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(65 *Tax Law Review* 99 (2011))

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USC Center in Law, Economics and Organization
Research Paper No. C11-2
USC Legal Studies Research Paper No. 11-7

CENTER IN LAW, ECONOMICS AND ORGANIZATION RESEARCH PAPER SERIES and LEGAL STUDIES RESEARCH PAPER SERIES

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The Lessons of Stateless Income

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I. Introduction

This Article continues the analysis begun in a companion paper, *Stateless Income*.[1] That prior analysis defined "stateless income" as "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 firm's customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company. . . Stateless income thus can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries without shifting the location of externally supplied capital or activities involving third parties."[2]

This Article extends the prior article along two margins. First, it considers the implications of the pervasive presence of stateless income for standard economic efficiency benchmarks by which international tax policy proposals are judged. Second, it analyzes realistic steps that policymakers might take to respond to the phenomenon.

Sections II and III analyze the problems that stateless income poses for standard efficiency benchmarks by first exploring the international tax policy recommendations that might logically be drawn from a hypothetical world without stateless income, and then introducing the phenomenon into the model. The analysis demonstrates that conclusions that are logically coherent in a world without stateless income do not follow once the presence of stateless income tax planning is considered.

More specifically, this Article identifies and develops the significance of implicit taxation as an underappreciated assumption in the standard economic efficiency models that are employed in arguing that the United States ought to adopt a territorial tax system; in doing so, the Article relates the existing domestic implicit tax literature to the transnational context. In this respect, the Article can be seen as extending and formalizing the reasoning of a recent paper by Harry

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[1] Edward D. Kleinbard, Stateless Income, 11 Fla. Tax Rev. 699 (2011).

[2] Id. at 702.

Grubert and Rosanne Altshuler, as well as those of some other authors, who have criticized the economic efficiency arguments for territorial tax systems.[3]

In particular, the "capital ownership neutrality" standard (CON) has much to recommend it in theory, and is based on more sophisticated theories of the multinational firm and the mobility of capital than is the older "capital export neutrality" principle (CEN).[4] But as presented by its developers, the CON principle contains an underappreciated assumption that source country taxation is fully capitalized into the prices of firms operating in that source country. Phrased alternatively, the CON model assumes that multinational firms face a constant after-tax rate of return everywhere in the world, and suffer the same tax burden everywhere, when "tax" for this purpose is defined to include both explicit and implicit taxes. This Article argues that stateless income tax planning vitiates the plausibility of this critical assumption.

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[3] See Harry Grubert & Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, in Fundamental Tax Reform: Issues, Choices, and Implications 319, 331-33 (John W. Diamond & George R. Zodrow eds., 2008). Grubert and Altshuler point out that efficiency criteria are only part of the process multinational firms face in their foreign investment decisions. Id. 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, and magnifies opportunities for income-shifting that are unavailable to purely local competitors. Id.

[4] The term "capital ownership neutrality," closely associated with Mihir Desai and James Hines, came into wide use in their influential paper, Evaluating International Tax Reform, 56 Nat'l Tax J. 487, 494-96 (2003) [hereinafter Evaluating Reform]. See also 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, 956-57 (2004) (discussing CON) [hereinafter Old Rules]. Desai and Hines define CON as the principle that "world welfare is maximized if the identities of capital owners are unaffected by tax rate differences." Desai & Hines, Evaluating Reform, supra, at 488. The term "capital ownership neutrality" appears, however, to have been coined by British economist Michael Devereux. Michael P. Devereux, Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality and All That (Inst. for Fiscal Stud., Working Paper, 1990)(unpublished manuscript on file with *Tax Law Review*) (discussing the potential that productivity levels vary with owners and evaluating the effect of this implication on worldwide welfare).

The usual policy recommendation to achieve CON is for countries to adopt territorial tax systems—that is, not to tax business income earned in source countries. See Jane G. Gravelle, Cong. Research Serv., Reform of U.S. International Taxation: Alternatives 8 (2010), available at http://assets.opencrs.com/rpts/RL34115_20101217.pdf. Alternatively, CON can be achieved if every country adopts a "worldwide" tax system, in which source country profits are taxed currently by the residence country as well, with the residence country mitigating double taxation by permitting resident firms to claim foreign tax credits for source country taxes that they have incurred. Id.

The CON principle has been advanced as the basis of a policy recommendation for the United States to adopt a territorial tax system.[5] But whatever the utility of the paradigm in wholly theoretical models, the full tax capitalization hypothesis on which the CON principle relies cannot describe a world imbued with stateless income. Without the full capitalization of source country taxes in firm valuations, reliance on the CON principle to recommend that the United States adopt a territorial tax system reduces to a plea for a "competitive" international tax framework, by which is meant a system no less generous than those available to firms domiciled in other countries. But that plea, in turn, is little different in practice from a call for trade export subsidies or the like, and strangely ignores the competitiveness of domestic operations.

Section IV briefly considers some other implications of implicit tax analysis in the international tax arena, particularly the differential treatment of explicit and implicit taxes for those countries that (like the United States today) employ a foreign tax credit mechanism to prevent double taxation of foreign income.

Sections V and VI then turn to a consideration of what tax policies might be implemented to respond to a world imbued with stateless income. Section V focuses on the practical implications of stateless income for territorial tax system design, while Section VI does the same for a possible alternative approach, in the form of worldwide tax consolidation. Each direction can fairly be criticized as suboptimal, even when measured against the standards of the quotidian world. Of the two, however, the worldwide tax consolidation approach, if coupled with an appropriately low corporate tax rate (perhaps in the neighborhood of 25-27%) would prove more robust to the corrosive effects of stateless income tax planning, while preserving an authentically competitive environment for both domestic and international activities of U.S. firms.

II. Economic Welfare Benchmarks

Economists have proposed a variety of standards for evaluating a country's policies for taxing income from outbound cross-border investments. The literature in the area is vast, but most of the debates have centered around two questions. First, which is the correct perspective from which to judge the efficiency of a country's international tax regime, its effects on worldwide or on national welfare? And sec-

[5] See Desai & Hines, Evaluating Reform, note 4, at 494; Mihir A. Desai, New Foundations for Taxing Multinational Corporations, 82 Taxes 39, 48 (2004); Desai & Hines, Old Rules, note 4, at 957.

ond, in light of the perspective that is adopted, which is the best benchmark to employ in measuring the success of any such regime?[6]

Shaped in large measure by the frameworks developed by Peggy Musgrave in two early works,[7] the academic consensus for many years was that efficiency should be judged from a worldwide welfare perspective, and that the most robust standard to apply was the benchmark of "capital export neutrality."[8] The choice of worldwide efficiency has been criticized as outdated in a world where the United States no longer dominates cross-border investments as it once did.[9] Nonetheless, that choice retains considerable power. One possible explanation is that the CEN benchmark (which relies on a worldwide welfare perspective) retains substantial intuitive appeal. Another is that it can be argued that in a world of many sovereigns dueling with each other over overlapping source and residence country taxing claims, significant and conspicuous deviations from a worldwide efficiency perspective will simply invite retaliation.[10] A third possible explanation relies on the fact that critical tax concepts like the "source" of income and the "residence" of a corporation are largely artificial constructs; in light of this fact, a worldwide welfare perspective may be less likely to do great harm than a national perspective (which must rely heavily on these artificial concepts to define its field of view).

The continued prominence of the worldwide welfare perspective also owes much to the fact that no single efficiency standard that promotes national welfare has gained many adherents. Musgrave pro-

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[6] For an excellent brief summary of the arguments from an economist's perspective, see generally Rosanne Altshuler, Recent Developments in the Debate on Deferral, 87 Tax Notes 255 (Apr. 10, 2000).

[7] Peggy Brewer Richman, Taxation of Foreign Investment Income: An Economic Analysis (1963); Peggy B. Musgrave, United States Taxation of Foreign Investment Income: Issues and Arguments (1969) [hereinafter Issues]. For a critique of Musgrave's conclusions, see Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, The David R. Tillinghast Lecture, NYU School of Law (Oct. 26, 2000), in 54 Tax L. Rev. 261, 284-94 (2001).

[8] See Graetz, note 7, at 269-74. Graetz points out that in 1962, President Kennedy presented to Congress legislative proposals that would have reflected more accurately CEN norms, but that Congress rejected them. Id. at 273-74. The legislation that emerged was the original enactment of Subpart F, which Graetz describes as a compromise between CEN and capital import neutrality. Id. at 274-75.

[9] See id. at 284-94; James R. Hines Jr., Reconsidering the Taxation of Foreign Income, 62 Tax L. Rev. 269, 270-75 (2009).

[10] See Daniel Shaviro, Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?, 60 Tax L. Rev. 155, 178 (2007) [hereinafter Worldwide Welfare] (analogizing the international tax debate to a prisoner's dilemma, where two sovereigns would both be best served by cooperation and harmonization of tax policy instead of self-interest). More recently, Shaviro has restated his views as more explicitly concerned with national welfare. Daniel Shaviro, The Case Against Foreign Tax Credits, 3 J. Legal Analysis 65, 74-77 (2011) [hereinafter The Case]. This neo-national neutrality argument is considered in Section II.D.

posed a standard that she termed "national neutrality," under which post-foreign tax foreign income would in turn be fully taxed in the United States.[11] As a result, foreign income would be taxed at higher aggregate rates than would domestic income, with the deliberate result that domestic firms would prefer domestic to foreign investments.[12] This particular articulation of national neutrality has been criticized as a simplistic standard that (among other failings) ignores responses by other jurisdictions, and, therefore, is a standard that might well actually not promote national welfare in the long run.[13]

CEN takes as its fundamental economic premise the goal of enhancing worldwide welfare by ensuring production efficiency, which is achieved when the reallocation of production factors from one country to another would not lead to greater output.[14] A state of global production efficiency implies that pretax normal returns are consistent throughout the global economy.[15]

Looking at the investment decisions of a U.S. multinational firm from this perspective, Musgrave concluded that production efficiency could be furthered by taxing all returns earned by a U.S. company, whether directly or through foreign subsidiaries, at the same (U.S.) rate. In that way, the U.S. parent company would make the same after-tax decisions as to where to situate a new investment as it would make in the absence of taxes (subject of course to any wealth effect of the tax burden itself).[16] Thus, CEN is usually advanced as the justification for tax systems that impose "worldwide" taxation on resident

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[11] Daniel Shaviro, The Rising Tax-Electivity of U.S. Corporate Residence, The David R. Tillinghast Lecture, NYU School of Law (Sept. 21, 2010), in 64 Tax L. Rev. 377, 393, 393 n.43; see also Musgrave, Issues, note 7, at 134 (first describing the standard of national neutrality).

[12] See Altshuler, note 6, at 256 n.2.

[13] See Graetz, note 7, at 274-75, 281, 286, 292-93; Hines, note 9, at 273; Shaviro, Worldwide Welfare, note 10, at 158-59. Very recently, Shaviro has written a series of papers arguing for a revival of a more explicitly national welfare approach to international taxation. Those papers are discussed in Section III.D.

[14] See Office of Tax Pol'y, Treasury Dep't, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations 118-19 (2000), available at http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf ("Under capital export neutrality, the foreign income of a U.S. company is taxed at U.S. rates so that the U.S. company pays at least the U.S. rate on its income whether it invests at home or abroad. Capital export neutrality thus eliminates tax as an investment factor."); Michael P. Devereux, Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations, 24 Oxford Rev. Econ. Pol'y 698, 701 (2008) ("CEN implies that (*a*) the international tax system will not distort the location decisions of any individual investor, (*b*) the pretax rate of return in all jurisdictions will be the same (production will be efficiently organized), but (*c*) investors in different jurisdictions may face different post-tax rates of return on their investment, and hence different incentives to save.").

[15] See Altshuler, note 6 at 256; Devereux, note 14, at 701.

[16] See Graetz, note 7, at 285.

companies (however defined), and that pair that worldwide taxation with a foreign tax credit.

Traditionally, the competing worldwide welfare standard to CEN was "capital import neutrality" (CIN). This is the idea that a U.S. firm should face the same tax burden in operating in a foreign country as do its domestic competitors in that foreign country. CIN, therefore, is associated with taxation only by the source country—that is, territorial taxation.[17]

Just as CEN focuses on production efficiency (the idea that firms should locate their investments in productive assets by reference to their pretax returns, not tax-effected income), CIN is said to promote worldwide welfare by ensuring that savers allocate their savings to opportunities in different countries based on the after-tax income that investments in each country offers. This implies that after-tax normal returns will be consistent throughout the global economy.

Some analyses have concluded that, if the United States were to adopt a territorial tax system in which foreign source royalty and interest income were fully taxable in the United States (unlike current law), and in which U.S. interest expense were disallowed to the extent it was allocable to "exempt" foreign income, the effective U.S. residual tax on foreign income actually would increase.[18] This result has been described as demonstrating that a properly-designed territorial tax system actually would be a move towards CEN, when compared with the laxity of current law,[19] or alternatively that the current system is "worse [from a welfare perspective] than [true] exemption."[20]

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[17] The definition of CIN is developed with more precision in Michael S. Knoll, Reconsidering International Tax Neutrality, 64 Tax L. Rev. 99, 119-21 (2011). Since CIN has largely been superseded by the CON benchmark, the point is not developed further in this Article.

[18] See, e.g., Harry Grubert & John Mutti, Taxing International Business Income: Dividend Exemption Versus the Current System 38-39 (2001)("static" revenue estimate based on 1994 data of $7.7 billion/year in increased revenue); Rosanne Altshuler & Harry Grubert, Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations, 54 Nat'l Tax J. 787, 797 (2001) (higher effective tax rate on foreign investment under exemption system with expense allocation than under current law); Harry Grubert, Enacting Dividend Exemption and Tax Revenue, 54 Nat'l Tax J. 811, 816 (2001)(estimating $9.7 billion/year in static revenue gains based on 1996 data).

[19] See Grubert & Mutti, note 18, at 12-13, 38-39.

[20] J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Worse Than Exemption, 59 Emory L.J. 79, 149 (2009) (concluding that the current system, with "deferral, defective income-sourcing and cost-allocation rules, generous transfer-pricing rules, generous cross-crediting, . . . the effective[ ] tax-exempt treatment of many types of foreign-source royalties, and the deduction of foreign losses against U.S.-source income can . . . combine[ ]," from a public policy standpoint, to produce worse-than-exemption results).

In a world where different countries have different tax rates, CEN and CIN cannot both be satisfied simultaneously.[21] At one time, most economists thought that CEN dominated CIN, because empirically firm decisions as to where to situate productive investments empirically are more sensitive to tax rates than are savers' decisions as to where to allocate their savings.[22] To these economists, CIN became a thinly veiled pretext for "international competitiveness," which in turn reduced to a sort of cheerleading for the international success of national champions, regardless of government revenue losses or other efficiency costs. Almost by process of elimination, CEN became the prevailing consensus view of how the United States should view the policy issues surrounding foreign direct investment.[23]

More recent work, however, has brought more nuanced views, shaped in part by rethinking Musgrave's original models in light of the rapid evolution of the global economy and cross-border capital flows.[24] One response has been to reject the idea that a single norm can guide policy, and instead to attempt to evaluate international tax policy simultaneously along several margins.[25]

Another response has been to tease out the logical weaknesses in the prevailing economic benchmarks by which international tax policy has been judged, and to develop alternative standards. The next Part describes one of the most important of these new views, CON, and considers whether its factual premises in fact correspond with current international tax benchmarks. CON deserves close scrutiny both because it has been proposed as a comprehensive new economic standard by which to judge international tax policies, and because it has achieved widespread currency in the current debate over the U.S. system for taxing foreign direct investment.

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[21] See Altshuler, note 6, at 255; Graetz, note 7, at 272.

[22] See Altshuler, note 6, at 257-58; Graetz, note 7, at 285.

[23] For a late comprehensive defense of CEN, see Office of Tax Pol'y, note 14, at 23-53.

[24] See Altshuler, note 6, at 257-58; Devereux, note 14, at 707-11 (reframing Musgrave's traditional approach in light of direct and portfolio investment by firms worldwide, where those firms are required to earn a single post-tax rate of return); see also Graetz, note 7, at 284-94 (critiquing Musgrave's conclusions). Altshuler's critique of Musgrave builds on work done by Thomas Horst, A Note on the Optimal Taxation of International Investment Income, 94 Q.J. Econ. 793 (1980).

[25] See, e.g., Grubert & Altshuler, note 3, at 320 ("The necessity to examine all the important responses to a change in the tax on international corporate income . . . makes it clear that no one-dimensional criterion is useful and that a complete evaluation of any reform proposal is not probably feasible."); Daniel N. Shaviro, Rethinking Foreign Tax Creditability, 63 Nat'l Tax J. 709, 710 (2010) (describing the "inadequacy" of the "battle of the acronyms" approach to international tax policy).

III. Tax Capitalization and Stateless Income

A. A World Without Stateless Income

To appreciate the central role of stateless income in disrupting some policy prescriptions for the taxation of foreign direct investment, consider the following stylized model. The United States taxes U.S. resident firms on their worldwide income (including income earned by foreign subsidiaries) and imposes a 35% tax rate. (This is *not* meant to correspond to how the U.S. tax system actually operates today, which is an ersatz variant on territorial tax systems.[26]) *Sylvania* taxes its multinational enterprises on a territorial basis, so that income earned outside *Sylvania* is taxed only by the source country; the *Sylvanian* tax rate on domestic income is 25%. *Snowdonia* has a territorial tax system like *Sylvania*'s, but a domestic rate of 35%. Finally, *Freedonia* imposes a 10% tax rate on domestic income; its outbound tax system is irrelevant to the examples. For simplicity, assume that all taxes on firm income are imposed at the firm level, so that there are no shareholder taxes or withholding taxes on distributions to foreign owners to take into account.

In this initial model, there is no such phenomenon as stateless income: Net income from business operations is taxed only to the firm earning it, and (with the exception of the U.S. comprehensive worldwide system) only in the source country (that is, where the relevant customers and factors of production that generate the income are located). Moreover, the identity of the source country is unambiguous, which in practice today would exclude many cases involving returns to intangible assets or the location of pure business opportunities. Finally, capital is globally mobile, and capital markets are efficient.

As a preliminary manner, ignore the United States and its genuine worldwide tax system. In this restricted world, all firms face only source country taxes, including on domestic income, which is simply income sourced to the country in which the firm is resident. Under these assumptions, all firms earn the same after-tax normal returns on their investments around the world, because that is the equilibrium price; if after-tax rates of return are higher in *Freedonia* than in *Snowdonia*, investment will leave the latter and flow to the former until equilibrium is achieved.[27] Assume that this global after-tax rate

[26] This is the theme of Kleinbard, note 1, at 702-06.

[27] This is a standard assumption in economics presentations. See, e.g., Altshuler, note 6, at 256 ("Under this tax system, both the pretax and posttax returns to capital will be equal across countries in equilibrium and, as a result, the allocation of capital is efficient."); Devereux, note 14, at 702 (stating investors will shift capital from investments with lower after-tax rates of return to investments with higher after-tax rates of return); George Zodrow, Capital Mobility and Capital Tax Competition, 63 Nat'l Tax J. 865, 881 (2010) ("[S]ource-based tax on capital income . . . would drive out perfectly mobile capital until

is 5%. What this implies is that *pretax* normal corporate returns will vary from country to country, to reflect differences in statutory tax burdens. Pretax corporate returns in *Snowdonia* will be 7.7%, while in *Sylvania* those returns will be 6.67%, and in *Freedonia* 5.56%.

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

Now introduce the United States into the mix, with its hypothetical (and ultimately counterfactual) true worldwide tax system. How

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the nationally or internationally determined after-tax rate of return to capital was achieved . . . ."). Because the text's model abstracts from shareholder-level taxes, we can ignore whether domestic or foreign taxable or tax-exempt investors are the marginal investors in firms.

If, by contrast, one were to posit a world in which net business income was taxed in all events immediately to ultimate individual owners, whether domestic or foreign, then one would expect pretax returns to be equated around the world (and the world's economies to operate in an environment best described as approximating CEN). This essentially is the case today for interest income, because portfolio interest income generally is deductible in source countries, taxed in residence countries, and exempt from withholding tax in source countries. See Staff of the Joint Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 388-94 (Comm. Print 1984). Since a portfolio investor resident in any given country faces the same tax rate on interest from any source, tax is irrelevant to the decision as to which debt instrument to acquire (although of course relevant to the fundamental decision to invest rather than to consume). See Devereux, note 14, at 705. Equilibrium prices, therefore, will correspond to pretax returns. Id. Investors resident in different countries with different tax rates will enjoy different after-tax returns, but each will capture the same after-tax return on otherwise identical debt instruments issued by issuers in different jurisdictions. See id. Differences in tax rates will affect the propensity to invest, and private after-tax wealth, but not prices. Id.

