

## Stateless Income

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## STATELESS INCOME

by

*Edward D. Kleinbard\**

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### ABSTRACT

This paper and its companion, *The Lessons of Stateless Income*, together comprehensively analyze the tax consequences and policy implications of the phenomenon of “stateless income.” 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 not the location of the customers or the factors of production through which the income was derived, and is not 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.

This paper focuses on the consequences to current tax policies of stateless income tax planning. The companion paper extends the analysis along two margins, by considering the implications of stateless income tax planning for the reliability of standard efficiency benchmarks relating to foreign direct investment, and by considering in detail the phenomenon’s implications for the design of future U.S. tax policy in this area, whether couched as the adoption of a territorial tax regime or a genuine worldwide tax consolidation system.

This paper 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 law disadvantages U.S. multinational firms in respect of the effective foreign tax rates they suffer, when compared with their territorial-based competitors.

This paper’s fundamental thesis is that the pervasive presence of stateless income tax planning changes everything. 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 (about \$1.4 trillion, by the most recent estimates) and cash outside the United States.

Stateless income tax planning as applied in practice to current U.S. law’s ersatz territorial tax system means that the lock-out effect now operates in fact as a kind of lock-in effect: firms retain more overseas earnings than they profitably can redeploy, to the great frustration of their shareholders, who would prefer that the cash be distributed to them. This tension between shareholders and management likely lies at the heart of current demands by U.S.-based multinational firms that the United States adopt a territorial tax system. The firms themselves are not greatly disadvantaged by the current U.S. tax system, but 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.

## I. INTRODUCTION

### A. *Stateless Income*

Like happy families, all multinational business enterprises are alike, in at least one critical respect: they all possess a special tax attribute, which is the ability to generate stateless income. By “stateless income,” I 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 not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group’s parent company.<sup>11</sup> Stateless income thus can be understood as the movement of

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1. I first used this term in Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 114 TAX NOTES 547, 559 (Feb. 5, 2007) [hereinafter Kleinbard, *Territorial Taxation*].

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.

As an example, a U.S. firm that sells software in Germany earns stateless income when (through mechanisms described below) the added value from the sales to German consumers is taxed in Ireland rather than Germany. The same analysis would apply to a German firm whose income from sales to U.S. or French customers comes to rest for tax purposes in Luxembourg.

The ability to generate stateless income is an attribute generally shared by most multinational enterprises, regardless of their parent companies' domiciles. It is a quality shared in practice by multinational firms domiciled in the United States (the last redoubt of putative worldwide taxation of income from foreign direct investments) and those domiciled in jurisdictions with "territorial" tax regimes. It is an attribute not available to wholly domestic firms.

The phenomenon of stateless income 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."<sup>2</sup> 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.<sup>3</sup> Stateless income tax planning, by contrast, is

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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.

2. Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility's Place in Optimal Taxation*, 63 NAT'L TAX J. 843, 844 (2010). Slemrod points in the direction of stateless income with his concept of "tax mobility;" this Article argues that stateless income is an even more pervasive phenomenon than Slemrod's paper might suggest.

3. George R. Zodrow, *Capital Mobility and Capital Tax Competition*, 63 NAT'L TAX J. 865, 881 (2010).

divorced from actual market transactions; it undercuts the functions of markets in setting market-clearing after-tax returns on capital investments, by offering advantageously-situated multinational enterprises the opportunity to earn what this Article calls “tax rents.”

Stateless income is an inevitable by-product of fundamental international income tax norms, like the recognition of the separate tax personas of different juridical persons, even when they are commonly owned, or the general practice of treating interest on indebtedness as deductible to the payor.<sup>4</sup> Those particular norms enable “earnings stripping” — the extraction of pretax earnings from a source country through tax-deductible payments to offshore affiliates. One example of earnings stripping is capitalizing one group subsidiary located in a low-tax country with equity, and then causing that subsidiary to lend its capital to an affiliate in a high-tax country.

The widely-shared tax norms on which stateless income relies also encompass, for example, a multinational enterprise’s relative freedom under consensus “transfer pricing” rules<sup>5</sup> to deal with a subsidiary as if it were an independent actor, or to treat the subsidiary’s capital (furnished by the parent) as if that capital were separate from the parent’s assets for purposes of measuring the business risks undertaken by the subsidiary (and therefore the share of group income properly attributable to the subsidiary).<sup>6</sup> Similarly,

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4. See, e.g., Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 *WORLD TAX J.* 291, 322–23 (2010) [hereinafter Vann, *Hard-Boiled Wonderland*] (noting that the principle of “freedom of contract” among affiliated companies in a multinational group is inherently inconsistent with the theory of the firm explanation for the prevalence of multinational enterprises). These norms are summarized through the prism of the Organization for Economic Cooperation and Development (“OECD”) Model Convention in Markus Leibrecht and Thomas Rixen, *Double Tax Avoidance and Tax Competition for Mobile Capital*, in *INTERNATIONAL TAX COORDINATION: AN INTERDISCIPLINARY PERSPECTIVE ON VIRTUES AND PITFALLS*, 61, 63–71 (Martin Zagler ed., 2010).

5. “Transfer pricing” rules refer to the terms under which the affiliated members of a multinational group should be viewed as dealing with each other for purposes of determining the income of each member of the group.

6. The OECD, a supranational organization comprised of 33 member states, including the United States and many other developed economies, publishes extensive guidance on the taxation of multinational businesses representing the consensus views of its members. It has recently published comprehensive guidance on transfer pricing issues in international tax administration. *OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS* (2010) [hereinafter *OECD Guidelines*].

The OECD Guidelines emphatically reject the idea of approaching the taxation of a multinational group of companies by ignoring the separate juridical

those norms contemplate that a multinational enterprise can situate economic rents attributable to unique business opportunities in low-tax countries, because pure business opportunities generally are not regarded as subjects of transfer pricing analysis in the first instance.<sup>7</sup>

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existence of subsidiaries and apportioning group income to worldwide activities on a “formulary apportionment” basis:

[T]he the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.

*Id.* at 33. The OECD Guidelines continue:

OECD member countries reiterate their support for the consensus on the use of the arm’s length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm’s length principle represented by global formulary apportionment should be rejected.

*Id.* at 41.

For a comprehensive critique of the arm’s-length principle as applied to intangible assets (the most important class of assets in modern transfer pricing disputes), see Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 96–104 (2008) [hereinafter Brauner, *Value in the Eye of the Beholder*].

7. *Hospital Corp. of Am. v. Commissioner*, 81 T.C. 520 (1983). The case involved, inter alia, the application of section 367, which imposes a “toll charge” on the outbound transfer from the United States of certain appreciated property, including intangible assets (for which a special regime exists under section 367(d)). In *Hospital Corp.*, the U.S. taxpayer presented a newly-formed foreign affiliate with an opportunity to enter into a lucrative contract to manage an overseas medical facility owned by an unaffiliated group. *Id.* at 532. The court in *Hospital Corp.* found that section 367 was not implicated by the arrangement, because the “opportunity to contract” did not constitute “property” to which section 367 might apply. *Id.* at 589–90. The court did conclude, however, that seventy-five percent of the net income of the foreign affiliate was attributable to the U.S. taxpayer under the principles of section 482. *Id.* at 301–02.

The Internal Revenue Service non-acquiesced as to the decision, but noted that “the Tax Court’s finding that ‘opportunity to contract’ was not property is not clearly erroneous.” See Action on Decision 1987-2 C.B. 1, 1, 2 n.22 (Oct. 26, 1987).

In the same vein, the OECD Guidelines appear to take the position that a business opportunity is not a tax-cognizable intangible asset to which transfer pricing rules might apply. OECD Guidelines, *supra* note 6, at 191–93 (defining commercial intangible assets subject to transfer pricing scrutiny as comprising trade and marketing intangibles, neither of which in turn is defined as including the simple right to pursue a lucrative opportunity), 256–67 (“The arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits. When applying the arm’s length principle to business restructurings, the

Stateless income also flourishes because of nations' collective failure to agree on other critical international tax norms that would determine the "source" of income — that is, the mechanical rules by which income is attributed to one jurisdiction or another, based on the perceived economic contribution in that jurisdiction to the generation of that income. This failure reflects the fundamental commercial and economic ambiguity surrounding the locus of the value added through the exploitation of intangible assets. The consequences of this failure in turn are exacerbated by aggressive transfer pricing strategies. As the earlier examples of income stripping demonstrate, however, stateless income tax planning encompasses more than the exploitation of the collective failure to develop binding normative source rules for income derived from intangible assets. And as this Article demonstrates, whatever first-order coherence in the definition of the source of income might exist in turn is vitiated when stateless income tax planning is layered on top of basic sourcing principles, because that planning can take income originally "booked" in an economically-rational jurisdiction and in a second, separate step move that income to another, lower-taxed jurisdiction.

Multinational firms thus 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).<sup>8</sup> 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.

Because the generation of stateless income relies on norms woven deep into the warp and woof of virtually every tax system, it is not possible to understand the consequences of a country's system for taxing income from

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question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements . . . ."), 266–67 (distinguishing the case of an indirect transfer of long-term customer contracts). See also Lee A. Sheppard, *Tax Officials Contemplate Bleak Future for Corporate Tax Base*, 129 TAX NOTES 169, 170 (Oct. 11, 2010) [hereinafter Sheppard, *Tax Officials*] ("Significantly, the OECD[] . . . says that a transfer of a business opportunity or profit potential is not a transfer of a cognizable asset requiring compensation."); Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 326 (OECD Guidelines appear to countenance that risk may be assigned within a group at will).

8. See, e.g., Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 313–43.



foreign direct investments without appreciating the first-order importance of stateless income tax planning. When unchecked, stateless income strips source countries (including the United States as the location of subsidiaries of foreign-controlled groups) of the tax revenues attributable to income generated in those jurisdictions. Its availability also distorts the investment decisions of multinational firms, and under current U.S. rules distorts a U.S. multinational firm's decision whether to repatriate that stateless income back to the United States.

The phenomenon of stateless income is closely allied with the problem of residence country base erosion, principally through aggressive transfer pricing strategies.<sup>9</sup> As used in this Article, however, the term is reserved for strategies to reduce high-tax source country income. Nonetheless, the policy recommendations made by this Article respond to both issues, for two reasons. First, the technologies employed in source and residence country base erosion overlap. Second, the Article'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.

### *B. An Illustrative Example: The Double Irish Dutch Sandwich*

The phenomenon of stateless income risks appearing vague, and its analysis tedious. Recent news stories on the internal tax planning of U.S. firms like Microsoft, Forest Laboratories and Google, however, have injected needed drama to the narrative, by providing useful insights into how firms generate stateless income in practice.<sup>10</sup> This section uses Google Inc.'s

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9. Examples of recent papers emphasizing how current arm's-length transfer pricing rules invite the erosion of residence country tax revenues include Yariv Brauner, *Cost Sharing and the Acrobatics of Arm's Length Taxation*, 38 *Intertax* 554 (2010) [hereinafter Brauner, *Cost Sharing*], 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* (Dec. 7, 2009), [http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert\\_March16.pdf](http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert_March16.pdf) [hereinafter, Grubert, *Foreign Taxes and Domestic Income*].

10. Richard Waters, *Tax Drives US Tech Groups to Tap Debt*, *FINANCIAL TIMES*, Feb. 6, 2011, p. 15 Col. 6 (Microsoft); Jesse Drucker, *U.S. Companies Dodge \$60 Billion in Taxes With Global Odyssey*, *BLOOMBERG*, May 13, 2010, <http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html> (Forest Laboratories); Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, *BLOOMBERG*, Oct. 21, 2010, <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html> (Google). In the same vein, Microsoft's very recent announcement of plans to acquire Skype Software S.a.r.l. (a

“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.<sup>11</sup> The same story (in a number of cases, literally so, because the 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.<sup>12</sup>

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.<sup>13</sup>

Ireland Holdings made an undisclosed “buy-in” payment for rights to the Google 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

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Luxembourg-based company) has been explained as a tax-efficient use of the firm’s vast hoard of offshore cash. See Zaid Jilani, *Microsoft Structured Acquisition Of Skype To Avoid U.S. Taxes*, <http://thinkprogress.org/2011/05/13/microsoft-skype-tax-havens/> [hereinafter Jilani, *Microsoft Structured Acquisition*].

11. 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, <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html> [hereinafter Drucker, *Google 2.4% Rate*] as supplemented by inferences drawn from Joseph B. Darby III and Kelsey Lemaster, *Double Irish More than Doubles the Tax Saving: Hybrid Structure Reduces Irish, US and Worldwide Taxation*, 11 PRACTICAL U.S./INT’L TAX STRATEGIES 2 (2007) [hereinafter Darby & Lemaster, *Double Irish*]. 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.

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

13. Angus Kelsall, *Dublin Go Bragh*, GOOGLE BLOG (Oct. 6, 2004), <http://googleblog.blogspot.com/2004/10/dublin-go-bragh.html> (“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. . .”).

market for those technologies.<sup>14</sup> As a practical matter, that buy-in payment 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.<sup>15</sup> 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.

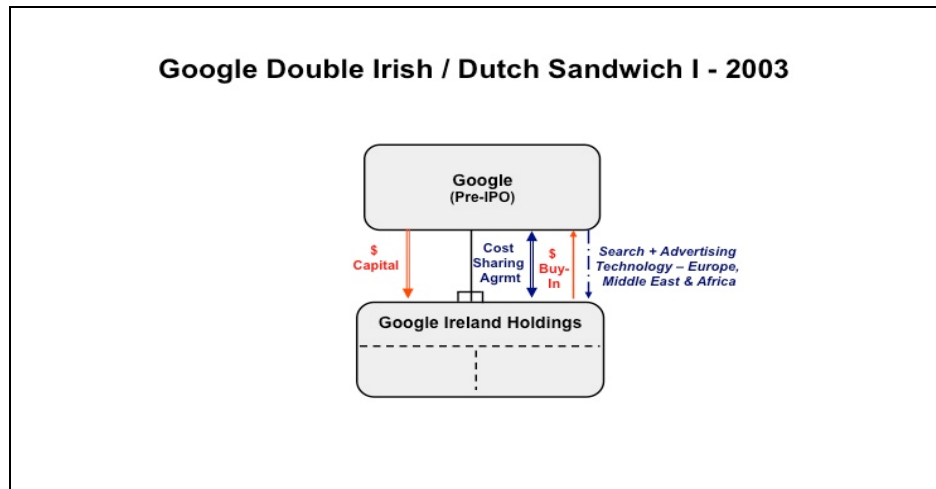
The Google structure immediately after entering into the cost sharing agreement can be represented schematically as follows:

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14. For a brief summary of cost sharing agreements, see Staff of the Joint Comm. on Tax'n, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10) 25–29, 111–14 (2010) [hereinafter JCT, INCOME SHIFTING AND TRANSFER PRICING].

Veritas Software Corp. 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. See *id.* at 315–16. For brief summaries, see, e.g., Kerwin Chung, Cindy Hustad, & Alan Shapiro, *Tax Court Rejects IRS’s Cost-Sharing Buy-In Analysis*, 125 TAX NOTES 1343 (Dec. 21, 2009); Stephen Blough, Charles Cope, & 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.

15. 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”<sup>16</sup> — that is, has made a special election relevant only for purposes of U.S. tax law not to be characterized as a 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. tax law, 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.<sup>17</sup> 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

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16. Treas. Reg. § 301.7701-3(b)(2). That is the structure proposed in Darby and Lemaster, *Double Irish*, *supra* note 11. Like all federal income tax return materials, “check-the-box” filings are not publicly available.

