Note

A Comprehensive Approach to Stateless Income

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Abstract

Multinational corporations are drastically reducing their tax burdens through aggressive tax structuring. These tax savings are largely realized through the creation of stateless income, which is income that is taxed in a jurisdiction other than where a corporation is domiciled or where it conducts its business operations. Stateless income can be created through a series of opaque paper transactions among wholly owned subsidiaries that take advantage of incongruences in the international corporate tax framework and peculiarities in U.S. tax rules. The United States currently has a worldwide-based corporate income tax regime, which taxes all income earned by corporations domiciled in the United States. However, the United States defers taxation of income earned by foreign subsidiaries of U.S. parent corporations until that income is made available to the U.S. parent corporation.

U.S.-domiciled multinational corporations create stateless income by shifting income from the United States to wholly owned subsidiaries in low- or no-tax jurisdictions. Once the earnings are shifted abroad, they are in effect locked outside the United States, as corporations are weary of subjecting earnings to relatively high American tax rates. As a result, enormous sums of corporate earnings are locked outside of the United States, totaling an estimated $1.7 trillion. These locked out funds are then not reinvested in the United States, taking away valuable capital and jobs from the U.S. economy. Further,

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stateless income significantly erodes the U.S. tax base, with the U.S. Treasury losing an estimated $82 billion of tax revenue per year due to stateless income structuring.

This Note argues that Congress should move the United States from a worldwide tax regime to a territorial regime that taxes corporate income when it more closely aligns with the United States than with any other nation. Moving to a territorial system better aligns the American corporate income tax system with the current global corporate tax framework, creating greater coherency in international corporate taxation and reducing the instances of double and non-taxation. This Note also argues that to counter the most aggressive tax structuring techniques, Congress should subject wholly owned foreign subsidiaries of U.S.-domiciled corporations to a minimum effective income tax rate of 25%.

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INTRODUCTION

In 2011, Apple, one of the world's most profitable corporations,[1] drastically lowered its tax liability by an estimated $2.4 billion through aggressive tax structuring.[2] Apple cut its tax bill by one third, paying an effective income tax rate of only 24.2%,[3] rather than the United States' top effective tax rate of 35% on corporations.[4] Apple achieved this substantially lower tax liability through the creation of stateless income[5]—income earned by a multinational corporation that is taxed in a jurisdiction other than where the corporation is domiciled or where it conducts its operations.[6] Stateless income is created by a series of complicated intercompany paper transactions that aim to shift income away from the United States, where the income would have been subject to relatively high U.S. corporate tax rates, to low- or no-tax jurisdictions.[7] This sort of structuring can be accomplished largely

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1 Scott Cendrowski, *20 Most Profitable Companies*, FORTUNE, http://archive.fortune.com/galleries/2011/fortune/1104/gallery.fortune500_most_profitable.fortune/8.html (last updated May 10, 2011, 8:38 AM). Apple reported $34.2 billion of pre-tax profits during 2011. Apple Inc., Annual Report (Form 10-K) 43 (Oct. 26, 2011)

2 *See* Martin A. Sullivan, *Apple Reports High Rate But Saves Billons on Taxes*, THE TAX ANALYSTS (Feb. 13, 2012), at 777, 778, *available at* http://taxprof.typepad.com/files/134tn0777.pdf. This number assumes that 50% of Apple's profits were earned in the United States. *Id.* Apple only reported that 30% of its profits were earned in the United States. *Id.* at 777.

3 *See* Apple Inc., *supra* note 1, at 43. Apple's effective tax rate is calculated by dividing Apple's paid U.S. income taxes for 2011 of $8.2 billion by Apple's 2011 net income before taxes of $34.2 billion. *Id.*

4 I.R.C. § 11(b) (2012). Apple is also subject to an 8.84% income tax rate in California where it is incorporated. *See* CAL. REV. & TAX. CODE § 23151(e) (West 2001). Effective tax rates are calculated by dividing total tax expense by pre-tax income. *See* Nishita Roesler & C.J. Getz, *The Effective Tax Rate: Can It be Managed Without Being Analyzed?*, J. INT'L TAX'N, Oct. 2004, at 28, 30. Marginal tax rates refer to the tax rate applied to the next dollar of income. *Marginal Tax Rate*, INVESTING ANSWERS, http://www.investinganswers.com/financial-dictionary/tax-center/marginal-tax-rate-2136 (last visited Feb. 28, 2015).

5 *See* Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, Apr. 29, 2012, Late Edition, at 1.

6 *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 701 (2011).

7 *See id.* at 701–02.

without changing any physical operations, hiring any employees abroad, or shifting sales to customers in other countries.[8]

Currently, the United States has a worldwide corporate income tax regime, under which all income earned by U.S.-domiciled corporations is taxed by the United States.[9] The United States, however, does not tax profits earned abroad by foreign subsidiaries of U.S.-domiciled corporations until those profits are made available to U.S. parent corporations.[10] This creates an incentive for multinational corporations to shift profits away from the United States to subsidiaries in lower-tax jurisdictions,[11] which do not have corporate income tax, like Bermuda.[12] While multinational corporations have traditionally shifted income abroad by moving physical operations to tax-friendly nations, corporations have started to shift income abroad through a series of intricate and opaque intercompany paper transactions.[13] This structuring results in large amounts of corporate profits parked offshore, leaving corporations with two choices.[14] First, corporations can bring these profits back to the United States on an as-needed basis and receive the benefit deferred of taxes,[15] but any repatriation would subject these profits to high U.S. tax rates.[16] Second, corporations can reinvest these earnings abroad.[17] Reinvesting these profits abroad means the profits will not be reinvested in the United States.[18]

Apple is not the only U.S.-based, multinational corporation that considerably lowers its tax burden by creating stateless income. Many prominent multinational corporations, including Google, Yahoo, Cisco, and Microsoft, are aggressively structuring their businesses to

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8 *See id.* Only 30% of Apple's profits were reported as U.S. income, despite Apple having 54% of its long-lived assets, 68% of its retail stores, and 39% of sales in the United States. Duhigg & Kocieniewski, *supra* note 5, at 23. Most of Apple's workforce and key employees were located in California. *See id.*

9 *See* Paul R. McDaniel, *Territorial vs Worldwide International Tax Systems: Which Is Better for the U.S.?*, 8 FLA. TAX REV. 283, 284 (2007).

10 *See* J. Clifton Fleming, Jr. et al., *Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty*, 13 FLA. TAX REV. 397, 452 (2012).

11 *See id.*

12 *Bermuda Highlights 2015*, DELOITTE, 1 http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-bermudahighlights-2015.pdf (last visited Mar. 24, 2015).

13 *See* Kleinbard, *supra* note 6, at 702.

14 *See id.*

15 Deferral means income is taxed at a year later than when earned. *See id.* at 718–19. The deferral of taxes is generally considered economically advantageous. *See infra* note 49.

16 *See* Kleinbard, *supra* note 6, at 718.

17 *See id.* at 763.

18 *See infra* Part II.B.

create stateless income.[19] Stateless income creates two main issues. First, estimates suggest the U.S. Treasury loses $21 to $87 billion a year due to stateless income structuring techniques.[20] The current U.S. budget deficit amplifies the impact of such a significant loss of tax revenues.[21] Second, the U.S. tax system creates a huge incentive for U.S. multinational corporations to keep their stateless income abroad.[22] With corporations having little incentive to bring foreign-earned profits back to the United States, there is now an estimated $1.7 trillion of U.S. corporate profits parked offshore.[23] The $1.7 trillion locked offshore are funds corporations could otherwise reinvest in the United States.[24]

To solve this problem, this Note argues that Congress should pass legislation moving the U.S. corporate tax regime from its current worldwide system towards a territorial-based system.[25] This system would ignore the domicile of corporations and tax income whenever income is more closely aligned with the United States than with any other nation.[26] To counter the most aggressive stateless income schemes, all foreign active income of U.S. controlled foreign corporations ("CFCs") would be subject to a minimum U.S. corporate income tax rate of 25%, less any taxes paid abroad.[27] In addition, the United States should continue efforts to harmonize corporate income sourcing rules with other nations through international cooperation.[28]

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19 *See* Emily Chasan, *At Big U.S. Companies, 60% of Cash Sits Offshore: J.P. Morgan*, WALL ST. J. CFO REP. (May 17, 2012, 3:47 PM), http://blogs.wsj.com/cfo/2012/05/17/at-big-u-s-companies-60-of-cash-sits-offshore-j-p-morgan/; Jesse Drucker, *Google Joins Apple Avoiding Taxes with Stateless Income*, BLOOMBERG BUS. (May 22, 2013, 12:15 AM), http://www.bloomberg.com/news/2013-05-22/google-joins-apple-avoiding-taxes-with-stateless-income.html.

