggregate dividend repatriation rate (about \$50 billion/year).⁷² A subsequent study concluded that this gigantic influx was *not* correlated with repayments of domestic debt, or with incremental investment in domestic property, plant or equipment (as would be expected if large U.S. multinational firms

⁶⁹ Cf. Bryant-Kutcher, Eiler & Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Foreign Earnings*, supra note 45 at 705 n. 16 ("Only seven percent of U.S. firms that accumulate excess cash outside the United States to avoid the U.S. repatriation tax appear to be constrained in their access to capital markets.")

⁷⁰ As examples from the Dow Jones Industrial Average companies Hewlett-Packard and (until recently) Microsoft.

⁷¹ For example, as previously described, Microsoft Corporation reported \$29.5 billion in permanently reinvested earnings at June 30, 2010 (the end of its fiscal year). At the end of its Fiscal Year 2011 second quarter (December 31, 2010), Microsoft reported holding \$41.2 billion in cash, cash equivalents and short-term investments. (As previously described, GAAP financial statements do not describe the location within a multinational group of these items.) In February 2011, Microsoft borrowed \$2.25 billion in the public capital markets, including \$1 billion of 5.30 percent notes due in 30 years and \$500 million of 4.00 percent notes due in 10 years.

⁷² Kleinbard & Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 TAX NOTES 1191 (Sept. 22, 2008).

were capital constrained in the United States), but was strongly positively correlated with stock buy-backs.⁷³

Perhaps the most that one can say about the costs imposed by the lock-out phenomenon on the managers of U.S. firms is that those firms that have been extraordinarily successful in stateless income tax planning have become hoist on their own petard. They have been so successful in their stateless income tax planning, and have removed so much income from the tax base in both the United States and in high-tax foreign jurisdictions, that they now are running out of remotely feasible ways of reinvesting those huge sums accumulating in their low-tax subsidiaries.⁷⁴

Another way of stating this conclusion is that the lock-out effect operates in fact as a kind of *lock-in* effect: firms retain more earnings (in this case overseas) than they profitably can redeploy, to the great frustration of their shareholders. The result is not that firms forego investments, but that *shareholders* are not able to optimize their portfolios. Profits earned by successful multinational firms are retained in relatively low-yielding liquid investments, or reinvested in suboptimal foreign acquisitions, all by virtue of the confluence of their great success in stateless income tax planning, on the one hand, and the lock-out phenomenon, on the other. Shareholders would prefer that the cash be distributed to them, but companies cannot afford to comply.

⁷³ Dhammika Dharmapala, C. Fritz Foley, & Kristen J. Forbes, *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*. (NBER Working Paper Series, June 2009), available at <http://www.nber.org/papers/w15023.pdf> (Concluding, “Repatriations did not lead to an increase in domestic investment, employment or R.& D., even for the firms that lobbied for the tax holiday stating these intentions.”). Ironically, the 2004 legislation prohibited the use of dividends eligible for the special repatriation holiday to fund stock buy-backs. The paradox is solved once one discovers that the prohibition did not incorporate any fungibility of money concept, so that firms could both accomplish their corporate finance objectives and comply with the law by segregating different pools of cash for different corporate expenditures.

⁷⁴ Foley, et.al, *Why Do Firms Hold So Much Cash?*, supra note 64 (U.S. tax rules for foreign direct investment induce U.S. firms to accumulate excessive cash).

In short, U.S. multinational firms themselves are not disadvantaged materially by the lock-out effect, but their shareholders are. The ultimate reward of successful stateless income tax planning from this perspective should be massive stock repurchases, but instead shareholders are tantalized by glimpses of enormous cash hoards just out of their reach. There is genuine deadweight loss involved, but it has little to do with “competitiveness” or job creation in the United States.

F. Summary of Implications.

Despite their protestations, U.S. multinational firms in fact enjoy substantially all the benefits of their territorial tax competitors, including the opportunity to employ stateless income tax planning to capture large tax rents (or to drive down their effective foreign tax rates into the single digits, which is the same thing by another name) – with one exception. That is the lock-out effect, which leads U.S. firms to hold extraordinary amounts of cash equivalents or to make suboptimal investments outside the United States, solely to preserve the efficacy of their stateless income generation machines.

The United States’ unique combination of a quasi-territorial tax regime, its enfranchisement of stateless income tax planning through idiosyncratic rules like check-the-box, and the lock-out effect leads to deadweight losses, but those losses do not appear to overlap with the usual formulations of “competitiveness” concerns. The current U.S. tax system causes U.S.-domiciled multinational firms, first, to prefer investments in foreign high-tax countries over investments in the United States (to set the stage for stateless income tax generation), second, to establish low-tax affiliates of sufficient size and activity to serve as receptacles of stateless income, third, to invest time and resources in manning the various dials and gauges of the tax planning mechanisms required to create and defend stateless income generation, and fourth, to retain the resulting earnings and cash in those low-taxed receptacles, in order to preserve both the cash and the financial accounting gains inhering in the production of stateless income. The results are distortions in original investment decisions, the distribution of earnings, and in reinvestments, as well as wasteful expenditures to maintain the apparatus.

The lock-out phenomenon generally is the consequence of low effective foreign tax rates and current law's deferral rules. Stateless income tax planning in turn pushes a firm's effective foreign tax rate downwards still further. The preservation of the benefits of stateless income through the acceptance of lock-out distorts firm behavior in welfare-decreasing ways, for the simple reason that U.S. multinational firms must find some non-U.S. use for their permanently reinvested foreign earnings, which can distort their investment decisions and is suboptimal for the firms' ultimate owners.

The lock-out phenomenon also has the pernicious effect of implicitly encouraging domestic leverage to fund cash needs, while leaving low-taxed foreign earnings abroad. This strategy allows U.S. multinational firms to compete in a quasi-territorial environment (by preserving the benefits of stateless income tax planning through deferral and financial accounting treatment of such earnings as "permanently reinvested"), but erodes the U.S. corporate tax base, because the interest expense is deductible in the United States, while the foreign earnings are not. The combination of deferral, as turbocharged by stateless income planning, and incomplete domestic expense allocation rules, which often are not binding, thus leads to U.S. tax base erosion and the quarantining of much of the firm's cash outside the United States. And in the case of *foreign-based* multinationals, stateless income tax planning technologies can be applied to the United States as a source country, thereby reducing U.S. domestic tax revenues directly.