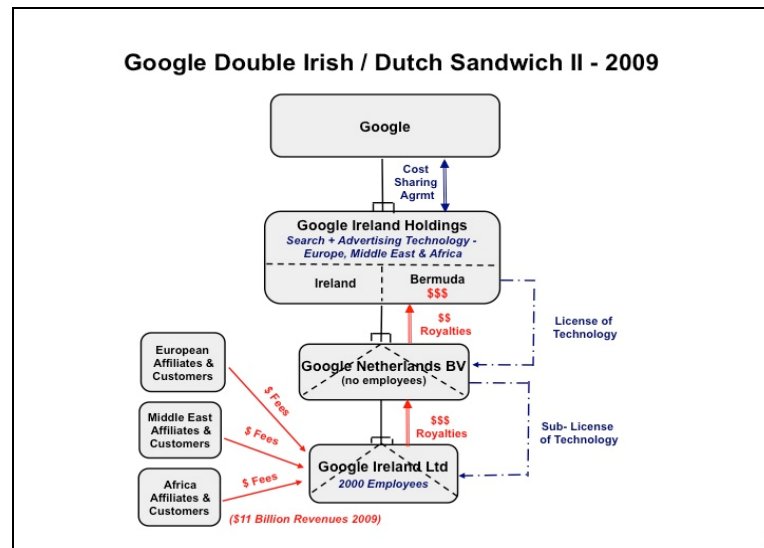
17. In a 2008 video interview, John Herlihy, the manager of Google Ireland, described Google’s Irish operations as the second largest Google office in the world. At the time, Google Ireland employed 1350 employees, of whom 900 worked in the “online [sales] team,” 250 “on the technology side,” and 200 apparently in corporate support type functions for the EMEA operations. Interview with John Herlihy, V.P. Online Sales, E,EA, Google, <http://www.youtube.com/watch?v=pYZsLLMQZxM&NR=1&feature=fvwp> (last visited May 19, 2011). Google describes its Irish operations this way:

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.

Google Dublin, <http://www.google.ie/intl/en/jobs/dublin/> (last visited May 20, 2011).

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.<sup>18</sup>

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

18. Treasury regulations governing cost sharing agreements were revised in 2008 to adopt the "investor model" of arm's length pricing. Treas. Reg. § 1.482-7T (as amended by T.D. 9441, 2009-7 I.R.B. 460). 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. JCT, INCOME SHIFTING AND TRANSFER PRICING, *supra* note 14, at 25–29, 111–14. But the regulations do not reject the idea of a "cash box" subsidiary participating in a cost sharing 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.<sup>19</sup> While much of Ireland Limited's income presumably comes directly 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.<sup>20</sup> 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.

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

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19. 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 whose resolution is irrelevant 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.

20. Darby and Lemaster do 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. Darby & Lemaster, *Double Irish*, *supra* note 11. The article by Drucker does discuss it. Drucker, *Google 2.4% Rate*, *supra* note 11.

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 firms);<sup>21</sup> 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.

### *C. Overview and Conclusions of Article*

This Article accepts as an arbitrary postulate the existence of a corporate income tax that in fact is meant to burden corporate income in some coherent fashion. The Article asks the question, how does the pervasive phenomenon of stateless income affect the operation of that tax today?

The Article's answer is that the pervasive presence of stateless income tax planning changes everything. As the example of Google's Double Irish Dutch Sandwich structure implies, it destroys any possible coherence to the concept of the geographic source of income, on which all territorial tax systems rely. It erodes the tax base of high-tax countries in which multinational firms are domiciled through debt-financed tax arbitrage. It privileges multinational firms over domestic ones by offering the former the prospect of capturing what the Article terms "tax rents" — low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. And since the costs required to accomplish it create noting of economic value, it leads to deadweight loss.

The Article presents a comprehensive picture of the role of stateless income in international tax planning, in contrast to existing literature's tendency to focus on a series of discrete problems. The Article demonstrates why the eradication of stateless income in the field is a highly implausible scenario. Finally, the Article considers the policy implications of stateless income tax planning for the design of tax systems.

Section II of this Article briefly reviews the current U.S. tax system for taxing the returns to corporate foreign direct investment. Beyond a recitation of these rules and principles, Section II argues 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 many presentations suggest, as a "worldwide" system of taxation, but rather as an

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21. Drucker, *Google 2.4% Rate*, supra note 11.



ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes.

Section III demonstrates how the current U.S. tax system, which purports to tax the worldwide income of U.S.-resident multinational firms, in fact, affords those firms the opportunity to operate in a quasi-territorial tax environment and to earn stateless income in the same manner that their territorial-based competitors do. Section III continues by reviewing available “cash” tax and financial accounting data to demonstrate that U.S.-based multinational firms today enjoy this favorable attribute.

Section IV considers the policy implications of stateless income tax planning for current income tax systems. When viewed from the perspective of U.S. tax policy, those implications include the dissolution of any coherence to the concept of geographic source, the systematic bias toward offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the 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 (roughly \$1.4 trillion, by the most recent estimates<sup>22</sup>) and cash outside the United States.

Section IV explains how stateless income tax planning enables multinational firms to capture “tax rents.” In brief, if one accepts the premise that after-tax returns on business income converge on a single worldwide level, then pre-tax returns must diverge, with commensurately higher pre-tax returns in high-tax countries.<sup>23</sup> Stateless income tax planning permits multinational firms to earn high-tax country pre-tax returns and then to migrate those to a low-tax jurisdiction, thereby capturing supranormal returns.

One policy implication that Section IV rejects as inconsistent with the data is that current law disadvantages U.S. multinational firms in respect of the effective foreign or aggregate 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

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22. *J.P. Morgan & Co., North American Equity Research, U.S. Equity Strategy Flash (June 27, 2011).*

23. *See infra* Part IV.B.

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

Stateless income tax planning as applied in practice to current U.S. law's ersatz territorial tax system means that the lock-out effect now actually operates as a kind of lock-in effect: firms retain more overseas earnings than they profitably can redeploy, to the great frustration of their shareholders, who would prefer that the cash be distributed to them. This tension between shareholders and management likely lies at the heart of current demands by U.S.-based multinational firms that the United States adopt a territorial tax system. The firms themselves are not greatly disadvantaged by the current U.S. tax system, but 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.

A companion paper to this Article, *The Lessons of Stateless Income*, picks up the analysis at this point; its themes are briefly described in Section V. *The Lessons of Stateless Income* considers the consequences of a world imbued with stateless income for the efficiency norms by which international tax proposals are judged, and then analyzes how one might go about developing a new international tax system that would address the idiosyncratic lock-out effect, that would be robust to stateless income tax planning, that would offer U.S. firms a reasonably pro-competitive international business environment, and that would protect U.S. tax revenues.

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

### A. *Worldwide and Territorial Tax Paradigms*

The usual point of departure in debating the design of systems to tax corporate income derived from foreign direct investment is to contrast worldwide and territorial solutions. "Foreign direct investment" is itself a term of art, and one not actually used in most tax codes. The U.S. tax term for a foreign subsidiary is a "controlled foreign corporation."<sup>24</sup> Tax laws also

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24. I.R.C. § 957(a) (definition). Technically, a controlled foreign corporation is a foreign corporation in which "United States shareholders" own more than 50 percent of the voting power or value of the stock of that corporation. *Id.* A "United States shareholder" is defined by section 951(b) as a "United States person" (as defined in section 957(c)) that owns 10 percent or more of the voting power of the stock of the controlled foreign corporation (employing the complex indirect and constructive ownership rules of section 958).

often treat income derived by a foreign company in which a parent holds a significant non-controlling stake (e.g., five or ten percent) as income from foreign direct investment.<sup>25</sup>

A true worldwide system would consolidate the operations of foreign subsidiaries with those of the parent company for tax purposes, so that (for example) foreign losses could offset domestic income. (As described below, the United States, although often described as a worldwide system, does not allow this.) To avoid double taxation, worldwide systems invariably are paired with the availability of foreign tax credits; these are dollar-for-dollar credits against the tentative income tax owed on worldwide income for the foreign taxes that the group has incurred to earn its foreign income.

The standard counterpoint to a worldwide system for taxing income from foreign direct investment is a territorial tax system, which is understood to mean a system under which the country in which the parent company of the group is domiciled (the residence country) forgoes any claim to tax source country earnings — that is, the active foreign business earnings of foreign subsidiaries or branches of the parent company. Because source country tax is a final tax, territorial tax systems do not employ a foreign tax credit. Every major country other than the United States today relies principally on a territorial system to tax the active business earnings of a multinational enterprise's foreign subsidiaries.

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25. France and the Netherlands, for example, offer resident firms a “participation exemption” from corporate tax for foreign shareholdings of at least five percent. Code Général des Impôts (General Tax Code), Art. 145 (Fra.); Wet op de vennootschapsbelasting 1969 (Corporate Income Tax Law of 1969), Art. 13 (Neth.). And, as noted in the preceding footnote, the U.S. Internal Revenue Code uses a 10 percent threshold to define a “United States shareholder;” that shareholder need not have a controlling interest in a foreign firm.

Similar definitions of “foreign direct investment” apply in standard presentations of international investment stock and flow data. For example, the U.S. Commerce Department's Bureau of Economic Analysis (BEA) defines a foreign “affiliate” as a foreign enterprise in which a U.S. firm has at least a 10 percent ownership interest (measured by voting power, which is assumed to equal profits interests). Raymond J. Mataloni, Jr. U.S. Bureau Econ. Analysis, *A Guide to BEA Statistics on U.S. Multinational Companies*, 75 SURVEY CURRENT BUS. 38, 39, 41 n.8 (1995). A foreign affiliate that is more than 50 percent owned by a U.S. entity or entities is referred to as a “majority owned foreign affiliate.” *Id.* at 44.

The International Monetary Fund (IMF) also follows a ten percent rule for defining “foreign direct investment.” IMF Statistics Dep't, Coordinated Direct Investment Survey Guide, (2010), <http://www.imf.org/external/np/sta/cdis/pdf/2009/120109.pdf>. The United States is in the process of aligning its data collection and presentation with the recommendations of the IMF. See Kristy L. Howell & Robert E. Yuskavage, *Modernizing and Enhancing BEA's International Economic Accounts: Recent Progress and Future Directions*, 90 Survey Current Bus. 6 (2010), [http://www.bea.gov/scb/pdf/2010/05%20May/0510\\_modern.pdf](http://www.bea.gov/scb/pdf/2010/05%20May/0510_modern.pdf).

Countries that rely on a territorial tax model for foreign direct investment generally do not treat interest and royalty income paid by a foreign subsidiary to its parent company as income qualifying for territorial tax relief.<sup>26</sup> The assumption is that these income streams have been deducted from the income of the foreign subsidiary in the source country, and therefore would be taxed nowhere if not taxed in the residence country of the parent of the group.

Of course, actual practice of course is much more complex than the sketch of these polar models might suggest. For example, many countries that employ territorial systems for taxing income earned from foreign direct investments also rely on worldwide taxation for certain abuse cases, or for income that is thought to be passive investment income or highly mobile. In those cases where the worldwide income backstop is invoked, a foreign tax credit also usually is available.

#### *B. The Current U.S. Tax System.*

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 in the taxable income of its U.S. parent company only when directly or indirectly made available to the U.S. parent.<sup>27</sup> (In a true worldwide system, foreign subsidiary net losses as well as profits would be fully included in the U.S. group's tax return as that income was earned.) This is a false picture of the U.S. tax system in operation.

For the reasons explained below, it is more accurate to say that, in practice, and in the hands of sophisticated multinational firms, the U.S. tax

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26. Kleinbard, *Territorial Taxation*, *supra* note 1, at 556–57. A well-designed territorial tax system would fully include royalty and interest income from foreign affiliates without any ability to offset the resulting tax liability with foreign tax credits attributable to other foreign income, thereby preventing the “blending” of high and low tax rates that would reduce the effective tax rate.

27. A standard treatise is JOSEPH ISENBURGH, *INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME* (4th ed. 2006) [hereinafter ISENBURGH, *INTERNATIONAL TAXATION*]. Other useful (and briefer) summaries include Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 *TAX NOTES* 255, (2000); J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 *EMORY L. J.* 79 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*]; Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 *TAX. L. REV.* 261 (2001); Grubert & Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-border Income*, in *FUNDAMENTAL TAX REFORM* 319 (John W. Diamond & George R. Zodrow eds., 2008) [hereinafter Grubert & Altshuler, *Corporate Taxes in the World Economy*].

system today operates as an ersatz territorial tax regime, with two odd twists.<sup>28</sup> 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 territorial regime).<sup>29</sup>

The United States 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.<sup>30</sup> This “deferral” aspect of U.S. law is technically the base case.

Observers often misunderstand the economic value to a taxpayer of deferring the inclusion of income that economically has accrued and is available for reinvestment. Very generally, the value of deferring income in the domestic context (for example, salary income used to fund a regular individual retirement account) is that no tax is imposed on earnings attributable to the *reinvestment* of the original deferred amount during the term of the deferral. Tax is not forgiven or discounted on the original deferral. Instead, it is the tax-exempt compounding of returns on the reinvestment of the original deferred amount that gives rise to a tax benefit.

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28. See Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 27, at 149 (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). 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. AUSTL. 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. TAX’N GLOBAL TRANSACTIONS 43 (2004) [hereinafter Lokken, *Does the U.S. Tax System Disadvantage*].

29. Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 27, at 325, 327.

30. ISENBERGH, *INTERNATIONAL TAXATION* *supra* note 27, at 68:1-68:2 (“The separate legal identity of corporations is a central determinant of U.S. taxation. . . . A foreign corporation, even though owned by Americans, may operate beyond the immediate reach of the U.S. taxing power. . . . The separate identity of corporations in the U.S. tax system means that a foreign corporation is not formally a U.S. person, . . . and has no immediate U.S. income tax obligation on foreign source income.”).

Deferral puts a taxpayer in the position of earning a *tax-exempt* rate of return on the *after-tax* value of the original deferred amount.<sup>31</sup>

The ability of a U.S. firm to defer U.S. tax on its returns from foreign direct investment operates similarly, except that the tax imposed on unrepatriated earnings is not zero, but whatever is the foreign rate on those reinvested earnings. Nonetheless, from a U.S. perspective international deferral, like domestic deferral, operates to *exempt* entirely from U.S. tax the compounding of returns on low-taxed unrepatriated income until that income is repatriated. In practice, however, international deferral goes further, by coming close to exempting from U.S. tax the original deferred earnings as well, because U.S. tax on foreign earnings can be deferred indefinitely and without regard to natural lifespans. U.S. firms that can afford to defer indefinitely the repatriation of foreign earnings thus can obtain a tax result strikingly similar to a territorial regime.<sup>32</sup>

The practical consequences of the deferral principle are dramatic. The accumulated earnings of foreign subsidiaries of U.S. resident parent companies totaled roughly \$1 trillion in 2008 and today total approximately \$1.4 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.<sup>33</sup>

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). Repatriation of a foreign subsidiary's active business income, and with it the triggering of residual U.S. tax liability, can

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31. STAFF OF THE JOINT COMM. ON TAX'N, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II (JCX-63-07) 7 (2007).

32. Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 27, at 149.