As described later in the text, if world after-tax rates of return on net business income in fact converge, then the traditional benchmarks of both CEN and CIN are satisfied by the universal adoption of territorial tax systems. See Section VI. In that case, the convergence in after-tax returns means that the tax burden on such income is constant, regardless of nominal differences in tax rates, because the total burden includes implicit as well as explicit taxes, and the sum of implicit and explicit taxes will be constant. See text accompanying notes 200-06. But see Knoll, note 17, at 105-06 (arguing from premise of converging pretax global returns, at least in the counterfactual case of comprehensive true "worldwide" taxation of net business income).

would a potential U.S. acquirer fare in the bidding, assuming again that all firms require the same after-tax returns and are price takers in the auction (that is, cannot unilaterally determine the winning bid)?[28] By virtue of the hypothesized genuine worldwide tax environment, U.S. firms face the same tax rate everywhere in the world (ignoring the possibility of excess foreign tax credits), but do not enjoy the same after-tax rate of return on investment as do their competitors in *Sylvania* and *Snowdonia* because pretax rates of returns vary around the world, for the reasons explained above. The result is that a U.S. firm cannot be competitive in bidding for an enterprise in a low-tax jurisdiction like *Freedonia*.[29]

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[28] It is reasonable to assume that worldwide after-tax, rather than pretax, returns converge, even in light of the (ultimately counterfactual) possibility that U.S. firms are taxed on their worldwide income. As developed in the text below, a worldwide tax system can be viewed as imposing a "soak-up" tax on U.S. direct investments in low-tax countries like *Freedonia*. This would put U.S. firms looking to make such a foreign direct investment at a disadvantage, but that does not mean that world rates of return necessarily will diverge from post-tax convergence to accommodate the tax postures of those U.S. firms.

On the other side of the ledger (1) income from foreign direct investment by firms resident in all countries other than the United States is taxed only in the country of source, (2) portfolio investments in corporate firms (whether domestic or cross-border) by investors located everywhere in the world, including the United States, are not taxed on a pass-through basis (and therefore the net income of such firms is taxed only on a source basis), and (3) direct investments by individuals in domestic firms also generally are not taxed on a pass-through basis. The fact that returns on portfolio investments ultimately are taxed in the investor's country of residence is irrelevant. The issue here is whether such an investor would look to pretax or after-tax corporate incomes in judging the attractiveness of competing investments. Since the corporate tax is not refundable or creditable in the hands of the portfolio investor, the answer should be the latter. All of this means that a great deal of the world's capital—including U.S. capital invested through portfolio investments—is competing for rates of return driven by source country firm taxation alone.

In operation, the actual U.S. international tax system is much closer to a territorial tax system than it is to the true worldwide tax system assumed in the text's model. Accordingly, both for the reasons suggested in the preceding paragraph and because there is no major economy in the world that in fact implements a true worldwide tax system, it is reasonable to expect to see in practice today a convergence around the world of risk-adjusted pretax interest income returns, and a similar convergence of after-tax net business income returns. Remaining barriers to capital flows, the "home-country bias" among investors, information and transaction costs, currency considerations, and other factors of course limit the extent to which full convergence is achieved, see Devereux, note 14, at 705, but the important point for the argument in this Article is that the convergence points in the directions noted.

[29] This of course does not mean that, within this hypothetical model of the United States as an outlier imposing true worldwide tax on its firms, U.S. firms would never be competitive anywhere in the world. The prices of U.S. domestic target firms would reflect the 35% U.S. tax rate, whether viewed from the perspective of U.S. bidders (for which the 35% rate in this hypothetical also is the worldwide rate), or from the perspective of foreign bidders (for which it is the source country rate). And U.S. firms would be competitive in bidding for target firms in high-tax foreign countries, where non-U.S. bidders would face a source country rate comparable to the U.S. rate. It is only when considering target companies in *Freedonia*, or other low-tax countries, that U.S. firms in this hypothetical would be systematically disadvantaged.

Imagine, for example, that both *Sylvania Co*. and *U.S. Co*. want to acquire *Beweave Co*. Ignoring firm-specific synergies and the like, *Sylvania Co*. (or a competing domestic *Freedonian* firm) will be able to bid up to $10,000 for *Beweave Co*. because *Sylvania Co*. incurs no additional tax burden on its investment in *Beweave Co*. as a consequence of the territorial tax system adopted by the *Sylvanian* legislature. *U.S. Co*., by contrast, cannot afford to bid that much: If it were to do so, it would earn the same $556 before tax that *Sylvania Co*. would earn, but only $556 x 0.65, or $361 after tax, as a result of the imposition of U.S. corporate income tax on top of the *Freedonian* 10%.[30] That implies a valuation of the business of only $7,220 in the hands of *U.S. Co*. Even if *U.S. Co*. were uniquely able to raise *Beweave Co*.'s pretax returns by $200 per year, to $756, as a result of *U.S. Co*.'s superior operational skills or better synergies with the target company, *Sylvania Co*. still would be able to outbid *U.S. Co*. for the company.[31] The net result would be that differences in the international tax systems employed by *Sylvania* and the United States would lead to *Beweave Co*. not being acquired by the company that could make the most productive use of it.

This is precisely the dilemma envisioned by Mihir Desai and James Hines in their important paper, *Evaluating International Tax Reform*,[32] and addressed further in several additional papers over the last several years.[33] Those papers develop a new benchmark for measuring whether a country's tax policies governing foreign direct invest-

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30 The *U.S. Co*. group would still bear $56 in *Freedonian* tax, but would obtain a U.S. foreign tax credit for that cost, so that its total tax liability in respect of the *Freedonian* investment would remain a constant 35% rate, or $195 ($56 *Freedonia* tax + $139 U.S. tax). See IRC §§ 901, 902.

31 In a 35% environment $756 in pretax income yields $491 after tax, which remains lower than the $500 that *Sylvania Co*. can earn after tax by virtue of facing only *Freedonian* taxes.

32 Desai & Hines, Evaluating Reform, note 4. Under the Desai and Hines framework, the inability of *U.S. Co*. to acquire *Beweave Co*. is the measure of the potential economic inefficiency that arises from ownership distortions. Id. at 499. Under their theory, tax systems that ensure that the identities of capital owners are unaffected by differences in residence country tax rates permit the market to allocate ownership rights where they are most productive. Id.

33 See, e.g., Desai, note 5, at 48 ("[T]ax rules should be evaluated by the degree to which they ensure that the identities of capital owners are unaffected by tax rate differences, thereby permitting the market to allocate ownership rights to where they are most productive."); Desai & Hines, Old Rules, note 4, at 957 (concluding U.S. taxation of foreign income distorts ownership patterns in the global marketplace and impairs domestic and foreign investments); James R. Hines, Jr., Foreign Income and Domestic Deductions, 56 Nat'l Tax J. 461, 473 (2008) [hereinafter Foreign Income] (concluding tax systems that exempt foreign income and allow domestic expense deductions promote efficient ownership and productivity); Hines, note 9, at 279-80 (arguing current tax system places unneeded transactional costs on multinational firms seeking synergistic efficiencies).

ment advance worldwide welfare,[34] which standard the authors term "capital ownership neutrality." In *Evaluating International Tax Reform,* Desai and Hines argue that the benchmark of CON dominates the standard of CEN,[35] which as noted in Section II previously had been the consensus measure of worldwide efficiency in this area.[36] Similarly, if national rather than worldwide welfare is the preferred perspective, the authors recommend replacing national neutrality as a norm with "national ownership neutrality."[37]

CON and national ownership neutrality in turn are seen as leading to a policy recommendation that the United States should adopt a "territorial" tax system.[38] The specific policy recommendations that are drawn from the latter two principles are essentially identical to each other, and include not only the exclusion of foreign income from a U.S. multinational firm's tax base,[39] but also the decision not to deny or otherwise limit deductions incurred by the U.S. parent company that might be thought to support the generation of that foreign income.[40]

Desai and Hines begin by arguing that the standard presentation of the CEN principle is incomplete.[41] That older principle essentially sees the U.S. firm as the only actor on the world stage.[42] Desai and Hines point out that the traditional CEN model assumes that an investment by a U.S. multinational corporation outside the United States creates a vacuum of investment within the United States, and that this assumption is not supported by logic or empirical evidence.[43]

In their new model, Desai and Hines replace the assumption that foreign direct investment by a U.S. firm creates a domestic investment vacuum with the polar opposite assumption: They assume that outbound direct investment by a U.S. firm is completely replaced by in-

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[34] Desai & Hines, Evaluating Reform, note 4, at 488-89; Desai, note 5, at 48; Desai & Hines, Old Rules, note 4, at 956-57; Hines, Foreign Income, note 33, at 468-69; Hines, note 9, at 275-78.

[35] Desai & Hines, Evaluating Reform, note 4, at 494-96.

[36] See text accompanying notes 4-5.

[37] Desai & Hines, Evaluating Reform, note 4, at 496-97. The analysis that follows in this Part does not generally depend on whether a worldwide or national welfare perspective is adopted, particularly once domestic base erosion issues are considered. For this reason, and because the relevant economic efficiency arguments are more clearly visible when worldwide welfare is the stated objective, this Part principally focuses on a worldwide rather than national welfare perspective.

[38] See Desai & Hines, Old Rules, note 4, at 957.

[39] Hines, Foreign Income, note 33, at 468-69.

[40] Id. at 471-73; Hines, note 9, at 282-85.

[41] Desai & Hines, Evaluating Reform, note 4, at 492.

[42] Id. at 493.

[43] Id. at 493-94.

bound direct investment from a foreign firm.[44] What is more, they assume that the U.S. income tax liability incurred by that inbound investment is identical to the tax revenues that would have been obtained had the U.S. multinational made the domestic investment.[45] They rest this assumption on empirical work undertaken by them and other researchers that demonstrates that foreign direct investment is associated with greater inbound investment,[46] and that foreign direct investment by U.S. manufacturing firms is associated with greater domestic investment by those same firms.[47]

The principal focus of this research, however, seems to be the quantum of domestic *investment*, rather than the U.S. tax paid on the resulting *income*. Harry Grubert, for example, has argued that U.S. multinational firms have systematically eroded the U.S. tax base by tax planning analogous to the stateless income tax strategies considered here;[48] this would suggest that it is important to distinguish more carefully between domestic investment and domestic taxable income.

The Desai and Hines assumption of pure investment (and associated tax liability) complementarity has been criticized.[49] Putting to

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[44] E.g., id. at 496 ("The same circumstances that make CON desirable from the standpoint of world welfare also imply that countries acting on their own, without regard to world welfare, have incentives to exempt foreign income from taxation no matter what other countries do. The reason is that additional outbound foreign investment does not reduce domestic tax revenue, since any reduction in home-country investment by domestic firms is offset by greater investment by foreign firms."); Hines, note 9, at 280 ("There is a flurry of recent evidence suggesting that greater outbound foreign direct investment may not reduce the size of the domestic capital stock, but instead more likely increases it."); see also Desai & Hines, Old Rules, note 4, at 950-53.

[45] Hines, note 9, 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 income and taxable income generally are closely positively correlated. A principal theme of this Article, by contrast, is that stateless income tax planning and analogous strategies employed by U.S.-domiciled multinational groups in respect of the U.S. tax base have substantially disassociated investment from taxable income.

[46] See id. at 280-81 (summarizing empirical research).

[47] 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, 182 (2009) (finding a 10% greater foreign investment is associated with 2.6% greater domestic investment).

[48] Harry Grubert, Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren't Being Globalized, Only Profits 6-8 (Oxford Univ. Ctr. for Bus. Tax'n, Working Paper No. 09/26, 2009), available at *http://web.gc.cuny.edu/economics/SeminarPapers/spring%202010/Grubert_March16.pdf.*

[49] See id. at 4. More generally, see 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). Grubert finds that Desai and Hines grossly overestimate the actual U.S. residual tax on foreign income because they use data for total foreign source income before adjustments for domestic losses. Id. at 263-64. Furthermore, he argues, their assumption that all U.S. residual tax relates to dividend repatriation is inaccurate. Id. at 263. Most of the U.S. tax revenue actually collected in respect of foreign direct investment stems from royalties

one side the efficiency of investment markets, as a pure tax matter, the assumption probably underestimates the possibilities for earnings stripping that are available to a foreign owner of a U.S. firm;[50] in general, it is easier for a foreign owner to engage in earnings stripping than it is for a domestic firm to strip income out of its own country.[51] Nonetheless, this Article accepts this assumption on its face, in order to concentrate instead on another critical assumption in the CON model—the assumption of convergence in worldwide after-tax normal rates of return from business investment, either under the current U.S. tax system or under the recommended territorial tax solution.[52]

Having concluded that the traditional presentation of CEN relies on a simplistic model that assumes that foreign direct investment creates a corresponding vacuum in domestic investment, Desai and Hines consider modern theories of the firm, which emphasize the role of multinational enterprises as platforms from which proprietary intangible assets can be exploited around the world.[53] In such a world, the productivity of assets depends not simply on where they are located, but on who owns them: A local domestic firm, for example, might not be able to exploit a local sneaker factory as productively as could Nike, with its strong trademarks, technical expertise, and worldwide distribution chains.

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or interest that are deductible abroad or activities performed purely in the United States. Id. at 263-64. Grubert therefore concludes that the Desai and Hines recommendations would put U.S. multinationals in a superior competitive position and constitute a large foreign investment subsidy. Id. at 273. For Desai and Hines's reply to Harry Grubert's "spirited comment," see Desai & Hines, Reply to Grubert, 58 Nat'l Tax J. 275, 275 (2005); see also Stephen Shay, Commentary: Ownership Neutrality and Practical Complications, 62 Tax L. Rev. 317 (2009).

50 For an extended discussion on this point, see notes 146-60 and accompanying text.

51 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. IRC §§ 952(a)(2), 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 § 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 subparagraphs (C) and (D) of [§] 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." IRC § 954(c)(6).

The § 954(c)(6) look-through provision is a temporary provision; Congress recently extended it. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 751, 124 Stat. 3296, 3321 (extending look-through provision to January 1, 2012).

52 See Desai & Hines, Evaluating Reform, note 4, at 494-95.

53 Desai & Hines, Old Rules, note 4, at 948-49. For another recent paper that relies heavily on the theory of the firm to structure its tax arguments, see Richard J. Vann, Taxing International Business Income: Hard-Boiled Wonderland and the End of the World, 2 World Tax J. 291, 293-94 (2010).

This in turn leads Desai and Hines to emphasize the theme of "ownership" neutrality.[54] Many corporate investments today take the form of secondary market acquisitions of existing enterprises, but ownership by itself is meaningful only because it conveys claims over productive assets.[55] Because the productivity of assets depends on who owns them, the productivity of a target firm (that is, the bundle of assets over which ownership of the firm conveys control) is not fixed, but rather depends on the identity of the owner.[56]

Building on these insights, Desai and Hines argue that worldwide welfare would suffer in the example with which this Section began if the United States were to employ a genuine worldwide tax system, while other jurisdictions relied on territorial tax systems.[57] As the earlier example demonstrates, a U.S. multinational firm's investment priorities would be unaffected by taxes because it would face a constant (35%) burden wherever its proposed investments were located, but the *Sylvanian* multinational firm would be able to outbid the U.S. firm for a *Freedonian* domestic company, even in cases where the target company would be more productive in the U.S. firm's hands, simply because the *Sylvanian* company would face only the (10%) *Freedonian* tax rate in respect of the returns earned by that target company, rather than its higher home country rates.

One way of summarizing the objections of Desai and Hines to a worldwide tax system would be to imagine that U.S. firms that acquire foreign target companies (but not foreign multinational competitors) are subject to special shareholder "soak-up" taxes equal to the positive difference (if any) between the U.S. corporate tax rate (35%) and the foreign source country's tax rate (10%, in the case of *Freedonia*). In that circumstance, a rational U.S. firm would acquire only U.S. and high-taxed foreign target companies because an acquisition of a low-taxed foreign firm would subject the U.S. acquirer to a soak-up tax that would bring its total after-tax returns in respect of that investment below world market rates. A pure worldwide tax system would operate in exactly this manner,[58] and in doing so would distort the U.S. firm's preferences in auctions for target companies around the world.

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[54] See Desai & Hines, Old Rules, note 4, at 956.

[55] Id.

[56] Id. at 956-57.

[57] See id. at 957.

[58] The text ignores the issue of whether higher-than-U.S. foreign taxes should be refundable by the United States; the answer here, unlike standard presentations of CEN principles, is that those excess foreign taxes should not be refundable because, again, the local source country rates will have been capitalized into prices.

A more accurate way of summarizing their objections, consistent with the analysis developed later in this Article, is that, within the genuine worldwide taxation case posited by Desai and Hines, the U.S. firm would be subject to double taxation, once in the form of *implicit* taxation (embedded in the market capitalization of *Freedonia*'s low tax rate in the price of the *Freedonian* target) and once in the form of *explicit* U.S. tax. But only explicit foreign taxes can be claimed as foreign tax credits; the implicit tax effectively only is deductible, which leads to double taxation (due to lower pretax income).

The CON argument can be seen as a more complete perspective on production efficiency, by including the thought that the productivity of local assets depends not only on where the investment is made, but on which firm owns them, and extending the analysis to encompass the competition of third country bidders for assets. Michael Devereux in turn has extended that perspective further, by proposing the term "market neutrality" to encompass all forms of command over assets, as well as different modes of exploiting them.[59] Devereux defines market neutrality to mean "that taxes should not distort competition (even in a very broad sense) between any companies operating in the same market."[60]

These points can be summarized with a simple metaphor.[61] As a principle of tax policy design, the norm of CEN contemplates that when a U.S. multinational draws up its shopping list of new investment opportunities both inside and outside the United States, that firm's shopping priorities remain unchanged once tax consequences are considered. Desai and Hines extend the principle by requiring that when an auction is held for a firm (or, following Devereux, any asset) located, for example, in a low-tax country, the identity of the winner of that auction will be the same in the world with income taxes as it would have been in the absence of taxes.[62]

Simply leaving the U.S. firm's shopping priorities unaffected would satisfy CEN because the U.S. firm would not prefer a foreign investment over a domestic investment after taking taxes into account if it would have preferred the domestic investment if tax considerations

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59 Devereux, note 14, at 707.

60 Id. at 704. Devereux points out that the requirements of "market neutrality" are more rigorous than those of CON, which can be achieved by an exemption system. Id. at 707. Rather, market neutrality requires full harmonization of the source and residence corporate taxes. Id.

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

62 See Desai & Hines, Old Rules, note 4, at 957; Devereux, note 14, at 717.

were ignored. But this result might not satisfy the test proposed by Desai and Hines, because even if the rank ordering of its preferences were not affected by taxes, the U.S. firm might not be able to bid as much as another high-tax jurisdiction resident company that faces only host country taxes on third country investments. That is the point of the inquiry into the *Freedonian* basket weaving industry with which this Section began.

Large multinational enterprises typically are not capital constrained, because they can borrow funds for most rational new investments in the global capital markets.[63] Not even the largest firms, however, have the management and support capacity to absorb every conceivable investment that might be justifiable as a marginal return on capital.[64] One observation that follows from this presentation, therefore, is that CON does not actually compete as a benchmark with CEN, but rather extends it. The "right" bidder will not emerge at every auction, whether domestic or foreign, unless two assumptions hold: First, the U.S. firm's rank ordering of its shopping priorities must not be affected by taxes (CEN), and second, the U.S. firm must be as competitive as other international bidders for third-country assets or firms (CON). If only the second objective is satisfied, then U.S. firms will be competitive with *Sylvanian* ones in bidding for *Freedonian* domestic companies, but the shopping priorities of U.S. firms will be distorted as between potential foreign and domestic target companies.

Critically, there are only two states of the world that satisfy both standards. Under the first state, all multinational enterprises are taxed on a worldwide basis by the countries in which the parent company is resident.[65] This fact pattern by definition satisfies CEN; Desai and Hines further demonstrate that CON also is preserved, even if residence country tax rates differ, so long as those rates bear a fixed relationship to each other (because then tax rate differences just act as a fixed adjustment to the relative wealth of firms).[66] Desai and Hines rightly observe, however, that this hypothetical state of the world does not describe reality, because territorial tax systems are overwhelm-

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63 See Kleinbard, note 1, at 764; Kane, note 61, at 75 (expressing the same point as in the text, and further arguing that this point substantially undercuts the Desai and Hines analysis, because in Kane's view that analysis considers only relative preferences, and in a world where capital is not rationed firms are not required to trade off ownership of one asset for another).