V. RESPONDING TO A WORLD IMBUED WITH STATELESS INCOME.

A. Overview.

If stateless income tax planning were expunged, then the design of tax policy for foreign direct investment would become embarrassingly easy: every country would adopt a territorial tax system, and in doing so would 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 an additional layer of residence-country tax: doing so 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 pre-tax returns to very low-tax jurisdictions, and by effectively doing the same with residence country pre-tax returns through interest expense arbitrage. The end result is that multinational firms can 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 subset of potential investors.

This Section V analyzes the problems that stateless income poses for standard efficiency benchmarks. The analysis demonstrates that conclusions that are logically coherent in a world without stateless income do not follow once the presence of stateless income tax planning is considered. In particular, the “capital ownership neutrality” standard has much to recommend it in theory. But the capital ownership neutrality benchmark 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 article 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 in turn 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.

Return to our earlier consideration of plucky Freedonia and its neighbors. Freedonia, it will be recalled, imposes a 10 percent tax rate on domestic income; its outbound tax system is

irrelevant to the example. Sylvania taxes its multinational enterprises on a territorial basis, so that income earned outside Sylvania 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 in which 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 relevant factors of production that generate the income are located). Moreover the identity of the source country is unambiguous, 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 these 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.⁷⁵ Assume that this global after-tax rate is 5 percent. As previously

⁷⁵ This is a standard assumption in economics presentations. See, e.g., Rosanne Altshuler, *Recent Developments on the Debate on Deferral*, 20 TAX NOTES INT'L 1579, 1581 (April 3, 2000); Michael Devereux, *Taxation of Outbound Investment* 24 OXFORD REVIEW OF ECONOMIC POLICY 698, 701 (2008) at 702 [hereinafter Devereux, *Taxation of Outbound Direct Investment*]; Zodrow, *Capital Mobility and Capital Tax Competition*, 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, for the reasons that (i) there does not exist in the world today any 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), (ii) portfolio investments in corporate firms (whether domestic or cross-border) are not taxed on a pass-through basis (and therefore the income of such firms is taxed only on a source basis), and (iii) direct investments by individuals in domestic firms also generally are not taxed on a pass-through basis. In theory withholding taxes also might be taken into account, but in practice withholding taxes 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.

pointed out, this implies that *pre-tax* normal corporate returns will vary from country to country, to reflect differences in statutory tax burdens. Pre-tax corporate returns in the Snowdonia will be 7.7 percent, while in Sylvania those returns 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 Co. ($\$10,000 \times 5\% = \500). Two multinational enterprises, one domiciled in Sylvania and the other in the Snowdonia, each eager to expand its global presence in the basket weaving sector, prepare bids to acquire Beweave Co. from the Freedonian family that controls it. How will taxes influence the outcome? They will not, at least directly: the Sylvanian and Snowdonian firms face different tax rates on their domestic operations, but not in respect of foreign direct investment in Freedonia, because under each jurisdiction’s territorial system the Freedonian net income tax is a final tax on Freedonian-source income.

Now introduce the United States into the mix. Further assume that the United States taxes U.S. resident firms on their worldwide income (including income earned by foreign subsidiaries) and imposes a 35 percent tax rate. (This is *not* meant to correspond the actual operation of the U.S. tax system today, which as described earlier is an ersatz variant on territorial tax systems.) How would a potential U.S. acquiror fare in the bidding, assuming again that all firms are price takers in the auction (that is, cannot individually determine the winning bid)? By virtue of the

If, by contrast, one were to posit a world in which net business income was taxed in all events immediately to ultimate individual owners, whether domestic or foreign, then 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 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 enjoy 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.

hypothetical genuine worldwide tax environment, U.S. firms face the same *tax rate* everywhere in the world (ignoring the possibility of excess foreign tax credits), but do not enjoy 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, for the reasons explained above. The result is that a U.S. firm cannot be competitive in bidding for an enterprise in a low-tax jurisdiction like Freedonia.⁷⁶ The net result would be that differences in the international tax systems employed by Sylvania and the United States would lead to Beweave Co. not being acquired by the company that could make the most productive use of it.

This is precisely the dilemma envisioned by Mihir Desai and James Hines in their important paper, *Evaluating International Tax Reform*,⁷⁷ and addressed further in several additional papers over the last several years.⁷⁸ Desai and Hines argue that worldwide welfare would suffer in the example with which this Section began if the United States were to employ a worldwide tax system that was consistent with the capital export neutrality paradigm, while other

⁷⁶ Imagine, for example, 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 Co., as a consequence of the territorial tax system adopted by the Sylvanian legislature. US Co., by contrast cannot afford to bid that much: if it were to do so, it would earn the same \$556 before tax that Sylvania Co. would enjoy, 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. foreign tax credit for that cost, so that its total tax liability in respect of 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 \$7220 in the hands of US Co. Even if US Co. were uniquely able to raise Beweave Co.'s pretax returns by \$200/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.

⁷⁷ Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (September 2003) [hereinafter *Evaluating International Tax Reform*]. Under the Desai and Hines framework, the inability of US Co. to acquire Beweave Co. is the measure of the potential economic inefficiency that arises from ownership distortions. Under their theory, tax systems that ensure that the identities of capital owners are unaffected by differences in residence country tax rates permit the market to allocate ownership rights where they are most productive. *Id.* at 499.

⁷⁸ Subsequent papers include Desai & Hines, *Old Rules and New Realities*, supra note 67; Mihir A. Desai, *New Foundations for Taxing Multinational Corporations*, TAXES, Mar. 2004; James Hines, *Foreign Income and Domestic Deductions*, supra note 54; and Hines, *Reconsidering the Taxation of Foreign Income*, supra note 50.

jurisdictions relied on territorial tax systems. In such a circumstance, 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 in cases where 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 in respect of 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 the authors term "capital ownership neutrality."⁷⁹ In *Evaluating International Tax Reform*, 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.⁸⁰

⁷⁹ Desai 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. *Evaluating International Tax Reform*, supra note 77 at 488. The term appears, however, to have been coined by British economist Michael Devereux in *Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality, and All That*, (IFS Working Paper. London:Institute for Fiscal Studies Unpublished Paper, June 11, 1990).