33. For the one-year repatriation holiday figure, *see* Melissa Redmiles, Statistics of Income Division, IRS, *The One-Time Received Dividend Deduction*, 27 SOI BULL. Spring 2008, at 103. For the \$1 trillion figure, *see* Economic Recovery Advisory Board, The Report on Tax Reform Options 82, [www.whitehouse.gov/sites/default/files/microsites/PERAB\\_Tax\\_Reform\\_Report.pdf](http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf) [hereinafter PERAB Report] ("U.S. companies reported over \$1 trillion of permanently reinvested earnings on 2008 financial statements."). For the \$1.4 trillion figure, *see* J.P. Morgan & Co., North American Equity Research, *U.S. Equity Strategy Flash* (June 27, 2011). *Those* offshore earnings are generally understood to be in large measure retained abroad solely to avoid the residual U.S. tax on repatriation. *See, e.g., id.* ("U.S. multinationals have a strong incentive to keep their overseas earnings outside the U.S. as a result of the interplay between the high U.S. statutory corporate tax rate and deferral."). Section IV.B. of this Article discusses the meaning of "permanently reinvested" earnings.

take the form of an actual cash dividend, or one of various forms of constructive distribution, such as a loan of funds to a U.S. affiliate.<sup>34</sup>

The United States also taxes on a current basis (for this purpose, through a deemed dividend mechanism) certain categories of passive investment income or highly mobile income earned by foreign subsidiaries of U.S. firms. This disfavored income, which is not eligible for deferral, is termed “subpart F income.”<sup>35</sup>

The technical operation of subpart F is too complex to be susceptible of summary. Over the last several years, however, 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.”<sup>36</sup> This scaling 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.<sup>37</sup>

A U.S. multinational firm can claim foreign tax credits against its tentative U.S. tax liability for the foreign income taxes incurred in earning foreign income actually included in its U.S. tax return, but the detailed application of those rules is even more cruelly byzantine than are the subpart F rules.<sup>38</sup> Foreign taxes can be claimed as credits only to the extent of the U.S. tax that would have been imposed on the taxpayer’s foreign income; this can be understood as a ceiling of 35 percent (the U.S. corporate tax rate) multiplied by the firm’s taxable foreign income, with that foreign income being determined under U.S. principles.<sup>39</sup> This formula is referred to as the “foreign tax credit limitation.” If a firm has more credits than it can claim in a year, it is said to be in an “excess credit” position; a firm that has foreign source taxable income that is not completely sheltered by foreign tax credits is said to be in an “excess limitation” position.

The U.S. foreign tax credit limitation calculation includes important rules that treat U.S. domestic borrowings as supporting a firm’s worldwide

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34. I.R.C. § 956 (investment of a controlled foreign corporation’s earnings in United States property).

35. See I.R.C. § 952.

36. See Lawrence Lokken, *Whatever Happened to Subpart F U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185 (2005) [hereinafter Lokken, *Whatever Happened to Subpart F*]. Lokken offers a series of hypothetical examples that demonstrate how the implementation of the check-the-box regulations has caused subpart F to lose its power to prevent U.S.-domiciled multinational enterprises from generating what this Article calls stateless income. *Id.* at 202–05.

37. See *infra* Part III.

38. ISENBERGH, INTERNATIONAL TAXATION, *supra* note 27, considers the topic in more detail.

39. I.R.C. § 904(a).

assets in proportion to the relative tax bases (costs) of those assets.<sup>40</sup> For this purpose, the relevant asset of a foreign subsidiary is the parent's investment in the affiliate's equity (and any debt claims held by the parent), not the gross assets of the subsidiary. 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.

The net effect of the 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. The rules therefore operate to constrain a U.S. firm's ability to utilize foreign tax credits, because those credits are limited to the tentative U.S. tax on foreign source income (as determined under U.S. tax principles). Nonetheless, 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 are not binding. 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.<sup>41</sup>

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-subsidiary 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 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 U.S. firm's available foreign tax credits can be applied to reduce its U.S. income tax liability in respect of any foreign-source income of the same general nature — in practice, any income ultimately derived from active business operations. "Active" business income in turn includes some income that in ordinary language might be viewed as passive investment returns, such as royalties or interest income derived from foreign

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

41. 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.



subsidiaries, so long as those subsidiaries in turn derive their income from active business operations.<sup>42</sup>

One important consequence of these design features 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.<sup>43</sup>

### C. Revenue Collections Under the Current System

As a result of the interactions of the complex rules summarized above, the United States today collects almost trivially small revenues from its current system for taxing the foreign income of U.S. multinational firms. In 2004, for example, the United States collected \$18.4 billion in tax from the foreign operations of U.S. multinationals. This amount includes not only taxes on dividends paid by foreign subsidiaries, but also taxes on subpart F income (constructive dividends that are treated as distributed to the U.S. parent by operation of law), as well as interest and royalty income paid from controlled foreign corporations to U.S. affiliates.<sup>44</sup>

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 paid \$12

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42. I.R.C. § 904(d).

43. Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 27; 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 L. REV. 751, 759–70 (2006) [hereinafter Lokken, *Territorial Taxation*]. As Lokken notes, a complete catalogue of techniques could fill several volumes. However, he discusses three commonly-used mechanisms in concrete examples. *See also* Kleinbard, *Territorial Taxation*, *supra* note 1, at 556–58.

44. 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, Senior Research Economist, U.S. Treasury Department. (on file with author) Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 27, 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.

billion in interest — altogether, some \$166 billion in total repatriations out of foreign earnings.<sup>45</sup> The \$18.4 billion in U.S. tax collections represents a U.S. tax rate of about 11 percent on that repatriated income.

By way of contrast, if the United States had employed a territorial tax system, it would have collected a modest amount of tax on the \$95 billion of dividend and subpart F income actually or constructively repatriated in 2004.<sup>46</sup> 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 current “worldwide” system.

In that same year, profitable foreign subsidiaries of U.S. firms (that is, those subsidiaries that reported positive income for the year) earned net income of some \$433 billion before foreign income taxes (but after interest and royalty payments to affiliates), and \$365 billion after payment of foreign taxes and before any repatriations to the United States.<sup>47</sup> After taking into account dividends paid to U.S. parent companies and taxable subpart F income (\$95 billion), \$270 billion (74 percent) of the after-foreign-tax net earnings of profitable foreign subsidiaries was not taxed on a current basis in the United States.<sup>48</sup>

The \$270 billion of net earnings of profitable foreign subsidiaries untaxed by the United States was approximately half as large as the \$533 billion in total taxable income (foreign and domestic) reported by all U.S.

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45. For the first two figures, *see* IRS, SOI Tax Stats – Controlled Foreign Corporations, <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html> (May 20, 2011). The data are measured employing U.S. tax principles, rather than U.S. GAAP. For the last figure, *see infra* Part III. tbl. 1.

46. 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.

47. *See supra* note 45 (providing IRS SOI data for controlled foreign corporations for 2004). The data are measured employing U.S. tax principles, rather than U.S. GAAP. As indicated in the text, the figures presented here ignore foreign subsidiaries that reported a loss for the year.

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

corporations that claimed any foreign tax credits on their 2004 income tax returns (essentially all firms with international operations), on which \$119 billion in U.S. tax was paid (after all tax credits, including credits for foreign income taxes paid).<sup>49</sup> And \$270 billion in after-foreign-tax 2004 foreign subsidiary earnings that went untaxed by the United States on a current basis looms large — about 43 percent — even when compared with the \$633 billion of *all* after-tax corporate income of any type that was subject to U.S. corporate income tax for that year, including the income of entirely domestic firms.<sup>50</sup>

#### *D. Arbitrage and Domestic Base Erosion*

The current U.S. regime for the taxation of foreign direct investment not only collects trivially small revenues (as suggested above, smaller than those that would be collected under some scenarios if the United States were to switch to a 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.<sup>51</sup>

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.

As one recent example, 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. Yet 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 issued these debt obligations to fund dividends and stock buy-backs while avoiding any repatriation tax, because 80 to 90 percent of its

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49. See IRS, SOI Tax Stats – Corporate Foreign Tax Credit Statistics, <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96337,00.html> (last visited May 20, 2011).

50. IRS, 2004 Corporation Source Book of Statistics of Income (line 73 minus line 82).

51. See also *infra* Part IV.C.

cash and short-term investments are held outside the United States.<sup>52</sup> Moreover, the article suggests that this pattern is becoming more common among U.S. technology companies generally.

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 borrow freely to buy tax-exempt municipal bonds.

#### *E. The Tax Distillery*

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.

These blends might, for example, encompass complex "triangular" flows, in which a low-taxed subsidiary's income is routed through higher-taxed subsidiaries to associate the repatriation with greater tax credits.<sup>53</sup> And when direct repatriations cannot be sheltered by foreign tax credits, U.S. firms often can simply borrow in the U.S. capital markets, relying in part on the implicit credit of their substantial retained overseas earnings.<sup>54</sup>

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52. Jilani, *Microsoft Structured Acquisition*, *supra* note 10.

53. Rosanne Altshuler & Harry Grubert, *Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy*, 87 J. PUB. ECON. 73, 75 (2002) ("Instead of investing in passive assets or reinvestment, the low-tax affiliate with potentially high taxes on direct repatriations can invest in, or lend to, a related foreign affiliate. This keeps the funds within the worldwide corporation and generates a triangular flow of funds with the MNC. Further, as long as the related downstream affiliate is not located in a low-tax country, it can become the vehicle for tax-free repatriation by the low-tax subsidiary.").

54. *Id.*

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. 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.

It also follows from the above that it is a mistake to confuse the modest U.S. tax cost to U.S. firms of ordinary course foreign income repatriations with the costs that would be incurred to repatriate the roughly \$1.4 trillion of foreign untaxed earnings of U.S. multinationals. Because the tax distilleries are not scaled to handle throughput of this magnitude, and because they would quickly run out of high-tax casks of foreign income were they to attempt to accommodate this volume of production, the actual U.S. tax cost of repatriating all of a firm's stock of low-taxed deferred foreign earnings (made even lower-taxed by virtue of years of stripping out foreign taxes to use against regular repatriation flows) would be expected to be quite high.<sup>55</sup> Another way of saying this is that the U.S. taxes collected today on regular flows of foreign earnings are an average cost applied to a certain volume of repatriations; that average cost bears little relationship to the marginal cost of bringing back the firm's much larger stores of very low-taxed deferred income.

This issue becomes critically important in contemplating whether U.S. firms would change their behavior very much if the United States were to move to a territorial tax system; the point made here is that the forgone tax charges that a U.S. firm would then enjoy when compared with current law would be much larger than would be implied by the modest U.S. tax rate imposed on regular course repatriations under the current system.

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55. Microsoft Corp., 2010 Annual Report, 58 n.13 (noting a \$9.2 billion cost to repatriate all of its extant foreign earnings). See *infra* text accompanying notes 93–95.

### III. STATELESS INCOME IN OPERATION

#### A. *The Value of Stateless Income Tax Planning*

Part II of this Article has explained how the current U.S. tax system operates in practice as an ersatz sort of territorial tax system, within the bounds of ordinary course repatriation flows. This result in turn comes at an important cost, which is the retention of low-taxed foreign earnings by a firm's foreign subsidiaries. If a U.S. firm seeks to maximize the aggregate benefits obtainable under present U.S. tax law (as many clearly do, in light of the roughly \$1.4 trillion that they collectively hold in indefinitely-deferred low-taxed foreign income), there are important reasons to minimize the firm's foreign tax liabilities.

First, a U.S.-based multinational firm typically needs to "borrow" only a fraction of its total foreign tax liabilities to shelter its regular course repatriations of earnings to the United States. Second, that firm obtains no current cash or financial accounting benefit for any remaining taxes associated with its indefinitely-deferred earnings. To the contrary, any foreign taxes paid on its indefinitely-deferred earnings are simply a current cash cost and an increment to its effective tax expense for financial accounting purposes. Moreover, as described below, the financial performance of a public firm, including the comparison of its tax expense to that of its global peers, ordinarily is judged through the prism of financial accounting. As a result, foreign taxes paid on indefinitely-deferred earnings are at best a contingent asset, while the cash saved from lowering those taxes is a real asset with an immediate and visible value.

Third, the firm's tax distillery needs to leave room in its blend for the bump in foreign effective tax rates triggered by the foreign tax credit interest expense rules described earlier. If the distillery starts with too high a foreign tax concentrate, it will not be able to avoid incurring excess foreign tax credits, which from a chief financial officer's point of view is the same as losing the tax deductibility of some of the firm's domestic interest expense. Put another way, a firm's ability to arbitrage the current system (by creating deductible U.S. interest expense that erodes the high-taxed domestic tax base) depends on having access to low-taxed foreign income.

As a result, U.S. firms today have every reason to aggressively pursue strategies to reduce their foreign tax burdens on their unrepatriated as well as repatriated earnings. This is the function of stateless income tax planning.

### *B. Mechanics of Stateless Income Tax Planning*

This subpart briefly describes a few of the most important and straightforward tax planning tools by which U.S. multinational firms can generate stateless income — that is, can cause income generated by economic activity in a high-tax jurisdiction to be taxed only in a low-tax foreign jurisdiction.<sup>56</sup> Booking such income in a low-tax jurisdiction by itself is not sufficient; the income also must be characterized as income arising from an active business (more technically, as income not described in subpart F).

At the outset, it is important to emphasize that stateless income generation is not simply a synonym for aggressive “transfer pricing” of transactions among affiliated companies. That phenomenon is real and greatly exacerbates the problem. But stateless income exists for reasons more fundamental than that, relating at their core to the global tax norm of treating corporate subsidiaries as separate juridical entities whose tax liabilities should be calculated without reference to their ownership.

#### *1. Business Earnings Stripping*

The most obvious way to generate stateless income is through internal group leverage — causing an affiliate in Ireland, for example, to lend to an affiliate in Germany. In 1984, the United States pioneered the repeal of source-country (the jurisdiction of the borrower) withholding tax on most cross-border interest flows by repealing the withholding tax on portfolio interest paid to foreign investors.<sup>57</sup> Since then most other countries have followed suit, as part of the long-term trend to the global integration of financial markets. While it is true that some countries, in particular the United States, do not extend their general exemption from withholding tax to interest paid to offshore affiliates of the borrower,<sup>58</sup> most tax treaties (and, in the EU, relevant Directives) do so; firms can rely on those treaties to avoid withholding tax notwithstanding domestic law.

In most cases, therefore, multinational firms can “strip out” high-tax source country earnings through internal group leverage.<sup>59</sup> In practice, this

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56. See Lokken, *Territorial Taxation*, *supra* note 43, at 759–69 for discussion of some more exotic techniques, which can yield results superior to outright exemptions.

57. I.R.C. §§ 871(h), 881(c).

58. I.R.C. § 871(c)(3)(B), (C).

59. See Harry Huizinga, Luc Laeven & Gaetan Nicodeme, *Capital Structure and International Debt Shifting*, 88 J. FIN. ECON. 80 (2008); Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *A Multinational Perspective on Capital Structure Choice and Internal Capital Markets*, 59 J. FIN. 2451 (2004). The latter

ability is subject only to two broad constraints. First, the affiliate debt must be respected as such under the laws of the source country. Second, some countries, such as Germany and Australia, have adopted “thin capitalization” rules, which limit a borrower’s ability to deduct interest on debt if the borrower’s capital structure is deemed to be excessively leveraged.<sup>60</sup> Similarly, in its role as a source country (that is, as a host for the local operations of foreign-based multinationals), the United States limits base erosion through the Code’s “interest stripping” provision, which can be understood as a species of thin capitalization.<sup>61</sup> The critical difference is that a true thin capitalization rule applies to all interest paid, while the U.S. rule operates only to limit interest paid to affiliates that are not U.S. persons or that otherwise are tax-exempt.