64 See Hines, note 9, at 276 ("Allocation on the basis of productivity typically does not imply that all assets would be held by a small number of highly efficient owners, since there are limits to the abilities of owners and managers to maintain the productivity of widespread business operations, and therefore benefits to specialized ownership.").

65 Desai & Hines, Evaluating Reform, note 4, at 492.

66 Id. at 494-95.

ingly the most popular design for addressing foreign direct investment.[67]

The second state of the world that would satisfy both requirements that the "right" bidder emerge from the hypothetical auction is the one explicitly developed in the model described at the beginning of this Section: The geographic source of business income (that is, the country to which it appertains) is unambiguous, those returns are taxed only in the source country where they are earned, and after-tax corporate normal returns throughout the world are the same.

Desai and Hines do not fully describe all of their assumptions in one place, but this in fact appears to be the model on which they rely in developing their policy recommendation that the United States adopt a territorial tax system. For example, in a recent article, Hines responds to criticisms that his proposals would be unfair to U.S. domestic firms by arguing that it is fair that the United States not tax the income of a U.S. firm's foreign subsidiary that does business in a zero-tax jurisdiction, while fully taxing the U.S. parent's domestic income, because competition will drive down the after-tax yield in the first jurisdiction to the same level as that of wholly domestic U.S. companies.[68]

Within the model laid out at the beginning of this Part, the Desai and Hines territorial tax policy recommendation makes perfect sense. (As developed below, however, a fundamental thesis of this Article is that, once the model's contrafactual assumptions are relaxed, the policy prescriptions proposed by Desai and Hines no longer would promote worldwide welfare.) What is more, it also follows that, within the confines of the model and the territorial tax implications that Desai and Hines infer from it, Hines can plausibly extend the CON thesis to argue that expenses incurred by the U.S. multinational in the United States should be fully deductible, regardless of whether those

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[67] See id. at 491, 498; Desai & Hines, Old Rules, note 4, at 957; Philip R. West, Across the Great Divide: A Centrist Tax Reform Proposal, 130 Tax Notes 1025, 1043 (Feb. 28, 2011); see also note 26 and accompanying text.

[68] Hines, note 9, at 292-93 ("[T]he zero tax rate in the foreign jurisdiction unleashes foreign competition that reduces the returns that investors can earn locally.").

For another example, see Desai & Hines, Evaluating Reform, note 4, at 495. There the point is made implicitly, in that the authors do not acknowledge that the only reason why after-tax returns might be the same worldwide for all investors would be if stateless income did not exist. Ironically, at the same time they also acknowledge that stateless income (particularly in the transfer pricing abuse context) is an undeniably real phenomenon. See Devereux, note 14, at 713 ("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.").

expenses support a foreign investment that is not subject to U.S. tax.[69] The reason is simple: If the U.S. firm can borrow at an after-tax cost of 5%, and can earn after-tax returns of 5% either in the United States or *Freedonia* (through its acquisition of *Beweave Co*.), there is no tax arbitrage opportunity present.[70] The U.S. firm will bear a 5% after-tax cost of funds wherever it borrows, and earn 5% after tax wherever it invests: In these circumstances, both its borrowing and its investment decisions will be governed entirely by nontax considerations.[71]

Another way of phrasing this conclusion is that, if one starts with source taxation of corporate income (both internationally and domestically) at the level of the corporation as the basic world norm (which is much closer to reality than the alternative starting point of all firms being subject to genuine worldwide taxation of corporate income),[72] and as a result after-tax returns on net business income converge on a single global rate, then that environment without more will satisfy both the benchmark of CEN and of CON, at least as they ordinarily are expressed. CEN will take care of itself because U.S. firms will face the same after-tax returns everywhere, and CON similarly will be satisfied because foreign and domestic investors will face the same after-tax opportunities. The problem that emerges is not with this logic, but rather with the fact that stateless income vitiates the existence of uniform market clearing prices for firms or for business investments.

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69 See Hines, Foreign Income, note 33, at 470 ("A policy that instead limits domestic expense deductions based on indicators of relative foreign and domestic activity or income would effectively tax foreign income, thereby introducing ownership distortions."); Hines, note 9, at 283-85. Hines explains this result in part on fairness grounds from the perspective of the taxpayer. In this argument, a U.S. firm should be indifferent to investing domestically or abroad without tax considerations; otherwise it is not maximizing profits. Id. at 285 ("Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns—and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.").

70 Hines, note 9, at 285, makes this exact argument. His alternative argument is that, if a U.S. firm borrows in the United States to invest abroad, then any resulting investment vacuum will be filled by a foreign firm investing in the United States, so that tax revenues will be made whole. Id. at 284-85. But this effectively assumes that the foreign inbound investment will be wholly equity funded into the United States, but if the inbound investment is debt-financed at all within the United States, then U.S. tax revenues must suffer compared to the status quo ante.

71 See, however, the discussion in Section III.C. on the revenue consequences of arbitrage even in the cases posited by Hines.

72 See notes 28-29.

B. An Implicit Tax Perspective

The policy prescriptions of Desai and Hines hold within the model because it assumes a world of perfect tax capitalization: that is, one where different tax burdens on different investments are reflected in prices, so that all instruments yield the same after-tax risk-adjusted returns. Hines acknowledges as much in passing, in the context of arguing that his proposals do not violate traditional notions of fairness.[73]

Tax capitalization also is described through the language of implicit taxation.[74] For example, imagine that U.S. fully taxable normal returns are 10%, and a high grade tax-exempt municipal bond yields 6.5%, so that both a $1,000 principal amount taxable bond with a 10% coupon and a $1,000 principal amount tax-exempt municipal bond with the same maturity and a 6.5% coupon trade for $1,000. In this case one can say that the different tax burdens have been capitalized into prices, or that the municipal bond's owner bears an implicit tax of 35%, because she accepts a 6.5% rather than 10% coupon.

Implicit taxes are not collected by a government, but instead are reflected in an investor's yield. In this sense, the Desai and Hines model can be described as assuming that all businesses wherever located in the world earn the same after-tax normal rate of return, and suffer the same tax burden, where "tax" for this particular purpose is understood to include *both* explicit and implicit taxes.

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[73] Hines, note 9, at 292-94.

> To the extent that investors are affected by local foreign competition, they incur costs that are associated with the competition triggered by low foreign tax rates. For example, foreign investment attracted by low foreign tax rates will tend to bid up real local wages, increasing the cost of business for all investors. As a consequence, it is more difficult than it would be otherwise for a firm to turn a profit in such a country; to put the same matter differently, an investor in a zero-tax country pays an implicit tax in the form of lower returns produced by market competition.

Id. at 293. Hines also analogizes to tax-exempt state and municipal bonds that may be tax-free and seemingly grant an edge to investors, but actually reach equilibrium after increasing demand lowers market yields. Id.

See J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income, 5 Fla. Tax Rev. 299, 317-18 (2001). These authors offer the implicit tax analysis on which Desai and Hines rely as a hypothetical justification for the policy prescriptions of Desai and Hines, but then conclude that implicit taxes fail the authors' fairness standards because implicit taxes do not fund actual costs of operating a government. Id. This Article takes a different approach, by first identifying the centrality of this assumption to the Desai and Hines model, and then demonstrating that the model's policy prescriptions cannot hold once the pervasive presence of stateless income is considered.

[74] Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Maydew & Terry Shevlin, Taxes and Business Strategy: A Planning Approach 132 (4th ed. 2009); Stanley Koppelman, Tax Arbitrage and the Interest Deduction, 61 S. Cal. L. Rev. 1143, 1172-73 (1988).

Explicit taxes yield genuine transfers to governments. By contrast, implicit taxes can be viewed as a form of government subsidy, when measured from a hypothetical baseline (in the domestic context, for example, a baseline in which investors are fully taxed on municipal bond income). There are clearly visible welfare differences between explicit and implicit taxes in the domestic context once government revenues are taken into account, but those differences are subtler in the international context.

For example, in the international full-tax-capitalization model of the sort assumed by Desai and Hines, the best analogy to the municipal bond example in the domestic context would be the implicit subsidy that *Freedonia* offers to domestic and foreign corporate investors in *Freedonia*, when compared to the United States, by virtue of the 10% rate of *Freedonian* corporate income tax imposed on both domestic and foreign investors.[75] But it is difficult to conclude in fact that the *Freedonian* corporate tax rate is a subsidy rate. There are a great many reasons other than a subsidy (a smaller scope of government services, for example) that might explain the lower *Freedonian* rate. Perhaps for these reasons, most academic analyses of international tax system design, and in particular the thesis of Desai and Hines, seem to focus exclusively on the firm's decision margins. By focusing exclusively on the firm, these analyses trade off implicit taxes at face value against explicit ones. This Article continues along these lines in order to address on its own terms the analysis proposed by Desai and Hines.

There is an extensive literature in the domestic context that explores the twin concepts of tax capitalization and implicit taxation.[76]

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[75] This is a better analogy than the characterization of the arrangements as a subsidy by the United States of foreign investment by U.S. investors for three reasons. First, like the municipal bond case, the objects of the purported subsidy are users of capital (*Freedonian* corporations), not providers of capital; that is, the subsidy could not exist without the lower *Freedonian* corporate tax rate in the first place. Second, the imagined subsidy does not depend on the participation of the United States, unless one postulates that U.S. suppliers of capital are the marginal suppliers to *Freedonian* firms. Third, if tax capitalization is complete, investors in fact obtain no tax subsidy; just as in the municipal bond case, their after-tax returns are identical whether they invest in U.S. or *Freedonian* firms.

[76] See, e.g., Scholes et al., note 74, at 132-60; Eugene Steuerle, Taxes, Loans, and Inflation: How the Nation's Wealth Becomes Misallocated (1985); Alan Auerbach, Should Interest Deductions Be Limited?, in Uneasy Compromise 195 (Henry J. Aaron, Harvey Galper & Joseph A. Pechman eds., 1988); Boris Bittker, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, 16 San Diego L. Rev. 735 (1979) [hereinafter Equity]; Boris Bittker, Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?, 28 Nat'l Tax J. 416 (1975) [hereinafter Tax Shelters]; Charlotte Crane, Some Explicit Thinking About Implicit Taxes, 52 SMU L. Rev. 339 (1999); Calvin Johnson, Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters, 71 Tax Notes 377 (Apr. 15, 1996); Koppelman, note 74; Philip Oliver, Section 265(2): A Counterproductive Solution to a Nonexistent Problem, 40 Tax L. Rev. 351 (1985); David Weisbach, Commentary, Implications of Implicit Taxes, 52 *SMU L. Rev.* 373 (1999).

By contrast, discussions of implicit taxes in the context of international tax planning are more limited.[77]

The breadth of the domestic tax capitalization literature reflects in part the abundance of natural experiments created by the Code. In particular, the existence in the capital markets of tax-exempt municipal bonds alongside otherwise-comparable taxable ones offers a perfect opportunity to explore the practical aspects of tax capitalization theory.[78] In addition, the capitalization of tax benefits into prices received a great deal of attention during the heyday of individual tax shelters. It was earnestly argued by some that the after-tax yields on tax shelter investments necessarily would fall to the same yields as otherwise comparable taxable investments, leaving the system (in the words of Boris Bittker) with inefficiencies (more office towers in Houston than might be the case in a world of constant burdens on capital investments) but not inequities (no taxpayers—or at most, only the very earliest movers—would capture inframarginal yields on their tax shelter investments).[79]

The literature reflects a consensus view that tax capitalization does not function as perfectly as theory would predict.[80] For example, mu-

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[77] Scholes et al., note 74, at 339-45, considers how the interplay between foreign explicit taxes, foreign implicit taxes, and the U.S. foreign tax credit can affect investment decisions over different investment horizons. That discussion does not consider the argument developed here, which is that implicit and explicit tax burdens can vary, depending on the status of the investor as one able to manufacture stateless income. Michael Knoll directly addresses implicit taxes in the international setting, but in the more limited context of rethinking the treatment of "tax sparing" arrangements. Michael Knoll, International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes (Univ. of Penn. Inst. for Law & Econ., Research Paper No. 08-21, 2008), available at http://ssrn.com/abstract=1259927. That paper appears to start from the premise that pretax, rather than after-tax, returns to net business income tend to converge in the real world. Id. For the reasons described earlier, see note 27, this Article (and, I believe, the work of Hines and Desai that this Part analyzes) starts from the opposite premise.

[78] See Merle Erickson, Austin Goolsbee & Edward Maydew, How Prevalent Is Tax Arbitrage? Evidence from the Market for Municipal Bonds, 56 Nat'l Tax J. 259 (2003). Erickson, Goolsbee, and Maydew find very few firms engaging in municipal bond tax arbitrage and conclude that "there must be serious transaction costs (broadly defined) associated with the activity." Id. at 268.

[79] See Bittker, Equity, note 76, at 739-42; Bittker, Tax Shelters, note 76, at 417-18.

For arguments that tax capitalization can self-correct for incentives introduced into the tax law, see, e.g., George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657, 707-14 (1985) (arguing that tax capitalization can solve at least some tax shelter problems); Oliver, note 76, at 398-402 (arguing that limitations on the deductibility of interest expense on debt incurred to purchase or carry tax-exempt municipal bonds are undesirable, in part because of tax capitalization); Theodore Sims, Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered, 42 UCLA L. Rev. 263, 303-04 (1994) (arguing that tax capitalization is a natural antidote to tax shelter activity).

[80] See, e.g., Johnson, note 76, at 387 ("Equilibrium between the returns from tax-favored investments and from debt has never happened and cannot be expected to happen.

nicipal bond yields are higher than would be the case in a world of perfect capitalization.[81] Indeed, Hines recognizes in his most recent article that municipal bonds are an example of a tax capitalization market failure, because of "insufficient demand" (for which one could equally write "oversupply").[82] But Hines does not then consider the possibility that multinational groups are able to defeat the mechanism of tax capitalization themselves, through stateless income tax planning.

There is less agreement in the literature on the reasons for these market failures. One school of thought has argued that the problem lies with the Code itself: By limiting the deductibility of debt incurred to acquire tax-favored investments, the Code interferes with normal arbitrage behavior, and accurate market clearing prices are not established. Others have reacted skeptically to this argument,[83] and one careful review of investor behavior in the municipal bond markets in fact demonstrated that taxpayers did not fully take advantage of the arbitrage opportunities expressly afforded to them through statutory or administrative "safe harbor" rules.[84]

One reason for skepticism about the efficacy of implicit taxes substituting perfectly for actual ones, beyond the conspicuous example of municipal bonds, is that even in a world of full tax capitalization, the government has much more to lose from the market arbitrage activity

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The supply of tax-favored investments is too large and too elastic. In absence of equilibrium, the interest deduction on debt-?nanced investments in tax-favored assets does not work right. In absence of equilibrium, debt-?nanced, high-bracket investors bid up the price of tax-favored investors and drive out all lower-bracket competitors. In absence of equilibrium, debt can become cost-free after tax: [T]he tax savings generated by the debt is more valuable than the debt itself costs in real or present value terms."); Scholes et al., note 74, at 143-45, 155-58 (reviewing economic literature finding evidence that tax capitalization does occur in general, but also pointing out that, in light of different clienteles, market frictions or tax-rule restrictions are required to prevent arbitrage opportunities); Weisbach, note 76, at 380 ("Reliance on full capitalization is utopian. Full capitalization has never happened and is unlikely to ever happen.").

81 See Erickson et al., note 78, at 267-68 (finding that there may be costs that raise the costs of borrowing for firms, thereby making arbitrage unprofitable); Johnson, note 76, at 381-86; Koppelman, note 74, at 1176–85.

82 Hines, note 9, at 293.

83 See Bittker, Equity, note 76, at 739-42 (showing how the benefits of tax-exempt bonds are capitalized to eliminate inequities); Bittker, Tax Shelters, note 76 (describing how only the first in line gets the tax benefit because the benefit is then wiped out by tax capitalization); Crane, note 76 (concluding that asset prices are contingent on tax consequences); Johnson, note 76, at 387 (arguing that even if the restriction on debt deductions were eliminated, the market equilibrium between tax-preferred investments and debt will not be reached).

84 Erickson et al., note 78, at 268 ("Despite a significant spread between interest rates for much of the corporate sector, we find that only a tiny fraction of firms exploit such discrepancies and even among those that do, many do so at a level smaller than the legal safe-harbor.").

that keeps after-tax prices in line than taxpayers have to gain. Thus, imagine that there are no limits on the deductibility of interest expense, after-tax U.S. interest rates are 5%, and that municipal bonds therefore yield the same rate. At a 35% tax rate, pretax rates are 7.7%. If a municipality offers a new tax-exempt bond issue at 5.1%, an arbitrageur will borrow the funds at 7.7% and buy the bond, thereby capturing the 0.1% after-tax profit. The demand from arbitrage buyers may drive up the bond's price in the secondary market such that immediately thereafter the bond trades at a 5% yield, but the lucky arbitrageur who captured the momentary opportunity will have cost the government 2.7% (the value of the interest deduction) to obtain his 0.1% profit.

Another reason for skepticism is to look to the supply side of the equation. Unlike classic nontax arbitrage, where the arbitrageur profits by buying real production (of wheat, or steel, for example) in one market and simultaneously selling it in another, and where overall production is not affected by the arbitrageur's activities, tax arbitrage creates its own supply. That is, it turned out in retrospect that there was no reality-constrained limit to the supply of Houston office towers during the retail tax shelter craze of 30 years ago,[85] and so the tax benefits never were fully capitalized into prices. (Instead, prices collapsed when it was suddenly realized that there were not enough sentient beings in the universe willing to occupy all the Houston office space then under construction.)

The tax capitalization literature has also developed another theme that is directly relevant to this Article, which is the distinction between what Stanley Koppelman termed "status" tax arbitrage and "asset" tax arbitrage.[86] Municipal bonds are an example of asset arbitrage: The asset itself carries the special tax preference. In theory, it would be possible to describe plausible circumstances (efficient markets, no limits on debt incurred for arbitrage activities, and a supply curve for tax-favored assets identical to that for otherwise-comparable tax-favored ones) under which full tax capitalization would be achieved in respect of these assets.

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[85] See J. Michael Kennedy, "See-Through" Interiors: Office Glut: It Sweeps the Country, L.A. Times, July 6, 1985, at 1, available at articles.latimes.com/1985-07-06/news/mn-9467_1_office-buildings.

[86] Koppelman, note 74, at 1175-76. Asset tax benefits are those which attach to specific assets, and are subject to market forces; prices of these assets will rise relative to other assets to reflect the tax benefit. Id. at 1175. Status tax benefits, on the other hand, arise from the status of the taxpayer or the status of the intermediary through which the taxpayer invests rather that the type of asset purchased (for example, bonds that yield nontaxable income because the taxpayer is exempt from tax). Id. at 1175-76. Status tax benefits are not capitalized and can present opportunities for status tax arbitrage. Eugene Steuerle used the terms "normal" and "pure" to make the same point. Steuerle, note 76, at 59-60.

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

The model laid out in Section III.A., and the Desai and Hines policy prescription, is a full-tax-capitalization model, moreover one in which implicit taxes are traded off against explicit ones from a social welfare perspective.[87] Each model assumes that, from the perspective of a U.S. multinational firm, an investment in a foreign target company functions exactly like a municipal bond in the U.S. domestic market with perfect tax capitalization. Without this assumption, Desai and Hines cannot conclude that a territorial tax regime can satisfy capital ownership neutrality. The only reason that a U.S. firm's shopping priorities for target companies would not be distorted in a territorial tax regime would be that all prospective target companies earn the same after-tax normal returns. If that assumption is relaxed, the U.S. firm would revise its priorities to capture those circumstances that would offer higher after-tax normal returns.

To see the point more clearly, imagine for a moment that *Freedonia's* tax system had the same 35% tax rate on business income as does the United States, but *Freedonia* offers a tax holiday on inbound foreign direct investment. As a result, potential U.S. and *Sylvanian* acquirers alike bid up the price of a *Freedonian* company to fully reflect its de facto tax-exempt status in their hands.

It would plainly be inconsistent with worldwide welfare goals for the United States to tax this *Freedonian* income stream that has borne a full 35% *implicit* tax subsidized by *Freedonian* taxpayers, just as it would be welfare-reducing if the United States were to announce that it will start tomorrow to tax existing tax-exempt bond yields that have already suffered a full implicit tax. This is the situation that Desai and Hines envision. That is, when they recommend territorial tax as a policy instrument, they assume that *Freedonian* normal returns already bear a full 35% tax (some explicit, and some implicit) when viewed from the (post-*Freedonian* tax) perspective of a prospective U.S. investor. If that assumption is relaxed, however, then territorial tax policy instruments in fact would change the U.S. multinational enterprise's priorities, and in doing so ownership neutrality might not be served.