⁸⁰ Capital 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. Michael Devereux, *Taxation of Outbound Direct Investment*, supra note 75 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. Devereux, *Taxation of Outbound Direct Investment*, supra note 75 at 701. See also Altshuler, *Recent Developments in the Debate on Deferral*, supra note 75.

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 as to where to situate a 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, 284-94, 285 (2001). Thus, capital export neutrality is

Capital ownership neutrality in turn is seen as leading to a policy recommendation that the United States should adopt a “territorial” tax system. The specific policy recommendations that are drawn 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.⁸¹

These points can be summarized with a simple metaphor.⁸² As a principle of tax policy design, the benchmark of capital export neutrality contemplates that, when a U.S. multinational draws up its shopping list of new investment opportunities both inside and outside the United States, that firm’s shopping 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 identity of the winner of that auction be the same in the world with income taxes as it would have been in the absence of taxes. Simply leaving the U.S. firm’s shopping priorities unaffected would satisfy capital export neutrality, but this result might not satisfy the test proposed by Desai and Hines, because even if the rank ordering of its preferences were not affected by taxes, the U.S. firm might not be able to bid as much as another high-tax jurisdiction resident company that faces only host country taxes on third country investments.

D. 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 explicitly developed in the model laid out above: the geographic source of business income (that is, the

usually advanced as the justification for tax systems that impose “worldwide” taxation on resident companies (however defined), and that pair that worldwide taxation with a foreign tax credit.

⁸¹ As to this last point, see in particular, Hines, *Reconsidering the Taxation of Foreign Income*, supra note 50; Hines, *Foreign Income and Domestic Deductions*, supra note 54.

⁸² See 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.”).

country to which it appertains) is unambiguous, those returns are taxed only in the source country where they are earned, *and as a result after-tax corporate normal returns throughout the world are the same*. Desai and Hines appear in fact to have relied on these assumptions in developing their policy recommendation that the United States adopt a territorial tax system.⁸³ The problem that emerges is not with this logic, but rather 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*: that is, 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.”⁸⁴ 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 instead 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

⁸³ For example, in a very recent article, Hines responds to criticisms 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 note 51, at 292-93. (“The zero tax rate in the foreign jurisdiction unleashes foreign competition that reduces the returns that investors can earn locally.” *Id.* at 293.)

⁸⁴ Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Maydew and Terry Shevlin, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH*, ch. 5 (4th Ed. 2009) [hereinafter, Scholes et. al., *Taxes and Business Strategy*]; Stanley Koppelman *Tax Arbitrage and Interest Deduction* 61 S. CAL. L. REV. 1143 at 1172-73 (1988) [hereinafter Koppelman, *Tax Arbitrage and Interest Deduction*].

the same tax burden, where “tax” for this particular 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. Without this assumption, Desai and Hines cannot conclude that a territorial tax regime can satisfy capital ownership neutrality.

There is an extensive literature in the domestic context that explores the twin concepts of tax capitalization and implicit taxation. The breadth of this literature reflects in part the abundance of natural experiments created by the Internal Revenue Code. 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.⁸⁵ In addition, the capitalization of tax benefits into prices received a great deal of attention during the heyday of individual tax shelters: it was earnestly argued by some 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 not inequities (no taxpayers – or at most, only the very earliest movers – would capture inframarginal yields on their tax shelter investments).⁸⁶

The literature reflects a consensus view that tax capitalization does not function as perfectly as theory would predict.⁸⁷ For example, municipal bond yields are higher than would be

⁸⁵ See Merle Erickson, Austan Goolsbee, & Edward Maydew, *How Prevalent is Tax Arbitrage? Evidence From the Market for Municipal Bonds*, 56 NAT'L TAX J. (2003) [hereinafter Erickson, Goolsbee & Maydew, *How Prevalent is Tax Arbitrage?*]. Erickson, Goolsbee, and Maydew find very few firms engaging in municipal bond tax arbitrage, and conclude that there must be serious (broadly defined) transaction costs associated with this type of arbitrage. *Id.* at 268.

⁸⁶ Bittker, *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).

⁸⁷ David Weisbach, *Implications of Implicit Taxes: Commentary on Crane's "Some Explicit Thinking*

the case in a world of perfect capitalization.⁸⁸ Indeed, Hines recognizes in his most recent article that municipal bonds are an example of a tax capitalization market failure, because of “insufficient demand” (for which one could equally write “oversupply”).⁸⁹ But Hines does not then consider the possibility that multinational groups are able to defeat the mechanism of tax capitalization themselves, through stateless income tax planning.

E. Extending the Model to Reflect Stateless Income.

One could develop powerful arguments why it would be implausible as a factual matter to assume the existence of perfect tax capitalization in the returns on business investments across different countries. Critically, however, it is not necessary 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 Professor Koppelman termed “status” tax arbitrage and “asset” tax arbitrage.⁹⁰ Municipal bonds

about Implicit Taxes, 52 SMU LAW REVIEW 373, 380 (1999) (“Reliance on full capitalization is utopian. Full capitalization has never happened and is unlikely to ever happen.”); Calvin Johnson, *Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters*, 71 TAX NOTES 377, 387 (April 15, 1996) [hereinafter, Johnson, *Inefficiency Does Not Drive Out Inequity*] (“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 investors 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., *Taxes and Business Strategy*, supra note 84 at 143-45 review economic literature finding evidence that tax capitalization does occur in general, but also point out that, in light of different clienteles, “market frictions or tax-rule restrictions are required to prevent arbitrage opportunities.”

⁸⁸ Koppelman, *Tax Arbitrage and Interest Deduction*, supra note 84 at 1176 – 1185; Erickson, Goolsbee, & Maydew, *How Prevalent is Tax Arbitrage?*, supra note 85 at 267-68 (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 87 at 381-86.

⁸⁹ Hines, *Reconsidering the Taxation of Foreign Income*, supra note 50 at 293.

⁹⁰ Koppelman, *Tax Arbitrage and Interest Deduction*, supra note 84 at 1175-76. Asset tax benefits are those which 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, on the other hand, arise 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

are an example of asset arbitrage: the asset itself carries the special tax preference. In theory, it would be possible to describe plausible 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 in respect of these 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 pre-tax return (i.e., a zero tax burden) to the maximum statutory marginal rate, depending on the status of the taxpayer.