The same analysis can be extended to other forms of deductible expenses, but internal group leverage is the starkest example, because it requires no physical infrastructure or staff in the low-tax jurisdiction that “earns” the interest income. The structure’s efficacy relies on several core normative principles of income tax statutes around the world. First, separate juridical entities are respected as separate taxpayers, even when commonly controlled. Second, the legal form of a capital investment (as debt or as equity) largely drives the tax analysis of that instrument.<sup>62</sup> Third, there is a strong international consensus to determine the income tax liabilities of firms through the application of the “arm’s-length principle,” which contemplates that affiliated firms are taxed separately, but their transactions with each

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paper, for example, concludes in part that “there is strong evidence that affiliates of multinational firms alter the overall level and composition of debt in response to tax incentives.” *Id.* at 2452. Moreover, “firms use internal capital markets opportunistically when external finance is costly and when there are tax arbitrage opportunities.” *Id.* at 2484. *See also* Julie H. Collins & Douglas A. Shackelford, *Global Organizations and Taxes: An Analysis of the Dividend, Interest, Royalty, and Management Fee Payments Between U.S. Multinationals’ Foreign Affiliates*, 24 J. ACCT. & ECON. 151 (1998) (employing data from 1990 and finding substantial evidence of tax-efficient routing of (nondeductible) dividends and (deductible) royalties and interest among foreign subsidiaries of U.S.-domiciled multinational firms). As the text makes clear, the opportunities to tax-optimize such payments among foreign affiliates of U.S. firms have become more complete in recent years, due to changes in U.S. law and regulations.

60. *See* Tim Edgar, Jonathan Farras & Amin Mawant, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*, 56 CAN. TAX J. 803, 810 (2008); Tim Edgar, *Policy Forum: Interest Deductibility Restrictions — Expecting Too Much from REOP?*, 52 CAN. TAX J. 1130 (2004).

61. I.R.C. § 163(j).

62. *See* Edward D. Kleinbard, *Designing an Income Tax on Capital*, in TAXING CAPITAL INCOME (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds. 2007).



other are tested to ensure that their terms are consonant with the terms under which unrelated entities would do business.<sup>63</sup> The combination of these principles in application allows for economically meaningless internal leverage to accomplish significant source country income tax base erosion.

In years prior to 1997, the United States constrained the ability of U.S. multinationals to generate stateless income through internal group leverage or other earnings stripping cash flows, because U.S. law at the time characterized as subpart F income most interest income (or other income items deducted by the payor) earned by a foreign subsidiary domiciled in a low-tax jurisdiction. As a consequence, a U.S. multinational group could strip income from one foreign jurisdiction to another, but by doing so the U.S. parent company would be taxed immediately on the interest income recognized by the low-taxed affiliate.

This state of affairs was said to be consistent with a capital export neutrality philosophy, because at the margin a U.S. firm could not costlessly generate low-taxed non-subpart F foreign income when making investments in high-tax foreign jurisdictions.<sup>64</sup> As a result, it could be argued that subpart F encouraged U.S. firms to make investment decisions without regard to any special tax planning opportunities that might be available in respect of foreign investments. The business community, however, argued forcefully that the U.S. international tax system, taken as a whole, put U.S. firms at a competitive disadvantage.<sup>65</sup> Moreover, U.S. business firms were incredulous that the United States would deliberately discourage U.S. firms from reducing their foreign tax liabilities.<sup>66</sup>

In 1997, the tax tectonic plates shifted, with the introduction of the “check-the-box” Treasury regulations.<sup>67</sup> Whether as a result of a conscious shift to a different guiding principle or as ad-hoc responses to industry pleas for a competitive international tax environment, these regulations

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63. See *supra* note 6 (discussing OECD Guidelines.).

64. See OFFICE OF TAX POLICY, DEPARTMENT OF THE TREASURY THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 119 (2000).

65. See, e.g., NATIONAL FOREIGN TRADE COUNCIL, ADDRESSING OFFSHORE TAX AVOIDANCE WITHOUT HARMING THE INTERNATIONAL COMPETITIVENESS OF U.S. BUSINESSES 1 (warning U.S. policymakers to evaluate all international tax reforms in light of competitiveness).

66. The best example of this mutual incomprehension was the promulgation of, and reaction to, Notice 98-11, 1998-1 C.B. 433. Notice 98-11 provided that regulations would be proposed to prevent taxpayers from utilizing hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. The Notice achieved instant notoriety, and no such regulations ever were issued.

67. Treas. Reg. § 301.7701-3.

substantially vitiated the scope of subpart F as a guardian against stateless income generating techniques.<sup>68</sup>

The check-the-box regulations permitted U.S. firms effectively to avoid the strictures of subpart F in many instances by electing, *solely for U.S. tax purposes*, to treat a foreign corporate subsidiary as a tax-transparent vehicle, rather than a separate taxable entity to which the rules of subpart F might apply. When a check-the-box election is made in respect of a wholly-owned subsidiary, the subsidiary is referred to as a “disregarded entity,” because its separate juridical status is ignored for all U.S. tax purposes. Instead, the subsidiary is treated as an extension of its sole corporate owner.

To take one common fact pattern, imagine that a U.S. multinational enterprise owns an Irish first-tier subsidiary, which in turn owns a French second-tier subsidiary. The U.S. parent company “checks the box” in respect of the French subsidiary, which thereupon becomes entirely disregarded for U.S. tax purposes, but not for Irish or French tax purposes. Now the Irish first-tier subsidiary lends money to its French subsidiary. For Irish and French tax purposes, the interest expense in France and the interest income in Ireland are treated as real, with the result that French business income is now taxed to that extent at Irish rates. For U.S. purposes, however, there is only one company — an Irish subsidiary with branch operations in France — and transactions between a branch and its home office are generally ignored for U.S. tax purposes. As a result, subpart F income cannot arise.

Altshuler and Grubert have found a pronounced change in the effective foreign tax rates of U.S. multinational firms after 1996, which they plausibly ascribe to the effects of check-the-box tax planning.<sup>69</sup> More recently, Grubert’s review of nonpublic Treasury files shows a decline in those effective foreign tax rates of five percentage points from 1996 to 2004. While some of that decline is attributable to reductions in statutory rates in some countries, a significant fraction represents the migration of stateless

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68. See Lokken, *Whatever Happened to Subpart F*, *supra* note 36, at 209 (“As a result of these devices, subpart F has fallen increasingly short of the goal of curbing tax haven sheltering.”); see also Martin J. McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017 (2002).

69. Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 FLA. TAX REV. 153 (2005) [hereinafter Altshuler & Grubert, *The Three Parties in the Race to the Bottom*]. Altshuler and Grubert found that from a period after 1997, when “check-the-box” was implemented, to 2002, intercompany equity income rose from \$40.7 billion to \$120.8 billion, and that in the same period there was almost 100 percent growth in the equity income of foreign affiliates of U.S. firms in seven major low-tax countries (Bermuda, Cayman Islands, Ireland, Singapore, the Netherlands, Luxembourg, and Switzerland). *Id.* at 170.

income to low-tax jurisdictions without subpart F consequences through the use of check-the-box tax planning.

Stateless income generation through income stripping was further nurtured by Congress, which in 2004 enacted section 954(c)(6) of the Internal Revenue Code. This provision largely vitiated any remaining vitality in subpart F's role as a guardian against stateless income planning, because it turned off the application of subpart F when one controlled foreign corporation pays deductible interest, royalties, or rents to another, so long as the first subsidiary's payments are derived from active business income. This "pass-through" rule was enacted in temporary form (and as extended in 2010, is scheduled to expire after 2011), which has limited its attractiveness as a planning tool when compared to the check-the-box regulations, but there are important instances in which section 954(c)(6) extends the reach of stateless income tax planning opportunities. Section 954(c)(6)'s enactment is too recent for its impact to appear in the data.

A third example of a recent administrative or legislative change that has had the effect of facilitating business earnings stripping by U.S. multinational firms is the adoption of revised "dual consolidated loss" regulations in 2007.<sup>70</sup> This exotic corner of the tax law aims to limit the ability of U.S. firms to "double dip," by claiming the same deduction in two different countries, if by doing so the deduction is made available to other companies (whether related or not). For example, imagine that a U.S. firm owns a first-tier subsidiary that is treated as a U.S. corporation under U.S. rules, but a French corporation under French rules, and that the subsidiary in turn is the parent of a French consolidated group. Further assume that the subsidiary incurs a loss. The dual consolidated loss regulations would prevent the U.S. group from claiming that loss on the U.S. consolidated tax return and also using the loss to shelter the income of lower-tier French subsidiaries from French income tax.

The 2007 revisions to the detailed Treasury regulations that articulate these rules provided for the first time clear guidance that interest paid between a check-the-box disregarded entity and its parent could not give rise to a prohibited dual consolidated loss, even though that loss was deducted against the income of two consolidated groups. For example, imagine that in the example above the U.S. parent company borrows funds from third parties and then lends those funds to its French first tier subsidiary, which is now a check-the-box disregarded entity. By virtue of this interest expense, the French subsidiary operates at a loss, which it applies against the income of its lower-tier subsidiaries for French tax purposes. One third-party borrowing has now been deducted inside two consolidated groups. Although the statute and prior history of the regulations could have supported the opposite conclusion, the 2007 regulations expressly

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70. Treas. Reg. § 1.1503(d)-1 to -8.

condoned this form of earnings stripping. Again, not enough time has passed for the effect of these new regulations to be visible in the Treasury data files.

## 2. *Transfer Pricing*

A great many studies have found that taxpayers both within and without the United States have relied on transfer pricing strategies (the prices at which intragroup transactions are effected) to generate stateless income.<sup>71</sup> To take one favorite example, Grubert and Altshuler found that in 2002 foreign manufacturing subsidiaries of U.S. firms operating in Ireland (a low-tax country with the powerful additional attraction of being a member of the European Union) were almost three times as profitable in proportion to their sales as was the mean of all such foreign manufacturing subsidiaries.<sup>72</sup> As I have observed elsewhere, it cannot be simply the luck of the Irish that explains the extraordinary profitability of Irish members of worldwide groups.<sup>73</sup>

Transfer pricing strategies are particularly effective because of the central role of high-value unique intangible assets as profit drivers for

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71. Representative works include: JCT, *INCOME SHIFTING AND TRANSFER PRICING*, *supra* note 14; Brauner, *Value in the Eye of the Beholder*, *supra* note 6; Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580 (March 28, 2011) [hereinafter Clausing, *Revenue Effects*]; Mihir A. Desai, *New Foundations for Taxing Multinational Corporations* (Nov. 15, 2003) (unpublished manuscript, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=483802](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=483802)); Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 27; Harry Grubert, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, 56 NAT'L TAX J. 221 (2003) [hereinafter Grubert, *Intangible Income*]; Michael P. Devereux & Christian Keuschnigg, *The Distorting Arm's Length Principle in International Transfer Pricing* (Apr. 20, 2008), (unpublished papers), (<http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/2008/keuschniggALP.pdf>, Oxford University Centre for Business Taxation); Martin A. Sullivan, *Transfer Pricing Costs U.S. At Least \$28 Billion*, 126 TAX NOTES, 1439 (2010); Martin A. Sullivan, *U.S. Multinationals Paying Less Foreign Tax*, 118 TAX NOTES 1177 (2008); Martin A. Sullivan, *U.S. Multinationals Shifting Profits Out of the United States*, 118 TAX NOTES 1078 (2008); Hearing on Transfer Pricing Issues Before the H. Comm. On Ways and Means, 111th Cong. (testimony of Thomas A. Barthold, Chief of Staff, Joint Comm. On Tax'n), <http://jct.gov/publications.html?fanc=startdown&id=3693>.

72. Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 27, at 322–23. The European Union's core member tax rate is now around 30 percent. While the 2002 Treasury files indicate that the average statutory tax rate for U.S. manufacturing subsidiaries abroad is about 29 percent, their effective tax rate on net income is only about 16 percent.

73. Kleinbard, *Territorial Taxation*, *supra* note 1, at 551–54.

multinational firms.<sup>74</sup> Indeed, Desai and Hines lay out a persuasive case that the theory of the multinational firm can in large measure be explained by its role as a platform from which to exploit unique global intangibles.<sup>75</sup> Almost by definition, it is very difficult to validate the pricing of intragroup licenses or other contracts involving these unique assets. Moreover, arm's-length principles simply do not address the allocation of group income attributable to the synergies that explain the reason for the group's existence in the first place.

Transfer pricing strategies are particularly important for U.S. firms that seek to generate stateless income by shifting profits from the United States (as opposed to a high-tax foreign jurisdiction) to a low-tax foreign country. The interest stripping strategy outlined earlier, for example, does not work to strip income of a U.S. firm to a low-tax offshore affiliate, by virtue of a number of subpart F rules designed to protect the U.S. tax base in those circumstances. Transfer prices, of course, are subject to scrutiny under the arm's-length principle, but once a high-value intangible is transferred outside the United States (including through a license that does not fully compensate the U.S. owner), the foreign owner or licensee generally can exploit the intangible without triggering subpart F income. The foreign affiliate that controls the intangible can exploit it through licensing to affiliates in high-tax foreign countries with the business earnings stripping consequences outlined earlier. Alternatively, in some cases, such as pharmaceutical manufacturing or retail sales of computer software, the low-tax affiliate can employ the intangible to manufacture a product for resale to affiliates located in other jurisdictions.

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74. For recent news stories outlining transfer pricing strategems involving both U.S. tax avoidance and stateless income planning, see Drucker, *Google 2.4% Rate*, *supra* note 11; Martin A. Sullivan, *Microsoft Moving Profits, Not Jobs, Out of the U.S.*, 129 TAX NOTES 271 (2010); Jesse Drucker, *U.S. Companies Dodge \$60 Billion in Taxes With Global Odyssey*, Bloomberg, May 13, 2010, <http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html>; Peter Cohn, *Are Multinationals Evading Taxes?*, NATIONAL JOURNAL, Sept. 4, 2010 at 13; Simon Bowers, *Google's Subsidiaries Allow Company to Avoid £450 m Tax on UK Advertising*, GUARDIAN, Dec. 20, 2009; Terry Macalister, *Google is Accused of UK Tax Avoidance*, GUARDIAN, Apr. 20, 2009; Prem Sikka, Op-Ed., *Shifting Profits Across Borders*, GUARDIAN, Feb. 12, 2009; Glenn R. Simpson, *Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe*, WALL ST. J., Nov. 7, 2005, at A1.

75. Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487, at 488–89 (“[M]ultinational firms are thought to engage in foreign direct investment when ownership confers specific advantages relative to arms-length relationships, so activities are most profitably undertaken within the firm.”); Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 293–99.

While the data showing the effects of transfer pricing strategies are clear, convincing, and generally accepted, it is helpful to break these strategies into three logically distinct categories. The first is the aggressive use of “cost sharing” arrangements.<sup>76</sup> Under this strategy, one affiliate (invariably located in a low tax jurisdiction) agrees to shoulder a portion of the development costs of a new intangible asset (which in turn often is an extension of some kind of an existing intangible), and in return receives the exclusive royalty-free use of the resulting asset in the affiliate’s assigned geographic territory. So, for example, an Irish subsidiary of a U.S. firm might agree to assume a portion of the cost of testing and bringing to market an existing ethical pharmaceutical compound for a new indication; the portion assumed would be designed to reflect the potential value of a successful product in the EU, as compared to the rest of the world. Cost sharing and check-the-box strategies are synergistic, because a foreign subsidiary that acquires region-wide ownership of an intangible through a cost sharing arrangement can in turn license the intangible to other affiliates in the region without triggering subpart F income if those affiliates are disregarded appendages of the intangibles owner for U.S. tax purposes.<sup>77</sup>

Researchers have identified cost sharing as a significant contributor to noneconomic transfer pricing outcomes.<sup>78</sup> It will not surprise many readers to learn that low-tax affiliates that enter into cost sharing agreements with their high-tax parent companies rarely are saddled with money-losing projects.<sup>79</sup> This factual skewing of outcomes is one important reason for the disparities across affiliate incomes that are observed.