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[87] See notes 57-62 and accompanying text.

C. *Extending the Model to Reflect Stateless Income*

One could develop powerful arguments why it would be implausible as a factual matter to assume the existence of perfect tax capitalization in the returns on business investments across different countries. Critically, however, it is not necessary to do so. Even if *asset* tax arbitrage theory worked perfectly in practice, the problem that the model described in Section III.A. assumes away, and that Desai and Hines similarly ignore, is that multinational enterprises can engage in *status* arbitrage. A multinational firm's income from foreign direct investment is not in fact invariably taxed in the source country, but instead can be moved from high-tax to low-tax jurisdictions—the phenomenon that this Article calls stateless income. Stateless income tax planning enables multinational firms to capture high-tax country pretax yields on which those firms pay tax only at low rates in other countries.

To see this point, return to the model described in Section III.A. and introduce the concept of stateless income. For the moment, the actual mechanisms for generating stateless income are unimportant.[88] Instead, simply assume that a multinational firm (but not a local domestic one) can arbitrarily move income from high-tax jurisdictions (including the multinational's home country) to low-tax ones, while retaining ownership of the income stream. The simplest example would be interest paid within the multinational enterprise's group, from a high-tax subsidiary to a low-tax one. Further assume that the United States has implemented the Desai and Hines policy prescription of a territorial tax system as the basis for taxing foreign direct investment by U.S. multinational firms. As a result, no U.S. tax is imposed on a foreign subsidiary's earnings.[89] Moreover, the United States has followed the Hines recommendation not to limit in any fashion the deductibility of U.S. domestic expenses, even where those expenses are directly incurred to finance foreign direct investments.[90] How do these new assumptions change the CON analysis, as summarized in the preceding Section?

The analysis changes fundamentally, *not* in respect of a prospective investment in a real business in *Freedonia*, or any other low-tax jurisdiction, but rather in respect of prospective investments in *Sylvania* or

[88] See generally, Kleinbard, note 1, at 715-50, for a discussion of the current U.S. tax system for taxing the returns to corporate foreign direct investment and how the U.S. tax system affords corporations the opportunity to earn stateless income.

[89] Technically, territorial tax systems also retain residence country taxation for certain categories of passive or mobile income (what in the United States is termed subpart F income). See generally IRC § 952. The text assumes that the stateless income strategies employed here would not trigger these rules.

[90] See Hines, note 33, at 470.

other *high-tax* countries. If one accepts the original model's assumption that after-tax (and before stateless income tax planning) rates of return are constant around the world,[91] then the injection of stateless income into the model means that a multinational enterprise, but not a wholly-domestic firm, can capture the higher pretax normal returns found in high-tax countries, but pay low taxes on them, by shifting the locus of taxation of those high pretax returns to a low-tax jurisdiction. *Stateless Income* termed these supranormal risk-adjusted returns "tax rents."[92]

In effect, to the extent that stateless income tax planning is available, investments in high-tax countries become opportunities to capture supranormal after-tax returns, but only for those multinational firms that can exploit those planning opportunities.[93] Only multinational enterprises can enjoy stateless income, because to generate it requires affiliates in low-tax as well as high-tax jurisdictions.

As an illustration, recall that in the original example normal pretax returns in *Sylvania*, with its 25% tax rate, are 6.67% (thus yielding 5% after tax), while normal pretax returns in *Freedonia* are 5.56% (also yielding a 5% after-tax return).[94] Now inject stateless income tax planning into a U.S. multinational firm's corporate acquisition strategy.

If a U.S. multinational enterprise were to acquire a S*ylvanian* target company entirely with equity and divert some of its income to

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[91] See text accompanying notes 28-29 for a discussion of why this is a plausible assumption from which to fashion actual policy.

[92] Kleinbard, note 1, at 713.

[93] 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 pretax 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. Most fundamentally, 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.) Second, all domestic investors and all portfolio investors (whether domestic or cross-border) are post-corporate tax investors. See text accompanying notes 28-29. Since most cross-border investment today is portfolio rather than direct investment, there is no particular reason to assume that direct investment by multinational firms sets asset prices. Third, not even this Article and its companion argue that all multinational firms convert 100% cross-border investment income into zero-taxed returns. Fourth, investment opportunities that yield normal returns 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.

[94] See Section III.A.

Freedonia, the U.S. firm would enjoy an after-tax return on that diverted income of 6%, not the global after-tax normal return of 5% (6.67% pretax return minus a *Freedonian* 10% tax). Thus, if the U.S. owner were able to divert one-half the *Sylvanian* firm's income to *Freedonia*, the aggregate after-tax return to the U.S. firm from acquiring the *Sylvanian* subsidiary would be 5.5%. And this opportunity to create supranormal returns would exist only through strategies available by virtue of the U.S. firm's status as a large multinational enterprise.

As this example illustrates, a U.S. (or foreign) multinational enterprise's shopping list for the global auctions that Desai and Hines envision[95] will be fundamentally rearranged once the firm's stateless income planning opportunities are considered. Ironically, the rearrangement of priorities will not directly affect the multinational firm's interest in domestic enterprises in low-tax jurisdictions. Those target companies presumably already are priced to reflect the low-tax environment in which they operate. Tax capitalization works in those cases. As it happens, however, genuine acquisition opportunities in low-tax countries are not that common. Even the largest domestic low-tax economies like Ireland are relatively small when compared to the populations and domestic economies of the largest (and generally higher-tax) countries.[96] And the investments in a low-tax country that a multinational firm needs to make to comply with international tax law norms when implementing stateless income strategies invariably are satisfied by establishing new subsidiaries, not bidding for existing domestic firms.

The multinational enterprise's priority that will change is its relative appetite to acquire target companies in high-tax countries. They will become much more attractive to the multinational firm than to domestic bidders, to the extent that, under the specific tax law of the jurisdiction in question, stateless income planning strategies are easily implemented. The effects of stateless income tax planning on a multinational enterprise's acquisition priorities thus cannot be divined simply by looking at statutory company tax rates. Different countries throw up larger or smaller roadblocks to streaming income to low-tax affiliates. But in general, the existence of the opportunity will in fact change a multinational firm's shopping list and prospects for success

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[95] See Desai & Hines, Evaluating Reform, note 4, at 490-96.

[96] Switzerland is the closest to an exception that proves the rule. Switzerland, with a population of around 7.7 million (2010) had a GDP in 2010 of $594 billion. Ireland's population is smaller (4.4 million) and its 2010 GDP was only $213 billion. By way of comparison, U.S. GDP in that year was $15.2 trillion. Global Finance: Country Reports & GDP Data, http://www.gfmag.com/gdp-data-country-reports.html (last visited Sept. 22, 2011).

in the hypothetical auctions for target companies. To the extent this occurs, CON will not be achieved.

The prior paragraphs have shown that tax capitalization cannot operate to squeeze out the inframarginal returns that multinational enterprises can enjoy on the stateless income that they extract or divert from high-tax jurisdictions to low-tax ones. And because stateless income is a status attribute of some taxpayers (multinational enterprises) but not others (domestic firms), in a world where stateless income is prevalent, tax capitalization also cannot flow in the opposite direction. That is, U.S. after-tax returns will not rise to the higher levels necessary to bring equilibrium between U.S. domestic returns and the returns enjoyed by special status taxpayers that can earn stateless income, because as the presumptive marginal investors in their home market, domestic investors in the United States will bid down U.S. yields. Domestic Irish firms and domestic U.S. firms might in fact each face the same after-tax normal returns on corporate income, but multinational enterprises will still exploit their special status to earn inframarginal returns through stateless income.

Now continue with the above example and add U.S. leverage to the mix. If the U.S. firm can reliably move one-half of a *Sylvanian* target company's pretax earnings to *Freedonia* through stateless income tax planning, then the U.S. firm has every reason to borrow in the United States to make a string of *Sylvanian* acquisitions, at least until it zeroes out its U.S. tax base. Each marginal investment would be funded entirely with debt bearing a 7.7% coupon; the value of the interest deduction would be 2.7%, for an after-tax cost of 5%. The asset acquired would yield 5.5%, leaving the U.S. firm (in this highly stylized example) with a low-risk .5% per annum arbitrage profit. And for each $5 of arbitrage profit captured on a $1000 investment, the United States would forgo $27 in U.S. domestic corporate income tax.

Stateless income tax planning thus also vitiates Hines' arguments that the domestic U.S. expenses of a U.S. multinational firm should be fully deductible in the territorial tax system, regardless of whether those expenses directly support foreign income not subject to U.S. tax.[97] In a world where stateless income can be earned, the end result would be a zeroing-out of the firm's domestic tax base.[98]

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[97] See Hines, note 33, at 463-66. Hines argues that not allowing for these deductions distorts behavior of U.S. multinational firms, and induces them to increase foreign rather than domestic investment.

[98] See Mitchell A. Kane, Commentary: Considering "Reconsidering the Taxation of Foreign Income," 62 Tax L. Rev. 299, 314 (2009) ("With arbitrage the concern is that the U.S. taxpayer could zero out tax liabilities on the income from the domestic deployment of capital.").

In other words, permitting a deduction for U.S. expenses that are directly allocable to earning foreign income would be tantamount to offering U.S. individuals unlimited IRA accounts and full deductibility of interest expense on all borrowings. Rational individual taxpayers would borrow in their personal capacity and invest in low-risk assets through their IRAs. They would capture a positive arbitrage profit not by virtue of a market failure in tax capitalization, but rather by virtue of their status (the IRA), which enables them to hold otherwise taxable financial assets without paying tax.[99] The same would apply—indeed, to a large extent does apply today—to a U.S. multinational firm that can use its status to transmute high-tax jurisdiction pretax normal returns into low-taxed income.

Stateless income tax planning requires investments in low-tax jurisdictions (*Freedonia* in the example, and countries like Ireland, Switzerland, Singapore, and the Cayman Islands in reality), but only to the extent necessary to comply with international tax law norms for the planning in question. So, for example, if a multinational enterprise wishes to move income from *Sylvania* to *Freedonia*, and does so through intercompany loans from a *Freedonian* subsidiary to its *Sylvanian* sister company, very little *Freedonian* infrastructure is required. Conversely, when a multinational firm seeks to situate valuable intangibles in a low-tax country and exploit those intangibles through licensing them to sister companies, the firm might well conclude that a more substantial presence in the low-tax jurisdiction is appropriate to demonstrate that the intangibles in fact have come to rest there. In every instance, though, the results are supranormal after-tax profits for the low-tax affiliate, by taking pretax returns that were set in the expectation of a high tax burden, and instead streaming them to a low-tax affiliate.

Even if one were to revise the original assumptions in the model presented in Section III.A. and maintain that, whether as a result of the stateless income phenomenon or otherwise, firms compete globally in a world with constant pretax (rather than after-tax) normal returns, the pursuit of stateless income would still be a valuable strategy under current law (with its ability for deferral), for the simple reason that doing so would improve a multinational firm's after-tax profits. The multinational firm's priorities will change to reflect the relative ease of implementing stateless income strategies in different countries, and the multinational firm will have a clear advantage over wholly-domestic companies when both raise their paddles at the imagined auction. Thus, under either assumption about rates of return (con-

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[99] Cf. Scholes et al., note 74, at 155-56 (describing the elimination of tax liability through leverage-based tax arbitrage where implicit tax burden is lower than explicit taxes saved).

stant after-tax or constant pretax global rates of return) the presence of stateless income vitiates CON.

In response to all the above, it might be observed that, while the existence of stateless income vitiates the tax capitalization story that lies at the heart of the CON theory, if every other country has adopted a territorial tax system and countenances (within broad limits) the existence of stateless income tax planning, then the United States should too, in order to create a "level playing field" for U.S. multinational firms. This argument is not, however, a worldwide welfare argument. It is in practice a simple call for "competitiveness,"[100] and at most an incomplete national welfare argument, but one of uncertain merit. The urge to cheer for the home team is understandable, but the intuitive sports metaphor does not necessarily hold.

In effect this argument is indistinguishable from a call for export subsidies, on the grounds that other countries offer export subsidies. If U.S. tax revenues are kept constant, those de facto subsidies must be borne by other Americans. The positive externalities to the United States of fielding a team of successful U.S. multinationals (complementarity in U.S. job creation, for example) must be weighed against the costs of funding the subsidy and the social costs of distorted investment decisions.[101] This is an altogether different analysis from that undertaken in advancing CON as a policy prescription for the United States.

IV. Other Implications of Implicit Tax Analysis

The previous discussion argued that CON at its core relies on a perfect tax capitalization story, and that the operation of status arbitrage through the generation of stateless income vitiates that story. The application of implicit tax analysis to the taxation of foreign direct investment raises another interesting issue, which is the embedded discrimination in current U.S. policy (or that of any country relying on the foreign tax credit) between explicit and implicit foreign taxes. Implicit foreign taxes are effectively deductible by a U.S. firm, because they are reflected simply as lower pretax income. Explicit taxes, by contrast, are creditable under the current foreign tax credit system.[102]

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100 See Kleinbard, note 1, at 762-68.

101 To suggest that U.S. multinationals are primarily owned by U.S. persons (which is true), and therefore that higher U.S. multinational profits justify "pro-competitive" international tax policies, looks at one side of the picture, but without more neglects the fact that those higher profits are being funded through subsidies provided by other U.S. persons (for example, domestic businesses).

102 For a proposal to create a foreign tax credit for implicit taxes in "tax sparing" circumstances, see Knoll, note 77.

To see the consequence, consider a world of perfect tax capitalization (which is the starting point of the Desai and Hines model), but one in which the United States uniquely (and without affecting world market-clearing prices) relies on a foreign tax credit mechanism. In that world, after-tax normal returns are the same everywhere, and pretax returns differ. For example, assume that tax rates are 35% in the United States, 20% in *Sylvania*, and 10% in *Freedonia*, and that pretax normal rates of return are 10% in the United States. These facts would imply that pretax rates of return are 8.1% in *Sylvania* and 7.2% in *Freedonia*, with the result that all three countries offer firms a 6.5% after-tax normal rate of return. A U.S. firm investing $1000 in *Sylvania* or *Freedonia* will earn the identical after-foreign tax income ($65), but will not be in the same position under current law if those earnings were repatriated to the United States.[103] The *Sylvanian* investment would be treated for U.S tax purposes as yielding $81 in taxable income, and a $16 tax credit, leaving a residual tax liability of $12.35 and netting the U.S. firm $52.65 after U.S. tax. The *Freedonian* investment would return $72 in taxable income along with a $7 credit, trigger a U.S tax liability of $18.20, and leave the U.S. firm with $46.80 after tax. The difference reflects the value of an incremental explicit $9 U.S. foreign tax credit when comparing *Freedonia* to *Sylvania*, against the implicit $9 of tax deduction claimed at an effective 35% rate when looking at *Freedonia* alone.[104]

Under the assumptions that the United States is a foreign tax credit system outlier in a sea of territorial tax systems, and that world after-tax returns on net business income still converge, this analysis implies that the U.S. foreign tax credit system leads to a systematic bias in favor of investment in high-tax foreign countries, not (as this project has argued) as the raw feedstock for the stateless income generation machine (whose returns under current law must remain offshore), but rather as a vehicle to maximize post-U.S. tax net cash flows on fully repatriated income. This in essence is the point pressed by Shaviro in three closely overlapping recent papers.[105] Shaviro maintains that much recent analysis "conflates two distinct margins affecting multinational firms. The first is the marginal incentive to invest abroad, which depends on expected domestic tax burdens with respect to such investment. . . . A second and distinct margin concerns resident mul-

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[103] The example assumes that no withholding taxes are imposed on the repatriation dividend, and rounds off the foreign tax credits.

[104] $52.65 - $46.80 = $5.85. $9 – (.35 x $9) = $5.85.

[105] Shaviro, The Case, note 10; Shaviro, note 25; Kimberly A. Clausing & Daniel Shaviro, A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?, 64 Tax L. Rev. 431 (2011).

tinationals' cost-consciousness with respect to foreign tax liabilities."[106]

Shaviro argues that this second margin is important from a national welfare perspective, because taxes paid to the United States are available to finance the welfare of U.S. individuals, while taxes paid to foreign jurisdictions are not.[107] By equating foreign income taxes and U.S. income taxes, he suggests, a foreign tax credit system renders U.S. persons indifferent to paying foreign tax rather than U.S. tax (unless the foreign tax credit limitation is binding), even though U.S. welfare would be advanced by a system that encouraged U.S. multinational enterprises to pay U.S. taxes rather than foreign ones.[108] For these reasons, Shaviro claims that the norm of national neutrality has been unfairly dismissed by policy analysts.[109]

The solution, he concludes, is to make foreign taxes deductible, rather than creditable, and to do so in a "burden neutral" manner by imposing a commensurately lower tax rate on foreign income.[110] In the most recent of his papers, co-authored with Kimberly Clausing, the authors suggest that such a system ideally would impose varying U.S. tax rates on foreign income that was subject to different tax rates; the lower the foreign tax rate (and hence the smaller the foreign tax deduction), the higher the U.S. rate should be.[111]

The fundamental point of this neo-national neutrality norm—that all other things being equal, it is preferable for U.S. persons to pay U.S. tax rather than foreign tax, yet foreign tax credit systems equate the two—cannot be gainsaid. Indeed, it has long been a concern in U.S. tax policy debates. For example, the international provisions in the Tax Reform Act of 1986,[112] such as its broadening of the reach of the interest expense allocation rules, the sharp curtailment of "cross-crediting" opportunities, and its anti-"subsidy" rules, were widely understood at the time as directed at creating incentives to reduce foreign tax liabilities.[113] Congress has since substantially relaxed, these

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[106] Clausing & Shaviro, note 105, at 431.
[107] Id. at 431-32.
[108] Id. at 431-34.
[109] Id.
[110] Id. at 433 n.7. The "burden neutral" terminology appears to have first been used in the context of foreign direct investment policy alternatives by Grubert & Altshuler, note 3.
[111] Clausing & Shaviro, note 105, at 7-8.
[112] See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1201-1249, 1261, 1271-1277, 100 Stat. 2085.
[113] See Staff of the Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 944 (Comm. Print 1987) (regarding interest expense: "In effect, prior law allowed taxpayers to arrange to have interest expense reduce U.S. income, even though that interest expense funded foreign activities (or freed up other cash to fund foreign activities), the income from which was sheltered from U.S. tax by the foreign tax credit or by the deferral of U.S. tax on the income of U.S.-owned foreign corporations.

provisions,[114] but Shaviro's recent work is an important reminder of the importance of this decision margin. As such, Shaviro's concerns (and the solutions adopted in the Tax Reform Act of 1986 and since abandoned) should resonate with the proponents of any reform proposal that contemplates retaining the foreign tax credit system.[115]

More fundamentally, however, the companion paper to this Article has demonstrated that current law contains abundant incentives to minimize foreign tax liabilities, precisely because the system rewards *nonrepatriation* to the United States.[116] U.S. firms today repatriate only a trickle of their foreign earnings.[117] Moreover, the U.S. multinational firms that are overwhelmingly the claimants of foreign tax credits in almost all cases are publicly-traded firms whose financial health and performance are judged through the lens of U.S. Generally Accepted Accounting Principles. Those rules in turn create powerful incentives to report profits outside the United States, to keep those earnings outside the United States, and to ensure that those earnings are taxed at as low a foreign tax rate as possible.[118] In these circumstances, the decision margin identified by Shaviro effectively has already been resolved in practice, because repatriation and the claiming of associated foreign tax credits is not the desideratum of current strategy.

At a more theoretical level, a foreign tax deduction system (including a territorial tax system, which is the Shaviro neo-national neutrality proposal with the residence country special rate on foreign income set to zero) is a more systematic resolution of the differential values of explicit and implicit taxes, because the effect is to treat both as deductible. From the point of view of the residence country, implicit foreign taxes are deducted in the form of a lower pre-explicit tax yield in low-tax countries. In turn, the residence country would permit an actual deduction for foreign explicit taxes from the taxpayer's pre-foreign tax yield, so that the net effect is that in every case the amount includible in the residence country tax base (or completely excluded, in the special case of a territorial tax) is net of both explicit and implicit foreign taxes.

Thus, not only was no U.S. tax paid on the foreign investment, but the investment generated negative U.S. tax on U.S. income."); 862, 868 (cross-crediting); 871 (subsidies).

114 For example, the number of foreign tax credit baskets generally relevant under § 904 has reverted to two. IRC § 904.

115 Other strategic moves that respond to the concerns raised by Shaviro include lower U.S. corporate income tax rates and more effective U.S. expense allocation rules (which increase the likelihood of excess foreign tax credits, unless expenses actually are relocated abroad).