Even if *asset* tax arbitrage theory worked perfectly in practice here, 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 in fact invariably taxed in the source country (in an economic sense); instead, stateless income tax planning enables multinational firms to capture high-tax country pre-tax yields on which those firms pay tax only at low rates in other countries.

To see this point, 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.⁹¹ Moreover, the United States

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 Steurle, TAXES, LOANS, AND INFLATION at 59-60 n.4 (1985).

⁹¹ Technically, territorial tax systems also retain residence country taxation for certain categories of passive or mobile income (what in the United States is termed subpart F income). The text assumes that the stateless income strategies employed here would not trigger these rules.

has followed the Hines recommendation not to limit in any fashion the deductibility of U.S. domestic expenses, even where 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* in respect of a prospective investment in a real business in Freedonia, or any other low-tax jurisdiction, but rather in respect of 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, then the injection of stateless income into the model means that a multinational enterprise, but not a wholly-domestic firm, can capture the higher pre-tax normal returns found in high-tax countries, but pay low taxes on them, by shifting the locus of taxation of those high pre-tax returns to a low-tax jurisdiction – what this Report terms “tax rents.”

In effect, to the extent that stateless income tax planning is available, investments in high-tax countries become opportunities to capture supernormal after-tax returns, but only for those multinational firms that can exploit those planning opportunities. Only multinational enterprises can enjoy stateless income, because to generate it requires affiliates in low-tax as well as 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 enterprise were to acquire a Sylvanian target company entirely with equity and divert some of the target's income to Freedonia, the U.S. firm would enjoy an after-tax return on that diverted income of 6 percent, not the global after tax normal return of 5 percent. (6.67 percent pre-tax return minus a Freedonian 10 percent tax.) And this opportunity to create supernormal returns would exist only through strategies available by virtue of the U.S. firm's status as a large 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, the rearrangement of priorities will not directly affect the multinational firm's interest in domestic 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 relative appetites to acquire 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 specific tax law of the jurisdiction in question, 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 vitiates Hines' 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.⁹² In a world where stateless income can be earned, the end result would be a zeroing-out of the firm's domestic tax base.⁹³

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 by virtue of a market failure in tax capitalization, but rather by virtue of their status (the IRA), which enables them to hold

⁹² Hines, *Foreign Income and Domestic Deductions*, supra note 54 at 463-65. Hines argues that not allowing for these deductions distorts behavior of U.S. multinational firms, and induces them to increase foreign rather than domestic investment.

⁹³ Mitchell A. Kane, *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").

otherwise taxable financial assets without paying tax.⁹⁴ 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 to all the above, it might be observed that, while the existence of stateless income vitiates the tax capitalization story that lies at the heart of the capital ownership neutrality theory, if every other country has adopted a territorial tax system and countenances (within broad limits) the existence of stateless income tax planning, then the United States should too, in order to create a “level playing field” for U.S. multinational firms. This argument is not, however, 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 export subsidies. 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. multinationals (complementarity 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.⁹⁵ This is an altogether 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 vitiates the

⁹⁴ Cf. *Scholes et. al, Taxes and Business Strategy*, supra note 84 at 155-56 (elimination of tax liability through leverage-based tax arbitrage where implicit tax burden is lower than explicit taxes saved).

⁹⁵ To 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 without more neglects the fact that those higher profits are being funded through subsidies provided by other U.S. persons (for example, domestic businesses).

implicit tax mechanism that lies at the core of the most cogent theoretical case for territorial taxation, and 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 VI therefore considers briefly how countries might plausibly 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 directions from which to address the phenomenon of stateless income. From the unique perspective of current 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 lock-out effect. The magnitude of the current quantum of locked-out earnings (in excess of \$1 trillion) and their accelerating growth argue powerfully for a decisive move in either direction and away from the bizarre status quo.

B. Cartoon Territoriality.

In light of the current vigorous debate within U.S. tax policy circles concerning the future direction of U.S. corporate tax policies towards 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,⁹⁶ testimony⁹⁷ and articles⁹⁸ by representatives of U.S. multinational firms and their advisors paint consistent pictures of both the

⁹⁶ Amy S. Elliott, *GE Executive Criticizes Possible U.S. Territorial System*, 130 TAX NOTES 998 (February 28, 2011) (Remarks of John M. Samuels, General Electric Vice President and Senior Counsel for Tax Policy and Planning).

⁹⁷ Testimony of Robert A. McDonald, Chairman, Fiscal Policy Initiative Business Roundtable, Before the House Committee on Ways and Means Hearing on Tax Reform January 20, 2011, 2011 TNT 14-42 (January 24, 2011) (testimony of president and CEO of Procter & Gamble).

⁹⁸ Philip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025 (Feb. 28, 2011); Barbara Angus, Tom Neubig, Eric Solomon and Mark Weinberger, *The U.S. International Tax System at a Crossroads*, 130 TAX NOTES 45 (Apr. 5, 2010); John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593 (June 29, 2009) [hereinafter Samuels, *American Tax Isolationism*].

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 employs 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). In particular, 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). What is more, these presentations imply that these systems are static in their design, and that there are no political or policy pressures to reform them to address the stateless income problems identified in this Report.

This standard presentation 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 vitally concerned about the tax avoidance issues implicit in the stateless income phenomenon,⁹⁹ international tax design is a subject of political controversy in other countries,¹⁰⁰ non-U.S. analysts have recently focused closely on the problem,¹⁰¹ and many natural experiments are underway in different countries to address exactly these concerns.

⁹⁹ Thomas 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*, at 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).

¹⁰⁰ Kristen A. Parillo, *Activists Protest Vodafone’s Alleged ‘Tax Dodge,’* 60 *TAX NOTES INT’L* 392, (Nov. 8 2010) (reporting on demonstrations against international tax planning activities of U.K. firm Vodafone by U.K. activist groups).