Just as remarkably, the money risked by the low-tax subsidiary is simply supplied as a capital contribution by the parent.<sup>80</sup> The risk sharing on

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76. See Brauner, *Cost Sharing*, *supra* note 9; JCT, INCOME SHIFTING AND TRANSFER PRICING, *supra* note 14, at 25-29, 111-14.

77. See Grubert, *Foreign Taxes and Domestic Income*, *supra* note 9; *supra* note 10, 12.

78. See Brauner, *Cost Sharing*, *supra* note 9; JCT, INCOME SHIFTING AND TRANSFER PRICING, *supra* note 14; Clausen, *Revenue Effects*, *supra* note 71, at 705; Grubert, *Intangible Income*, *supra* note 71 (finding that income derived from R&D intangibles account for about half the income shifted from high-tax to low-tax countries, and that subsidiaries undertake a large number of transactions, thus increasing the opportunities to shift income); Julie Roin, CAN THE INCOME TAX BE SAVED? THE PROMISE AND PITFALLS OF ADOPTING WORLDWIDE FORMULARY APPORTIONMENT, 61, 171-75, 182-85 (2008).

79. The famous counterexample that proves the rule is Xerox Corporation. John Mulligan, *How Ireland Almost Ruined the Photocopier King*, [IRISH] SUNDAY TRIB. (Apr. 22, 2001), <http://www.tribune.ie/article/2001/apr/22/how-ireland-almost-ruined-the-photocopier-king/>.

80. Newly-revised cost sharing regulations seek to minimize the advantages of the baldest of such arrangements; whether the new regulations will prove

which cost sharing rules are predicated thus is no more meaningful than if the parent company were to pay “insurance” premiums to a subsidiary whose only insurance customer was the parent. But in the latter case, courts have long recognized that such “insurance” arrangements do not in fact shift risk from the parent company, and therefore do not accomplish the economic purpose of insurance in the first place; the resulting premiums accordingly are not deductible.<sup>81</sup>

The second cluster of transfer pricing strategies that firms rely on to generate stateless income is simply aggressive contractual terms.<sup>82</sup> In a world where licenses of high-value internally-created intangibles have no observable market value and where the arm’s-length principle itself fails to assign the synergies created by operating as a multinational enterprise, firms can be expected to adopt intragroup contractual terms that favor low-taxed affiliates. The U.S. Internal Revenue Service in particular has recognized and struggled with this problem, both in administrative regulations and through litigation, but every case it brings is a multimillion dollar commitment of time and resources, and success is not assured.<sup>83</sup>

Aggressively low buy-in payments in cost sharing agreements or in contractual license terms can be described as simply a question of getting the transfer price “right,” but the data all point to the fact that the Internal Revenue Service, despite years of effort, has largely lost the battle.<sup>84</sup> Profits of low-taxed foreign subsidiaries are systematically greater than profits of U.S. or high-taxed foreign siblings, for reasons inexplicable except by reference to widespread transfer pricing gaming.

The third logical group of transfer pricing strategies to generate stateless income is the case of a pure business opportunity.<sup>85</sup> A multinational

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efficacious remains to be seen. For a politely skeptical view, *see* Hearing Before the H. Ways and Means Comm., 111th Cong. (testimony of R. William Morgan, Managing Director, Horst Frisch Incorporated) (2010). [hereinafter Morgan testimony]

81. *See, e.g.*, *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989).

82. JCT, *INCOME SHIFTING AND TRANSFER PRICING*, *supra* note 14, at 77–83 (Delta Company example).

83. *See* *Veritas Software Corp. et al. (Symantec) v. Commissioner*, 133 T.C. 297 (2009) (cost sharing arrangement between Veritas Software and its Irish subsidiary in which Veritas assigned all its existing intangibles to its subsidiary in return for royalties and a buy-in payment of \$118 million between the two was an arm’s-length transaction); Morgan testimony, *supra* note 80.

84. *See supra* note 75, 76. *See also* JCT, *INCOME SHIFTING AND TRANSFER PRICING*, *supra* note 14; Kleinbard, *Territorial Taxation*, *supra* note 1, at 552–55.

85. *See* *Hospital Corp. of Am. v. Commissioner*, 81 T.C. 520 (1983). Absent a finding that the arrangement lacks a business purpose, the current rules only allow for price adjustment of the transaction, and not its complete disregard. *See* Sheppard, *Tax Officials*, *supra* note 7.

group often is in a position to exploit a special business opportunity in circumstances in which the group is reasonably confident that the project will be very profitable; in such circumstances, it frequently is the case that relevant transfer pricing statutes will not treat the assignment of that opportunity at the very outset of the project to a low-taxed affiliate as an intragroup transfer of any asset to which transfer pricing principles might be applied at all.<sup>86</sup> Unlike the first two instances of transfer pricing issues, this is a conceptual limitation in the application of transfer pricing principles.

### 3. *Legal System Arbitrage*

A third standard tool in stateless income planning is the arbitrage of different legal systems. For example, an instrument might be treated as tax-deductible debt in one jurisdiction, but as equity in the hands of the investor from the perspective of the latter's jurisdiction. More commonly, the U.S. "check-the-box" regulations described earlier permit firms to present their operations as conducted by one entity for non-U.S. tax purposes, but by another under U.S. tax principles.

### C. *How Large is Stateless Income?*

There is strong evidence that multinational firms substantially reduce their aggregate worldwide tax burdens 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 conclusion is that 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.

#### 1. *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.<sup>87</sup> Fortunately, the Internal Revenue Service Statistics of Information

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86. See *supra* note 7. When the OECD invited commentary on its newly issued OECD Guidelines, many organizations argued that such business opportunities were potentially outside the scope of transfer pricing. See Letter from PriceWaterhouseCoopers to Jeffrey Owens, Director OECD Centre for Tax Policy and Administration (Sept. 2, 2010), [www.oecd.org/dataoecd/52/7/46043673.pdf](http://www.oecd.org/dataoecd/52/7/46043673.pdf).

87. U.S. GAAP accounting requires companies to set out their cash tax payments in a year, but those payments are an undisclosed amalgam of estimated tax payments for the current year, final payments for the preceding year, payments or



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.<sup>88</sup> 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.

In 2006 (the most recent year for which such data have been released), the Internal Revenue Service Statistics of Information Division’s 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.<sup>89</sup> 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.

In a very recent study relying on Treasury nonpublic data, Grubert studied 754 large nonfinancial U.S. multinational corporations and 111 financial ones for which data were available for both 1996 and 2004; this population represented about 80 percent of all the foreign income of U.S.-based multinationals in the later year.<sup>90</sup> Grubert reported that the effective foreign tax rate of the foreign subsidiaries of these firms was 21.3 percent in 1996; that same figure fell to 15.9 percent in 2004.<sup>91</sup> (This of course accords with the 2004 and 2006 Statistics of Information data on the larger universe of all U.S.-controlled foreign corporations summarized in the preceding

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refunds received as a result of audit settlements, and similar factors. The net amount shown in the financial statement therefore does not correspond to a firm’s income tax liability in respect of that year.

88. For greater detail on the calculation of this information, see Lee Mahoney & 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.)

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

90. Harry Grubert, *Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren’t Being Globalized, Only Profits* 11 (Oxford Univ. Centre For Bus. Tax’n, Working Paper WP09/26), <http://www.sbs.ox.ac.uk/centres/tax/papers/Pages/PaperWP0926.aspx> [hereinafter Grubert, *Foreign Taxes and Domestic Income, Working Paper*].

91. *Id.* at Appendix Table.

paragraph.) To put that 15.9 percent effective foreign tax rate in context, the Government Accountability Office calculated that for 2004 the weighted average U.S. domestic effective tax rate for large profitable U.S. corporations was 25.1 percent; the median stood at 31.8 percent.<sup>92</sup>

As described in the next subsection, financial accounting data suggest that these low tax rates are not shared universally by all U.S. multinationals, but rather are concentrated in some sectors, such as technology and pharmaceutical manufacturing. This in turn suggests that the foreign tax rates enjoyed by controlled foreign corporations in these industries often must be 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).<sup>93</sup> Microsoft also noted that the tax cost of repatriating those earnings to the United States would be \$9.2 billion.<sup>94</sup> These numbers suggest that Microsoft's permanently reinvested foreign earnings enjoyed an effective foreign income tax rate in the neighborhood of 4 percent.<sup>95</sup>

As another example, largely by virtue of the Double Irish Dutch Sandwich structure described above, Google Inc.'s 2009 Financial Statements imply that Google paid an effective tax rate on its foreign income of roughly 2.4 percent.<sup>96</sup> As one final example, the pharmaceutical firm

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92. U.S. Gov't Accountability Office, GAO-08-950, U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income Is Reported 12 (2008).

93. Microsoft Corporation, 2010 Annual Report, p. 59 [http://www.microsoft.com/investor/reports/ar10/10k\\_dl\\_dow.html](http://www.microsoft.com/investor/reports/ar10/10k_dl_dow.html). The next subsection describes the concept of "permanently reinvested earnings" in more detail.

94. *Id.* 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.

95.  $9.2/29.5 = 31$  percent, implying that foreign tax credits associated with the repatriation of all permanently reinvested earnings would amount to only about four percentage points.

96. See Drucker, *Google 2.4% Rate*, *supra* note 11. The 2.4 percent figure technically relies on financial accounting data, because that is all the public information that is available. The author appears to have calculated the figure as follows. Note 14 to Google's 2009 consolidated financial statements attached to its 2009 Form 10-K set out the firm's income from foreign operations and its provisions for foreign income taxes (see Google, 2009 Annual Report, [http://investor.google.com/documents/2009\\_google\\_annual\\_report.html](http://investor.google.com/documents/2009_google_annual_report.html)). The author apparently took as

Johnson & Johnson reported in its public financial statements for 2007 that its operations in Ireland and Puerto Rico alone reduced its financial accounting provision for income taxes from the statutory rate of 35 percent to 26.2 percent.<sup>97</sup> That is, income reported for tax purposes in Ireland and Puerto Rico was so large as to reduce the *worldwide* financial accounting tax provision of Johnson & Johnson by 8.8 percentage points. Readers will appreciate that this reduction in worldwide tax costs (as measured for financial statement purposes) is not proportionate to the relative size of the Irish and Puerto Rican pharmaceutical markets in comparison to those of all the markets in which Johnson & Johnson operates.

These extraordinarily low *effective* foreign income tax rates theoretically could be explained if most countries had commensurately low *statutory* corporate income tax rates. But that is a false hypothesis. The unweighted average of the maximum statutory corporate income tax rates of member states of the OECD in 2006 was just about 28 percent (25.6 percent in 2010, excluding in this case the United States).<sup>98</sup> And 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.<sup>99</sup> As another example, Koninklijke Philips Electronics N.V. (Philips), a major Dutch multinational industrial group, reported in its 2007 annual report that the weighted average

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his numerator the total financial accounting tax provision (current and deferred) for foreign taxes for the three-year period 2007-09, and took as his denominator the firm's total from foreign operations for the same three-year period. It is possible of course that there can be significant differences between GAAP accounting determinations of what constitutes income from foreign operations and the income that a U.S. multinational firm actually treats as income includible on the tax returns of its foreign subsidiaries.

97. Johnson & Johnson, 2007 Annual Report, p. 56, <http://files.shareholder.com/downloads/JNJ/1275963148x0x171267/057640F8-B2C0-4B0F-9F54-7A24A553C3CE/2007AR.pdf>. At year end 2007 Johnson & Johnson's permanently reinvested earnings totalled \$24.2 billion.

98. OECD, OECD IN FIGURES 2009 58 (OECD Publishing) (2009), Table of 2006 Comparative Income Tax Rates (28.1 percent OECD simple average of maximum corporate statutory rates, including subnational taxes on corporate income).

99. See Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income* 322-23 (Rutgers Univ., Dept. of Econ. Working Paper No. 2006-26), <ftp://sndr.rutgers.edu/Rutgers/wp/2006-26.pdf> (29 percent effective statutory rate for foreign subsidiaries in 2003). See *infra*, text at notes 127-130 for 2010 figures and discussion.

statutory tax rate of all the jurisdictions in which it did business was 26.9 percent.<sup>100</sup>

Some of the difference between statutory and effective tax rates can be explained by tax preferences like accelerated depreciation, but it is highly improbable that most can be. To the contrary, the general trend in corporate tax systems for many years has been lower statutory rates combined with broader bases, which operate to reduce the value of tax preferences.<sup>101</sup> And the OECD's annual statistical survey shows that, when comparing 1995 to 2005, corporate tax revenues rose on average across the OECD member states, both as a fraction of country GDP and as a fraction of country tax revenues.<sup>102</sup>

It is stateless income tax planning that explains the success of U.S. firms in reducing their average effective foreign income tax rate in the 2002-2006 period to the neighborhood of 16 percent, and particularly adroit firms in reducing it to single digits. There also 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:

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100. Koninklijke Philips Electronics N.V., 2007 Annual Report, Note 6 to US GAAP Financial Statements & Note 42 to IFRS Financial Statements, [http://xbrl.rienks.biz/company/annualreport/Koninklijke\\_Philips\\_Electronics\\_N.V./2007](http://xbrl.rienks.biz/company/annualreport/Koninklijke_Philips_Electronics_N.V./2007). The text returns to Philips at [Text at Note 119], where its financial statements are compared to those of a U.S. competitor, General Electric Company.

101. Johannes Becker & Clemens Fuest, *Optimal Tax Policy When Firms are Internationally Mobile*, (Oxford Univ. Centre for Business Tax'n, Working Paper No. 09/07), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=863484](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=863484). Becker and Fuest suggest that the optimal tax strategy to address the increasing mobility of international firms is a tax rate cut coupled with a broadened base.

102. OECD 2008 Revenue Statistics, Tables 12 and 13. [http://www.oecd-ilibrary.org/taxation/revenue-statistics-2008\\_rev\\_stats-2008-en-fr](http://www.oecd-ilibrary.org/taxation/revenue-statistics-2008_rev_stats-2008-en-fr). The figures are unweighted averages. In most large economies foreign-owned domestic firms are a minority of the local economy. As result, these rising corporate tax revenues can be explained by increasing profitability of domestically-owned firms, or increasing effective tax rates on them.

**Table 1: Royalty and Interest Paid by Controlled Foreign Corporations<sup>103</sup>**

| Year | Rents, Royalties & License Fees |                  | Interest                   |                  |
|------|---------------------------------|------------------|----------------------------|------------------|
|      | 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 approximately \$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 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. As another example, if an Irish controlled foreign corporation owned 100 percent of a German second-tier subsidiary and “checked the box” with respect to the German entity, for U.S. tax purposes the separate existence of the German company would terminate and the Irish corporation in turn would be viewed as directly engaged in business in Germany through a branch operation. When the German company paid interest or royalties to its Irish parent, those payments generally would be deductible for German tax purposes (the relevant inquiry for stateless income purposes), but would be invisible in the data collected by the Internal Revenue Service and summarized above.

The other 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.<sup>104</sup> This concentration of U.S. multinational firms’

103. Electronic communication from the U.S. Internal Revenue Service, Statistics of Information Division (Sept. 27, 2010) (on file with the author).

104. Clausing, *Revenue Effects*, *supra* note 71 (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.*

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 high-tax countries.