116 See Kleinbard, note 1.

117 See id. at 715-27.

118 See id. at 733-37.

Given the importance of complete tax capitalization along other economic margins, it follows that Shaviro's neo-national neutrality system should impose a flat rate of tax on all foreign income (net of foreign taxes), not the different compensating rates that Shaviro and Clausing recommend by referring only to explicit taxes that are designed to compensate for the shift from foreign tax creditability to deductibility.[119] What should that single flat rate be? In the neo-national neutrality paradigm and a world of perfect tax capitalization, the only U.S. tax rate that would not distort investment location or ownership decisions by U.S. taxpayers and that would be tantamount to a foreign tax deduction system would be a U.S. tax rate of zero—in short, a territorial system exactly along the lines proposed by Desai and Hines.[120]

A zero tax on foreign income—a territorial system—in turn does not appear to enhance U.S. national welfare along the margins on which Shaviro focuses,[121] because it raises no additional domestic taxes and does not by itself offer private investors the opportunity to earn higher after-tax returns. Instead, its welfare-enhancing properties exist along the margin on which Desai and Hines focus (the creation of proper incentives to encourage CON).[122] The neo-national neutrality argument in this respect becomes one of support for the original Desai and Hines results[123] (under the assumptions of their model), by way of an observation that those results also encourage U.S. taxpayers not to be indifferent to foreign taxes.

In the absence of a systematic response to stateless income tax planning, a foreign tax deduction system combined with a lower rate on foreign than on domestic earnings (whether zero or some higher rate) no longer would be neutral as between different investment opportunities (the objection this Article made earlier to the Desai and Hines project). Instead, as described above, stateless income planning cre-

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[119] A foreign tax credit system discriminates between implicit and explicit foreign taxes, because a foreign tax credit system effectively gives a deduction for implicit taxes and a credit for explicit ones. At a minimum, this would seem to imply that it is not possible to honor the principle of neo-national neutrality (deductibility and a single tax rate on foreign income) and at the same time be burden-neutral (which would imply different tax rates on foreign income from different jurisdictions, to preserve the current U.S. tax burden), except in the most aggregated sense (that is, by defining burden-neutrality as a single global number), which in turn means creating many individual corporate winners and losers. Clausing and Shaviro get to the same conclusion on the grounds of administrability. See Clausing & Shaviro, note 105, at 445-49.

[120] See Desai & Hines, Evaluating Reform, note 4. The reason is that a foreign tax rate greater than zero burdens foreign investments that, after foreign taxes, have the same yield as do U.S. investments after U.S. taxes.

[121] See Clausing & Shaviro, note 105.

[122] See Desai & Hines, Evaluating Reform, note 4.

[123] See id. at 494-99.

ates incentives for U.S. multinational firms to invest in *high-tax* foreign countries, just as does the current law foreign tax credit system that Shaviro rejects, but for different reasons. In the stateless income case, it is to capture high explicit tax pretax returns and migrate them to low-tax jurisdictions, without suffering implicit taxes along the way. Under the current foreign tax credit system, by contrast, it is because the U.S. system permits U.S. firms to avoid the explicit taxes suffered in the absence of stateless income planning.

Stateless income planning is costly in many dimensions. Rather than addressing the distortive effects of stateless income tax planning, the neo-national neutrality proposal without further elaboration would embrace them, and encourage U.S. firms to do still more along this undesirable margin. By contrast, it can be argued that the foreign tax credit system today mitigates, if only to a limited and fortuitous extent, the distortions attendant on stateless income planning, by reducing the opportunity cost of forgoing such activity. By making explicit foreign taxes deductible rather than creditable in a world where stateless income strategies are effective, the neo-national neutrality system rewards exactly these costly behaviors more than does the current foreign tax credit system, and with them generates additional and deadweight losses. Once again, stateless income changes everything.

V. Putting Teeth into Territoriality

A. *Overview*

In a world dominated by territorial regimes for the taxation of foreign direct investment, but imbued with robust source rules and scrubbed of stateless income, multinational firms could not capture tax rents, and every investment in firms or real assets would bear the same tax burden, when implicit as well as explicit taxes were considered. In that world, the design of tax policy for foreign direct investment would become embarrassingly easy. Those robust territorial tax regimes by themselves would satisfy every known articulation of worldwide efficiency norms. Firms would face the same tax costs for foreign as well as domestic investment (once implicit taxes were considered), thereby satisfying the benchmark of CEN. Firms also would face the same local tax rates in respect of a foreign investment as would local competitors (and competitors in third countries), thereby satisfying the benchmark of CIN. In this happy tax ecosystem it would make no sense to add an additional layer of residence-country tax. Doing so would only drive down after-tax returns on investments for affected cross-border investors to levels below what they could obtain at home. Moreover, this environment would also address the neo-national neutrality criterion of eliminating any incentive for firms to incur explicit foreign tax liabilities.

Every country that is the residence of major multinational enterprises, other than the United States, has adopted some form of territorial tax system. But stateless income vitiates the implicit tax mechanism that lies at the core of the most cogent case for territorial taxation, and compounds the meaninglessness of the entire concept of the "source" of income. Stateless income tax planning enables savvy multinational firms to capture tax rents, by deflecting high-tax source country pretax returns to very low-tax jurisdictions. Stateless income planning also enables firms effectively to do the same with residence country pretax returns through arbitrage, by locating a disproportionate amount of debt in the residence country. The end result is that multinational firms can capture risk-adjusted rates of return much higher than world after-tax norms, without incremental risk, as a result of planning opportunities available only to this privileged subset of potential investors. The economic case for territorial taxation therefore compels a campaign to eradicate stateless income tax planning opportunities of every form.

This Part therefore considers briefly how countries might plausibly respond to the phenomenon of stateless income within the context of territorial tax systems. The next part then considers whether there is value in the United States adopting an alternative regime of worldwide tax consolidation. In each case, the emphasis is on 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"[124] is eschewed. The issues have a particular urgency today, in light of the substantial interest among both the President and policymakers in revisiting the U.S. corporate income tax in general, and its treatment of foreign direct investment in particular.

Territorial tax systems and worldwide tax consolidation are polar opposite directions from which to address the phenomenon of state-

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[124] Cf. Desai & Hines, Old Rules, note 4, at 953 (acknowledging that territorial tax systems put additional pressure on transfer pricing enforcement, but not proposing any solutions); Hines, note 9, at 296 ("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. 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. Edward D. Kleinbard, Throw Territorial Taxation from the Train, 114 Tax Notes 547 (Feb. 5, 2007).

less income. From the unique perspective of current U.S. law, however, both territorial tax systems and a worldwide tax consolidation regime share an immediate welfare-enhancing aspect, which is the elimination of the "lock-out" effect.[125] The magnitude of the current quantum of "locked-out" earnings (in excess of $1 trillion) and the accelerating growth in accumulating additional locked-out earnings argue powerfully for a decisive move in either direction and away from the bizarre status quo.

B. Cartoon Territoriality

In light of the current vigorous debate within U.S. tax policy circles concerning the future direction of U.S. corporate tax policies towards foreign direct investment, it is important to begin the discussion of territorial tax responses to the stateless income phenomenon by clarifying the current state of the art in territorial tax design. Recent speeches,[126] testimony,[127] and articles[128] by representatives of U.S. multinational firms and their advisors paint consistent pictures of both the current U.S. tax system in operation[129] and the current state of development of territorial tax systems.

In the standard version of this presentation, every major country that employs a territorial tax system does so with at most inconsequential restrictions (such as a blanket inclusion in taxable income of 5% of otherwise-exempt dividends from foreign subsidiaries).[130] In particular, expenses incurred in the residence country are not allocated against tax-exempt (territorial) income or otherwise limited or disallowed (beyond the 5% "haircut" referenced above).[131] What is more, these presentations imply that these systems are static in their

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[125] Kleinbard, note 1, at 766-68.

[126] E.g., Amy S. Elliott, GE Executive Criticizes Possible U.S. Territorial System, 130 Tax Notes 998 (Feb. 28, 2011) (remarks of John M. Samuels, General Electric Vice President and Senior Counsel for Tax Pol'y and Planning).

[127] E.g., Hearing on Fundamental Tax Reform Before the H. Comm. on Ways and Means, 112th Cong. (2011) (testimony of Robert A. McDonald, Chairman of the Board, Procter & Gamble).

[128] E.g., Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, The U.S. International Tax System at a Crossroads, 127 Tax Notes 45 (Apr. 5, 2010); John M. Samuels, American Tax Isolationism, 123 Tax Notes 1593 (June 29, 2009); West, note 67.

[129] For a review of the current U.S. tax system for taxing the returns to corporate foreign direct investment, see Kleinbard, note 1, at 715-26.

[130] Samuels, note 128, at 1594; Examining Whether There Is a Role for Tax Reform in Comprehensive Deficit Reduction and U.S. Fiscal Policy: Hearing Before the Subcomm. on Fiscal Responsibility and Economic Growth of the S. Comm. on Finance, 112th Cong. (2011) (statement of John M. Engler, President, Business Roundtable), available at http://finance.senate.gov/imo/media/doc/Engler%20Testimony.pdf.

[131] E.g., Elliott, note 126, at 998 ("No major industrial country in the world denies deductions for interest or other expenses allocated to exempt foreign income.").

design, and that there are no political or policy pressures to reform them to address the stateless income problems identified in this Article.

This standard presentation is incomplete and misleading, to the point where it fairly can be labeled a cartoon version of the territorial tax policies followed by other nations. Foreign policymakers are vitally concerned about the tax avoidance issues implicit in the stateless income phenomenon,[132] international tax design is a subject of political controversy in other countries,[133] and many natural experiments are underway in different countries to address exactly these concerns. The remainder of this Part fleshes out some of these policy responses.

Before doing so, some sense of both the urgency and the importance that non-U.S. academics and high-level practitioners attach to the problem of stateless income (albeit without the benefit of that phrase) can be gained by reviewing, by way of three very recent examples, the thoughtful analyses published by Wolfgang Schön, Maarten F. de Wilde, and Richard Vann.[134] Their policy prescriptions differ, but it is fair to suggest that they all share three basic themes. First, they are deeply concerned by the problems of tax avoidance inherent in many current implementations of territorial tax systems, especially with regard to transfer pricing and internal leverage. Second, they all struggle to develop comprehensive and administrable policy responses

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[132] See Markus Leibrecht & Thomas Rixen, Double Tax Avoidance and Tax Competition for Mobile Capital, in International Tax Coordination: An Interdisciplinary Perspective on Virtues and Pitfalls 61, 70-71 (Martin Zagler ed., 2010) (identifying government responses to stateless income planning and further speculating that the breadth of these responses to date may have been limited by international tax competition among nations, at the behest of multinational firms).

[133] E.g., Kristen A. Parillo, Activists Protest Vodafone's Alleged "Tax Dodge," 60 Tax Notes Int'l 392 (Nov. 8, 2010) (reporting on demonstrations by U.K. activist groups against international tax planning activities of U.K. firm Vodafone).

[134] See generally Wolfgang Schön, International Tax Coordination for a Second-Best World (pts. 1-3), 1 World Tax J. 67 (2009) [hereinafter Tax Coordination part 1], 2 World Tax J. 65 (2010), 2 World Tax J. 227 (2010) [hereinafter Tax Coordination part 3] (casting taxation of foreign direct investment as an exercise in inter-sovereign coordination, urging an incremental "continuity approach," and ultimately recommending allocation of taxing rights and income on a "sales and services" basis); Vann, note 53, at 339-40 (focusing on transfer pricing as the core stateless income tax avoidance problem, rejecting current practice as based on inappropriate market analogies that ignore the theory of the firm, and encouraging both limits on intragroup contractual freedoms and the wider use of profit split methods); Maarten F. de Wilde, A Step Towards a Fair Corporate Taxation of Groups in the Emerging Global Market, 39 Intertax 62, 67-68, 81-82 (2011) [hereinafter Fair Corporate Taxation] (recommending eliminating intragroup interest expense in consolidation, but ultimately allocating income from real investments following OECD transfer pricing guideline principles for permanent establishments); Maarten F. de Wilde, Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy, 38 Intertax 281, 289 (2010) [hereinafter Fair Allocation] (analyzing tax-induced distortions of economic behavior arising in cross-border contexts and recommending the development of worldwide tax consolidation solutions to reflect a "unitary business approach").

that would substantially revise many aspects of common territorial tax implementations.

Third, all three authors understand that in a territorial system, little tax meaning attaches to identifying the country of "residence" of the parent firm of a multinational group, because a territorial tax system means in practice that every country, including the residence country, is just another source country.[135] This in turn suggests that the fundamental issue in designing a territorial tax system that is robust to stateless income planning is one of inter-sovereign coordination through the allocation in some fashion of group real income. Schön and de Wilde prefer that this allocation be rooted in the first instance in analogies to arm's-length market transactions, as reflected in the OECD's work in the transfer pricing arena,[136] while Vann is quicker to abandon this model,[137] but both Schön and de Wilde appreciate that this model has been overextended and leads to systematic misallocations.[138]

The theme that a territorial tax system is a tax regime in which the residence country is just another source country has important ramifications for the underlying rationale for adopting a territorial system in the first place. The existence of the corporate income tax is best explained as simply an exercise in substitute taxation, under which the firm's owners are taxed on a current basis through the convenient mechanism of collecting tax from the entity.[139] Within this framework, residence-based worldwide taxation makes most sense when there is almost complete overlap between the firm's residence and that of its owners; in that case, worldwide corporate taxation can be seen as a surrogate for worldwide taxation of the firm's individual owners resident in the same jurisdiction, just as the domestic corpo-

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[135] Vann, note 53, at 310.

[136] Schön, Tax Coordination part 1, note 134, at 111; de Wilde, Fair Corporate Taxation, note 134, at 77.

[137] See Vann, note 53, at 323.

[138] Schön, for example, urges that groupwide "synergy rents" should be allocated by reference to groupwide sales, not by the current arm's-length standard as applied by many taxpayers. Schön, Tax Coordination part 3, note 134, at 255-56. de Wilde argues for the consolidation of multinational groups, so as to treat every subsidiary like a branch, and then to allocate income among these constructive branches relying on current OECD guidelines for the attribution of profits to a permanent establishment. de Wilde, Fair Corporate Taxation, note 134, at 65.

[139] Cf. Daniel N. Shaviro, Decoding the U.S. Corporate Tax 10-14 (2009) (summarizing entity and aggregate theories for the existence of the corporate income tax). To this author, the entity theory is more an explanation of how one might implement the aggregate theory than it is an independent rationale for corporate taxation.

To say that the corporate income tax is a substitute tax for one that otherwise would be imposed on the firm's owners addresses only the statutory burden of the tax; the economic incidence of the corporate income tax (or any tax on net business income) is a separate matter not strictly relevant to the points made in the text.

rate income tax operates.[140] As it happens, this fairly accurately describes the ownership of U.S. public firms, as detailed in Part VI.

A territorial tax system, by contrast, is a particularly good fit for a small open economy where the owners of multinational enterprises domiciled therein are drawn from many other countries. By treating the residence country as just another source country, a territorial tax regime limits the residence country's tax base to business activities in that country, thereby offering a neutral investment environment for third-country shareholders.[141]

One final extremely important overarching theme for U.S. policymakers is that the rationales that other countries employ in adopting territorial systems extend beyond economic efficiency arguments. Within the European Union, territorial tax systems are easier to implement than are worldwide tax consolidation regimes in a manner consistent with the tightly integrated nature of the European market, and with European Court of Justice jurisprudence interpreting Treaty of European Union constitutional principles governing "freedom of establishment."[142] And some countries (for example, Canada[143]) have adopted relatively toothless territorial tax systems as conscious subsidies for their corporate national champions. This is an economic *inefficiency* argument at work, and one that hardly should be cited as precedent for the United States, any more than one would cite export trade subsidies by another country as a principled reason for the United States to adopt tax expensing of capital investment.

To that end, policymakers should reflect on the fact that the United States, which today remains by far the largest economy in the world, operates what *Stateless Income* described as an ersatz sort of territorial tax regime, which in many respects—for example, its sheltering of interest and royalty income repatriated to the United States, or the

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140 Schön, Tax Coordination part 1, note 134, at 69.

141 Vann, note 53, at 309 (arguing that determining corporate residence is not a particularly difficult question, but further claiming that "it is the residence of shareholders that is increasingly driving policy underlying the exemption system rather than the location of the firm").

142 EU constitutional concerns plainly limit the ability of one member state to restrict the ability of a company to redomicile in another member state. See Carsten Gerner-Beuerle & Michael Schillig, The Mysteries of Freedom of Establishment After Cartesio, 59 Int'l & Comp. L.Q. 303, 303-04 (2010). de Wilde, at least, appears to believe that constitutional concerns would not prohibit the adoption of unilateral mandatory worldwide tax consolidation by an EU member state, as he advocates just such a rule in analyzing a variety of European tax systems, including France's optional worldwide tax consolidation system. de Wilde, Fair Corporate Taxation, note 134, at 75-76. See also de Wilde, Fair Allocation, at 289-90; Maria Cruz Barreiro Carril, National Tax Sovereignty and EC Fundamental Freedoms: The Impact of Tax Obstacles on the Internal Market, 38 Intertax 105, 108 (arguing that consistently applied worldwide taxation is consistent with EU treaty norms).

143 Samuels, note 128, at 1595.

costless tax system arbitrage abetted by the "check-the-box" regulations—is more conducive to stateless income tax planning than are more coherent territorial tax regimes.[144] It is not surprising that other countries find it so difficult to deflect the pressures of their national champions to countenance tax competition through weak implementation of constraints on territorial tax rules when those national champions can persuasively argue that the largest stateless income abusers of current law, ironically enough, hail from the United States, the last redoubt of putative worldwide taxation. It is the United States that needs to make the first move if the stateless income problem is to be addressed.

The remainder of this Part considers some of the natural experiments currently underway in territorial tax countries to address the stateless income problem.

C. Thin Capitalization

It is true that no major jurisdiction that employs a territorial tax system disallows interest expense incurred in the parent company's domicile on the theory that it has been incurred for the purpose of earning tax-exempt foreign dividends, but to make this assertion without qualification paints a very misleading picture. In fact several major economies get to precisely this result through another means—thin capitalization statutes.[145]

Thin capitalization statutes traditionally were understood as source country rules that limited "earnings stripping" from the source country to a low-tax affiliate by constraining the introduction of excessive internal leverage within a multinational group.[146] More recent and

[144] Kleinbard, note 1, at 715-26.

[145] For a comprehensive and recent overview, see generally Tim Edgar, Jonathan Farrar & Amin Mawani, Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis, 56 Can. Tax J. 803 (2008). See also Alfred Storck, The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements, 65 Bull. for Int'l Tax'n 27 (2011); Stuart Webber, Thin Capitalization and Interest Deduction Rules: A Worldwide Survey, 60 Tax Notes Int'l 683 (Nov. 29, 2010). In 2008, an International Fiscal Association study concluded that eighteen out of thirty four countries that the study examined had adopted thin capitalization statutes. Storck, supra, at 36.

[146] Section 163(j) is an example of a source country thin capitalization statute aimed, in this case, at protecting the United States as a source country.

For reviews of the economic evidence of the prevalence of this earnings stripping phenomenon through the use of intragroup leverage, see generally 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 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 sophisticated thin capitalization statutes, however, go much further, by constraining the amount of interest deductions allowable to the parent company of a multinational group in its country of domicile.

The German thin capitalization regime is a good example of this more sophisticated approach.[147] As applied to a German parent of a multinational group, the German thin capitalization rules impose a "hard cap" on interest deductions of 30% of the firm's earnings before interest, taxes, depreciation, and amortization (EBITDA).[148] As a result, if a German firm were to borrow extensively to invest in the equity of foreign subsidiaries (the dividends from which would be exempt), the German parent company would run directly into the hard cap on interest deductibility. The same rule applies to German firms as to source country taxpayers.

There is only one relevant "escape clause" from this outright limit on tax-advantaged leverage: A German parent company can deduct interest without limitation if the firm's German equity-to-debt ratio (looking only at German business assets, not equity in foreign subsidiaries) is no less than two percentage points lower than the firm's worldwide equity-to-debt ratio.[149] In other words, interest expense incurred by the German parent in Germany is fully deductible only if the German parent on a stand-alone basis is no more than immaterially more highly leveraged than are its non-German operations. Australia's rule is roughly similar,[150] and

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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.

Michael Graetz points out that source country thin capitalization rules by themselves (particularly uncoordinated ones) can lead to expenses being deductible nowhere in the world. Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, 62 Bull. for Int'l Tax'n 486, 493 (2008). Presumably a response to this is that companies will bring their internal and external financings into alignment with different source country rules, so as to minimize the cost, but these strategies will not always be entirely successful and have their own efficiency costs.