20 The Joint Committee on Taxation estimates $15.3 billion of lost revenue related to foreign deferral of income and $6.2 billion of lost income related to the deferral of active financing income in 2011. STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011–2015 32 (Comm. Print 2012). Controlling for tax rate differences, there was an estimated $87 billion of lost tax revenues in 2002. Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT'L TAX J. 703, 711 (2009).

21 *See infra* Part II.A.

22 *See* Tim Worstall, *Apple's Tim Cook to Propose Profit Repatriation Tax Changes*, FORBES TECH (May 18, 2013, 12:19 PM), http://www.forbes.com/sites/timworstall/2013/05/18/apples-tim-cook-to-propose-profit-repatriation-tax-changes/.

23 *See* Chasan, *supra* note 19.

24 *See infra* Part II.B.

25 *See infra* Part III.A.

26 *See infra* Part III.B.

27 *See infra* Part III.C.

28 *See infra* Part III.D.

I. The Current International Tax Framework and the Creation of Stateless Income

There are nearly as many different corporate taxation regimes as there are countries.[29] Although there are only two basic international corporate tax regimes,[30] each individual system differs from the other, offering little uniformity in the world of international corporate taxation.[31] Sourcing rules provide the general outline of each corporate tax regime;[32] they allocate income to individual nations for the purpose of determining from which country taxable income derived.[33] Understanding the base corporate tax regimes and their sourcing rules is necessary to understanding how corporations create stateless income.

A. The Current International Corporate Income Tax Framework

There are two basic types of international corporate tax regimes.[34] Worldwide-based regimes assign income to countries based on the domicile of corporations.[35] Territorial-based regimes source income based on where the activities that derive the income are located.[36]

1. Worldwide-Based Regimes and the Current U.S. International Taxation System

A minority of developed countries—which includes the United States—use a worldwide-based regime.[37] In a pure worldwide system,[38] all types of foreign income earned by domestic corporations are

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29 *See Tax Guides and Highlights*, Deloitte, https://dits.deloitte.com/#TaxGuides (last visited Mar. 24, 2015). Corporations are typically subject to tax on their income. Income is taxed based on a specified tax rate for certain levels of income. Income is defined as all revenue less any allowable deductions. *See generally* I.R.C. § 63(a) (2012).

30 *See* Barbara Angus et al., *The U.S. International Tax System at a Crossroads*, 30 Nw. J. Int'l L. & Bus. 517, 530–31 (2010).

31 *See* Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 Tul. L. Rev. 125, 127 (2009).

32 *See* Fred B. Brown, *An Equity-Based, Multilateral Approach for Sourcing Income Among Nations*, 11 Fla. Tax Rev. 565, 567 (2011).

33 *See id.* Each country determines their own sourcing rules and more than one country may consider income sourced in their country. *See* Fleming et al., *supra* note 10, at 401.

34 *See* Angus et al., *supra* note 30, at 530.

35 *See id.*

36 *See id.*

37 *See* Philip Dittmer, *A Global Perspective on Territorial Taxation*, Special Report (Tax Found., Washington, D.C.), Aug. 10, 2012, at 2–3, *available at* http://taxfoundation.org/article/global-perspective-territorial-taxation.

38 Worldwide regimes are associated with the theory of Capital Export Neutrality

taxed by the domestic nation in the year income is earned.[39] In order to prevent income from being taxed twice, a tax credit is allowed for taxes assessed by foreign nations on income that is also taxed domestically.[40] The tax credit is limited to the amount of tax owed in the domestic country.[41]

The United States does not have a pure worldwide system. Instead of taxing all income in the year income is earned, current U.S. tax laws defer the taxation of foreign-earned active income until it is made available to the U.S. parent corporation.[42] This deferral leaves multinational corporations with two choices. First, they may bring back earnings to the United States, which will likely subject the earnings to the 35% effective U.S. corporate income tax rate.[43] This option is understandably unattractive due to the United States' relatively high corporate tax rates.[44] The second option is to keep the earnings abroad for reinvestment, usually in the form of foreign acquisitions or new capital projects overseas.[45] Corporations are increasingly keeping income abroad to avoid high U.S. corporate tax rates,[46] resulting in nearly 60% of large corporations' cash being held overseas, totaling an estimated $1.7 trillion.[47] The large stockpiles of cash abroad lowers the amount of funds corporations have for investment in capital projects within the United States, and discourages employment of

("CEN"). James R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 272 (2009). CEN suggests that equal taxation of income earned in different locations removes location-based tax incentives, incentivizing investments to go where they generate the greatest pre-tax returns. *See id.* CEN is associated with market-based outcomes and efficient production incentives. *See id.*

39 *See* McDaniel, *supra* note 9, at 289.

40 *See id.* at 290.

41 *See id.*

42 *See* Fleming et al., *supra* note 10, at 452.

43 *See* I.R.C. § 11(b) (2012).

44 *See* Kleinbard, *supra* note 6, at 718–19. In comparison, the United Kingdom has a top marginal tax rate of 21%, Germany has a top rate of 29.58%, Canada has a top rate of 26.5%, and China has a top rate of 25%. *Corporate Tax Rates Tables*, KPMG, http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx (last visited Mar. 1, 2015).

45 *See* Richard Rubin, *Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax*, BLOOMBERG (Mar. 12, 2014), http://www.bloomberg.com/news/print/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html.

46 For example, Microsoft used foreign-earned funds to purchase Luxembourg-based Skype. *See* Steve Goldstein, *Microsoft-Skype Deal Shows Need for Tax Reform*, WALL ST. J. MARKETWATCH (May 10, 2011, 3:38 PM), http://www.marketwatch.com/story/microsoft-skype-deal-shows-need-for-tax-reform-2011-05-10. Luxembourg's corporate income tax rate is 22%. *Id.*

47 Chasan, *supra* note 19.

U.S. workers.[48] Although this presents difficulties when corporations need cash for use in the United States, corporations still enjoy the benefit of tax deferral for as long as the profits are overseas.[49]

In line with a pure worldwide system, the United States does allow credit for taxes paid in other nations on income that is also taxed in the United States—the foreign tax credit.[50] These rules, however, create tax arbitrage opportunities.[51] For example, parent corporations can purchase equity in their own foreign subsidiaries with debt, then deduct the interest paid on that debt from their U.S. domestic income.[52] The foreign subsidiary then earns income that is not taxable in the United States.[53] The nontaxable income creates a deduction in the United States for the interest paid, without a corresponding source of U.S. income or equivalent foreign tax paid.[54]

2. *Territorial-Based Regimes*

The majority of the world's developed nations currently use territorial-based regimes instead of worldwide regimes.[55] Twenty-seven of the thirty-four members of the Organization for Economic Co-operation and Development ("OECD") have territorial regimes.[56] Territorial regimes ignore the domicile of the corporation earning the income,[57] sourcing income to the jurisdiction where the underlying transaction that derived the income occurred.[58] A nation's specific sourcing rules are especially important in territorial regimes, as there

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48 *See* Kleinbard, *supra* note 6, at 763–64.

49 *See id.* While the impact of the benefit of deferral is debated, most consider the deferral of taxation as beneficial to taxpayers as the time value of money reduces corporations' effective tax rates. *See* Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 205–06 (2009).

50 *See generally* John P. Dombrowski, *Foreign Tax Credits: The Recent Decision in* Proctor & Gamble v. United States *Allows Procedure to Override the Statutory Intent*, 44 U. TOL. L. REV. 405, 408–11 (2013).

51 *See* Kleinbard, *supra* note 6, at 724–25. Tax arbitrage arises when a taxpayer is subject to tax in more than one jurisdiction and the taxpayer uses differences in tax laws between nations to incur a lower net tax liability than if the transaction were subject to only one nation's tax laws. *See* Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555, 560 (2007).

52 *See* Kleinbard, *supra* note 6, at 720–21.

53 *See id.* at 721.

54 *See id.*

55 *See* Dittmer, *supra* note 37, at 3.

56 *Id.*

57 *See* McDaniel, *supra* note 9, at 290–91. In territorial-based systems, foreign investment income of domestic corporations is not excluded from taxation in corporations' home nations. *See id.* This Note is concerned only with active foreign-based income.

58 *See id.*

are many variations of determining where an underlying transaction occurred.[59] The aim of territorial regimes is to tax corporations where they receive benefits from host governments, as well as tying taxation to where corporations actually earn their profits.[60]

B. Stateless Income in Operation

No matter the tax regime, multinational corporations seek to reduce their tax burdens. Traditionally, corporations have lowered their tax liability by taking advantage of capital mobility.[61] Capital mobility involves shifting profits to low-tax jurisdictions by moving abroad physical factors of production, such as manufacturing and labor, as well as pursuing sales in tax-friendly states.[62] Corporations recently, however, have been reducing their tax liabilities through structuring techniques that do not involve moving large portions of the underlying physical attributes of their company or its transactions.[63] Multinational corporations have been able to reduce their tax liability in this manner by creating what is known as stateless income.[64]

1. Stateless Income Defined

Stateless income is income earned by a multinational group of entities that is subject to tax only in a jurisdiction other than the jurisdiction in which the parent corporation is domiciled, or not in a jurisdiction where the factors of production that created the income are located.[65] Stateless income strategies aim to shift income to jurisdictions with low or no corporate tax rates without changing the physical attributes of the desired transaction.[66] This structuring can be accom-

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59 *See id.* at 291.