Harry Grubert's most recent paper is not an inquiry into the constituent parts of stateless income as such; instead, it studies the factors that explain the surge in the foreign share of the worldwide income of U.S. multinationals from 1996 (when the foreign share of worldwide income of U.S. firms stood at 37.1 percent) to 2004 (when the foreign share reached 51.1 percent).<sup>105</sup> Nonetheless, in the course of his analysis, Grubert identifies several themes consistent with the pervasive presence of stateless income tax planning in general. For example, Grubert attributes about 2 percentage points of the 5.4 percentage point decline in foreign effective tax rates from 1996 to 2004 to the implementation of check-the-box strategies.<sup>106</sup> And more generally, he finds evidence that lower tax rates abroad are positively correlated not only with a larger foreign portion of a firm's worldwide income, but also with higher profit margins on sales abroad, and lower profit margins domestically.<sup>107</sup>

The fruits of stateless income tax planning are that by mid-2011 foreign subsidiaries of U.S. firms held about \$1.4 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).<sup>108</sup> To the same effect, Grubert, in the recent study summarized earlier, found that, from 1996 to 2004 (i.e., in the period immediately preceding the one-time repatriation tax holiday), the share of

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*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*, *supra* note 69, at 170, 182 (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).

105. Grubert, *Foreign Taxes and Domestic Income*, Working Paper, *supra* note 90, at 10, 12.

106. *Id.*

107. *Id.* at 19-20. As a result, "not only do companies shift income from high tax foreign countries to low tax foreign countries but also from the United States abroad."

108. *J.P. Morgan & Co., North American Equity Research, U.S. Equity Strategy Flash* (June 27, 2011).

U.S. firms' worldwide income that was retained by foreign subsidiaries each year climbed from 17.4 percent to 31.4 percent.<sup>109</sup>

## 2. *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.<sup>110</sup> 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.<sup>111</sup> 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 U.S. statutory rate (35 percent) applied to GAAP (not tax) measures of the firm's income. Differences between the actual U.S. tax burden and the hypothetical GAAP figure must 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). Financial accounting further assumes that temporary timing differences between income as measured for GAAP and tax law purposes will reverse at the statutory rate; these temporary differences multiplied by the statutory tax rate give rise to a "deferred tax asset" when GAAP timing benefits run ahead of the tax law and a "deferred tax liability" in the converse case. Permanent differences, however, are

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109. Grubert, *Foreign Taxes and Domestic Income*, *supra* note 9, at 2.

110. John R. Graham, Michelle Hanlon & Terry Shevlin, *Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions*, J. ACCT. RES. (forthcoming 2011) [hereinafter *Braham, Hanlon & Shevlin, Accounting Rules*]. This Article 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.

111. *See id.* for a more detailed description of GAAP applicable to taxes relating to foreign earnings.

reflected simply as a reduction in the firm's tax expense, and therefore its effective tax rate.

In particular, 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. A better term for this amount might be "indefinitely reinvested" foreign earnings. 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.<sup>112</sup> This means that low-taxed "permanently reinvested" earnings bring down a firm's GAAP tax expense. It also means 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."<sup>113</sup> In the other, Graham, Hanlon and Shevlin report the results of an extensive survey of firm tax executives; the 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."<sup>114</sup>

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.<sup>115</sup> Even if the market does discount these stocks, recent

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112. 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.

113. Jennifer L. Blouin, Linda K. Krull & Leslie A. Robinson, *Is U.S. Multinational Intra-Firm Dividend Policy Influenced by Reporting Incentives?* 6 (Tuck Sch. of Bus. Working Paper No. 2009-68), <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.

114. Graham, Hanlon & Shevlin, *Accounting Rules*, *supra* note 110, at 3.

115. See Mark Bauman & Ken Shaw, *The Usefulness of Disclosures of Untaxed Foreign Earnings in Firm Valuation*, 30 J. AM. TAX. ASSOC. 53 (2008)



corporate practice seems to tilt heavily 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.<sup>116</sup>

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 (GE) and its GAAP-consolidated subsidiaries was 15.1 percent.<sup>117</sup> (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.<sup>118</sup>

By way of rough comparison, Philips, which is domiciled in a territorial tax country (the Netherlands) and is a competitor of General Electric in many markets, prepares its financial statements under both U.S. GAAP and International Financial Reporting Standards (IFRS). As previously noted, Philips reported for 2007 that the *weighted* average statutory tax rate of the jurisdictions in which it did business was 26.9 percent; its effective financial accounting tax rate for the year was 13.9 percent applying U.S. GAAP, and 11.1 percent under International Financial

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(“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, *INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY* 143–172 (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).

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* (2006), <http://www.entrepreneur.com/tradejournals/article/197721239.html> (last visited, Aug. 18, 2011). 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.

116. See Table 2, *infra*.

117. GE, 2009 Annual Report, p. 93, <http://www.ge.com/ar2009> (showing 2007 as well as 2009 effective tax rate data).

118. *Id.*

Reporting Standards (IFRS).<sup>119</sup> Under either accounting standard, the tax cost reported to investors was not dramatically different from that reported by GE.<sup>120</sup> The substantial difference under either measure between Philips' global weighted average statutory tax rate (26.9 percent) and its financial accounting provision for income taxes (13.9 or 11.1 percent) also is consistent with the fundamental stateless income story that this Article addresses.

An examination of the financial accounting results of a larger population of major U.S. firms shows again that many appear to earn significant stateless income, sufficient to drive down their worldwide effective tax rates by a substantial amount. The following table (Table 2) shows the fiscal year 2007 financial statement global effective tax rates for firms that in 2010 were constituents of the Dow Jones Industrial Average. (2007 was chosen as the last year not affected by the recent global economic crisis.) The list of constituent firms includes some companies whose operations are primarily domestic, and others (the natural resources firms) for which foreign taxes are both extraordinarily high and a substitute for royalties to the sovereigns in which they operate.

Column 3 lists the contributions of permanently reinvested earnings to that effective tax rate; like the second column, these figures are calculated by each firm and reported in the notes to its financial statements. Very generally, Column 3 represents each firm's calculations of the effect of all the factors that are reflected in the effective tax rate associated with its permanently reinvested earnings on the firm's global reported effective tax rate. Those factors include differences in tax rates (which in turn are attributable both to real operations in low-tax jurisdictions and to stateless income tax planning), but also other differences between U.S. GAAP accounting and the taxes actually scheduled to be collected on the foreign operations in question (for example, a tax-motivated "foreign tax credit generator" transaction). Although the data presented in Column 3 technically include factors other than the difference between the U.S. tax rate and the tax rates that a firm actually enjoys on foreign income, it is realistic to assume that the permanent differences summarized in Column 3 do in fact primarily relate simply to low foreign tax rates.<sup>121</sup>

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119. Philips 2007 Annual Report, pp. 155, 219, [http://xbrl.rienks.biz/company/annualreport/Koninklijke\\_Philips\\_Electronics\\_N.V./2007](http://xbrl.rienks.biz/company/annualreport/Koninklijke_Philips_Electronics_N.V./2007).

120. The text, of course, presents one year's comparison between two companies, not a statistically valid sample, but the point retains some illustrative power of the importance of "permanently reinvested" foreign earnings to the reported tax liabilities of U.S. firms.

121. To test this intuition, I have attempted to isolate in very approximate terms how much of Column 3 is attributable to firms enjoying low tax rates on their permanently reinvested income, as opposed to any of the other factors that firms reflect in the data presented in Column 3.

Column 4 lists each firm's accumulated permanently reinvested earnings at the end of 2007. Column 5 identifies those firms that provided an estimate of the U.S. residual tax cost of repatriating their permanently reinvested earnings, along with their estimate thereof.

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To do so, I first estimated the growth in current year permanently reinvested earnings for firms other than financial or natural resources companies listed in Table 2. (There are 24 such firms in Table 2 for which the available disclosure provided the necessary information.) Since actual current year contributions to permanently reinvested earnings are not disclosed, I estimated the number by comparing accumulated permanently reinvested earnings at the end of 2006 and 2007. (This calculation of course is inaccurate to the extent a firm has reclassified permanently reinvested earnings as no longer permanently reinvested, or vice versa.) I assumed that those earnings were taxed at a rate of 16 percent (the average effective foreign tax rate applicable to U.S.-controlled foreign corporations in 2006); that assumption of course likely is wrong when applied to any individual firm, but should be roughly accurate when the results are averaged. I then calculated for each such firm the difference between (i) the U.S. statutory rate of 35 percent and (ii) that 16 percent rate, each applied to the calculated approximation of current year permanently reinvested income, and expressed the result as a contribution in percentage points.

The unweighted average for the 24 selected firms of the percentage point effect on their effective tax rates of permanent differences relating to foreign income (i.e., Column 3) was 7.8 percent. The unweighted average of the alternative estimate outlined above was 7.5 percent. This suggests that the intuition that the bulk of Column 3 relates simply to lower tax rates and not to other more exotic financial accounting issues is reasonably accurate.

**Table 2: Effective Tax Rates and Permanently Reinvested Earnings of Constituent Firms of 2010 Dow Jones Industrial Average for Fiscal Years Ending in 2007**

| (1)               | (2)     | (3)                                                                                                   | (4)                                      | (5)                                            |
|-------------------|---------|-------------------------------------------------------------------------------------------------------|------------------------------------------|------------------------------------------------|
| Company Name      | ETR (%) | Percentage Point Effect on ETR of Permanent Differences Relating to Foreign Operations <sup>122</sup> | Accumulated PRE (in billions of dollars) | Disclosed Cost to Repatriate PRE (in billions) |
| 3M                | 32.1    | (2.8)                                                                                                 | \$5.7                                    | Not Provided                                   |
| Alcoa             | 34.6    | (3.7)                                                                                                 | \$8.8                                    | Not Provided                                   |
| American Express  | 27.3    | (5.1)                                                                                                 | \$4.9                                    | \$1.1                                          |
| AT&T              | 34.4    | (0.0)                                                                                                 | Immaterial                               | Immaterial                                     |
| Bank of America   | 28.4    | (2.3)                                                                                                 | \$5.8                                    | \$0.9                                          |
| Boeing            | 33.7    | Not Provided                                                                                          | Not Provided                             | Not Provided                                   |
| Caterpillar       | 30.0    | (4.7)                                                                                                 | \$7                                      | Not Provided                                   |
| Chevron           | 41.9    | 8.3                                                                                                   | \$20.6                                   | Immaterial                                     |
| Cisco             | 22.5    | (12.8)                                                                                                | \$16.3                                   | Not Provided                                   |
| Coca-Cola         | 24.0    | (10.8)                                                                                                | \$11.9                                   | Not Provided                                   |
| Disney            | 37.2    | (0.5)                                                                                                 | Immaterial                               | Immaterial                                     |
| DuPont            | 20.0    | (7.5)                                                                                                 | \$9.6                                    | Not Provided                                   |
| Exxon Mobil       | 44.4    | 10.4                                                                                                  | \$56                                     | Immaterial                                     |
| GE                | 15.5    | (15.7)                                                                                                | \$62                                     | Not Provided                                   |
| Hewlett-Packard   | 20.8    | (13.2)                                                                                                | \$7.7                                    | Not Provided                                   |
| Home Depot        | 38.1    | 0.0                                                                                                   | \$1.2                                    | Not Provided                                   |
| IBM               | 28      | (6.0)                                                                                                 | \$18.8                                   | Not Provided                                   |
| Intel             | 23.9    | (4.7)                                                                                                 | \$6.3                                    | Not Provided                                   |
| Johnson & Johnson | 20.4    | (18.0)                                                                                                | \$24.2                                   | Not Provided                                   |
| JPMorgan Chase    | 32.6    | (1.1)                                                                                                 | \$3.6                                    | Not Provided                                   |
| Kraft             | 30.5    | (4.9)                                                                                                 | \$3.9                                    | Not Provided                                   |
| McDonald's        | 34.6    | (7.5)                                                                                                 | \$6.7                                    | Not Provided                                   |

122. As reported by firms in their 2007 financial statements. These figures include not only the tax savings from permanently reinvested earnings, but also any other permanent benefit.

In looking at these figures, it is important to remember that if, for example, a U.S. firm earns 50 percent of its pretax income domestically, and records a reduction in its global effective tax rate of 6 percentage points, in reality its foreign effective tax burden would be some 12 percentage points below the U.S. rate.

|                           |      |        |              |              |
|---------------------------|------|--------|--------------|--------------|
| Merck                     | 2.8  | (35.5) | \$17.2       | Not Provided |
| Microsoft                 | 30.0 | (5.1)  | \$6.1        | \$1.8        |
| Pfizer                    | 11.0 | (21.6) | \$60         | Not Provided |
| Procter & Gamble          | 29.7 | (4.3)  | \$17         | Not Provided |
| Travelers                 | 26.0 | (0.0)  | \$0.4        | Not Provided |
| United Technologies       | 28.8 | (5.2)  | Not Provided | Not Provided |
| Verizon                   | 42.0 | 5.9    | \$0.9        | Not Provided |
| Wal-Mart                  | 33.6 | (1.8)  | \$8.7        | Not Provided |
| <b>Unweighted Average</b> | 28.6 | (5.9)  |              |              |

The variability in effective tax rates is extraordinary, but not surprising to specialists. It is consistent with a story in which firms driven by economic rents derived from high-value intangible assets (the pharmaceutical and technology companies, for example) find it particularly easy to generate stateless income, while consumer firms have somewhat less ability to do so, and natural resources firms face higher tax rates abroad (where the bulk of their resource extraction takes place) than in the United States.

#### IV. IMPLICATIONS OF STATELESS INCOME

This section considers the immediate implications of a world imbued with stateless income for current tax systems for taxing foreign direct investment. The discussion emphasizes the United States, but attempts also to identify issues that are particularly important for territorial systems. The companion article, *The Lessons of Stateless Income*, extends this discussion along two margins, by analyzing what the pervasive presence of stateless income means for standard efficiency norms by which international income tax systems are judged, and by reviewing how those systems might be revised to be more robust to the corrosive effects of stateless income.

##### A. The Fruitless Search for Source

The global tax norms that define the geographic source of income or expense are largely artificial constructs.<sup>123</sup> Is interest income earned and

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123. See, e.g., Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J. 67, 68 (2009) (“[T]he whole concept of ‘source’ has become less and less meaningful as a starting point for international tax allocation.”); Tim Edgar, Jonathan Farrar & Amin Mawani, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy*

taxed where the lender is located and capital provided, or at the location of the borrower, where the capital is put to use? The accepted norm, and thus the general operating rule, is the former, which is why source countries typically give deductions for interest paid to nonresident affiliates of a local firm. And if a U.S. parent company borrows externally but then contributes those funds to the equity of a subsidiary, should the interest deduction remain with the U.S. parent? If not, how should the interest expense be apportioned among members of the group? By tracing? By a fungibility standard?

The artificiality of the global norms that define the source of income is a well-known problem, for which solutions are not obvious.<sup>124</sup> 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 important for the current U.S. tax system,

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*Analysis*, 56 CAN. TAX J. 803, 834–41 (2008); Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. FOR INT’L TAX. 486, 489 (2008) [hereinafter Graetz, *A Multilateral Solution*]; Hugh J. Ault & David P. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11 (Assaf Razin & Joel Slemrod, eds. 1990).

When referring to the “source” of income or expense, the text is describing where that item is includible in income or deducted. If a U.S. firm lends funds to a foreign affiliate, the resulting interest income is taxed in the United States; the fact that for U.S. foreign tax credit purposes that income is described as “foreign source” does not alter where it is taxed, but rather (under the unique conceptual confusions of the current U.S. system) simply makes it more likely that the income will be sheltered from tax anywhere in the world through the use of the cross-crediting techniques described earlier in this article.