¹⁰¹ Wolfgang Schoen, *International Tax Coordination for a Second-Best World*, 1 *WORLD TAX J.* 67 (Oct. 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 inter-sovereign coordination, urging an incremental “continuity approach,” and ultimately recommending allocation of taxing 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 *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

One final extremely important overarching theme for U.S. policymakers is that the rationales that other countries employ in adopting territorial systems extend beyond economic efficiency arguments. Within the European Union, 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.”¹⁰² And some countries (e.g. Canada¹⁰³) 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 by far the largest economy in the world, operates an ersatz sort of territorial tax regime, which 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 of their national champions to countenance tax competition through weak implementation of constraints 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

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 guideline principles for permanent establishments); Vann, *Taxing International Business Income*, supra note 48 (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).

¹⁰² EU constitutional concerns plainly limit the ability of one member state to restrict the ability of a company to redomicile in another member state. Carsten Gerner-Beuerle and Michael Schillig, *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. Maarten F. de Wilde, *A Step Towards a Fair Corporate Taxation of Groups in the Emerging Global Market*, 39 *INTERTAX* 62, 75-76 (2011).

¹⁰³ John M. Samuels, *American Tax Isolationism*, supra note 99 at 1595.

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 VI considers some of the natural experiments currently underway in territorial tax countries to address the stateless income problem.

C. Thin Capitalization.

It is true that no major jurisdiction that employs 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 this assertion without qualification paints a very misleading picture. In fact several major economies get to this result through another means – thin capitalization statutes.¹⁰⁴

Thin capitalization statutes traditionally were understood as source country rules that limited “earnings stripping” from the source country to a low-tax affiliate by constraining the introduction of excessive internal leverage within a multinational group.¹⁰⁵ More recent and sophisticated thin capitalization statutes, however, go much further, by constraining 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.¹⁰⁶ As applied to a German parent of a multinational group, the German thin

¹⁰⁴ In 2008, an International Fiscal Association study concluded that 18 out of 34 countries that the study 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*, BULL. FOR INTL. TAX., Jan. 2011, 27 at 36 [hereinafter Storck, *The Financing of Multinational Companies and Taxes*]. For a comprehensive and recent overview, see Tim Edgar, Jonathan Farrar & 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*, 60 TAX NOTES INT'L 683 (Nov. 29, 2010).

¹⁰⁵ I.R.C. §163(j) is an example of a source country thin capitalization statute aimed, in this case, at protecting the United States as a source country.

¹⁰⁶ Wolfgang Kessler and Rolf Eicke, *Germany's Growth Acceleration Act – Taming the Sunshine Tax Legislation*, 58 TAX NOTES INT'L 127 (April 12, 2010) summarizes current German law. The text's recitation of the relevant German rules is drawn primarily from this article.

capitalization rules impose a “hard cap” on interest deductions of 30 percent of the firm’s earnings before interest, taxes, depreciation and amortization (EBIDTA). As a result, 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 directly into the hard cap on interest deductibility. The same rule applies to German firms as source country taxpayers.

There is only one relevant “escape clause” from this outright limit on tax-advantaged leverage: a German parent company can deduct interest without limitation if the firm’s 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 the firm’s 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 standalone basis is no more than immaterially more highly leveraged than are its non-German operations. Australia’s rule is roughly similar,¹⁰⁷ and Sweden recently has introduced innovative “debt push-down” legislation.¹⁰⁸

Thin capitalization statutes are growing in importance and sophistication, precisely because countries that employ territorial tax regimes understand how easy it is to game their tax bases in the absence of such rules through the location of external or internal debt.¹⁰⁹ Critically, the Council of the European Union in 2010 published a Resolution on the design of EU

¹⁰⁷ Tim Edgar, Jonathan Farrar & Amin Mawani, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*, 56 CAN. TAX J. 803, 840-41 (2008). Australian thin capitalization rules deny the deduction of interest on debt of an Australian-resident corporation controlled by a non-resident, to the extent that the amount of such debt exceeds 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. Treas. Reg. § 1.861-10T(e) (imposing certain limitations for foreign tax credit purposes on interest arising on U.S. parent company debt that is disproportionately large in comparison to the indebtedness of its controlled foreign corporations).

¹⁰⁸ Alfred Storck, *The Financing of Multinational Companies and Taxes*, supra note 105 at 35.

¹⁰⁹ 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”)

Constitution-compliant thin capitalization and “controlled foreign corporation” (“CFC”)¹¹⁰ laws.¹¹¹ This Resolution recommends a very narrow scope for intra-EU CFC laws, to reflect European Court of Justice jurisprudence on the constitutional freedoms of establishment and movement of capital, but suggests essentially no EU Constitution-mandated restrictions on thin capitalization statutes, beyond the observation that they should in fact reach instances of thin capitalization. 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 “controlled foreign corporation” 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 anti-abuse 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 with respect to 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.¹¹²

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 hence occupy a narrower role within the European Union than might otherwise be the case.¹¹³ Nonetheless, EU member states are actively reviewing their existing CFC rules, with a view to addressing tax avoidance concerns of the same nature as those developed in this Article and its

¹¹⁰ When used outside the United States, the term “CFC” has a somewhat different meaning than the U.S. application of the phrase. See the discussion in section VI.D., *infra*.

¹¹¹ Resolution of the Council of the European Union C 156/1, reprinted as Tax Analysts Document 2010-13338.

¹¹² Nicolas Garfunkel, *Are All CFC Regimes the Same? The Impact of the Income Attribution Method*, 59 TAX NOTES INT’L 53 (July 5, 2010).

¹¹³ Text at note 116.

predecessor, to the extent permitted by EU constitutional parameters.¹¹⁴ In fact, in March 2011, in connection with its proposal for an EU-wide Common Consolidated Tax Base, the European Commission recommended the adoption of a European-wide CFC rule applicable to subsidiaries outside the European Union.¹¹⁵ And outside the EU, CFC rules can play a much larger role in constraining stateless income tax planning in a territorial tax regime.

For example, in 2009 Japan abandoned a deferral and foreign tax credit regime roughly similar in broad outline to current U.S. law for the taxation of income derived from foreign direct investment, and 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.¹¹⁶ This change of heart has been much discussed by proponents urging the United States to adopt what this Report earlier described as cartoon territoriality.

Less frequently observed, however, is that Japan also deploys a stringent CFC rule. Under this rule, 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

¹¹⁴ See, e.g., Bill Dodwell, Joanne Bentley and Tim Haden, *U.K. Begins Corporate Tax Reform Discussion*, 60 TAX NOTES INTERNATIONAL 723 (Dec. 6, 2010) (discussing U.K. review of its CFC rules).