60 *See* Brown, *supra* note 32, at 589–93. Territorial-based regimes are commonly associated with the theory of Capital Import Neutrality ("CIN"). *See* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 104 (2011). CIN posits that an investment should be taxed at the same total rate regardless of the location of the investor that earned the income. *See* Hines, *supra* note 38, at 273. CIN is thought to promote worldwide welfare because investors will invest based on where their after-tax income will be highest, ensuring consistent returns throughout the global economy. Kleinbard, *supra*.

61 *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575–76 (2000); Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility's Place in Optimal Taxation*, 63 NAT'L TAX J. 843, 844 (2010).

62 *See* Jessica C. Kornberg, Comment, *Section 965: A Traditional Corporate Tax Policy*, 4 BYU INT'L L. & MGMT. REV. 87, 89 (2007).

63 *See* Kleinbard, *supra* note 6, at 702.

64 *See id.*

65 *Id.* at 701.

66 *See id.* at 702. Approximately 45% of all foreign profits earned by U.S.-domiciled cor-

plished largely through a series of paper transactions between wholly owned subsidiaries of a multinational group.[67] In this manner, stateless income divorces income tax planning from actual market realities.[68]

Wholly domestic corporations cannot create stateless income because they lack the structuring capabilities to create these transactions.[69] A multinational corporation can create stateless income whether it is domiciled in a nation with a territorial or worldwide-based regime.[70] Differences in taxation regimes, loopholes in individual taxation systems, and lack of cohesion among tax regimes provide multinational corporations opportunities to create stateless income.

2. *Creation of Stateless Income*

U.S.-based multinational corporations are able to create stateless income due to a confluence of lax income sourcing rules and the U.S. deferral provisions for foreign active income.[71] Although previously corporations employed a number of different stateless income techniques,[72] a common method used today utilizes a mix of cost-sharing and transfer-pricing strategies.[73] Cost-sharing involves transferring a patent developed by the U.S. parent corporation to a subsidiary in a low-tax jurisdiction.[74] The subsidiary's property rights to the patent gives the subsidiary the rights to the profits of that patent, ensuring any future profits from the patent are taxed in the low-tax jurisdiction.[75] Transfer pricing arrangements involve a subsidiary in one jurisdiction selling products or components of products to another entity of the multinational group in another jurisdiction.[76] Corporations

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porations are earned in the low-tax jurisdictions of the Netherlands, Luxemburg, Bermuda, Ireland, and Switzerland. Clausing, *supra* note 20, at 713.

67 *See* Kleinbard, *supra* note 6, at 728 ,733.

68 *See id.* at 702.

69 *See id.*

70 *See id.*

71 *See id.* at 725–26.

72 *See* Kornberg, *supra* note 62, at 90–92. A once-popular method involved subsidiaries in low-tax jurisdictions making loans to parent corporations in high-tax jurisdictions. *See id.* The parent corporation would then deduct the interest paid in the high-tax jurisdiction and report the interest as income in the low-tax jurisdiction. *Id.* The difference in tax rate in the high-tax jurisdiction and low-tax jurisdiction represented a gain for the corporation. *See id.* The United States has passed legislation to try to counter this practice, but more complex transactions have been developed to skirt these laws. *See id.*

73 *See id.* at 90–93.

74 *Id.* at 91.

75 *See id.*

76 *See id.* at 91–92.

must assign prices to each transaction between controlled companies.[77] The prices for each transaction are set at or near the cost of products, allowing corporations to shift income to foreign nations with lower tax rates.[78]

A typical transfer-pricing structure is as follows: Company *A* is domiciled in the United States and Company *B* is domiciled in Ireland. Company *A* and Company *B* are under common control. Company *A* sells a widget for $100 in the United States. Company *B* in Ireland manufactures the widget. Company *B* sells the widget to Company *A* for $99.99. Company *A* then only has $.01 of U.S. income ($100 revenue minus the $99.99 cost of widget). Assigning profits and costs related to intellectual property to a physical location is difficult,[79] allowing corporations with significant intellectual property to shift profits to low-tax jurisdictions, as they are able to price-transfer transactions at or near sales the final sale price.[80]

A popular method of combining cost-sharing and transfer-pricing strategies to create stateless income is the "Double Irish Dutch Sandwich."[81] The aim of this method is to shift earnings from the United States (which typically imposes a 35% corporate tax rate) to Ireland (which has a 10% to 12.5% corporate tax rate), and eventually to a tax

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77 *See id.* An analysis of the benefits of a transfer-pricing arrangement begins with the assumption that commonly controlled entities can have an arms-length transaction with one another. *See* Michael C. Durst & Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Theory*, 57 TAX L. REV. 37, 82–83 (2003). Despite the possible tension in assuming that wholly owned subsidiaries can conduct arms-length transactions, there are other regularly occurring transactions involving long-term cooperative parties, such as those in a joint venture, that are subject to similar market constraints. *See id.* at 100.

78 *See* Kornberg, *supra* note 62, at 91–92.

79 *See* Kleinbard, *supra* note 6, at 705. The challenge of valuing intellectual property is coupled with the difficulty of matching the source of returns to intangible assets, often allowing intangible assets created in high tax jurisdictions to "earn" income in low tax jurisdictions. *See id.*

80 *See* Kornberg, *supra* note 62, at 92.

81 *See* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 399–400 (2013). The "Double Irish Dutch Sandwich" method is especially prevalent among technology companies who can move patents abroad, as seen in recent structuring by Apple, Twitter, Google, and Facebook. *See* Duhigg & Kocieniewski, *supra* note 5, at 23; Tim Worstall, *Of Course Twitter Is Using the Double Irish with a Dutch Sandwich, They'd Be Mad Not to*, FORBES TECH (Oct. 19, 2013, 9:11 AM), http://www.forbes.com/sites/timworstall/2013/10/19/of-course-twitter-is-using-the-double-irish-with-a-dutch-sandwich-theyd-be-mad-not-to/; Robert W. Wood, *Twitter Follows Apple, Google and Facebook to Irish Holy Grail*, FORBES TAXES (Oct. 20, 2013, 10:43 PM), http://www.forbes.com/sites/robertwood/2013/10/20/twitter-follows-apple-google-facebook-to-irish-holy-grail/.

haven such as Bermuda, which has no corporate income tax.[82] Forest Laboratories' manufacture and sale of Lexapro demonstrates a typical "Double Irish Dutch Sandwich" structure in action.[83]

3. *Forest Laboratories Creation of Stateless Income*

Forest Laboratories is a multinational pharmaceutical manufacturer,[84] which developed and manufactures the popular antidepressant Lexapro.[85] Forest Laboratories, Inc., the parent company of the Forest Laboratories multinational group, is domiciled in the United States.[86] The majority of Lexapro sales are to U.S. customers through the use of U.S. marketing channels.[87] The first step in Forest Laboratories' strategy to create stateless income is to shift income from the sale of Lexapro in the United States, which has a 35% effective corporate tax rate, to Forest Laboratories' Irish subsidiary, which is subject to, at most, a 12.5% tax rate.[88] The Irish subsidiary manufactures Lexapro, using a sublicense of the patent from another Forest Laboratories subsidiary.[89] Forest Laboratories utilizes transfer-pricing rules to shift the income from the U.S. sale of Lexapro to Ireland by having the U.S. parent purchase the physical drug from the Irish subsidiary.[90]

Forest Laboratories then shifts the income from Ireland to the Netherlands.[91] This is accomplished by having the Irish subsidiary sublicense the patent for Lexapro from Forest Financial BV, which is a wholly owned subsidiary domiciled in the Netherlands.[92] The Dutch

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82 *See* Jesse Drucker, *Companies Dodge $60 Billion in Taxes Even Tea Party Condemns*, BLOOMBERG NEWS (May 13, 2010, 3:00 PM), http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html.

83 *See id.*

84 *See* FOREST LABS., INC., 2013 ANNUAL REPORT 2 (2013).

85 *See id.* at 13.

86 *See id.* at 45.

87 *See* Drucker, *supra* note 82.

88 *See id.* The Irish subsidiary is Forest Laboratories Holdings, Ltd., and is wholly owned by the U.S. parent. *See* FOREST LABS., INC, *supra* note 84, at 40.