147 For a summary of current German law, see generally Wolfgang Kessler & Rolf Eicke, Germany's Growth Acceleration Act—Taming the Sunshine Tax Legislation, 58 Tax Notes Int'l 127 (Apr. 12, 2010). The text's recitation of the relevant German rules is drawn primarily from this article.

148 Id. at 128.

149 Id. at 129.

150 Edgar et al., note 145, at 840. ("[Australian thin capitalization rules deny] the deduction of interest on debt of an Australian-resident corporation controlled by a non-resident, to the extent that the amount of such debt exceeds [ ] 75% debt-to-asset ratio. . . .[T]he Australian [rules] effectively limit . . . the amount of debt that can be sourced domestically for interest deductibility purposes to the greater of (1) 75% of Australian assets and (2) 120% of the leverage of . . . worldwide corporate group."). Cf. Reg. § 1.861-10T(e) (imposing certain limitations for foreign tax credit purposes on interest arising on U.S. parent company debt that is disproportionately large in comparison to the indebtedness of its controlled foreign corporations).

Sweden recently has introduced innovative "debt push-down" legislation.[151]

The German approach to thin capitalization as applied to a German parent company protects the German domestic tax base from the arbitrage strategies outlined in *Stateless Income.*[152] Indeed, it cuts more deeply than do the current U.S. rules allocating U.S. interest expenses against foreign income for foreign tax credit purposes, because those rules have largely been vitiated by the very low effective foreign tax rates (before taking these expense allocations into account) that U.S. firms have engineered for themselves through stateless income tax planning.[153]

Thin capitalization statutes are growing in importance and sophistication, precisely because countries that employ territorial tax regimes understand how easy it is to game their tax bases in the absence of such rules through the location of external or internal debt.[154] Critically, the Council of the European Union in 2010 published a resolution on the design of EU Constitution-compliant thin capitalization and "controlled foreign corporation" ("CFC")[155] laws.[156] This resolution recommends a very narrow scope for intra-EU CFC laws, to reflect European Court of Justice jurisprudence on the constitutional freedoms of establishment and movement of capital, but suggests essentially no EU Constitution-mandated restrictions on thin capitalization statutes, beyond the observation that they should in fact reach instances of thin capitalization.[157] This resolution plainly augurs further thin capitalization statutes along the German lines in the years to come.

Even the most sophisticated thin capitalization statutes, however, have limited scope, because they do not reach other forms of intragroup income stripping beyond interest expense. In particular, thin capitalization statutes do not address what has been described as the "black hole" of territorial tax systems: the use of intercompany royalty payments on group intangibles to strip out not just normal returns, but also rents, from a source country to a low-tax affiliate that

[151] Storck, note 145, at 35.

[152] Kleinbard, note 1, at 757-58.

[153] Id. at 717-26.

[154] Storck, note 145, at 29 ("Following this trend, it can be expected that intra-group financing and leverage in general will in the future be scrutinized to a much greater extent than in the past . . . .").

[155] When used outside the United States, the term "CFC" has a somewhat different meaning than the U.S. application of the phrase.

[156] Council Resolution of 8 June 2010 on Coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalization Rules Within the European Union, 2010 O.J. (C 156) 1.

[157] Id. at 2.

holds the group's intangible assets.[158] The size of royalty payments within U.S. multinational groups—some $79 billion in 2006 in royalty and license payments from foreign subsidiaries of U.S. firms to other affiliates, not counting U.S. tax-invisible payments by or to "disregarded entities"—gives some sense of the importance of intangible assets to multinational groups, and also some indication of the potential scope for source country income stripping that returns to intangible assets represent.[159] The magnitude of the issue is exacerbated both by aggressive transfer pricing tax return positions and by the siting of pure business opportunities that do not rise to the level of a transaction to which transfer pricing rules might apply at all.[160]

One might imagine extending thin capitalization principles to intragroup royalties and other returns on intangibles, but that extension is not conceptually straightforward. Firms can raise capital in the form either of debt or equity; in the absence of tax considerations, commercial and bankruptcy considerations would determine a firm's mix of the two. Thin capitalization statutes effectively take inspiration from the results actually obtained in the external financing of firms and apply similar standards to internal group financings.

But firms ordinarily can acquire the use of unique high-value intangible assets that they do not own in only one way: by paying royalties. A limit on the deductibility of royalty payments becomes, in effect, a requirement that firms transfer the ownership of certain assets to affiliates operating in the affected country. This requirement that individual subsidiaries obtain ownership of certain assets not available in the general marketplace is quite different from requiring that those subsidiaries finance their assets and operations through debt and equity capital in proportions roughly consonant with external market norms. The latter brings subsidiaries closer to market behavior; the former interferes with market decisions as to how business will be conducted.

The more general way of expressing this point is that the global tax norms that define the geographic source of income or expense are largely artificial constructs, difficult to administer and often devoid of any conceptual foundation.[161] The extension of thin capitalization principles to royalties paid for the use of unique high-value intangibles

[158] Edgar et al., note 145, at 853.

[159] See Kleinbard, note 1, at 706-13.

[160] Id. at 705.

[161] See, e.g., Devereux, note 14, at 712-13 ("A source-based international tax system would require a multinational company to allocate its profit between the taxing jurisdictions in which it operates. However, attempting to define where profit is generated is often very difficult, and in some cases impossible. . . . [T]his problem is not just one of complexity and uncertainty: it can—and perhaps should—also affect the fundamental design of the tax system."). See also Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global

is tantamount to asserting that the source of income derived from the use of those intangibles (in a territorial tax model, the jurisdiction with the sole claim to tax that income) is the location where the intangibles' customers are located, not the jurisdiction in which the development of the intangible took place, or where the legal owner of the intangible is domiciled. One can make a reasoned argument for this outcome, but it is not compelled by existing tax norms, which give considerable weight to such factors as legal ownership.

These are well-known problems, for which solutions are not obvious.[162] But territorial tax solutions ultimately require their resolution, because the source rules that are adopted determine both the initial allocation of the right to tax the income in question, and the prospects for the use of stateless income tax planning to relocate that income. Thin capitalization rules cannot carry all the burden of both apportioning income to the correct source jurisdiction in the first place and curbing the possibility that such income in turn might migrate to a more hospitable location through stateless income tax planning.

D. CFC Rules

In U.S. tax parlance, a "controlled foreign corporation" signifies simply that a foreign company (typically a corporate subsidiary) ultimately is controlled by a relatively small number of U.S. shareholders.[163] A U.S. shareholder[164] of a CFC includes amounts in gross

Economy 11, 12 (Assaf Razin & Joel Slemrod eds., 1990); Edgar et al., note 145, at 834-36; Graetz, note 146, at 489.

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. See Part IV.

[162] See Graetz, note 146, at 489. Graetz 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. Id. at 489, 492-93. 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 case of the European Union, it would be desirable to develop more immediate solutions that look to unilateral action.

[163] IRC § 957(a).

[164] IRC § 957(b).

income in respect of that foreign company if the CFC incurs subpart F income, such as foreign personal holding company income, and no exception applies, or if the CFC makes an investment in U.S. property,[165] but not otherwise. In other words, shareholders of a U.S. CFC are not disqualified from the benefits of deferral by virtue of that characterization of the foreign company.

By contrast, many other jurisdictions use the term "controlled foreign corporation" to refer to a foreign subsidiary whose income for some reason is disqualified from eligibility for that jurisdiction's territorial exemption rules. In those jurisdictions, to refer to "CFC rules" is to refer to anti-abuse rules of one stripe or another.

In effect, when a territorial tax system adopts CFC rules, it abandons the territorial principle in favor of residence-based taxation with respect to activities within the scope of those rules. Countries that have adopted territorial tax regimes have looked to CFC rules to limit the sorts of tax avoidance that this Article describes under the rubric of stateless income.[166]

As noted in the previous Subsection, far-reaching CFC rules are difficult to reconcile with EU constitutional law guarantees of freedom of establishment and movement of capital, and hence occupy a narrower role within the European Union than otherwise might be the case.[167] Nonetheless, EU Member States are actively reviewing their existing CFC rules, with a view to addressing tax avoidance concerns of the same nature as those developed in this Article and its predecessor, to the extent permitted by EU constitutional parameters.[168] In fact, in March 2011, in connection with its proposal for an EU-wide Common Consolidated Tax Base, the European Commission recommended the adoption of a European-wide CFC rule applicable to subsidiaries outside the European Union.[169] And outside the EU, CFC rules can play a much larger role in constraining stateless income tax planning in a territorial tax regime.

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165 IRC § 956.

166 Nicolas Garfunkel, Are All CFC Regimes the Same? The Impact of the Income Attribution Method, 59 Tax Notes Int'l 53, 54 (July 5, 2010).

167 See text accompanying notes 155-56.

168 See, e.g., Bill Dodwell, Joanne Bentley & Tim Haden, U.K. Begins Corporate Tax Reform Discussion, 60 Tax Notes Int'l 723 (Dec. 6, 2010) (discussing U.K. review of its CFC rules).

169 Eur. Comm'n, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), art. 82, at 47, COM (2011) 121 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. Very briefly, the CFC rule would be triggered if the statutory tax rate in the non-EU country was less than 40% of the average EU rate, and the subsidiary located there derived primarily passive or mobile income of the sort that U.S. readers might associate with foreign personal holding company income, IRC § 954. Most important, tainted income includes royalties from intangible assets and interest income.

For example, in 2009 Japan abandoned a deferral and foreign tax credit regime roughly similar in broad outline to current U.S. law for the taxation of income derived from foreign direct investment, and instead adopted a territorial tax system, under which a Japanese parent company can exclude from its income 95% of the dividends it receives on substantial investments (25% or more) of the stock of a foreign corporation.[170] This change of heart has been much discussed by proponents urging the United States to adopt what this Article earlier described as cartoon territoriality.[171]

Less frequently observed, however, is that Japan also has a stringent CFC rule. Under this rule, a foreign subsidiary of a Japanese firm that has an effective tax rate of less than 20% (ignoring dividends from substantial participations in other foreign affiliates in the income calculation), or whose head office is in a jurisdiction that has no income tax, is not eligible for the new dividend exemption regime.[172] As a result, this income is immediately taxed in the hands of the Japanese parent company.[173]

If the United States were to adopt a territorial tax system with a CFC rule similar to Japan's, then income derived from an arrangement like the Google Double Irish Dutch Sandwich, as described in *Stateless Income,*[174] would fail to qualify for the exemption.[175] As this example suggests, CFC rules like Japan's thus could serve as an important constraint on stateless income tax planning in a U.S. territorial tax system.[176]

E. Haircuts

The parent company of a multinational group typically incurs unreimbursed expenses that benefit the entirety of the worldwide group. Groupwide external debt that is concentrated at the parent company is the most dramatic example. As discussed above, sophisticated thin capitalization statutes are a direct response to this case. A typical parent company, however, will also incur many other unreimbursed

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[170] 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, 628 (2010).

[171] See, e.g., Joseph Henchman, Rethinking U.S. Taxation of Overseas Operations: Subpart F, Territoriality, and the Exception for Active Royalties 2 (Tax Found. Special Rpt. 2011), available at http://taxfoundation.org/files/sr197.pdf.

[172] Id. at 641-42.

[173] Id.

[174] Kleinbard, note 1, at 706-13.

[175] In doing so, Google's tax burden would increase, but it is difficult to believe that Google requires a 2.4% effective tax burden in order to remain competitive on the world stage. Id. at 739.

[176] This also is the conclusion of Lokken & Kitamura, note 170, at 643-45.

groupwide expenses. In the absence of countervailing tax rules, a territorial tax jurisdiction that is the domicile of a multinational firm will find that its tax revenues are reduced by these expenses incurred to support income sourced to other countries, and therefore exempt in the parent company's country of residence.

Many territorial regimes for the taxation of foreign direct investment address this problem through an arbitrary inclusion in the parent company's income of a fraction—often 5%—of otherwise-exempt dividends that the parent receives from its participations in foreign operations. Japan is one example, as described above; France, Germany and Italy are others.[177] These "haircuts" are administratively useful tax heuristics, but they address only a very small part of the stateless income problem—as demonstrated by the willingness of U.S. corporate proponents of cartoon territoriality to offer them up.[178]

F. Transfer Pricing and Formulary Apportionment

Thin capitalization rules and haircuts imperfectly address the sourcing of groupwide indirect expenses (that is, those one step removed from the direct costs of earning business profits). CFC rules put a floor on the most extreme stateless income tax planning stratagems that a country will tolerate, by substituting residence-based taxation for the general territorial rule in the abuse cases described by its CFC rules. None of these rules, however, addresses the first-order question of the sourcing of gross income, particularly income from intangibles, within a multinational group whose parent is domiciled in a jurisdiction that employs a territorial tax system.[179]

The literature in this area is voluminous, and recent contributions generally reach a similar conclusion, which is that the "transfer pricing" rules that dominate the sourcing of income (and the concomitant allocation of taxing rights among source countries) largely fail to reflect the location of observable economic contributors to such income.[180] As a result, this Section presents only a brief narrative summary, and the notes point only to a handful of the most recent papers in the field.

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[177] Samuels, note 128, at 1594.

[178] West, note 67, at 1044; Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, The U.S. International Tax System at a Crossroads, 127 Tax Notes 45, 59 (Apr. 5, 2010) (offering Japan's territorial tax system, with a 5% haircut, as an exemplar); Tax Reform Options: International Issues: Hearings Before S. Comm. on Finance (2011) (statement of Scott Naatjes, Vice President and Gen'l Counsel, Cargill Inc.) (acknowledging use of haircuts by other countries, without criticism).

[179] See text accompanying notes 158-59.

[180] See Kleinbard, note 124, at 552-60 (briefly summarizing a sampling of this literature); see also Kleinbard, note 1, at 703-05

Territorial tax systems rely exclusively on rules defining the geographic source of income to allocate taxing rights among countries. Those sourcing rules in turn should allocate a multinational firm's worldwide group profits in a transparent, predictable, nondistorting, and consistent manner among the countries that are the source of those profits. For many years, the dominant approach to the articulation of these critical sourcing rules has been the "arm's length" standard, as developed in the OECD's transfer pricing guidelines;[181] this standard seeks to allocate income (and with it taxing rights for territorial tax systems) among controlled affiliates of a multinational group by analogizing those affiliates to independent third parties free to contract with each other at market-determined prices.[182] As an organization comprising the governments of thirty-four major economies,[183] including the United States, the views of the OECD carry enormous weight; in practice, the OECD guidelines in this area have largely determined how countries have defined the source of income earned by multinational groups.

The last several years, however, have witnessed an extraordinary conceptual collision between competing approaches to sourcing a multinational group's profits.[184] On the one hand, the OECD has clung ever more tightly to the arm's length model, articulating its application in guidelines of extraordinary length and complexity.[185] On the other, evidence has mounted that the model has failed as a practical matter, and that the administrators of territorial tax systems are

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[181] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (2010).

[182] See Kleinbard, note 1, at 703-05, for background on the OECD transfer pricing guidelines; see also Leibrecht & Rixen, note 132, at 63-69 (helpfully situating the OECD's arm's length standard in the larger ecosystem of the allocation of taxing rights among countries, as articulated in the OECD's Model Convention for the avoidance of double taxation).

[183] Members and Partners, OECD, http://www.oecd.org/document/25/0,3746,en_36734052_36761800_36999961_1_1_1_1,00.html (last visited Nov. 16, 2011).

[184] Reuven S. Avi-Yonah, Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation, 2 World Tax J. 3, 3-5 (2010). The debate is briefly and helpfully summarized from a U.S. perspective (and the OECD's approach roundly criticized) in a series of short articles by Michael C. Durst. Michael C. Durst, Congress: Fix Transfer Pricing and Protect U.S. Competitiveness, 59 Tax Notes Int'l 483 (Aug. 9, 2010); Michael C. Durst, It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws, 57 Tax Notes Int'l 247 (Jan. 18, 2010) [hereinafter Academic]; Michael C. Durst, The Two Worlds of Transfer Pricing Policymaking, 61 Tax Notes Int'l 439 (Feb. 7, 2011) [hereinafter Two Worlds].

[185] See Durst, Two Worlds, note 184, at 440 n.3 ("Chapter 9 of the revised [OECD] guidelines devotes about 26,000 words—more than twice the number in Samuel Beckett's *Waiting for Godot* . . . , including stage directions—to the difficulties faced in [intragroup] restructurings, particularly the problems inherent in respecting contracts among legal entities the economic interests of which entirely coincide."); Durst, Academic, note 184, at 247-48 (summarizing OECD's continuing commitment to the arm's length standard).

extremely vulnerable to firms' aggressive transfer pricing positions.[186] More fundamentally, many scholars have concluded that the concept of "source" ultimately is meaningless when applied to a wide range of group activities, particularly when one takes into account the theory of the firm, which emphasizes that multinational firms exist to capture unique groupwide synergies.[187] These synergistic profits in turn have no natural home that can be ascertained through the application of the arm's length standard.

This is the fundamental crisis confronting all territorial tax systems today: They allocate taxing rights among nations solely by reference to the criterion of the geographic source of a firm's profits, but there is now a strong consensus that the existing source rules are unimplementable as a practical matter, and bankrupt as a conceptual matter. As a result, many thoughtful observers have coalesced around the idea that a world in which territorial taxation is the model for taxing foreign direct investment requires the adoption of some sort of (ideally coordinated) formulary apportionment of income methodology as the mechanism for allocating a multinational enterprise's global income to source countries.[188] That methodology in turn could be applied to all group activities on a consolidated basis (a "unitary" approach) or to a subset of activities where arm's length pricing methodologies appear particularly deficient as a conceptual and administrative matter.[189]

In short, a powerful case can be made that a well-ordered territorial tax system necessarily implies the systematic application of formulary apportionment rules for at least some activities of a multinational group. In an extraordinary development, the European Union in March 2011 took a major step in just that direction, when the European Commission released a detailed proposal for a pan-EU "com-

[186] For one recent econometric study, see Kevin S. Markle, A Comparison of the Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries (Nov. 2010) (unpublished manuscript), available at http://ssrn.com/abstract=1764031. For the viewpoints of practitioners in the area, see Durst, Academic, note 184, at 248-53; Kleinbard, note 124, at 555 (arguing that it is doubtful that enhanced administration can adequately address the transfer pricing abuses that multinational entities possessing highly valuable intangibles pose to a territorial tax system).

[187] See, e.g., Devereux, note 14, at 712-13; Durst, Academic, note 184, at 249; Schön, Tax Coordination pt. 3, note 134, at 246-49; Vann, note 53, at 313-43.

[188] In addition to the articles by Vann, Schön, Devereux, and Durst cited earlier, see, e.g., Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, 9 Fla. Tax Rev. 497, 498 (2009); Reuven S. Avi-Yonah & Ilan Benshalom, Formulary Apportionment—Myths and Prospects, 3 World Tax J. 371, 380-81 (2011); Reuven S. Avi-Yonah & Kimberly A. Clausing, Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment, in Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes 319, 326-33 (Jason Furman & Jason E. Bordoff eds., 2008).

[189] See Avi-Yonah & Benshalom, note 188, at 380-81, 383-87.

mon consolidated corporate tax base" ("CCTB").[190] This is the culmination of a project begun ten years earlier.

If approved by the European Parliament and agreed to unanimously by the EU's member states in Council, the CCCTB would permit a firm with operations in the European Union to elect to consolidate its EU operations, and then to apportion its consolidated net EU income among the members of the group (and member states) in accordance with a formula.[191] The European Commission summarized that formula as follows:

> The formula for apportioning the consolidated tax base should comprise three equally weighted factors (labour, assets and sales). The labour factor should be computed on the basis of payroll and the number of employees (each item counting for half). The asset factor should consist of all fixed tangible assets. Intangibles and financial assets should be excluded from the formula due to their mobile nature and the risks of circumventing the system. The use of these factors gives appropriate weight to the interests of the Member State of origin. Finally, sales should be taken into account in order to ensure fair participation of the Member State of destination. Those factors and weightings should ensure that profits are taxed where they are earned. As an exception to the general principle, where the outcome of the apportionment does not fairly represent the extent of business activity, a safeguard clause provides for an alternative method.[192]

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

In light of the administrative failures and conceptual bankruptcy of the arm's length standard, some sort of formulary apportionment may be a necessary implication of any well-ordered territorial tax system, but formulary apportionment is not a panacea, and brings with it its own implementation and abuse problems.[193] The system can be gamed, for example, through the relocation of relatively fungible real assets or personnel to low-tax jurisdictions (to attract a disproportionate amount of groupwide net profits), or by the acquisition of low-value-added but high-volume businesses (for example, a grocery store

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[190] See Eur. Comm'n, note 169.