¹¹⁵ European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM/2011/121, at 47 (Article 82), available at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm. Very briefly, 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.

¹¹⁶ Lawrence Lokken and Yoshimi Kitamura, *Credit vs. Exemption: A Comparative Study of Double Tax Relief in the United States and Japan*, 30 NORTHWESTERN J. OF INT'L L. AND BUS. 621, 628 (2010) [hereinafter Lokken and Kitamura, *Credit vs. Exemption*].

presumptively ineligible for the new dividend exemption regime.¹¹⁷ As a result, this income is immediately taxed in the hands of the Japanese parent company.¹¹⁸

If the United States were to adopt a territorial tax system with a CFC rule similar to Japan's, then income derived from an arrangement like the Google Double Irish Dutch Sandwich presumably would fail to qualify for the exemption. As this 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.¹¹⁹

E. Haircuts.

The parent company of a multinational group typically incurs unreimbursed expenses that benefit the entirety of the 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. A typical parent company will also, however, 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 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 company'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, as described above; France, Germany and Italy are others.¹²⁰ These “haircuts” are administratively useful tax heuristics, but they address only a very small part of the stateless income problem – as demonstrated by the eagerness of U.S. corporate proponents of cartoon territoriality to offer them up.

¹¹⁷ Id. at 641-42.

¹¹⁸ Id.

¹¹⁹ This also is the conclusion of Lokken and Kitamura, *Credit vs. Exemption*, supra n. 132, at 643-45.

¹²⁰ John M. Samuels, *American Tax Isolationism*, supra note 99 at 1595 (June 29, 2009).

F. Transfer Pricing and Formulary Apportionment.

The fundamental crisis confronting all territorial tax systems today is that they allocate taxing rights among nations solely by reference to the criterion of the geographic source of a firm's profits, but there is now a strong consensus that the existing source rules are unimplementable as a practical matter, and bankrupt as a conceptual matter. As a result, many thoughtful observers have coalesced around the idea 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 methodology as the mechanism for allocating a multinational enterprise's global income to source countries.¹²¹ That methodology in turn could be applied to all group activities on a consolidated basis (a "unitary" approach) or to a subset of activities where arm's-length pricing methodologies appear particularly deficient as a conceptual and administrative matter.¹²²

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 activities of a multinational group, in order to impose some economic foundation and consistency to the concept of source. In an extraordinary development, the European Union in March 2011 took a major step in just that direction, when the European Commission released a detailed proposal for a pan-EU "common consolidated tax base" ("CCTB").¹²³ This is the culmination of a project begun ten years earlier.

¹²¹ See, e.g., Reuven S. Avi-Yonah and Ilan Benshalom, *Formulary Apportionment—Myths and Prospects*, available at <http://ssrn.com/abstract=1693105> [hereinafter, Avi-Yonah and Benshalom, *Formulary Apportionment—Myths and Prospects*]; 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 & 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* 319-44 (Jason Furman & Jason E. Bordoff, eds. 2008).

¹²² Avi-Yonah and Benshalom, *Formulary Apportionment—Myths and Prospects*, supra note 122.

¹²³ European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base*, supra note 116.

If approved by the European Parliament and agreed to unanimously by the EU's member states in Council, the CCTB would permit a firm with operations in the European Union to elect to 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 European 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.¹²⁴

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 a necessary implication of any well-ordered territorial tax system, but formulary apportionment is not a panacea, and brings with it its own implementation and abuse problems.¹²⁵ The system can be gamed, for example, 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 (e.g., a grocery store chain) in a low-tax jurisdiction to augment the sales factor in that jurisdiction.¹²⁶ This in turn requires responses such as the ability of tax administrators to divide firms into different subgroups where necessary to prevent abuse. In the

¹²⁴ Id. at 14, Par. (21).

¹²⁵ Compare Rosanne Altshuler and Harry Grubert, *Formula Apportionment: Is it Better than the Current System and are There Better Alternatives?*, 63 NAT'L TAX J. 1145 (2010) [hereinafter Altshuler and Grubert, *Formula Apportionment*] with Avi-Yonah and Benshalom, *Formulary Apportionment—Myths and Prospects*, supra note 122. -

¹²⁶ Altshuler and Grubert, *Formula Apportionment*, supra n. 125.

absence of a multilateral implementation along the lines contemplated by the European Union, formulary apportionment also has been roundly criticized as highly likely to lead to under or over-taxation, because its goals of taxing income where earned will be drowned out by the cacophony of 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.¹²⁷ 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 impose residual U.S. tax, net of a foreign tax credit, on a current basis, regardless of where the income is retained as a cash matter.¹²⁸

A worldwide tax consolidation system has some important advantages over the current U.S. rules applicable to foreign direct investment. First, it removes the lock-out constraint on

¹²⁷ A worldwide “imputation” system recently was recommended in Samuel C. Thompson, Jr., *An Imputation System for Taxing Foreign-Source Income*, 130 TAX NOTES 567 (Jan. 31, 2011). That paper briefly reviews some of the same issues considered in this section, but is ambiguous as to whether the system that Professor Thompson contemplates would be tantamount to tax consolidation, in which net losses as well as net income of foreign subsidiaries would be includible in a U.S. parent company’s tax return.

¹²⁸ To achieve the purposes contemplated by the text, the ownership threshold for consolidation of foreign subsidiaries should be set at 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. In the case of a conflict between two United States 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 tie-breaker rule would be required.

It also may be necessary to retain current law principles to address companies that are today controlled by foreign corporations, but that do not have a single United States shareholder with sufficient control to consolidate that company. These cases are not very frequent in practice.