89 *See* Drucker, *supra* note 82. Five percent of Forest's 5,200 employees were located in Ireland in 2009. *Id.* The Irish subsidiary reported $2.5 billion sales during 2009, which was 70% of the company's $3.6 billion total net sales worldwide. *Id.* Ireland has become increasingly attractive for foreign investment because it has an educated workforce, access to the European Union, and low corporate rates. *See* Ted G. Telford & Heather A. Ures, *The Role of Incentives in Foreign Direct Investment*, 23 LOY. L.A. INT'L & COMP. L. REV. 605, 609–10 (2001).

90 *See* Drucker, *supra* note 82. While not disclosed in financial statements, the U.S. parent likely purchased Lexapro from the Irish subsidiary at or near U.S. sales cost in order to shift as much income as possible away from the United States. *See id.*

91 *See id.*

92 *See id.* Ireland has proposed legislation that would restrict the ability of multinational corporations to avoid taxation through sublicensing arrangements. *See* Caelainn Barr & Theo

subsidiary has no employees in the Netherlands, but reported $1.19 billion in licensing earnings, of which 99.6% are paid as licensing expenses to other wholly owned Forest Laboratories subsidiaries.[93] Forest Laboratories must pass the earnings through the Netherlands because Ireland imposes a 20% withholding tax on certain royalty payments for patents, but exempts the withholding tax if the earnings go to another E.U. member.[94] The Netherlands does not have a similar withholding tax, allowing the Dutch subsidiary to shift the income outside of the European Union.[95]

Forest Laboratories' final step is to shift the income from the Netherlands to a subsidiary in Bermuda.[96] The Dutch subsidiary has a sublicense agreement for the Lexapro patent with Forest Laboratories Holdings Ltd., a wholly owned corporation in Bermuda.[97] All U.S. Lexapro patents are held by this Bermudian subsidiary.[98] Despite having no employees in Bermuda, Forest Laboratories' management designates Bermuda as the corporation's principal place of business for tax purposes.[99] This effectively shifts almost all Lexapro earnings to Bermuda, which has no corporate tax rate.[100]

This structuring has a significant impact on Forest Laboratories' bottom line earnings. In 2012, Forest Laboratories saved an estimated total of nearly $175 million in taxes through its tax structuring and reported an effective tax rate of only 20.9%.[101] Except for manufac-

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Francis, *Ireland Moves to Close One Tax Break and Opens Another*, WALL ST. J. BUS. (Nov. 4, 2014, 8:07 PM), http://online.wsj.com/articles/ireland-closes-one-tax-break-and-opens-another-1415149644. This proposed legislation, however, would only apply to newly-formed Irish corporations and would be phased in over a six-year period for existing corporations. The proposed legislation includes a provision that would allow corporations to pay no tax on income derived from patents, licenses, and other types of intellectual property. *See id.* That provision would still incentivize U.S.-domiciled multinational corporations to shift income abroad through the cost-sharing and transfer-pricing arrangements described in this Note. *See id.*

93 Drucker, *supra* note 82.

94 *See* Zoltan M. Mihaly, *Incentive Planning for Offshore Manufacturing* (pt. 1), J. INT'L TAX'N, Apr. 2004, at 40, 50. The Netherlands has an estimated 13,000 entities "established by foreign multinational corporations for the purpose of channeling financial assets from one country to another." Drucker, *supra* note 82 (internal quotation marks omitted).

95 *See* Kleinbard, *supra* note 6, at 712.

96 *See* Drucker, *supra* note 82.

97 *See id.*

98 *See id.*

99 *See id.*

100 *See* Kleinbard, *supra* note 6, at 712. The Irish and Dutch subsidiaries likely used a U.S. provision that allows these corporations to be considered disregarded entities for taxation purposes, but remain a jurisdictional person for all other aspects of the law. *See* Treas. Reg. § 301.7701-3(b)(2) (2006).

101 *See* FOREST LABS., INC, *supra* note 84, at 62–64. Forest Laboratories reported $1.237

turing Lexapro in Ireland, these savings are completed almost entirely without any foreign direct investment, movement of capital, or change in relationship with third parties.[102] This structuring is entirely legal under the current U.S. tax code, with only transfer-pricing arrangements between the U.S. parent and Irish subsidiary earning IRS scrutiny.[103]

II. The Implications of Stateless Income

Multinational corporations receive significant advantages from stateless income strategies, but these strategies are not without great costs to other actors. As discussed below, (1) the U.S. Treasury directly and indirectly loses tax revenue,[104] (2) the U.S. economy is deprived of funds that may lead to investment and job creation,[105] and (3) competing corporations face steeper effective tax rates than corporations that are able to create stateless income.[106]

A. *Lost U.S. Tax Revenue*

Although it is difficult to determine the exact cost to the U.S. Treasury, it is clear that stateless income has a material effect on the U.S. corporate tax base.[107] Estimates on the yearly loss of tax revenue from stateless income strategies range from $21.5 billion[108] to $87 billion.[109] Given that in 2010 the IRS collected a total of $223 billion of corporate income taxes,[110] any of these amounts would constitute a significant erosion of the corporate income tax base.[111]

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billion in pre-tax income and a 20.9% effective income tax rate, meaning Forest Laboratories paid $175 million less in income taxes than it would have if it were taxed at the U.S. rate of 35%. *Id.*

102 *See* Drucker, *supra* note 82.

103 *See id.* The IRS challenged Forest Laboratories' transfer-pricing arrangements, but the dispute was settled by an amount that did not have a material effect on Forest Laboratories' financial statements. *See id.*

104 *See infra* Part II.A.

105 *See infra* Part II.B.

106 *See infra* Part II.C.

107 *See* Clausing, *supra* note 20, at 711.

108 *See* Staff of Joint Comm. on Taxation, *supra* note 20, at 32. The Joint Committee on Taxation estimates $21.5 billion of lost revenue related to foreign deferral of income in 2011. *See id.*

109 *See* Clausing, *supra* note 20, at 711. Controlling for tax rate differences, there was an estimated $87 billion of lost tax revenues in 2002. *Id.*

110 Internal Revenue Serv., Dep't of the Treasury, Corporation Income Tax Returns 1–2 (2011), *available at* http://www.irs.gov/pub/irs-soi/10coccr.pdf.

111 *See* Fleming et al., *supra* note 10, at 408.

Beyond the straightforward loss of tax revenue created by stateless income, there are also hidden lost tax revenues related to stateless income strategies.[112] Because profits are pushed offshore and corporations need to fund domestic operations, corporations increasingly must use debt financing to fund their operations.[113] Corporations are allowed to deduct interest when determining their U.S. tax liability.[114] This creates a situation where a corporation can reduce its taxable income through interest deductions.[115] However, the benefits created by the debt, such as future income, are not counted as U.S. taxable income due to future stateless income structuring.[116]

The current U.S. budgetary issues amplify the effect of lost revenue from stateless income strategies.[117] While the U.S. deficit has fallen over the past three years, the deficit still stood at $483 billion in fiscal year 2014.[118] Current debt levels are widely seen as unsustainable,[119] as it is estimated federal debt will reach 78% of GDP by 2024, and 106% of GDP by 2039.[120] Persistent U.S. government deficits make recapturing lost revenue from stateless income all the more pressing.

B. Harm to the U.S. Economy

The U.S. tax code defers taxation of foreign-earned income until that income is made available to the U.S. parent corporation.[121] This facet of the U.S. tax code is a major tool in creating stateless income.[122] As a result, mass sums of foreign-earned profits are locked offshore in foreign subsidiaries.[123] Nearly 60% of large U.S. multinational corporations' cash is currently held overseas, amounting to at least $588 billion.[124] Additionally, U.S. multinationals have at least

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112 *See* Kleinbard, *supra* note 6, at 758.

113 *See id.*

114 *See* I.R.C. § 163(a) (2012).

115 *Id.*

116 *See* Kleinbard, *supra* note 6, at 758.

117 *See* Fleming et al., *supra* note 10, at 406–08.

118 *See* Stan Collender, *Stop and Smell the Roses: Final 2014 Federal Deficit Fell. . . Big Time*, FORBES (Oct. 16, 2014, 6:07 AM), http://www.forbes.com/sites/stancollender/2014/10/16/stop-and-smell-the-roses-final-2014-federal-deficit-fell-big-time/.

119 *See* Fleming et al., *supra* note 10, at 406.

120 CONG. BUDGET OFFICE, THE 2014 LONG-TERM BUDGET OUTLOOK 1, 3 (2014), *available at* https://www.cbo.gov/sites/default/files/45471-Long-TermBudgetOutlook_7-29.pdf.

121 *See* Fleming et al., *supra* note 10, at 452.

122 *See supra* Parts I.A–B.