[191] Id. art. 6, at 21, art. 55, at 38, art. 86, at 49.

[192] Id. at 14.

[193] Compare Rosanne Altshuler & Harry Grubert, Formula Apportionment: Is it Better than the Current System and Are There Better Alternatives?, 63 Nat'l Tax J. 1145, 1180 (2010), with Avi-Yonah & Benshalom, note 188, at 390-92.

chain) in a low-tax jurisdiction to augment the sales factor in that jurisdiction.[194] This in turn requires responses such as the ability of tax administrators to divide firms into different subgroups where necessary to prevent abuse. In the absence of a multilateral implementation along the lines contemplated by the European Union, formulary apportionment also has been roundly criticized as highly likely to lead to under- or over-taxation,[195] because its goals of taxing income where earned will be drowned out by the cacophony of competing measurement systems.

G. Summary

The global adoption of ideal territorial tax systems no doubt would lead to optimal taxation of foreign direct investment within the confines of an income tax. The difficulty is in implementing territorial tax regimes that are not easily susceptible to the depredations of stateless income tax planning. *Stateless Income* demonstrated the pervasiveness of the stateless income problem; this Article in turn has reviewed how difficult it is for territorial tax systems in practice to respond to the phenomenon.

In the absence of granting a substantial role to formulary apportionment, territorial tax systems are highly susceptible to income shifting through stateless income tax planning.[196] Thin capitalization rules and haircuts can address allocation problems relating to some indirect expenses incurred by a multinational group, but do not touch at all on the misallocation of net business income in the first place. CFC rules, where available, can put a floor on stateless income tax planning, but CFC rules are inconsistent with the territorial impulse, because to the extent of their scope they turn territorial tax regimes into worldwide tax systems. Moreover, they often are highly controversial beyond ordinary tax politics, particularly when they are structured as "black lists" of countries with unacceptably low tax rates, because they are seen as involving matters of state. As such, the floors they set often leave room for extensive stateless income tax planning.

As a result, territorial tax systems necessarily imply some significant role for formulary apportionment of net business income, whether of the entire multinational enterprise or of some constituent elements. But there has been very little real world experience with large-scale cross-border formulary apportionment regimes, and their susceptibility to gaming once released into the field is an important unknown.

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[194] Altshuler & Grubert, note 193, at 1182-83.
[195] Id. at 1148.
[196] See Markle, note 186, at 40.

More important, in the absence of some form of multilateral cooperation in the implementation of formulary apportionment factors, there is substantial risk of systematic over- or under-taxation of different firms.

It is difficult to imagine how a multilateral global formulary apportionment system can come to pass, but it is equally difficult to envision how territorial taxation can be protected from the depredations of stateless income tax planning without such a system. The conflict is irreconcilable.

VI. Worldwide Tax Consolidation

A. *Introduction*

The logical alternative to a territorial tax system is a worldwide global tax consolidation (or "full-inclusion") model.[197] As the prior paper in the stateless income project pointed out, this is *not* the same as the current U.S. system for taxing foreign direct investment.[198] A genuine worldwide tax model would effectively consolidate the operations of foreign subsidiaries with those of the parent company for tax purposes, just as they today are consolidated for financial accounting purposes, and impose residual U.S. tax, net of a foreign tax credit, on a current basis, regardless of where the income is retained as a cash matter.[199]

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[197] A worldwide "imputation" system recently was recommended in Samuel C. Thompson, Jr., An Imputation System for Taxing Foreign-Source Income, 130 Tax Notes 567, 575-78 (Jan. 31, 2011). That paper briefly reviews some of the same issues considered in this Part, but is ambiguous as to whether the system that Thompson contemplates would be tantamount to tax consolidation, in which net losses as well as net income of foreign subsidiaries would be includible in a U.S. parent company's tax return.

[198] Kleinbard, note 1, at 715-26.

[199] To achieve the purposes contemplated by the text, the ownership threshold for consolidation of foreign subsidiaries should be set at the direct or indirect ownership of stock comprising more than 50%, by vote or value, of the stock of the foreign corporation. Consolidation would be mandatory in these circumstances. In the case of a conflict between two U.S. shareholders, one of which owns more than 50% of a domestic firm's voting stock, and the other more than 50% of the value of that firm's stock, an arbitrary tie-breaker rule would be required.

It also may be necessary to retain current law principles to address companies that are today CFCs, but that do not have a single U.S. shareholder with sufficient control to consolidate that company. These cases are not very frequent in practice.

Current law governing the consolidation of domestic affiliates, by contrast, generally requires ownership of at 80% of the voting power and value of the stock of a domestic company, through chains of other includible domestic companies. IRC § 1504(a). Solely for purposes of current law rules that allocate domestic interest expense in part to foreign sources for purposes of calculating a taxpayer's maximum allowable foreign tax credit, Treasury regulations provide that domestic firms linked through the ownership of 80% of the voting power or value of a firm's stock (including through foreign corporate intermediaries) will be treated as affiliated. Reg. § 1.861-11T(d)(6).

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

Second, a worldwide tax consolidation solution treats losses symmetrically with income. Symmetry in the taxation of losses and income is critical to the accurate taxation of capital income.[200] Current law is asymmetrical, in that a foreign subsidiary's losses do not give rise to reductions in U.S. tax, while foreign income ultimately is includible in the U.S. tax base when repatriated. Both territorial and worldwide tax consolidation systems resolve this distortion. In the territorial case, that result follows from the fact that foreign operating earnings are taxed by the residence country at a zero rate, and conversely no deductions are available in the residence country for foreign losses. In the worldwide tax consolidation case, that result follows from the extension of tax consolidation to foreign operations, so that foreign operating losses (including losses incurred by a foreign subsidiary) are fully available to offset domestic income.

Third, a worldwide tax consolidation system by definition satisfies the traditional CEN benchmark. This is not the only relevant goal in designing an international tax system, but it is nonetheless a desirable result, if it can be obtained without introducing other major distortions in taxpayer behavior. More generally, a worldwide tax consolidation system focuses policymaker attention on domestic productivity and competitiveness as well as on international business competitiveness, because the tax system links the two. Territorial tax systems, by contrast, do not implement neutrality in investment location decisions in a world imbued with stateless income.

Fourth, and most critically for the themes developed in this Article, a worldwide tax consolidation system directly addresses the problem of stateless income. Under such a regime, a multinational business enterprise obtains no advantage from generating stateless income, provided that its average effective foreign tax rate before taking stateless income into account is not higher than the residence jurisdiction tax rate.[201] The reason of course is simply that income moved to a

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[200] Edward D. Kleinbard, Designing an Income Tax on Capital, in Taxing Capital Income 165, 168-69 (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007).

[201] The text here assumes a foreign tax credit mechanism that permits some amount of cross-crediting, as does the current U.S. system. It is a fair question, though, whether current law or the law of cross-crediting circa 1986 is the better implementation of the idea,

low-tax foreign jurisdiction is nonetheless taxed in the residence country at the latter's rates.

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

Fifth, a worldwide tax consolidation system resolves two specific, large and otherwise intractable administrative issues embedded in current stateless income tax planning. Worldwide tax consolidation largely resolves the problem of transfer pricing enforcement, because again there is no advantage to using aggressive transfer pricing strategies to move income from the residence country to a low-tax foreign affiliate, or even from one foreign affiliate to another (again provided that the average effective foreign income tax rate does not exceed the residence country rate).[202]

Worldwide tax consolidation also mitigates the otherwise intractable problem of expense allocations. Contrary to Hines' prescription, a territorial tax system that operates in a world imbued with stateless income (so that the implicit tax model fails for privileged actors) requires that domestic expenses be disallowed in some fashion to the extent they support foreign exempt income, because the failure to do so exposes the domestic tax base to erosion through straightforward arbitrage.[203] But just as the geographic source of income is an ambiguous concept, so too the allocation of some domestic expenses as attributable to foreign-source activity is an artificial exercise. Every practical solution (for example, a German-style thin capitalization rule) is simply a rule of convenience that can be criticized as inconsistent with commercial realities in specific applications.

In a worldwide tax consolidation system, by contrast, expense allocation rules are not a critical component of the allocation of taxing rights, because every item of global income and expense is reflected on a current basis on the parent company's tax return.[204] In other words, a worldwide tax consolidation system can accept a taxpayer's unilateral decisions as to where to site its expenses, because those decisions will have no effect on the taxpayer's ultimate tax liability

particularly in light of the need to encourage U.S. taxpayers to minimize foreign tax liabilities.

202 This is the theme of Kleinbard, note 124.

203 Kleinbard, note 1, at 757-58.

204 See Grubert & Altshuler, note 3, at 354. Grubert and Altshuler couple the full worldwide inclusion taxation system with a reduced corporate tax rate of 28%. Id at 347.

(again assuming that the average effective foreign tax rate does not exceed the residence rate).[205] If firms were tax-indifferent across this dimension, one would expect that expenses generally would be booked in the jurisdictions to which they have a commercial nexus.[206]

Notwithstanding this general observation, thin capitalization statutes are necessary even in worldwide tax consolidation. The reason is to ensure that U.S. multinational firms are encouraged to "push down" debt to their foreign subsidiaries. Without a thin capitalization statute, U.S. firms might otherwise be indifferent to the magnitude of their foreign tax liabilities, by virtue of the foreign tax credit.[207]

B. Defining the Contours of a Worldwide Tax Consolidation Regime

The remainder of this Part develops in more detail the basic contours of a readily-implementable worldwide tax consolidation regime that would address the more obvious objections that might be raised. For the sake of clarity, however, it is useful to summarize by way of a stalking horse the contours of a system that might usefully be proposed as an alternative to the adoption of territorial taxation.

This summary leaves out the fundamental tax reform step described at the end of this Part, which comprises revisiting the corporate income tax (more accurately, the income tax on net business income) to convert the entity-level tax to a consumption tax, while preserving the ultimate income taxation of capital income through a new form of taxation at the investor level. This fundamental tax reform proposal (the Business Enterprise Income Tax, or BEIT) has many administrative and economic efficiency virtues outside the international tax arena, but also is enormously helpful in responding to the inevitable objections that a worldwide tax consolidation system unfairly disadvantages the competitiveness of U.S. multinational enterprises.

As applied to the United States, then, a worldwide tax consolidation regime for taxing foreign direct investment that is incremental to current law would contain the following elements:

- Reduce the U.S. corporate tax rate significantly (to bring it into conformity with evolving world norms and improve the competitiveness of the U.S. *domestic* economy) and eliminate current corporate tax expenditures, such as accelerated depreciation.

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[205] Those decisions as to where to site expenses (particularly interest expense), however, will affect a multinational group's allocation of tax payments between residence and source countries. This point is developed in more detail in the text below.

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

[207] This is consistent with the concerns expressed by Shaviro in his papers discussed in Stateless Income, note 1, pt. IV.

The rate necessary to achieve the international conformity goals is in the range of 25–27%.

- Tax the worldwide income of U.S.-domiciled firms on a current basis by bringing foreign affiliates into the U.S. consolidated group (to remove the attribute of stateless income and to protect the domestic tax base from earnings stripping by U.S. firms).[208]
- Retain the existing foreign tax credit system in general.
- Revise the definition of U.S. corporate residence to reflect the "mind and management" of a firm, not its place of incorporation.
- Abandon existing interest expense allocation rules for purposes of calculating the foreign tax credit, as unnecessary in an environment of current worldwide taxation (thereby mitigating the total tax burden on foreign direct investment that might follow for firms whose operations are predominantly in foreign jurisdictions with relatively high tax rates).
- Adopt thin capitalization rules that protect the U.S. base both as to parent companies of multinational groups that are resident in the United States and as to U.S. subsidiaries of multinational groups whose parent companies are foreign residents.

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

Worldwide tax consolidation is an effective and easily implementable response to the pervasive problem of stateless income tax planning, but it is unpopular both among multinational firms, which understandably enjoy current law's freedom to reduce their effective tax burdens to a small fraction of weighted average statutory rates, and among many scholars, who see it as in theory distorting investment decisions when compared with an ideal (and unobtainable) territorial tax.[209] These are important concerns; the fact that many multinational firms overstate their case does not mean that there is no case to be made. But there is a reasonably satisfactory response, which is the coupling of worldwide tax consolidation with tax rates comparable to a relevant global median rate.[210]

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[208] Note 199 describes modifications that would need to be made to current law's definition of the requisite ownership requirements that would trigger consolidation.

[209] Michael P. Devereux, Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations, 24 Oxford Rev. of Econ. Pol'y 698, 709-10, 716-17 (2008).

[210] The Business Enterprise Income Tax further directly addresses the competitive tax environment that firms face.

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

Many low-tax jurisdictions are the depositories of enormous amounts of multinational firm *income*, from both U.S. and foreign firms. But when presented as a competitiveness argument this is not a tax capitalization or capital ownership neutrality story. Rather, it is akin to a competition in export subsidies: That is, because some countries have poorly-implemented territorial tax systems, thereby enabling their national champions to funnel income from high-tax to low-tax countries through stateless income tax planning, the United States should as well.

As in competition among nations to match and outdo each other in export subsidies, the economically rational behavior here is to abstain. What is more, in light of the leading role that the United States (the largest economy in the world) today plays as an abetter of stateless income tax planning by *its* national champions, there is reason to be believe that more balanced U.S. rules will enable other sovereigns to address weaknesses in their policing of aggressive stateless income generation by their national champions. In fact, confusing tax subsidies with tax policies ignores the many steps that many major jurisdictions already have undertaken (as outlined in Part V) to improve the robustness of their territorial tax systems.

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

Stateless Income considered global tax rates in some detail.[211] The 2010 unweighted average corporate tax rate of the eleven largest OECD countries excluding the United States was almost exactly 30%; the unweighted average of the "BRICs" (Brazil, Russia, India, and the People's Republic of China) was 28%; China's tax rate was 25%.[212] This suggests that a worldwide consolidated tax rate in the neighborhood of 25-27% would satisfy both genuine competitiveness concerns and the capital ownership neutrality benchmark—in the latter case, not because a worldwide consolidated tax regime was the theoretically correct design, but because the rate actually employed by the United States on worldwide income would happen to coincide with the tax rates reflected in the tax capitalization of asset prices in the major relevant countries in the world. The United States does not need to compete with the tax rates available to domestic firms in the Slovak Republic (19%, as it happens[213]) for U.S. firms to be competitive on the global stage.

U.S. tax rates comparable to the median rates for major economies go a long way to addressing legitimate competitiveness concerns. Just as important, those lower U.S. rates make the *domestic* operations of U.S. firms more competitive on the world stage as well. Given the size of the U.S. economy, and the dominant role therein of U.S.-based firms, this is not a small issue, even if it is one largely unaddressed in recent tax policy debates designed to influence the decisions of policymakers.

The next Section continues this analysis with respect to the concern that worldwide tax consolidation would lead to the emigration of firms from the United States.

D. What's Not to Like?—Meaninglessness of Residence

The second problem associated with a worldwide tax consolidation regime is that, like territorial systems, it is vulnerable to the criticism that it relies on a critical artificial conceptual foundation. In the case of territorial systems, that artificiality lies in the definition of "source," which in turn operates to allocate among jurisdictions the right to tax the relevant item of income. In the case of worldwide tax consolida-

[211] See Kleinbard, note 1, at 758-62.

[212] Author's calculation from data in KPMG, Corporate and Indirect Tax Survey 2010, at 12-14 (2010), available at www.kpmg.com/GE/en/IssuesAndInsights/ArticlesPublications/Documents/Corp-and-Indirect-Tax-Oct12-2010.pdf. The author's calculation employs the standard (nonpreferential regime) maximum corporate income tax rate, which is consistent with the OECD methodology.

[213] KPMG, Corporate and Indirect Tax Survey 2011, at 8 (2011), available at www.kpmg.com/CH/en/Library/Articles-Publications/Documents/Tax/pub-20111102-corporate-and-indirect-tax-survey-en.pdf.

tion systems, the artificiality lies in the concept of corporate "residence."[214]

Certainly it is true that the most sophisticated multinational enterprises can be described as having transcended ordinary concepts of citizenship in only one state. And of course it is the case that the current U.S. definition of corporate tax residence (which looks solely to the place of incorporation) is completely artificial. But it also is the case that it is difficult to think today of many significant examples of firms that in the popular imagination are U.S.-domiciled, but that as a tax matter are not. In short, in many cases the practical tax categorization of the residence of a parent firm of a multinational group is easier than theory might suggest.[215]

Very importantly, it also is the case that there are more national ties between U.S. firms and their owners than one might expect. For example, in 2001 U.S. investors owned 87% of the aggregate value of firms traded on U.S. stock markets (in turn, overwhelmingly firms treated as U.S. residents).[216]

This Article earlier pointed out that most coherent theory for the existence of a corporate income tax is that it serves as a substitute for the imposition of current tax on the firm's owners. Where (as is the case in small open economies) there is only a partial correspondence between the residence of a firm and the residences of its owners, the case for a worldwide tax consolidation system that elevates the consequences to nonresident investors of the parent company's domicile is proportionately weakened, and a territorial tax system is closest to implementing economic neutrality, given the portfolio investment options of nonresident shareholders.

But as applied to the United States, whose resident companies are overwhelmingly owned by U.S. investors, the rationale for worldwide taxation along this margin is strong. In other words, if the U.S. corpo-

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[214] See, e.g., Shaviro, note 105, at 429 ("In an increasingly integrated global economy, with rising cross-border stock listing and share ownership, it is plausible that U.S. corporate residence for income tax purposes, with its reliance on one's place of incorporation, will become increasingly elective for taxpayers at low cost. This trend is potentially fatal over time to worldwide residence-based corporate taxation, which will be wholly ineffective if its intended targets can simply opt out.").

[215] See Vann, note 53, at 307 n.44 (In practice, "the test of corporate residence generally is robust for the parent in an MNE group," but not for its foreign subsidiaries.).

[216] Philip R. Lane & Gian Maria Milesi-Ferretti, International Investment Patterns 31 (Int'l Monetary Fund, Working Paper, WP/04/134, 2004). For a sense of scale, the U.S. domestic stock market capitalization represented 49% of the world's stock market capitalization in that year. Id; see also Anil V. Mishra, International Investors' Home Bias in Portfolio Equity Investment (2007), http://eprints.usq.edu.au/2176/2/Mishra_2007_International_investors.pdf (last visited Nov. 9, 2011) (analyzing some of the factors that explain investors' marked bias in favor of investing in companies they identify as resident in their home countries).

rate income tax is best justified as a substitute tax on U.S. individual owners when the corporation in question is both domestically owned and operated, and if it also is accepted that taxing U.S. individuals on their worldwide income is an appropriate exercise of U.S. taxing power from an economic perspective (again accepting as a given a tax system that burdens capital income), then it must surely follow that imposing U.S. corporate income tax on the worldwide income of firms that are overwhelmingly ultimately owned by U.S. persons also is theoretically sound.

In short, if U.S. firms (however defined) are in fact overwhelmingly owned by U.S. persons, then treating those firms as themselves U.S. persons is a fair first-order approximation of a more sophisticated answer. And the completely artificial current statutory definition of corporate residence in turn can be modernized to look to a company's "mind and management" (the U.K. concept[217]) rather than simply its place of incorporation. As so modified, the rule might retain some artificiality, but the consequences of the application of that artificial rule do not seem hugely distortive.

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

The first response to this concern, of course, is the point developed in the preceding Section: A tax burden squarely in the median of other major relevant economies (that is, in the neighborhood of 25-27%) is not much of a competitive burden at all, except to the extent that one believes that all such other economies will continue to countenance unlimited stateless income tax planning by their national champions. But as noted this in turn is at best an argument for matching other countries' government subsidies, not a genuine competitiveness argument, and one that in any event is not relevant to foreign competitors in their domestic markets.

Second, the United States today has an "anti-inversion" statute that prevents a U.S. firm from simply situating a foreign holding company on top of it.[218] That statute is imperfect in its reach,[219] but those im-

[217] See Mitchell A. Kane, Strategy and Cooperation in National Responses to International Tax Arbitrage, 53 Emory L.J. 89, 91 & n.4 (2004).
[218] IRC § 7874.

perfections reflect a political judgment, not the existence of irresolvable technical difficulties in broadening its application.

Third, a more modern definition of corporate residence responds to the claim that in a worldwide tax consolidation system simply organizing a U.S. business as a foreign corporation will lead to tax savings. If U.S. individuals are the "mind and management" of the organization, it will be a U.S. firm, regardless of its place of incorporation.[220] For these reasons, I believe that the concerns expressed by Shaviro in a recent paper on the topic are overstated in practice today, and can be successfully addressed in the future.[221]

Fourth, existing law today imposes a prohibitive "toll charge" on the transfer of U.S. business assets to a foreign firm in a tax-free incorporation or reorganization transaction.[222] Those rules also can apply to tax-free stock acquisitions in which the stock of a U.S. firm is acquired by a foreign company, and U.S. shareholders control the combined enterprise.[223] Again, these rules might not be completely watertight, but if there is a bona fide competitiveness concern that remains in respect of tax-free acquisitions, any remaining seams can readily be caulked.