124. See, e.g., Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 291, 305–43 (2010). Graetz, *A Multilateral Solution*, *supra* note 123, 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.

Such a solution would be very desirable, but if one is going to hypothesize that it is realistic, why not also hypothesize that worldwide agreement can be obtained on formulary apportionment of all components of taxable income? As we have few examples today of functional multilateral income tax treaties outside the special (and limited) case of the European Union, it would be desirable to develop more immediate solutions that look to unilateral action.

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 according to some economically rational set of agreed-upon 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 sales to German advertisers are deducted by those customers on their 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. Stateless income planning thus poses dramatic challenges for the design of international tax systems.<sup>125</sup>

### *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

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125. Michael Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, 24 OXFORD REV. ECON. POL'Y 698, 713 (2008) ("Identifying where profit is generated is a fundamental problem of conventional corporation taxes in an international setting. In some ways it is a problem with which the world has learned to live, even though allocating profit among source countries is in practice a source of great complexity and uncertainty. But this problem is not just one of complexity and uncertainty: it can — and perhaps should — also affect the fundamental design of the tax system.").

country net income tax effectively is the final tax on cross-border investment income.<sup>126</sup> As a result, one should 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 will withdraw capital from those where returns are below normal.<sup>127</sup> But corporate income tax 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 returns, by redirecting pre-tax income from the high-tax country to the low-tax one.<sup>128</sup> By doing so,

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126. This view is consistent with the facts 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.

127. The standard view in economics presentations is that under the conditions suggested by the text, net business income earns the same after-tax (not pre-tax) risk-adjusted returns around the world. *See, e.g.*, George Zodrow, *Capital Mobility and Capital Tax Competition*, 63 NAT’L TAX J. 865, 881 (2010); Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203, 211, 213–14 (2007).

These points are developed at greater length in the companion paper, *The Lessons of Stateless Income*, at Sections III.A. and C. *But see* Michael Knoll, *Reconsidering International Tax Neutrality*, U. Penn. L. School Research Paper No. 09-16 (May 2009), <http://ssrn.com/abstract=1407198> (arguing from counterfactual case of true “worldwide” taxation of net business income).

128. 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 supra* note 126. Since much cross-border investment today is portfolio investment, there is no particular reason to assume that direct



multinational firms can be said to capture “tax rents.” 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, capital is globally mobile, and capital markets are efficient. As a result, *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 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 example 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.<sup>129</sup> U.S. firms thus prefer investments in foreign

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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 *The Lessons of Stateless Income*, 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, it seems implausible to think that market forces by themselves would be sufficient to vitiate the “tax rents” story developed in the text.

129. 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. I.R.C. §§ 954(a)(1), (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 section 954(c)(6), which specifically excludes from subpart F income dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation . . . to the extent attributable or properly allocable (determined under rules similar to the rules of

high-tax countries to investments in the United States because the former are more easily employed in stateless income planning. The income already is foreign source, and straightforward earnings stripping technologies that are unavailable for domestic income can be used to move that income to a low-tax affiliate.<sup>130</sup>

The net effect 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 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.

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.<sup>131</sup> But this argument confuses U.S. investment with U.S. taxable income.<sup>132</sup> To a foreign-domiciled multinational firm, the

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subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.

I.R.C. § 954(c)(6). The section 954(c)(6) look-through provision is a temporary provision that recently was extended through 2011.

130. For example, interest income paid by a U.S. affiliate to a controlled foreign corporation may be subject to withholding tax in the absence of tax treaty protection (I.R.C. § 881(c)(3)(C)), and in any event gives rise to U.S.-source subpart F income, usually as foreign personal holding company income (I.R.C. § 954(a)(1), (c)), or alternatively as an investment in U.S. property under section 956) Foreign income taxes in turn are not creditable against U.S. source income. Moreover, “check-the-box” tax planning is generally not available to move income from a U.S. parent group to an offshore affiliate. None of these limitations apply when the income originally is earned outside the United States.

131. For a summary of the research underlying this counterargument, see James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 280 (2008-2009) [hereinafter Hines, *Reconsidering the Taxation of Foreign Income*].

132. *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

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

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U.S.-domiciled multinational groups in respect of the U.S. tax base have substantially disassociated investment from taxable income.

In one fairly recent study on earnings stripping 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. DEP'T. TREAS., REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES, at 3 (Nov. 2007). ("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), <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.

The Treasury study can be criticized as having taken an excessively narrow view of earnings stripping as comprising only the excessive use of deductible interest. *See, e.g.*, the Treasury study at 7 ("Earnings stripping usually refers to the payment of excessive deductible interest by a U.S. corporation to a related person when such interest is tax exempt (or partially tax exempt) in the hands of the related person. Consequently, the Treasury Department has [studied] . . . the shifting of income of domestic corporations offshore through related-party debt and associated interest payments."). This would ignore, for example, the entirely straightforward decision of a foreign acquiror to keep its valuable intangible assets outside the United States and to license them to its new U.S. subsidiary.

For a more complete picture of the role of interest expense in the tax liabilities of foreign-controlled domestic companies, *see* Harry Grubert, *Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States* (U.S. Dep't Treas. OTA Technical Working Paper No. 1, 2008) (finding no evidence of systematic earnings stripping through interest deductions). One interesting observation made by Grubert is that his "control" population comprised U.S. multinational enterprises. *Id.* at 6. To the extent that the control population were themselves enthusiastic users of earnings stripping opportunities, the foreign-controlled domestic companies studied by Grubert could appear normal in their behavior, while in fact engaging heavily in earnings stripping.

the arts of stateless income planning when it is the United States that is the source country. Moreover, the same researchers who argue that foreign investment into the United States serves as a substitute for U.S. investment that has moved offshore also argue for a positive “headquarters” effect, in which investment by a firm generates investment (and income) associated with its headquarters operations in addition to those associated with the incremental investment itself.<sup>133</sup>

Notwithstanding the existence of some statutory protections against earnings stripping,<sup>134</sup> and the ambiguous studies of earnings stripping through internal group leverage noted immediately above, there thus are good reasons to believe that the United States is a net revenue loser in respect of cross-border investment flows. 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. 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.

### *C. Domestic Base Erosion Through Tax Arbitrage*

A U.S. firm’s stateless income tax planning yields inframarginal tax rents. These rents come at a contingent cost, however: they can be enjoyed only if the earnings are retained outside the United States. This gives rise to the “lock-out” phenomenon discussed below.

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 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. As the earlier example of Microsoft Corporation’s recent debt financing suggests, this arbitrage operation is not a theoretical abstraction.

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133. See, e.g., Mihir Desai, C. Fritz Foley & James R. Hines Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J. ECON. POL’Y 181 (2009) (10 percent greater foreign investment is associated with 2.6 percent greater domestic investment).

134. See I.R.C. § 163(j).

As described earlier, a few special rules exist whose nominal purpose it is to limit this arbitrage — in particular, those that treat a fraction of U.S. interest expense as a reduction in foreign income. By doing so, the limitation works to increase a firm's effective foreign tax rate on its repatriated income, thereby making it more difficult to claim foreign tax credits. In practice, however, this limitation often does not constrain the full deductibility of U.S. interest expenses. Stateless income planning in general makes current law's limitation less effective, because that planning drives down foreign effective tax rates (thereby increasing a firm's capacity to absorb the operation of the limitation). In turn, the tax director, in her capacity as master blender of the tax distillery, chooses which casks of foreign income to tap in creating her annual vintage of repatriated income to take this rule into account, and therefore creates a very low-taxed repatriated foreign income blend (including interest and royalty income) that has capacity to absorb the allocation of U.S. expense.<sup>135</sup>

More fundamentally, there are no practical limits beyond those imposed by the marketplace on the amount of debt a U.S. firm can issue to third-party investors and then claim tax deductions for the resulting interest expense. Moreover, there is no rule of current law that directly disallows or defers otherwise-deductible domestic interest expense because it arises on debt that arguably was incurred indirectly to repatriate low-tax foreign permanently reinvested earnings. Given that the United States has high statutory corporate 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 generators, would not complete the tax minimization circle by funding their global cash needs through U.S. domestic borrowings. As an economic matter, the consequence 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 (or at least will soon have) the highest federal statutory corporate tax rate of any of the world's largest economies.<sup>136</sup> Relying in part on this fact, and in part on their assertion that

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135. 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.”).

136. The government of the previous record holder, Japan, had announced plans to reduce its national total (central and sub-central government) corporate tax

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.<sup>137</sup> The data point in a different direction.

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.<sup>138</sup> 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. 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 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.<sup>139</sup> The right statutory rate comparison in that case is the total

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rate to 34.5 percent on April 1, 2011. Those plans were temporarily postponed as a result of that country's devastating earthquake in March 2011.

137. "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. INDUS. COMPETITION & TRADE 137 (2006); Michael Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771 (2009). Michael Knoll kindly called the former paper to my attention.

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.

138. For 2010 data, see OECD Tax Database, Corporate and Capital Income Taxes, Table II.1, [http://www.oecd.org/document/60/0,3746,en\\_2649\\_34897\\_1942460\\_1\\_1\\_1\\_1,00.html#C\\_CorporateCapital](http://www.oecd.org/document/60/0,3746,en_2649_34897_1942460_1_1_1_1,00.html#C_CorporateCapital).

139. 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.

(central and sub-central) foreign tax rate to the U.S. federal statutory rate (35 percent).

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.<sup>140</sup> 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.<sup>141</sup>

More fundamental to the thrust of this article, 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 in Section II suggest that residual U.S. tax today is a small fraction of total foreign earnings. The data summarized in Section III in turn suggest that many 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 to levels far below the foreign tax statutory average.

Taken together, these data imply that the current U.S. tax system is not a direct competitive burden on many U.S. firms' current foreign operations. Instead, the data on cash U.S. tax liabilities, the GAAP financial accounting record (which in turn is the lens through which financial stakeholders perceive a company) and the experience of seasoned legal

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Finally, three states (California, Utah and West Virginia) permit worldwide consolidation and apportionment at the taxpayer's election.

140. Author's calculations from the dataset cited *supra* note 127. 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 8, [http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference\\_report.htm](http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference_report.htm).

141. Author's calculation from data in KPMG Corporate and Indirect Tax Survey 2010, <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.

practitioners alike all 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 interest, royalties and license fee income.<sup>142</sup>

In the same vein, Grubert's recent study of several hundred U.S. multinational firms, employing nonpublic Treasury data, concludes that from 1996 to 2004 there was no meaningful correlation between lower foreign tax rates and the growth rate of U.S. firms.<sup>143</sup> 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."<sup>144</sup>

There is evidence, however, particularly in the public financial statements of affected firms, that the benefits of stateless income tax planning are not evenly distributed across U.S. industries. Some industries enjoy extraordinarily low effective foreign tax rates, while others reap more modest rewards. Those in the latter category (for example, services and retail firms) have reason to believe that the current U.S. tax system for foreign direct investment is an uncompetitive environment for them, if not for other U.S. multinational firms.

By contrast, U.S. firms that do enjoy the benefits of stateless income do not suffer significant U.S. residual tax costs in the aggregate on their regular course repatriations of foreign earnings. Nor do such residual taxes appear measurably to influence the thinking of investors viewing a U.S. firm through the lens of GAAP accounting.

In sum, the interactions across the different components of current U.S. corporate tax law as applied to foreign direct investment offer sophisticated multinational taxpayers, particularly (but not exclusively) those in intangibles-driven businesses, the opportunity to earn income from foreign operations that is taxed no more heavily (and in some cases is taxed more lightly) than is the offshore income of territorial-based competitors. That income is just as susceptible of cash tax minimization through stateless income tax planning as is the foreign income of territorial tax competitors, and that income is reported to shareholders and other stakeholders through financial statements that portray a U.S. firm largely as if it operated under a territorial tax regime. Some U.S. multinational firms have an easier time than do others of generating large quantities of stateless income by virtue of their age or industry, but the example of General Electric Company's effective tax rate serves as an effective reminder that those firms that invest heavily in

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142. The author counts himself as a seasoned, if now superannuated, practitioner, having practiced in the field for 30 years before graduating to a more contemplative career. See also J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*. 59 EMORY L. J. 79 (2009).

143. Grubert, *Foreign Taxes and Domestic Income*, *supra* note 9, at 19.

144. *Id.*



stateless income tax technicians can achieve extraordinary effective tax rate results, and capture tax rents along the way.<sup>145</sup>

The components of U.S. law that interact with each other in ways that can be manipulated to produce territorial-type tax liabilities include deferral, the treatment of each foreign subsidiary as a separate cask of income and credits, foreign tax credit blending across intercompany royalties and interest as well as dividends, cost sharing, check-the-box, and section 954(c)(6) “look through” treatment of interaffiliate deductible payments. These interact in turn in ways favorable to sophisticated firms with global international tax norms like the treatment of a subsidiary as an economic actor separate from its parent company, the honoring of intragroup debt finance, and the arm’s-length standard.

#### *E. Competitiveness of U.S. Firms: Lock-Out*

Over the last several years, economists and tax law specialists have authored dozens of articles addressing how the United States should tax income from foreign direct investments. The volume of literature is inexplicable when viewed against the trivial tax collections currently at issue and U.S. firms’ success in arranging their affairs to operate in a quasi-territorial tax environment. The academic efforts, however, are not necessarily perverse, if measured against the possible welfare costs to the country of roughly \$1.4 trillion in offshore permanently reinvested earnings, some significant portion of which is not necessary to support firms’ offshore operations.<sup>146</sup> The “lock-out” phenomenon that current law engenders may burden firm managers less than they sometimes maintain, but it and related phenomena can nonetheless have material welfare costs for the United States.

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 those U.S. multinational firms that are able to

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145. *See supra* text, at notes 112–13.

146. In this connection, recall that U.S. firms repatriated some \$312 billion in extraordinary dividends in response to the one-year repatriation holiday afforded by section 965, at a time when total permanently reinvested earnings were much lower than the current figure.

engage in widespread stateless income tax planning is not current U.S. taxation of foreign operations, or even current U.S. taxation of ordinary course cash repatriations of low-taxed foreign source income; it is the extraordinary accumulation of profits *and cash* in foreign subsidiaries, and the inability of most firms' tax resources to absorb a very large repatriation dividend. This distorts behavior (for example, by encouraging firms to borrow in the United States and to make relatively unproductive investments outside the United States), and leads to deadweight loss.

A recent business news story illustrates this point effectively. 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, it 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."<sup>147</sup> Another recent article describes how eBay "has 70 percent of its cash outside the US and [as a result] is hunting for acquisitions in Europe."<sup>148</sup>

In theory, the lock-out phenomenon could exist without stateless income strategies, for example, if every country but the United States had taxed corporate income at rates comparable to those of Ireland. In practice, however, the profits recorded for tax purposes in Ireland and similar countries are wholly disproportionate to the size of their economies, which suggests that the lock-out phenomenon in practice is closely bound with stateless income tax planning opportunities.

One popular formulation of the deadweight loss attributable to the lock-out phenomenon is that the U.S. economy has been deprived of the use of U.S. firms' permanently reinvested earnings, presumably to the detriment of job creation and other economic activity in the United States. This formulation of the problem is vastly overstated. To the extent that permanently reinvested earnings are held in liquid financial assets, those assets are highly likely to take the form of U.S. dollar denominated debt instruments, such as U.S. bank deposits, U.S. commercial paper, U.S. government securities and other debt instruments of U.S. obligors.<sup>149</sup> The reason simply is that in each case the U.S. parent company relies on the U.S. dollar as its functional currency for GAAP purposes, and unhedged

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147. Serena Saito, *Tech Companies Go Shopping Abroad*, BLOOMBERG BUSINESSWEEK, Sept. 2, 2010, [http://www.businessweek.com/magazine/content/10\\_37/b4194031986280.htm](http://www.businessweek.com/magazine/content/10_37/b4194031986280.htm).