123 *See* Kleinbard, *supra* note 6, at 762–67.

124 Chasan, *supra* note 19.

$1.7 trillion in undistributed foreign earnings that remain abroad.[125] Absent a reparation holiday, which would grant an exemption of income tax on the repatriation of foreign-earned income for some set period of time such as the one granted in 2004,[126] these profits are unlikely to come back to the United States.

Profits locked abroad push reinvestment away from the United States and into foreign countries where the profits will not be taxed when invested.[127] Multinational corporations increasingly use locked-out earnings to purchase foreign companies and invest in labor and manufacturing abroad.[128] Some U.S. multinational corporations have even gone as far as vowing not to repatriate any profits to the United States until the U.S. international corporate tax regime is reformed.[129] The actual impact to U.S. employment is debated and difficult to quantify,[130] but evidence does show that when domestically-based multinational corporations increase production overseas, certain domestic production is displaced.[131] In addition, the lack of available U.S. funds increases borrowing costs for multinational corporations.[132]

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125 *Id.*

126 *See* I.R.C. § 965 (2012). Corporations repatriated approximately $362 billion during the 2004 repatriation holiday. Melissa Redmiles, *The One-Time Received Dividend Deduction*, SOI BULL., Spring 2008, at 102, 103, *available at* http://www.irs.gov/pub/irs-soi/08sprbul.pdf.

127 *See* Kleinbard, *supra* note 6, at 762–63.

128 *See id.* Microsoft purchased Skype, based in Luxembourg where there is a 22% corporate income tax rate, with foreign-earned funds. *See* Steve Goldstein, *Microsoft-Skype Deal Shows Need for Tax Reform*, MARKETWATCH (May 10, 2011, 3:38 PM), http://www.marketwatch.com/story/microsoft-skype-deal-shows-need-for-tax-reform-2011-05-10. Google is investing in a $1.6 billion UK headquarters using unrepatriated profits. Reuters, *Google's Latest $1 Billion Acquisition: A London HQ*, BUS. INSIDER (Jan. 18, 2013, 8:09 AM), http://www.businessinsider.com/googles-latest-1-billion-acquistion-a-london-hq-2013-1.

129 Cisco, which holds approximately 80% of its cash abroad, has been aggressively purchasing only foreign-based entities. Julie Bort, *Cisco Won't Buy Any US Companies or Hire Any US Workers Until the Tax Code Is Changed*, BUS. INSIDER (Feb. 15, 2013, 11:53 AM), http://www.businessinsider.com/cisco-not-acquiring-us-companies-2013-2. Its CEO stated in 2013, "[i]f the majority of our money remains outside the U.S., and this depends on tax policies, that's where you'll see us acquire going forward." *Id.*

130 *See* Kleinbard, *supra* note 6, at 762–66. There is some debate over whether the lock-out effect has a material impact on the U.S. economy. *See id.* at 763–66. Profits from the United States are likely to be in the form of U.S. dollars or other U.S. dollar denominated instruments, and use of these profits will eventually be employed in the U.S. economy. *See id.* at 763–64. Further, many of the companies that employ stateless income strategies typically have low debt ratios and already have high amounts of capital in the United States. *See id.* at 764.

131 JOINT COMM. ON TAXATION, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME, JCX-42-11 78 (2011); PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 85–86 (2010).

132 *See* Kleinbard, *supra* note 6, at 766–68.

The lockout effect also distorts behavior with regards to reinvestment decisions of multinational corporations. Deferral provisions disincentivize multinational corporations from paying dividends to U.S. shareholders[133] and from reinvesting in the United States.[134] The distortions in incentives create deadweight losses as corporations may be forced to seek less efficient opportunities than if they were able to reinvest the profits into the United States or distribute dividends to shareholders.[135]

C. *Uneven Playing Field for Domestic Corporations*

Stateless income negatively affects wholly domestic corporations.[136] Wholly domestic corporations do not have the ability to create stateless income because they do not have any operations or subsidiaries abroad for the necessary structuring.[137] This grants multinational corporations a competitive advantage, as their lower tax burden allows them to offer their customers lower prices on products and services.[138] Similarly, U.S.-based multinational corporations whose businesses do not rely heavily on intellectual property are at a competitive disadvantage when compared to corporations that derive significant incomes from their intellectual property.[139]

III. A Move Towards a Strong Territorial System with a Catchall Rule

Given the scope of stateless income strategies and the negative impact of stateless income on stakeholders, the current U.S. system needs reform. To capture income of multinational corporations into the U.S. tax system more effectively, Congress should reform the U.S. tax code to move the United States towards a territorial system with strong sourcing rules. As a backstop for the most aggressive structuring techniques, controlled foreign corporations should be subject to a minimum effective income tax rate of 25%. Furthermore, the United States should continue to seek greater harmonization of tax regimes through international cooperation.

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133 The lower amount of dividends also distorts shareholder behavior, creating inefficiencies in U.S. shareholder investing decisions. *See id.*

134 *See id.* at 762–63.

135 *See* Joint Comm. on Taxation, *supra* note 131, at 72–73.

136 *See* Kleinbard, *supra* note 6, at 701–02.

137 *See id.*

138 *See id.* This competitive advantage also makes multinational corporations more attractive to investors. *See id.*

139 *See* President's Econ. Recovery Advisory Bd., *supra* note 131, at 85–86.

A. *Shift to a Territorial Regime*

Worldwide coordination of sourcing rules would ensure there are minimal gaps between different sets of sourcing rules and would best capture multinational corporations' incomes.[140] Unfortunately, widespread international cooperation is unlikely.[141] Governments consider their tax systems a crucial aspect of national sovereignty, closely linked to their ability to regulate actors within their borders and fund government operations.[142] Nations often disagree on wide-reaching international tax reform because nations have diverse goals with respect to international tax policy.[143] More developed and wealthier nations typically seek fairness in their regimes and aim to ensure corporations are not able to aggressively skirt tax rules.[144] Wealthier nations also seek to maximize their tax bases.[145] Developing and poorer nations seek to create more attractive tax regimes to lure multinational corporations to their shores[146] and to protect their already limited tax bases.[147] Concerns over national sovereignty and differences in views over appropriate tax systems create huge hurdles in the development of a comprehensive international corporate taxation system.[148]

Due to these difficulties of international cooperation, Congress should reform the U.S. tax code to move the United States from its current worldwide-based regime to a territorial regime.[149] The new regime's sourcing rules would ignore whether the corporation is domiciled in the United States and instead focus on the substance of the underlying transactions.[150] The new regime would tax all corporate income that is derived from activity occurring in the United States.[151] A move towards a territorial system would help give more coherence

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140 *See infra* Part III.D.

141 *See* Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555, 556 (2009).

142 *See id.* at 557–61.

143 *See* Adam H. Rosenzweig, *Thinking Outside the (Tax) Treaty*, 2012 WIS. L. REV. 717, 742–43.

144 *See* Ring, *supra* note 141, at 564–65.

145 *See* Rosenzweig, *supra* note 143, at 743.

146 *See* Ring, *supra* note 141, at 565–67.

147 *See* Rosenzweig, *supra* note 143, at 743.

148 *See supra* notes 141–42 and accompanying text.

149 Moving to a territorial system would be accomplished through legislation reforming a wide net of current tax laws that define the scope of the U.S. corporate taxation system, most notably subchapter F of the tax code. *See* I.R.C. §§ 951–65 (2012).

150 *See* David Hasen, *Tax Neutrality and Tax Amenities*, 12 FLA. TAX REV. 57, 67–68 (2012).

151 *See id.*

to international corporate taxation.[152] The United States' current worldwide-based system is an outlier, as most other developed nations currently use territorial-based regimes.[153] Variations between tax regimes may create double taxation or opportunities for tax avoidance for multinational corporations through stateless income.[154]

For example, under current tax rules, a U.S. corporation that sells a product in the United Kingdom may be subject to taxation in the United States because the corporation is domiciled in the United States, and may also be subject to taxation in the United Kingdom because the United Kingdom may deem the transaction as occurring in the United Kingdom. Similarly, as in a Double Irish Dutch Sandwich structure, corporations can use differences in base sourcing rules to avoid taxation almost entirely.[155] A U.S. system that is more in line with the rest of the world would help ensure that the same sourcing approach is used for all or most transactions, creating a greater likelihood that corporations would be taxed only and at least once on their income.[156] In the described scenario, income would likely be taxed only once, as the similar U.S. and U.K. territorial rules would deem the transaction as occurring only in their country. Furthermore, moving the U.S. tax regime closer to other developed nations sets the stage for future harmonization among international tax regimes.