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 the accurate taxation of capital income.¹²⁹ Current law is asymmetrical, in that a foreign subsidiary's losses do not give rise to reductions in U.S. tax, while foreign income ultimately is includible in the U.S. tax base if and when repatriated. Both territorial and worldwide tax consolidation systems resolve this distortion. In the territorial case, that result follows from the fact that 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, by contrast, 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 Article, 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, provided that its average effective foreign tax rate before taking stateless income into account is

¹²⁹ Edward D. Kleinbard, *Designing an Income Tax on Capital*, in Henry J. Aaron, Leonard E. Burman, and C. Eugene Steuerle, *TAXING CAPITAL INCOME* (2007) at 168-69.

not higher than the residence jurisdiction tax rate.¹³⁰ The reason of course is simply that income moved to a low-tax foreign jurisdiction is nonetheless 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 nonetheless is highly effective at curbing the problem. By contrast, and as the prior Section suggested, territorial tax systems have only limited tools available to protect the base of income 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 issues embedded in current stateless income tax planning. Worldwide tax consolidation substantially mitigates the problem of 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).¹³¹

Worldwide tax consolidation also simplifies the otherwise intractable 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 on a current basis 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 a commercial nexus.¹³²

¹³⁰ The text here assumes a foreign tax credit mechanism that permits some amount of cross-crediting, as does the current U.S. system. It is a fair question, though, whether current law or the law of cross-crediting circa 1986 is the better implementation of the idea, particularly in light of the need to encourage U.S. taxpayers to minimize foreign tax liabilities.

¹³¹ This is the theme of Kleinbard, *Throw Territorial Taxation From the Train*, supra note 3.

¹³² Of course source countries have reason to police expense allocations to subsidiaries operating in their jurisdictions, since as to them there is no residual tax fallback.

Nonetheless, as described below, thin capitalization statutes may be a necessary adjunct 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, by virtue of the foreign tax credit.¹³³

B. Defining the Contours of a Worldwide Tax Consolidation Regime.

It is useful to summarize by way of a stalking horse the contours of a system that might usefully be proposed as an alternative to the adoption of 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 is in the range of 25 – 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 remove the attribute of stateless income and to protect the domestic tax base from earnings stripping by U.S. firms)¹³⁴;
- Retain the existing foreign tax credit system in general;
- Revise the definition of U.S. corporate residence to reflect the “mind and management” of a firm, not its place of incorporation;
- Abandon existing interest expense allocation rules for purposes of calculating the foreign tax credit, as unnecessary in an environment of current worldwide taxation (thereby

¹³³ This is consistent with the concerns expressed by Daniel Shaviro in three closely overlapping recent papers. See Daniel Shaviro, *The Case Against Foreign Tax Credits*, NYU Law & Economics Research Paper Series Working Paper No. 10-09 (March 2010); Daniel 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 (August 2010).

¹³⁴ Note 128, *supra*, describes modifications that would need to be made to current law’s definition of the requisite ownership requirements that would trigger consolidation.

mitigating the total tax burden on foreign direct investment that might follow for firms whose operations are predominantly in foreign jurisdictions with relatively high tax rates); and

- 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. What's Not to Like About Worldwide Tax Consolidation?—Competitiveness.

Worldwide tax consolidation is unpopular both among multinational firms, which understandably enjoy current law's freedom 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. These are important concerns; the fact that many multinational firms overstate their case does not mean that 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 real world competitiveness issue facing U.S. firms is not their competitiveness in operating or bidding for factories in tax havens, or even whole firms domiciled in tax havens, to the extent they actually have factors of production located there. 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 not significant, 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 firms. 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 as well.

As in competition among nations to match and outdo each other in export subsidies, the economically rational behavior here is to abstain. What is more, in light of the leading role that the United States (the largest economy in the world) today plays as an abetter 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 national champions. Moreover, confusing tax subsidies with tax policies ignores the many steps that many major jurisdictions already have undertaken to improve the robustness of their territorial tax systems.

The genuine competitiveness and capital ownership neutrality issue for U.S. firms on the adoption of a worldwide tax consolidation would be to ensure their competitiveness in respect of 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*, then legitimate competitiveness concerns are addressed, as against foreign local competitors in particular, and to a fair degree as against multinational competitors domiciled in jurisdictions that take territorial tax system design seriously.

The tax rate data summarized earlier 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 in respect of 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 employed 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 major relevant countries in the world. 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 competitive on the global stage.

Just as important, those lower U.S. rates make the *domestic* operations of U.S. firms more competitive on the world stage 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 one largely unaddressed in recent tax policy debates designed to influence the decisions of policymakers.

D. What's Not to Like?—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 a critical artificial conceptual foundation. In the case of territorial systems, that artificiality lies in the definition of “source,” which in turn operates to allocate among jurisdictions the right to tax the relevant item of income. In the case of worldwide tax consolidation systems, the artificiality lies in the concept of corporate “residence.”¹³⁵

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 it is the case that the current U.S. definition of corporate tax residence (which looks solely to the place of incorporation) is completely artificial. But it also is the case that it is difficult to think today of many significant examples of firms that in the popular imagination are U.S.-domiciled, but that as a tax matter are not. In short, in many cases the practical tax categorization of the residence of a parent firm of a multinational group is easier than theory might suggest.¹³⁶

Very importantly, it also is case that 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

¹³⁵ See, e.g. Daniel Shaviro, *The Rising Tax-Electivity of Corporate Residence* at 70 (NYU Law Sch. fifteenth annual Tillinghast Lecture on International Taxation, Working Paper, September 21, 2010), 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.”)

¹³⁶ Richard J. Vann, *Taxing International Business Income*, supra note 48 at 307-08 (in practice, “the test of corporate residence generally is robust for the parent in an MNE group,” but not for its foreign subsidiaries).

aggregate value of firms traded on U.S. stock markets (in turn, overwhelmingly firms treated as U.S. residents).¹³⁷

The most coherent theory 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. Where (as is the case 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 in question 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 surely 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, if U.S. firms (however defined) are in fact overwhelmingly owned by U.S. persons, then treating those firms as themselves U.S. persons is a fair first-order approximation of a more sophisticated answer. And the completely 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

¹³⁷ Philip R. Lane & Gian Maria Milesi-Ferretti, *International Investment Patterns* at 31 (Int'l Monetary Fund, Working Paper, WP/04/134, 2004). For a sense of scale, 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).

retain some artificiality, but the consequences of the application of that artificial rule do not seem hugely distortive.

The modernization of the technical definition of corporate residence is a partial answer to an issue that in practice is more a political talking point than an urgent issue of tax policy. This is the concern that, if the United States were to adopt a worldwide tax consolidation regime, U.S. firms would redomicile 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 in the first instance.