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

149. The "investment in U.S. property" rules of I.R.C. § 956 are not implicated by the acquisition of debt (or, for that matter, equity) instruments of unrelated U.S. corporations. I.R.C. § 956(c)(2)(F).

investments in other currencies would expose it to income statement volatility through exchange rate fluctuations. For this reason, it can be expected that a large fraction of U.S. firms' liquid permanently reinvested earnings already is employed in the U.S. economy.

Other measures of this deadweight loss have been the subject of spirited debate.<sup>150</sup> Without restating all of that dialog, one practical mode of inquiry into whether the "lock-out" phenomenon imposes substantial costs on U.S. firms from their own perspective 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.<sup>151</sup> 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.<sup>152</sup> Indeed, since contingent residual U.S. taxes on the repatriation of "permanently reinvested" earnings are not recorded as liabilities on U.S. GAAP financial statements (and in many cases are not even quantified in the notes thereto), and since those financial statements are prepared on a global consolidated basis (so that the location of cash or liquid investment assets is not specified) one would expect that prospective lenders in the public capital markets might to that extent overvalue the net worth and liquidity of firms with extensive foreign operations, thereby facilitating borrowings in the United States. When such

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150. 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 (2004) (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 Policy 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 & James R. Hines, Jr., *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 Univ. Centre For Bus. Tax'n, Working Paper No. 09/27), [http://www.sbs.ox.ac.uk/centres/tax/Documents/working\\_papers/WP0927.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/working_papers/WP0927.pdf).

151. Cf. Lisa Bryant-Kutcher, Lisa Eiler & David A. Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Foreign Earnings*, 56 NAT'L TAX J. 705 n. 16 (2008) ("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.")

152. As examples from the Dow Jones Industrial Average companies listed earlier, Hewlett-Packard, Travelers and (until recently) Microsoft.

firms do borrow domestically there is scant evidence that they suffer punitively high borrowing costs.<sup>153</sup>

There is implicit evidence that supports the idea that large U.S. multinational firms with substantial “permanently reinvested” earnings are not capital-constrained in the United States. In 2004, Congress enacted a one-year foreign income repatriation holiday. U.S. firms responded by repatriating \$312 billion in cash dividends in excess of their normal aggregate dividend repatriation rate (about \$50 billion/year).<sup>154</sup> (Most of these repatriations occurred in 2005, but by virtue of the vagaries of differences in corporate fiscal years some took place in 2004 and 2006.) 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 were capital constrained in the United States), but was strongly positively correlated with stock buy-backs.<sup>155</sup>

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153. 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.

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

155. 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, Working Paper No. 15023, 2009), <http://www.nber.org/papers/w15023.pdf> (“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,”); Floyd Norris, *Tax Breaks For Profits Went Awry*, N.Y. TIMES, June 4, 2009, at B1. (“There is no evidence that companies that took advantage of the tax break — which enabled them to bring home, or repatriate, overseas profits while paying a tax rate far below the normal rate — used the money as Congress expected.”); Charles I. Kingson, *The Great American Jobs Act Capers*, 58 TAX L. REV. 327, 388–91 (2005) (unreality of dedicating uses to which repatriated funds could be put in light of fungibility of money). Dell, for example, lobbied for the holiday in order to fund a new plant, bringing back \$4 billion, and only spend \$100 million on the plant, which they admitted they would have built anyway, and then used \$2 billion for share buyback.

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

Perhaps the most that one can say about the costs to U.S. firms of the lock-out phenomenon 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.<sup>156</sup> The cost of deferral therefore probably is rapidly increasing, by virtue of U.S. firms' outstanding record of generating stateless income in the first place.<sup>157</sup>

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 that shareholders are not able to optimize their portfolios, because the 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.

This tension between shareholders and management — the lock-out effect as, in fact, a lock-in effect — probably lies at the heart of current demands by multinational firms that the United States adopt a territorial tax system. The firms themselves are not disadvantaged materially by the current U.S. tax system, but 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.

The very recent report of the President's Economic Recovery Advisory Board (PERAB) is largely consistent with the above analysis. That report began its discussion of the issue by correctly observing that U.S. firms pay little U.S. tax on their foreign operations, but that the "lock-out" problem

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comply with the law by segregating different pools of cash for different corporate expenditures.

156. C. 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).

157. *See supra* text at notes 117–22. *See also* Lisa Bryant-Kutcher, Lisa Eiler & David A. Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Earnings*, 56 NAT'L TAX J. 699, 702–03 (2008) ("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").

nonetheless exists.<sup>158</sup> It then noted that, “because US MNCs have been successful in reinvesting their income abroad and deferring U.S. taxes, this [the U.S. system’s] tax disadvantage may be small. Nevertheless, U.S. companies . . . bear costs that arise from tax-induced inefficiencies *in their financial structure* — costs that their competitors based in territorial countries do not bear.”<sup>159</sup>

As suggested above, this, in fact, is the nub of the real competitiveness issue to the extent one exists. The objective tangible evidence of inefficient financial structures would come in the form of higher borrowing costs for U.S. multinational firms that are compelled to leave cash abroad and borrow domestically. But if that is the concern, then the behavior of U.S. firms with respect to the 2004 legislation’s one-year dividend repatriation holiday is puzzling.

At the same time, the PERAB Report demonstrates the dangers of drawing policy implications from an incomplete meditation on how the U.S. system for taxing foreign direct investment actually operates.<sup>160</sup> In particular, the PERAB report makes three competitiveness arguments that do not follow from its own conclusion quoted above.

The PERAB report first claims that “The combination of lower foreign corporate tax rates and the territorial system of corporate taxation used by other countries reduces the cost of production for foreign firms competing with U.S. companies outside of the U.S. — thus raising the relative cost of U.S. MNCs operating in lower-tax foreign jurisdictions.”<sup>161</sup> But that assertion is belied by the absence of any evidence of actual current U.S. tax burdens, or any adverse U.S. GAAP financial accounting consequence to relying on deferral.

To be sure, U.S. firms maintain disproportionately large tax departments to twist the valves and levers of the tax liqueur blending process, and U.S. firms also find themselves with excess cash outside the United States, and make suboptimal investments to put that cash to use. But those are at best arguments concerning the cost of the lock-out effect, not about day-to-day operational costs in a foreign jurisdiction.

Second, the PERAB Report argues that “The [U.S.] worldwide/deferral approach to corporate taxation favors foreign firms operating in their own country compared to U.S. firms in that country.”<sup>162</sup> If

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158. PERAB Report, *supra* note 33, at 82 (Emphasis added). U.S. companies reportedly have over \$1 trillion of permanently reinvested earnings. The report also states that many business people would repatriate a significant portion of the income if there were another tax holiday or a reduction in the corporate tax rate.

159. *Id.* at 86. (Emphasis added).

160. *Id.* at 82–94.

161. *Id.* at 86.

162. *Id.*

anything, experience suggests exactly the opposite: in many countries it is easier for a multinational firm from a second country to implement stateless income tax planning with respect to the first than it is for a domestic multinational enterprise to strip income out of its home jurisdiction.

Third, the PERAB report argues that “The worldwide/deferral tax approach also puts U.S. MNCs at a disadvantage in the acquisition and ownership of businesses in other countries compared to foreign companies that operate under a territorial approach.”<sup>163</sup> This is a high-level restatement of the capital ownership neutrality argument. If used as a competitiveness argument, it rests on the fundamental misapprehension that the U.S. tax system actually collects significant revenues from firms’ international business operations or impedes their access to capital. In the absence of actual tax costs or adverse GAAP accounting consequences, one is hard pressed to identify any operational disadvantages that flow from the U.S. tax system. And if used to advance a more abstract efficiency argument the argument is undercut by the analysis developed in the companion paper, *The Lessons of Stateless Income*.

#### *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 in practice 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 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 particularly large deadweight losses. 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

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163. *Id.* The PERAB Report uses the example of a foreign company that can pay more than a U.S. company to acquire a firm in a low-tax country because the net-of-tax profits resulting from the acquisition will be higher for the foreign company than for the U.S. bidder.

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.

U.S. firms prefer investments in foreign high-tax countries to investments in the United States because the former are more easily employed in stateless income planning. The result is the first deadweight loss described above.

Firms must invest in foreign low-tax locations solely to create vehicles of a heft adequate to convince tax authorities in high-tax jurisdictions to respect the transactions into which the low-tax affiliate enters. This is particularly acute in the case of cost sharing and other intangible transfer pricing strategies, where tax planners place a premium on moving portable research jobs to the low-tax affiliate, to improve the prospects of prevailing in very large transfer pricing disputes. All of this investment is wasteful.

Firms then must invest significant time and resources in the planning and execution of stateless income strategies. Again, all of this is simply deadweight loss.

Finally, firms can reap the rewards of stateless income strategies for both cash tax and financial accounting purposes only by keeping the resulting profits and cash in their low-tax vehicles. Thus, stateless income planning feeds directly into the lock-out phenomenon.

The lock-out phenomenon is driven by 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. Firms also may ignore U.S. investment opportunities that on a pre-tax basis would be preferred.

The lock-out phenomenon 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 lead 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.

In summary, it is difficult to find genuine evidence that the current U.S. system for taxing foreign direct investment has hobbled the "competitiveness" of U.S. firms, as that term is used, for example, by multinational firms and trade associations in lobbying for another repatriation holiday or a territorial tax system without meaningful constraints. It is not difficult, however, to accept as plausible the thesis that stateless income tax planning and allied phenomena have significant long-term welfare implications for the United States. Those costs are uniquely compounded by the lock-out effect, which is an unavoidable cost of American stateless income tax planning.

#### V. RESPONDING TO A WORLD IMBUED WITH STATELESS INCOME

If stateless income tax planning were expunged and rational source rules generally adopted (including for the source of expenses incurred to fund worldwide activity), 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 for this solution is that the world today offers reasonably liquid and open global markets for savings and investment. One therefore might expect 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.<sup>164</sup> In such a state, a U.S. firm would face the same tax costs for foreign as well as domestic investment (once implicit taxes were considered), and the norm of capital export neutrality would be satisfied.<sup>165</sup> That U.S. firm also would face the same local tax rates as would local competitors (and competitors in third countries that adopted similar comprehensive source rules), thereby satisfying the norm of capital import neutrality. In this state, it would make no sense to add an additional layer of residence-country tax:

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164. This is the central theme of *The Lessons of Stateless Income*.

165. As developed in *The Lessons of Stateless Income*, the idea is that tax capitalization (the bidding up of prices for assets whose returns are tax-favored) will lead to convergence in after-tax risk-adjusted global returns on net business income. "Implicit taxes" are another way of stating the same phenomenon. They simply are the measure of the lower pre-tax return that an investor accepts by virtue of bidding up the price of a tax-favored asset.

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. As Section IV has discussed, 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 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. And, as further described above, stateless income planning compounds the meaninglessness of the entire concept of the “source” of income. How should international tax systems respond?

One suggested answer has been to minimize the importance of the problem. For example, in James Hines’ most recent article recommending that the United States adopt a territorial tax system (and couple that with no expense allocation rules), Hines dismisses the traditional efficiency norm of capital export neutrality as an outmoded framework consumed by “the inefficiencies that may arise from too many factories in tax havens.”<sup>166</sup> If only that were the issue, Hines’ policy prescriptions might survive, even if one quarreled with his underlying reasoning, because one could count on nontax factors to limit investments in bricks and mortar factories across the tax havens of the world. But the issue of course is not that the current U.S. tax system encourages investments in property, plant, and equipment on various islands; it is that the system improperly countenances the relocation of *income* without real investment from high-tax jurisdictions to those low-tax locales. Income wholly disproportionate to investment is the challenge of stateless income.

The companion paper to this, *The Lessons of Stateless Income*, picks up at this point by exploring the implications of stateless income tax planning for standard efficiency norms that are used to evaluate international tax reform proposals. That paper shows that critical assumptions to some of these efficiency norms are irrevocably eroded through the pervasive presence of stateless income. Moreover, tax system design is about more than efficiency models, and in this case in particular the standard efficiency models all tend to a certain level of myopia, under which efficiency along one margin is emphasized to the exclusion of all others.<sup>167</sup> This leads to the

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166. Hines, *Reconsidering the Taxation of Foreign Income*, *supra* note 131, at 282.

167. Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 319, 331–33 (John W. Diamond & George R. Zodrow eds., 2008). Grubert and Altshuler also point out that efficiency

sterile exercise that I previously have described as “the battle of the neutralities.”<sup>168</sup>

*The Lessons of Stateless Income* therefore continues by considering how U.S. international tax policy might be revised as a practical matter, not only to address the lock-out phenomenon (its most obvious deadweight cost today), but also to be robust to the corrosive effects of stateless income tax planning. In each case, the article emphasizes pragmatic solutions for which there are some prospects of both implementation and success. Wishful thinking along the lines of “transfer pricing enforcement must be enhanced”<sup>169</sup> is eschewed.

*The Lessons of Stateless Income* argues that U.S. policymakers today confront a Hobson’s choice between two imperfect and fundamentally opposing policies to address both stateless income tax planning and the deadweight losses associated with the lock-out effect. First, the United States could adopt a territorial tax system that effectively addressed stateless income planning through a radical and comprehensive set of source rules covering both income and expenses. In that case, foreign-source active business income could freely be repatriated without further tax. Alternatively, the United States could adopt a worldwide tax consolidation regime; in that case, foreign-source income earned by U.S.-based multinationals also could be freely repatriated to the United States, because it would have already been taxed by the United States.

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criteria are only part of the process multinational firms face in their foreign investment decisions. They argue, for example, that the capital ownership neutrality principle ignores the critical role of the location of intangible capital, does not address opportunities for income shifting to alter the overall effective tax rates for multinational firms, magnifies opportunities for income-shifting that are unavailable to purely local competitors. *Id.*

168. Kleinbard, *Territorial Taxation*, *supra* note 1, at 555.

169. *Cf.* 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, 954 (2004) (acknowledging that territorial tax systems put additional pressure on transfer pricing enforcement, but not proposing any solutions); James R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 296–97 (2008) (“This Article follows almost all of the preceding literature in taking enforcement matters to be outside the scope of the present inquiry, in large part because the traditional case for worldwide taxation is not presented in those terms.”). In fact, it would seem incumbent on those proposing a new tax system for the United States that so conspicuously puts *additional* pressure on a beleaguered tax enforcement mechanism critical to the protection of the U.S. tax base to propose how that enforcement mechanism could be expected to function in the new environment. And as it happens, at least one article has been published that explicitly relies on the problems of transfer pricing mechanisms in formulating a case for worldwide taxation. Kleinbard, *Taxation*, *supra* note 1, at 548.

For 40 years, public finance economists, legal scholars, and policymakers have debated which solution dominates the other. This article demonstrates that the question cannot be answered in practice without also considering the implications of stateless income for the design of territorial tax systems in particular. Conclusions that are logically coherent in a world without stateless income do not follow once the pervasive presence of stateless income tax planning is considered. *The Lessons of Stateless Income* concludes that the Hobson's choice reduces to one 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 (and ultimately by a more sophisticated approach to the taxation of capital income), the project ultimately concludes by recommending a worldwide tax consolidation solution.