A territorial-based system would also better match taxation with the benefits corporations receive from operating in the United States. The benefits principle posits that income should be taxed where taxpayers receive benefits from operating.[157] Corporations receive certain benefits from operating in nations, such as access to markets, labor, customers, legal infrastructure, and physical infrastructure.[158] Therefore, according to the benefits principle, taxation should be linked to these benefits.[159] The current U.S. tax regime bases taxation on the domicile of corporations, regardless of whether income has any nexus to the United States or if the corporation receives benefits from

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152 *See* Brown, *supra* note 32, at 579–82 (describing the lack of coherence in the current tax regime).

153 *See* Dittmer, *supra* note 37, at 2. Currently twenty-seven of thirty-four OECD members have some form of territorial international corporate tax regimes, and Japan, the United Kingdom, and Turkey have moved from worldwide to territorial regimes in recent years. *See id.* at 2–3.

154 *See* Brown, *supra* note 32, at 582–85.

155 *See supra* notes 81–103 and accompanying text.

156 *See* Brown, *supra* note 32, at 585.

157 *See id.* at 590.

158 *See id.* at 608.

159 *See id.*

operating in the United States, which ignores the nature and location of corporations' activities.[160] American corporations certainly do receive benefits merely from being domiciled and conducting substantial operations in the United States, but this does not take into account the current global nature of business.[161] American corporations operate all around the world and many of their transactions have little economic nexus to the United States.[162] Subjecting transactions with little to no connection to the United States would not properly match taxation with the benefits of domicile. A territorial-based regime taxes only those transactions in which the transaction has a substantial connection to the territory.[163]

A comprehensive territorial regime with substantial international cooperation would help ensure all income is captured by some developed nation's tax system, but as will be discussed, this solution is unlikely.[164] This likely lack of coherence among sourcing rules may provide opportunities for corporations to find gaps between different nations' sourcing rules.[165] To combat these gaps, strong sourcing rules will be necessary to properly capture income in the U.S. tax net.

B. *Strong Sourcing Rules*

Within a territorial regime, sourcing rules must determine when a transaction is deemed as occurring within a jurisdiction.[166] Due to the likely lack of international coordination of sourcing rules between territorial regimes,[167] strong sourcing rules are crucial in properly capturing income within the U.S. tax system.[168] Multinational corporations are increasingly complex and have the ability to spread their activities across the globe, making associating income to any one physical location very difficult.[169] Due to these difficulties, a sourcing test that is comprehensive and flexible is necessary.

The United States should recognize income as U.S.-sourced when income is more closely aligned with the United States than with any other nation. In determining if income is more closely aligned with

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160 *See* McDaniel, *supra* note 9, at 284.

161 *See* Angus et al., *supra* note 30, at 524–26.

162 *See id.*

163 *See* Kleinbard, *supra* note 60, at 151–52.

164 *See infra* Part III.D.

165 *See* Brown, *supra* note 32, at 584.

166 *See* Kleinbard, *supra* note 6, at 716.

167 *See supra* notes 141–45.

168 *See* Brown, *supra* note 32, at 582–84.

169 *See* Kleinbard, *supra* note 6, at 705, 728–30.

the United States than with any other nation, there would be two factors considered. The first factor is the location where the sale of goods or services occurs. The second factor is the location of the underlying factors of production related to the sale, such as physical infrastructure, location of labor, use of legal and business infrastructure, and use of public safety services.[170] With such broad sourcing rules, there is a substantial likelihood of income being sourced in both the United States and another nation, which would result in double taxation. In order to prevent double taxation, the current foreign tax credit rules would remain in place. Foreign tax credits give corporations a tax credit for any foreign taxes paid on U.S.-sourced income.[171]

The proposed sourcing test is an adaption of a proposal by the European Commission for a pan-European Union "common consolidated corporate tax base" ("CCCTB").[172] The EU proposal has three factors: sales, assets, and labor—all equally weighed.[173] This Note's proposed test collapses the assets and labor factors. Both of these factors are similar in that they are both factors of production used to derive income.[174] In addition, with the likely administrative issues associated with the fact-specific nature of this Note's proposed test, a simpler test with fewer prongs will be easier to administer.[175]

A sourcing standard that taxes income when it is most closely aligned with the United States rather than any other country would best capture income that has an economic nexus with the United States. Such a standard would prevent corporations from artificially

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170 *See* Brown, *supra* note 32, at 608–10.

171 *See* I.R.C. §§ 901–08 (2012). The operation of foreign tax credit rules is very complex with varying regulations and tax treaties affecting the operation of the credit. A complete explanation is beyond the scope of this Note. *See generally* Dombrowski, *supra* note 50.

172 *See* European Comm'n, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121/4 final (Mar. 16, 2011), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf. The Commission's proposal has not yet been passed, as individual E.U. members have been hesitant in relinquishing control over their individual tax policies, but discussions about the proposal are ongoing. *See* Jeremy Fleming, *Furore Over Tax Evasion Opens Door to New EU Proposal on Corporate Tax*, EURACTIV (Nov. 19, 2013, 8:46 AM), http://www.euractiv.com/specialreport-european-corporate/furore-tax-evasion-opens-door-ne-news-531777.

173 *See* European Comm'n, *supra* note 172, at 14.

174 Common ways to source income often differentiate between merely conducting activities in a country and using a country to extract property, capital, or services. *See* Brown, *supra* note 32, at 607–10. Labor is not differentiated from other forms of capital by these measures. *See id.*

175 *See id.* at 623–24.

spreading operations abroad to escape U.S. sourcing rules.[176] On the other hand, a mechanical territorial standard that taxes income if the transaction meets a threshold (e.g., over 50% relation to the United States) is not adequate because corporate operations are spread around the globe, resulting in many transactions that would likely not meet the determined threshold.[177]

The proposed sourcing standard is less arbitrary than a system that allocates a set percentage for given transactions. For example, the United States currently treats 50% of income derived from international communication activities as income in the United States.[178] This method ignores the location of the underlying factors of production of the transaction, such as the location of labor, infrastructure, and other capital.[179] As such, it does not reflect the economic reality.[180] Additionally, if the proposed standard is adopted by other territorial regimes, income will be sourced in one, and only one nation. This result would have the desirable effect of eliminating, or at least limiting, instances of double taxation and nontaxation.[181]

Moving to a territorial system with strong sourcing rules will capture most of the income that is derived from operations in the United States, but corporations may still try to shift profits abroad by using complex transfer-pricing schemes and by spreading operations around the globe. For example, in Forest Laboratories' current Lexapro structure, most Lexapro-associated income would be sourced to the United States under this Note's proposed sourcing rule. Forest Laboratories develops the Lexapro patents largely in the United States, markets Lexapro in the United States, and sells Lexapro primarily to U.S. customers.[182] With these operations located in the United States, income from Lexapro certainly falls under the proposed, "more closely aligned with the U.S." standard. Forest Laboratories, however, could still seek to further stretch their operations around the globe to avoid the proposed tax net. In response to these potential, and likely strategies, a minimum controlled foreign corporate income tax is needed.

176 Critics may claim that the proposed standard is too broad, as it will source income to the United States that is merely incidental to U.S. activity. However, keeping the foreign tax credit will minimize this impact by allowing for credits for taxes paid on income taxed abroad.

177 *See* Kleinbard, *supra* note 6, at 705.

178 I.R.C. § 863(e) (2012).

179 *See* Brown, *supra* note 32, at 625–27.

180 *See id.*

181 *See id.* at 582–84.

182 *See* Drucker, *supra* note 82.

C. *Controlled Foreign Corporations Rule Subjecting Foreign Active Income of Domestic Corporations to a Base Minimum Income Tax Rate of 25%*

Corporations would likely work to spread operations around the globe to avoid even the most stringent sourcing rules. To prevent the most aggressive tax structuring techniques a catch-all rule is needed. Congress should pass legislation that all domestic corporations and their controlled foreign corporations ("CFCs") are subject to a minimum 25% income tax on all foreign-earned active income.[183] If the corporation, or its subsidiaries, has an effective foreign tax rate of 25% or less, then the United States will tax that income at the difference between 25% and the effective foreign tax rate.[184] The current CFC definition will remain, which defines a CFC as any foreign corporation that is 50% or more owned by U.S. shareholders.[185]

The minimum CFC tax ensures that wholly owned subsidiaries that are domiciled in foreign countries pay at least some base tax rate.[186] Because this rule subjects foreign-earned income to U.S. income tax, foreign-earned cash would no longer be constrained by U.S. deferral rules, eliminating the lockout effect and incentivizing corporations to immediately use foreign-earned income in the United States.[187] American multinational corporations may try to avoid the above-proposed sourcing rules, so this rule serves as a catch-all, creating in effect a floor on corporate effective tax rates. In the above-discussed Lexapro example, even if Forest Laboratories was able to avoid the proposed sourcing rules, all of Forest Laboratories' subsidiaries in the "Double Dutch Irish Sandwich" structure will be subject to the CFC minimum tax.[188] All of the Irish, Dutch, and Bermudian subsidiaries are CFCs because they are wholly owned by the U.S. par-

183 Other types of foreign income, such as foreign investment income, would not be subject to the proposed rule. Active income is generally income earned in the ordinary course of business operations, as distinguished from income from investment type activities. *See* Kleinbard, *supra* note 6, at 721–22.