The first response to this concern, of course, is the point developed in the preceding subsection: a tax burden squarely in the median of other major relevant economies (i.e., in the neighborhood of 25 – 27 percent) is not much of a competitive burden at all, except to the extent that one believes that all such other economies will continue to countenance unlimited stateless income tax planning by their national champions. But as noted this in turn is at best an argument for matching other countries' government subsidies, not a 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.¹³⁸ That statute is imperfect in its reach,¹³⁹ 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 the organization, it will be a U.S. firm, regardless of its place of incorporation.¹⁴⁰

¹³⁸ I.R.C. §7874.

¹³⁹ Philip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025, n. 112 (Feb. 28, 2011).

¹⁴⁰ As an anecdotal aside, I note that virtually 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.

Fourth, existing law today 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.¹⁴¹ Those rules also can 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.¹⁴² Again, these rules might not be completely watertight, but if there is a bona fide competitiveness concern that remains in respect of tax-free acquisitions, any remaining seams can readily be caulked.

Finally, it is useful to compare the definitional problems that must be overcome 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 deployed in a world where source rules for both income and expenses are transparent, comprehensive and nondistortionary. To accomplish this requires the efforts of many sovereigns to introduce effective thin capitalization and other anti-base erosion legislation, as well as multilateral agreement among those sovereigns on novel source rules on matters like situs of income earned from the use of intangible assets. For the reasons developed earlier, it is likely that such 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 principally 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, though, is that

Facebook, Google and Amazon.com 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 today (e.g., never dealing with subpart F of the Internal Revenue Code, and avoiding the lock-out 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 done so are not easy to find. (Some years ago a number of new enterprises did organize as offshore companies from the start, but some of those whose names come most easily to memory (e.g. Global Crossing) have since collapsed.)

¹⁴¹ I.R. C. § 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.

¹⁴² I.R.C. § 367(b).

the consequences of an imperfect definition of corporate residence will be visited only on those firms at the margin of whatever definition is adopted: the remainder will be unaffected. By contrast, 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 decisionmaking would not appear to be comparable at all.

E. What’s Not to Like?—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 to the extent that 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 then tax results will 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, were a firm actually to do so, the resulting taxes would not be creditable, because current law provides that taxes are creditable only to the extent of the legal minimum due.¹⁴³ In sum, 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.

Nonetheless, the problem does exist in worldwide tax consolidation regimes with respect to siting of indirect expenses, particularly interest expense. Based on current practice and

¹⁴³ Treas. Reg. § 1.901-2(e).

financial markets behavior, and in the absence of any countervailing rule, parent companies would be likely to undertake the vast bulk of group external debt funding. Capital markets ordinarily prefer parent-level financing, because all of the group's operations then support the loan, and because the agency costs associated with policing parent-subsidary transfer pricing and transactions are irrelevant.

The result would be residence country base erosion. A parent company would have no incentive to fund foreign subsidiaries with anything other than equity; the resulting foreign operating income would be includible in the parent's worldwide consolidated tax return, but would be sheltered by foreign tax credits. The net result would be the same aggregate worldwide tax burden as if the group's external debt were distributed throughout the group's member companies, but the residence country would be a revenue loser, and source countries revenue winners. Since the United States is still a private direct investment net investor,¹⁴⁴ this suggests that U.S. revenues could be at risk.

This issue can be addressed by a well-designed thin capitalization statute along the lines of the German rules described earlier. A well-designed thin capitalization statute thus 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, such a statute does so without requiring tracing of proceeds by taxpayers or multilateral agreements among countries.¹⁴⁵

A final problem with worldwide tax consolidation is that to some extent it limits a sovereign's flexibility in setting corporate income tax rates. For the reasons developed earlier in this subsection, a sensible worldwide tax consolidation system requires that a country's corporate tax rates be comparable to world median rates. Since these rates would apply to domestic as well

¹⁴⁴ See Staff of Joint Committee on Taxation, *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 (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).

¹⁴⁵ Compare Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, supra note 48 (urging an explicitly-multilateral solution).

as to international operations,¹⁴⁶ 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) ought not to 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 today 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 across all relevant margins. All that we can do is to consider which system on balance is likely to impose the fewest distortions in corporate behavior while raising adequate revenues.¹⁴⁷

As applied to the United States, both territorial and full inclusion tax systems resolve the distortions attendant on the “lock-out” 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 along the lines 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 where “tax” is understood to include implicit as well as explicit taxes. As a result, corporate investment and ownership decisions will be systematically distorted.

¹⁴⁶ It is possible of course to imagine split tax rates, with different rates imposed on domestic and foreign income, but that solution 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, etc.). On balance, a split rate approach would seem to be both too complex and insufficiently ungrounded in principle to be a useful direction to pursue.

¹⁴⁷ Cf. Grubert and Altshuler, *Corporate Taxes in the World Economy*, supra 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.”).

Moreover, a poorly implemented territorial tax system will dramatically 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, 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.

In sum, unless the stateless income phenomenon is eradicated, the adoption by the United States of a territorial tax system would both 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 easy to understand why an ideal territorial tax system is the better answer as a matter of economic logic in a Panglossian world, but less obvious why it should be the preferred outcome from a practical policy perspective in light of the substantial risks it poses.

By contrast, 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, is robust to transfer pricing gaming or to tax arbitrage strategies. It can be implemented unilaterally, and does not depend very heavily on parsing the mysteries of expense allocation rules. It authentically embraces capital export neutrality (except in the unlikely scenario where U.S. corporate tax rates are materially lower than the world median), which may not be everything, but at least is something. It effectively reaches results consistent with capital ownership neutrality principles in the vast majority of 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 enjoy the *de facto* subsidies that stateless income tax planning offers foreign competitors in jurisdictions with poorly-implemented territorial systems in respect of investments in high-tax third countries. As to the first cost, it is the case that 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 tradeoff.

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.¹⁴⁸ Moreover, as the erosion of domestic source country tax revenues through the phenomenon of stateless income becomes better appreciated throughout the world's major economies, one can expect increased focus in particular on developing more robust 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 direction in which the United States should head.

¹⁴⁸ Grubert and Altshuler, *Corporate Taxes in the World Economy*, supra note 23 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.”)