184 The effective tax rate will be calculated in the same manner as in Japan's CFC tax rule, by dividing taxable income by foreign corporate taxes on U.S. taxable income. *See* Yasutaka Nishikori et al., *New Developments in Japan's CFC Rules: Liberalisation, Expansion, and Clarification*, EUROMONEY HANDBOOKS 51, *available at* http://www.jurists.co.jp/en/publication/tractate/docs/euromoney_corporate_tax_handbook.pdf (last visited Mar. 3, 2014).

185 I.R.C. § 957(a) (2012). More specifically, 50% ownership refers to either the total value of stock or total combined voting power of all classes of stock. *Id.*

186 *See* Kleinbard, *supra* note 60, at 146.

187 *See supra* Parts I.A & II.B.

188 *See* Kleinbard, *supra* note 60, at 147. The Lexapro transactions may also be considered U.S.-sourced income under the proposed sourcing rules, which would tax each subsidiary at an effective rate above 25% and the proposed CFC rules would not apply. *See id.*

ent corporation, and would be subject to the 25% tax, as each subsidiary has an effective tax rate less than 25%.[189]

The minimum tax rate of 25% reflects the current worldwide effective corporate income tax rate.[190] Setting the minimum rate at a level equivalent with most other developed nations' corporate tax rates will ensure that the minimum CFC tax is not excessively harsh. Comparatively, the current 35% U.S. effective tax rate is relatively high, and if the minimum CFC tax rate were set at that rate,[191] corporations might shy away from operating in the United States. Corporations that are taxed in other developed nations would likely not be subject to the proposed CFC rule because most other nations have corporate tax rates at or above 25%.[192] Corporations that aim to shift their profits to subsidiaries in low- or no-tax jurisdictions, such as Bermuda, to skirt the proposed sourcing rules will likely still have to pay the proposed CFC minimum tax.[193]

The proposed CFC rule has been implemented in similar forms in other developed nations, most notably in Japan recently.[194] The proposed CFC rule works in practice similar to Japan's current rule, with the main difference being that Japan's minimum tax rate is 20%, as compared to this Note's proposed rate of 25%.[195] As previously discussed, a 25% minimum tax rate is in line with most other developed nations' effective corporate tax rates, and such a level should not push corporations abroad.[196]

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189 *See id.* at 146 (explaining how Japan's tax system captures the income of subsidiaries of Japanese-domiciled parent corporations through CFC minimum tax rate rule similar to the one proposed above).

190 As of 2014, the global corporate effective income tax rate was 23.64%. KPMG, *supra* note 44. The OECD average corporate effective income tax rate was 24.11%. *Id.*

191 *See id.* KPMG lists the U.S. effective tax rate as 40%, taking estimated state and local taxes into account. *See id.*

192 *See id.*

193 *See* Lawrence Lokken & Yoshimi Kitamura, *Credit vs. Exemption: A Comparative Study of Double Tax Relief in the United States and Japan*, 30 Nw. J. Int'l L. & Bus. 621, 642–44 (2010).

194 KPMG Tax Corp., *Japanese Tax Haven (CFC) Rules*, Japan Tax Brief (KPMG Tax Corp., Tokyo, Japan) Aug. 2010, *available at* http://www.us.kpmg.com/microsite/tnf-asiapacific/2010/Japan_August24.pdf.

195 *See id.* Japan's original CFC rule used a 25% effective tax rate, but lowered the rate to 20% as several neighboring countries have rates between 20% and 25%. Nishikori et al., *supra* note 184. Such concerns are not applicable to the United States.

196 *Supra* note 190 and accompanying text. New Zealand and Sweden have similar CFC rules but only apply their CFC rules to subsidiaries operating in certain designated countries that have low tax rates or no corporate income tax at all. *See* Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455, 495 (1999); Jochem Van Rijn, *The New Swedish Holding Company Regime*, 15 J. Int'l Tax'n 54,

D. Increased International Cooperation

International cooperation between developed nations to create a comprehensive system using standardized sourcing rules would be most effective at preventing stateless income structuring.[197] Standardized sourcing rules, or at least coordinated sourcing rules, would create a common basis for taxation that could ensure corporate income is taxed once and only once.[198] A standardized tax base would help close gaps that multinational corporations use to shift profits to low- or no-tax jurisdictions.[199] As previously discussed, however, international coordination of sourcing is unlikely.[200]

Despite these difficulties, the United States should still try to negotiate with other nations to create a more comprehensive international corporate taxation system.[201] Developed nations widely recognize that stateless income is a pressing problem and needs to be addressed in some manner.[202] Efforts to stop stateless income techniques are continually being considered by several international organizations.[203] The United States should continue to negotiate with other nations and international organizations to create a more comprehensive system.

55–56 (2004). Favoring or disfavoring subsidiaries depending on the nation of domicile creates potential political friction, making Sweden's and New Zealand's approach to CFC rules undesirable.

197 *See* Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 522 (2009).

198 In recent years, there has been a shift towards standardizing international financial reporting. *See id.* These standardized rules for determining income, with perhaps some adaptations, could be used to further standardize tax bases. *See id.*

199 *See* Kleinbard, *supra* note 60, at 149–51.

200 *See supra* notes 140–48 and accompanying text.

201 *See* Kleinbard, *supra* note 60, at 149 (discussing a territorial tax system alternative).

202 *See* Angus et al., *supra* note 30, at 519; SOL PICCIOTTO, EUROMEMO GROUP CONFERENCE, TAXING TNCS: WHAT IS WRONG AND HOW TO FIX IT 4 (2013), *available at* http://www2.euromemorandum.eu/uploads/picciotto_taxing_tncs.pdf; David Bradbury, Assistant Treasurer, Australian Treasury, Address to the Tax Institute of Australia's 28th National Convention: "Stateless Income"—A Threat to National Sovereignty (Mar. 15, 2013) (transcript available at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&DocType).

203 OECD has responded to a G-20 mandate with several reports, and currently has a series of deadlines to produce several concrete recommendations. *See* OECD, OECD SECRETARY-GENERAL REPORT TO THE G20 LEADERS, 55–67 (2013), *available at* http://www.oecd.org/tax/SG-report-G20-Leaders-StPetersburg.pdf; Brett Weaver et al., *Global Tax Reform: OECD Efforts on BEPS and Transparency*, TAX NOTES 319, 320–23 (2013), *available at* http://www.kpmg-institutes.com/content/dam/kpmg/taxwatch/pdf/2013/global-tax-reform-beps-tn-102113.pdf. Similarly, the European Union is considering a pan-E.U. approach to reforming corporate sourcing rules. *See supra* European Comm'n, *supra* note 172.

Additionally, a United States move to a territorial regime might influence other nations to make similar reforms.[204] A territorial regime that taxes income when more closely aligned to the United States than with any other country would likely overlap with other nations' sourcing rules and result in corporations being taxed in more than one jurisdiction.[205] It would likely be in the self-interest of other nations to protect their domestically-based corporations from taxation in multiple jurisdictions by aligning their sourcing rules with this Note's proposed sourcing rules.[206] In the interim, this Note's proposed domestic reforms will counter many stateless income structuring techniques until a more comprehensive international system can be developed.

IV. Comparisons with Other Reform Proposals

There is no shortage of proposals to reform the U.S. international corporate tax system. Some propose to keep a worldwide system, but reduce the impact of deferral rules for CFCs.[207] Others propose a move towards a territorial system, but differ on how to prevent corporations from aggressively taking advantage of cost-sharing opportunities and transfer-pricing rules.[208] Many of these proposals address several of the problems associated with stateless income, but none take as comprehensive of an approach as proposed in this Note.

A. Proponents of a Worldwide System with Set Percentages

Some propose the United States keep a worldwide system, but reform certain areas of the tax code to prevent stateless income strategies. There are two notable proposals to reform the current U.S. worldwide system in this manner.[209] The first keeps the current deferral rules, but taxes foreign-earned income at U.S. tax rates if that in-

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204 *See* Avi-Yonah, *supra* note 197, at 510.

205 For example, Canada generally taxes nonresident corporations if they are deemed to be carrying on business in Canada. Heenan Blaikie LLP, *Carrying on Business in Canada*, 28 (May 2013), *available at* https://www1.toronto.ca/static_files/economic_development_and_culture/docs/carrying_on_business_in_canada.pdf. Carrying on business includes incorporating a subsidiary in Canada, soliciting orders in Canada, offering anything for sale in Canada, or producing or manufacturing anything, wholly or in part, in Canada. *Id.* These broad sourcing rules would likely overlap with this Note's more closely aligned test.

206 *See id.*

207 *See infra* Part IV.A.

208 *See infra* Part IV.B.

209 *See* KPMG, Analysis of Senate Finance Discussion Draft of International Tax Reform Proposals 2 (2013), *available at* https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/international-tax-reform-draft-analysis.pdf.

come is subject to a foreign tax rate that is below a specified percentage of the U.S. tax rate, tentatively set at 80% of the U.S. corporate tax rate.[210] The second proposal eliminates the current deferral rules and taxes all income of CFCs immediately, but exempts a set amount of income that is derived substantially outside the United States.[211] Both of these systems aim to target corporate income that is substantially earned in the United States but was shifted to low- or no-tax jurisdictions through stateless income structuring.[212] Proponents of either of these plans could argue a shift to a purely territorial system is not necessary, as stronger rules on CFC income would be sufficient to stem stateless income techniques.[213]

Both of the proposed adaptations of the current worldwide system operate in a general matter that is similar to this Note's proposed CFC rule, in that both proposals seek to bring income earned abroad, which is taxed at rates substantially lower than the U.S. corporate tax rate, into the U.S. tax net.[214] Although the two worldwide-based proposals do meet these aims, they do not have all of the benefits of moving to a territorial system. A territorial-based system moves the U.S. corporate tax regime in line with other developed nations' regimes, creating a more uniform basis for determining where income will be taxed.[215] This will create greater coherence within the international corporate framework and reduce opportunities for corporations to shift income to low- or no-tax jurisdictions that have little nexus to that income.[216] Further, a system that uses the same basis to determine where income is taxed reduces the instances of double taxation.[217] On the other hand, keeping a worldwide system will produce

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210 *See* Staff of S. Comm. on Fin., 113th Cong., Title __—Foreign Tax Provisions [Option Y], (Chairman's Staff Discussion Draft 2013), *available at* http://www.finance.senate.gov/imo/media/doc/Chairman%27s%20Staff%20International%20Discussion%20Draft%20Option%20Y.pdf; KPMG, *supra* note 209, at 4.

211 *See* Staff of S. Comm. on Fin., 113th Cong., Title __—Foreign Tax Provisions [Option Z], (Chairman's Staff Discussion Draft 2013), *available at* http://www.finance.senate.gov/imo/media/doc/Chairman%27s%20Staff%20International%20Discussion%20Draft%20Option%20Z.pdf; KPMG, *supra* note 209, at 11. This proposal draft would exempt 40% of this "active foreign income," which would tax foreign-earned active income at 21%. KPMG, *supra* note 209, at 2.

212 *See* William McBride, *Summary of Baucus Discussion Draft to Reform International Business Taxation*, Tax Found. (Dec. 3, 2013), http://taxfoundation.org/blog/summary-baucus-discussion-draft-reform-international-business-taxation.

213 *See id.*

214 *See* KPMG, *supra* note 209, at 2.

215 *See supra* Part III.A.

216 *See supra* Part III.A.

217 *See supra* Part III.A.

more instances of double taxation, which requires the application of complex and cumbersome foreign tax credit rules.[218] Reducing the instances of double taxation through a territorial system, which reduces foreign tax credit application, creates a simpler and easier-to-apply international corporate tax framework.[219]

B. Proponents of a Territorial System with No Controlled Foreign Corporations Rule

Similar to this Note's proposal, some propose to shift towards a territorial system. Advocates of moving towards a territorial system recognize a need to prevent domestic corporations from skirting sourcing rules.[220] This Note proposes a CFC-based rule to respond to this need, but other proposals for moving toward a territorial system respond by taxing "excess income."[221] This rule taxes excess income at U.S. tax rates if that income was derived from the transfer, lease, or license of intellectual property from a U.S. parent corporation to a foreign subsidiary.[222] Excess income is defined as the cost of income plus some predetermined markup, tentatively set at 150%.[223] This proposal is clearly aimed at corporations, such as Forest Laboratories, that have been transferring intellectual property to low- or no-tax jurisdictions to shift income abroad.[224]

The excess income proposal has several issues that this Note's proposed CFC rule would address. By only attacking intellectual property that is transferred away from the United States, the excess income rule only attacks current stateless income techniques.[225] Cor-

218 *See supra* Part III.A.

219 *See* Kleinbard, *supra* note 60, at 113–14. Further, if there is great enough international coordination of sourcing rules, foreign tax credit rules could be greatly simplified. This would reduce the opportunities for interest arbitrage of which many U.S. multinational corporations currently take advantage. *See supra* note 51.

220 *See* Kleinbard, *supra* note 60, at 134–35. Some have referred to these types of regimes as "cartoon territoriality." *See id.* at 136–37.

221 *See, e.g.*, STAFF OF H. COMM. ON WAYS AND MEANS, 112TH CONG., [WAYS AND MEANS DISCUSSION DRAFT] H.R.___, 44–46 (2011), *available at* http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf.

222 PricewaterhouseCoopers LLP, *PKN Alert United States—Obama Administration Releases Draft Legislative Language for Excess Returns and Intangibles Proposals*, TRANSFER PRICING, Oct. 7, 2011, at 2–3, http://www.pwc.com/en_GX/gx/tax/newsletters/pricing-knowledge-network/assets/pwc-obama-excess-returns-intangibles-proposals.pdf.

223 *See id.* at 3. The cost of deriving income would be determined by current tax and generally accepted accounting principles with the final determination of cost varying greatly based on accounting method used. *See id.* at 3–4.

224 *See FY 2013 Federal Budget Proposals*, CBIZ MHM (Mar. 1, 2012), http://www.cbiz.com/pdfs/CBIZMHM_SpecialReport_FY2013FederalBudgetProposals.pdf.

225 *See* Rosenzweig, *supra* note 51, at 615–16.

porations are innovative in their tax structuring strategies and consistently find new, aggressive means of avoiding tax liability.[226] Therefore, narrowly tailoring a rule to current tax structuring strategies is shortsighted. A simpler, broader rule that attacks all strategies that shift income to low- or no-tax jurisdictions casts a wider net and better prevents future tax avoidance techniques. The proposed CFC rule meets this aim by, in effect, setting a minimum corporate tax rate for all types of income,[227] not just income related to the transfer of intellectual property.

The excess income proposal employs an all-or-nothing approach by subjecting all income that is taxed below a certain rate, and is determined to be in excess of related costs, to U.S. tax rates.[228] In this manner the excess income rule is too broad; there is no middle ground between high U.S. tax rates and the low- to no-tax rates of other jurisdictions.[229] Multinational corporations have operations spread around the globe.[230] Setting a rate between the high U.S. 35% tax rate, tax rates in developed nations, and low rates in tax havens implicitly recognizes that certain income is not entirely derived from the benefits of operating in the United States. Instead, income may be derived from the benefits of operating in many nations, which impose lower tax rates than the United States does.[231] The excess income rule merely subjects all income that falls under the excess income definition to high U.S. tax rates without reflecting the global nature of the income.[232] This Note's proposed CFC rule better reflects the global nature of these transactions by setting a 25% minimum tax rate, as this rate is in line with most other developed nations' tax rates and close to the global average.[233]

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226 *Id.* at 557.

227 *See supra* Part III.C.

228 PricewaterhouseCoopers LLP, *supra* note 222, at 3. The proposed excess income rule technically only applies if the foreign tax rate is not above a set rate, currently proposed at 15%. This still does not provide for much of a middle ground between high U.S. effective tax rates and minimal foreign effective tax rates, as would be created by this Note's proposed 25% CFC minimum tax. *See supra* Part III.C.

229 *See id.* The excess income rule also does not require the involvement of any U.S. person or activity of a U.S. corporation. *See id.* This means excess income would include income from intellectual property arrangements that have no relation to the United States and arrangements that were not intended for tax avoidance purposes. *See id.*

230 *See generally* Kleinbard, *supra* note 6.

231 *See* Brown, *supra* note 32, at 575.

232 PricewaterhouseCoopers LLP, *supra* note 222, at 3.

233 *See supra* note 190.

Conclusion

Multinational corporations are increasingly aggressive in structuring transactions to shift earnings to jurisdictions with much lower corporate income tax rates than the United States. The current U.S. worldwide system creates a strong incentive for corporations to keep foreign-earned profits abroad, which has resulted in an estimated $1.7 trillion of foreign-earned corporate profits locked outside of the United States. This has eroded the U.S. corporate tax base as well as lowered investment in the United States by multinational corporations. Congress should reform the U.S. international corporate income tax regime by moving to a territorial-based regime with strong sourcing rules and by subjecting subsidiaries of U.S. domiciled multinational corporations to a minimum effective tax rate of 25%.