Finally, it is useful to compare the definitional problems that must be overcome in implementing a successful territorial tax regime with the different definitional issues raised by a worldwide tax consolidation system. As described above, territorial tax systems satisfy coherent economic norms only when deployed in a world without stateless income, or, phrased alternatively, in a world where source rules for both income and expenses are transparent, comprehensive, and

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219 See West, note 67, at 1042 n.112.

220 As an anecdotal aside, I note that virtually all of the enormously successful "new economy" firms created in the last few years that were organized by U.S. entrepreneurs were formed as U.S. corporations. Facebook, Google, and Amazon are three examples. It might be argued that the stakes will be raised once worldwide tax consolidation is introduced, but the counterpoint is that today it is virtually costless to organize as a foreign firm, while in the future it will require relocating senior management and board of directors supervision outside the United States. Yet despite the clear tax advantages to organizing as a foreign firm today (for example, never dealing with subpart F of the Code, and avoiding the lock-out price that must be paid for stateless income tax planning), and the ease of doing so, real-life examples of successful new public firms that have done so are not easy to find. (Some years ago a number of new enterprises did organize as offshore companies from the start, but some of those whose names come most easily to memory (for example, Global Crossing) have since collapsed.) Lee A. Sheppard, Will Treasury Stop Cross-Border Mischief?, 94 Tax Notes 547 (Feb. 2, 2002); Lee A. Sheppard, Preventing Corporate Inversions, 95 Tax Notes 29 (Apr. 7, 2002).

221 See Shaviro, note 105, at 429.

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

223 IRC § 367(b).

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

By contrast, a worldwide tax consolidation system can be implemented unilaterally, but is principally vulnerable to the risk that its definition of a corporate "resident" will prove to be overinclusive in some instances, and underinclusive in others. The key difference, though, is that the consequences of an imperfect definition of corporate residence will be visited only on those firms at the margin of whatever definition is adopted: The remainder will be unaffected. By contrast, in a territorial tax world *every* multinational firm will be able to exploit weaknesses in different (or for that matter, identical) definitions of "source," or the decision by one or more countries not to join the new world order, out of a belief, for example, that adopting less restrictive anti-base erosion rules than the new international norms a country could encourage inflows of capital. Each approach to the taxation of foreign direct investment is vulnerable to definitional imprecision, but the aggregate consequences of those failings for neutrality in economic decisionmaking would not appear to be comparable at all.

E. *What's Not to Like?—Disincentivizing Foreign Tax Reduction*

A third concern that would be raised on the adoption of a worldwide tax consolidation system would be that resident multinational firms would have no incentive to reduce their foreign tax burdens, at least to the extent that their average effective foreign tax rate was below the residence country rate. This is the point of Shaviro's recent project to promote neo-national neutrality concerns, as described in Part IV.[224] In that circumstance, foreign income taxes would be fully utilizable as foreign tax credits, and firms would incur no incremental cost for bearing those taxes.

A partial answer of course lies in choosing the right residence country rate: The lower it is, the more aggressively firms will be required to pursue local source-country tax minimization strategies. A more complete answer would be that, when placed in an environment of worldwide tax consolidation, firms generally can be expected to site their income where their business operations are located, because

[224] See text accompanying notes 107-12.

then tax results will comport with the firm's real factors of production, and with how income is recorded for management purposes.

There is little reason for a U.S. firm deliberately to overpay a foreign source country, just to spite the United States. And of course, were a firm actually to do so, the resulting taxes would not be creditable, because current law provides that taxes are creditable only to the extent the amount is not greater than a reasonable approximation of the final tax liability.[225] In sum, it seems much more probable that the United States would collect residual tax not collected today from operations in low-tax countries than it is that all this potential residual tax will be secretly bargained away by firms looking to curry favor with source country tax administrations.

Nonetheless, the problem to which Shaviro calls our attention does exist in worldwide tax consolidation regimes, not with respect to the siting of investment or arbitrage of the domestic tax base, but rather with respect to siting of indirect expenses, particularly interest expense. The next Section addresses those problems.

F. What's Not to Like?—Expense Allocations and Sovereignty Issues

The prior Section argued that the United States generally could rely on the tax heuristic that, once placed in a worldwide tax consolidation environment, firms would locate their activities wherever it makes the most commercial sense, and therefore expense allocation rules were not important to such a system's designs. The location of interest expense is an important exception to this intuition.

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

The result would be residence country base erosion. Imagine, for example, that firms faced the same tax rates everywhere in the world. Even in that environment, nontax capital markets preferences would lead a multinational firm to borrow extensively in its residence country, at least until external interest expense reached a ceiling of domestic operating income. The parent in turn would have no incentive to fund foreign subsidiaries with anything other than equity; the resulting foreign operating income would be includible in the parent's world-

[225] Reg. § 1.901-2(e).

wide consolidated tax return, but would be sheltered by foreign tax credits. The net result would be the same aggregate worldwide tax burden as if the group's external debt were distributed throughout the group's member companies, but the residence country would be a revenue loser, and source countries revenue winners. Since the United States is still a private direct investment net investor,[226] this suggests that U.S. revenues could be at risk.

This is a serious issue, but one that can be addressed by a well-designed thin capitalization statute along the lines of the German rules described earlier.[227] Such a statute would effectively permit a U.S. parent company to deduct interest expense on its U.S. tax return only to the extent of a "hard cap" (if one is adopted) or, more plausibly, to the extent that its domestic debt-to-assets ratio (counting only residence country assets) was not substantially greater than the group's worldwide external debt-to-equity ratio. A parent-level thin capitalization statute thus can impel firms to "push down" parent-level external debt through internal intercompany loans to foreign affiliates.[228] The pushed-down debt would bring taxable interest income (largely unsheltered by foreign tax credits) up to the residence country, thereby protecting the residence country's tax base.

A well-designed thin capitalization statute thus functions in practice as a form of worldwide interest apportionment, after firms apply straightforward internal financing decisions as a kind of self-help mechanism. What is more, such a statute does so without requiring tracing of proceeds by taxpayers or multilateral agreements among countries.[229]

Stewardship expenses, and research and development expenses, also can be substantial, arguably benefit the group as a whole, and often are undertaken by the group's parent company or a local affiliate thereof. Actual "chargebacks" to offshore affiliates of stewardship expenses are probably not appropriate, however, if one accepts as a starting point the view that these items are incurred for the benefit of the shareholder (the parent company).

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[226] See Joint Comm. on Tax'n, Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States 16-17 (2008), available at http://www.jct.gov/publications.html?func=startdown&id=1290 (reporting that in 2006 foreign direct investment by U.S. persons outweighed direct investment into the United States by foreign persons by roughly $800 billion, measured at cost).

[227] See text accompanying notes 147-51.

[228] Id. (discussing Germany and Sweden's response to thin capitalization). For the result postulated in the text to work correctly, back-to-back loans would need to be treated under the relevant thin capitalization statute only as borrowings by the second group member (the borrower under the internal loan).

[229] See Graetz, note 146, at 486-87 (2008) (urging an explicitly-multilateral solution).

Research and development (the more important of the two) is an expense incurred to create an asset, and if the self-created asset is treated as owned by the parent company, then so too should the expenses be the parent's. The protection of the U.S. tax base from depredation through locating research and development expenses in the United States is to embrace that result (for all the usual positive externality reasons), and to concentrate on the other side of the ledger, which is the arm's length royalties that should be received from foreign affiliates for the use of the resulting intangibles.

Of course that implicates all the failings of current transfer pricing administration, but the idea is that, in a world of a constant tax burden, U.S. firms would no longer have systematic incentives to undervalue intangibles that are created in the United States and exploited globally by the group—except to the extent that doing so would avoid conflict with a source country's tax administration. The IRS thus would still have a role to fill in transfer pricing, but as a general matter U.S.-based multinational firms should behave as neutral stakeholders, rather than enemy combatants. In any event, Treasury would be immeasurably better protected from erosion through transfer pricing abuse than would be the case under a territorial tax system.[230]

A final problem with worldwide tax consolidation is that to some extent it limits a sovereign's flexibility in setting corporate income tax rates. For the reasons developed earlier in this Section, a sensible worldwide tax consolidation system requires that a country's corporate tax rates be comparable to world median rates. Since these rates would apply to domestic as well as to international operations,[231] the result would be a circumscribed range of plausible corporate tax rates that a country might adopt. The only answer to this is that in a global economy the tax rates imposed on domestic capital income (as well as on income from foreign investments) are an important part of the overall competitiveness of local firms. It may be that the tail (the taxation of foreign direct investment) ought not to wag the dog, but if one consequence of adopting an otherwise-useful scheme for the taxation of foreign direct investment is that the dog is nudged closer to world norms, that is not an undesirable outcome.

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[230] Kleinbard, note 124, at 554-55.

[231] It is possible of course to imagine split tax rates, with different rates imposed on domestic and foreign income, but that solution would import many of the weaknesses of current law (transfer pricing disputes, stateless income tax planning more generally, importance of the definition of source of income, allocations of expenses, and the like). On balance, a split-rate approach would seem to be both too complex and too unsuccessful to be a useful direction to pursue.

G. Transition Issues

The transition from the current U.S. ersatz territorial system for taxing foreign direct investment to a true worldwide tax consolidation system ought not to be mechanically difficult. At a technical level, the definition of an "affiliated group" (the group of companies eligible to file consolidated federal income tax returns) would be amended to strike current law's exclusion of foreign corporations.[232] The amended statute would further need to require (rather than permit) the filing of consolidated federal income tax returns when a group includes a foreign corporation,[233] and to incorporate the anti-abuse rules of the existing tax regulations governing the allocation of interest expense within affiliated groups.[234]

The new regime would require a comprehensive thin capitalization statute (a useful idea in any event), which could be modeled, for example, after existing legislation in Germany or Australia.[235] The definition of corporate residence would need to be revised; legislation introduced in 2010 by Congressman Doggett could serve as a useful starting point in this regard.[236]

Existing earnings of foreign subsidiaries that previously were taxed in the United States would not be taxed on distribution under the new system without the need for any further statutory adjustments, but pre-existing untaxed foreign earnings (essentially, financial accounting "permanently reinvested income") would have to be brought into the U.S. tax base at the time of adoption of the new system. Since the current amount of such earnings is very large (over $1 trillion), consideration could be given to a special tax rate to be imposed on this one-time adjustment to the worldwide tax consolidation system. And regardless of any special rate, the norm in tax legislation in such circumstances is to give taxpayers several years to pay the tax arising from such a fundamental accounting change;[237] such plainly would be appropriate here.

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[232] IRC § 1504(b)(3)(excluding foreign corporations from the definition of includable corporation).

[233] IRC § 1501 offers firms the option of filing consolidated federal income tax returns, but does not generally require them to be filed.

[234] Those anti-abuse rules (1) effectively revise the definition of affiliation to include a foreign corporation if U.S. members of the group own stock representing at least 80% of either the foreign corporation's voting power or value (rather than both), Reg. § 1.861-11T(d)(6)(ii), and (2) ignore the interposition of partnerships or other vehicles that might otherwise break tax consolidation. Reg. § 1.861-11(d)(7).

[235] See text accompanying notes 147-51.

[236] International Tax Competitiveness Act of 2010, H.R. 5328, 111th Cong. § 2 (2010).

[237] See, e.g., Omnibus Budget Reconciliation Act of 1993, Pub L. No. 103-66, § 13223(a), (c)(2), 107 Stat. 312, 481-85 (codified at IRC § 475) (requiring securities dealers to adopt a mark-to-market method of accounting for their annual income and providing that affected

H. The Business Enterprise Income Tax—A Brief Reintroduction

This Article already is long and discursive, but it is nonetheless useful to reintroduce readers very briefly to the charms of the Business Enterprise Income Tax (BEIT).[238] In essence, the BEIT converts the corporate income tax into a consumption tax (analogous in effect to a cash flow tax) through the introduction of an "allowance for corporate capital" (to use the generic term), which the BEIT termed a "Cost of Capital Allowance" (COCA).[239] There are many advantages to businesses facing a consumption tax rather than income tax burden, including a more neutral economic environment (because normal returns to income no longer are measured, much less taxed, since they are exempt under a consumption tax) and lower tax burdens (if corporate tax rates are not adjusted upwards).

The unique feature of the BEIT is that it restores the total tax burden on capital invested in business enterprises to a single comprehensive income tax on that capital by adding to the firm-level consumption tax a tax at the shareholder level on normal returns to income (the very returns that the COCA mechanism exempts at the firm level). In practice the investor-level tax operates like the Dutch "box" tax on investment income: It is an automatic inclusion in income of a normal return multiplied by the investor's tax basis in her investments in the firm, regardless of the investment's actual performance for the year. All other returns from an investment in a business enterprise would be exempt at the investor level.[240] Because the tax on investor-level normal returns would be wholly unsheltered by depreciation or the like, it would be both easy to measure and would restore government tax revenues to those that would be obtained in a well-ordered income tax (which, after all, is what the BEIT is).

The BEIT has some particularly attractive qualities when employed as part of a worldwide tax consolidation system that relies on a foreign tax credit. First, by shifting part of what today is a corporate-level tax burden (the tax on normal returns to capital invested in a firm) to

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taxpayers would pay the one-time tax arising from the change in accounting methods ratably over five years).

[238] For a more in depth discussion of the BEIT, see Edward D. Kleinbard, Rehabilitating the Business Income Tax (Hamilton Project, Discussion Paper No. 2007-09, 2007), available at http://www.hamiltonproject.org/files/downloads_and_links_Rehabilitating_the_Business_Income_Tax_1.pdf; Kleinbard, note 200, at 178-80.

[239] See OECD, Tax Policy Studies, Fundamental Reform of Corporate Income Tax 133-35 (2007), for a discussion of allowances for corporate capital in general, and that organization's analysis of the BEIT, in particular.

[240] For reasons of political economy the original presentation envisioned a possible additional tax at the investor level, to raise the tax burden on extraordinarily successful investments, but I have been at pains ever since to explain that the additional tax was not required (and indeed was inconsistent with) the underlying theory.

investors, the BEIT would actually reduce the tax burdens faced by corporate managers and reflected in GAAP financial statements below those that would obtain in an ordinary corporate income tax bearing the same nominal rate. Second, and less intuitively obvious, the United States could continue to grant a full corporate foreign tax credit under the BEIT for foreign *income* taxes, even though normal (income) returns to capital are exempt from tax under the BEIT.

The reason is simply that the corporate-level tax is only one part of the BEIT, whose larger purpose it is to tax all income from capital invested in a business enterprise once and only once, which means that the double taxation of dividends, for example, is eliminated. The apparent subsidy by the United States at the firm level (through a foreign tax credit for what effectively is exempt income in the hands of the firm—the normal return to capital) is perfectly offset by full taxation of that very same income at the investor level, without the benefit of any foreign tax credits. The sum of the two is exactly the same as one would obtain in a perfectly functioning income tax imposed exclusively at the investor (or firm) level.[241] From the point of view of firm *managers*, however, the BEIT enables the firm to enjoy what appear to be (but in fact are not) subsidies in respect of foreign direct investment.

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[241] These positive international tax implications of the BEIT were briefly described in Kleinbard, note 124, at 561-64. The BEIT project was criticized in turn in Alvin C. Warren, The Business Enterprise Income Tax: A First Appraisal, 118 Tax Notes 921 (Feb. 25, 2008) [hereinafter First Appraisal]. This paper in turn precipitated a spirited series of exchanges on the international (and other) aspects of the BEIT that thrilled readers of *Tax Notes* well into that spring. See Edward D. Kleinbard, Letter to the Editor, 118 Tax Notes 1043 (Mar. 3, 2008); Alvin Warren, Letter to the Editor, 118 Tax Notes 1254 (Mar. 17, 2008); Edward D. Kleinbard, Letter to the Editor, 118 Tax Notes 1417 (Mar. 31, 2008).

To the best of the author's recollection, the upshot of the exchange was that Warren pointed out a number of places where the BEIT's presentation could be clarified or corrected in ways requiring the work of a few minutes, Warren consistently misapprehended the entire nature of the BEIT (as when he dismissed it as aping earlier work by Boadway & Bruce, First Appraisal, note 241, at 923, 927, 936, when in fact the BEIT's contribution was to use a similar starting point to achieve a completely different objective, which was a fully integrated and comprehensive tax on capital income), and Warren was wrong in his criticism of the foreign tax credit analysis in the BEIT, apparently because he believed that the benefits of a foreign tax credit should not indirectly pass to investors in a firm, id. at 935, even though the entire point of the BEIT was to tax capital income once and only once, and in fact investors are eligible for direct tax credits from business operations conducted in limited liability entity form (such as through a limited liability company). (Individual investors today do not enjoy indirect tax credits, but that fact is simply the artifact of an analogy to current law's imposition of a double tax on net corporate earnings, not an expression of an economic neutrality proposition, and in any event is irrelevant to a worldwide consolidation system that is designed to impose a single level of income tax on business income.) Warren may have a different recollection.

VII. Conclusion

We live and design tax systems today in a world imbued with stateless income and with dramatically different national corporate income tax rates. Territorial tax solutions are vulnerable to the former condition, and worldwide tax systems to the latter. There is no approach that is optimal across all relevant margins. All that we can do is to consider which system on balance is likely to impose the fewest distortions in corporate behavior while raising adequate revenues.[242]

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

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

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

By contrast, a worldwide tax consolidation system coupled with a corporate tax rate in the range of the world median for comparable

242 In this connection, see Grubert & Altshuler, note 3, at 320 ("it [is] clear that no one-dimensional criterion is useful and that a complete evaluation of any reform proposal is probably not feasible . . . . Nonetheless, it is clear that progress can be made along a number of decision margins.").

economies, when combined with a thin capitalization regime, is robust to transfer pricing gaming or to tax arbitrage strategies. It can be implemented unilaterally, and does not depend very heavily on parsing the mysteries of expense allocation rules. It authentically embraces CEN (except in the unlikely scenario where U.S. corporate tax rates are materially lower than the world median), which may not be everything, but at least is something.[243] It effectively reaches results consistent with CON principles in the vast majority of cases, if one corrects for actual subsidies that some sovereigns may run through their tax systems. And if other jurisdictions were to follow the example of the United States, a world where full inclusion systems were the norm ultimately would fully implement the CON norm as well.[244]

The result of the United States adopting a worldwide tax consolidation system along the lines suggested here would be a tax system in which a U.S. firm's investment decisions would not be distorted (at least, not greatly distorted) by tax considerations, aggressive transfer pricing strategies and standard stateless income planning would not erode the domestic tax base, and in which U.S. firms would not be dramatically uncompetitive with foreign-domiciled peer firms.

There are two irreducible costs to be paid for the benefits of a full inclusion system. U.S. firms will not be tax-competitive in bidding for real assets (or companies) in genuinely low-tax jurisdictions, and U.S. firms will not enjoy the de facto subsidies that stateless income tax planning offers foreign competitors in respect of investments in high-tax third countries.[245] As to the first cost, it is the case that most genuinely low-tax jurisdictions are small economies, and if the protection of the domestic tax base and the removal of systematic incentives for U.S. firms to invest outside the United States require that U.S. firms be somewhat disadvantaged in this one dimension, that would appear to be a fair tradeoff. As to the second, it is difficult to see why the United States should respond to systematic tax subsidies offered by other countries for their resident firms to invest offshore by mimick-

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243 As described earlier, see text accompanying note 41-51, even if Desai and Hines are correct that there is no domestic investment vacuum that follows from an outbound investment by a U.S. firm, because a foreign firm will fill the hole, that does not necessarily mean that the replacement investment will generate as much taxable income. As a general matter, the United States is just as vulnerable as are most other source countries to earnings stripping through the standard stateless income tax planning strategies described earlier.

244 Desai and Hines point out that if many countries adopt the full inclusion paradigm, they also can achieve CON, even with different national tax rates. Desai & Hines, Old Rules, note 4, at 956.

245 Grubert & Altshuler, note 3, at 342 ("The advantages of a low-tax location would be preserved under [a territorial tax system] but not under the constant overall burden worldwide system which would maintain overall competitiveness abroad but not necessarily in low-tax jurisdictions. This might be disturbing to the 'competitiveness' advocates of CIN or CON.").

ing that behavior, any more than it is thought to be efficient for one country to respond to another's trade subsidies by implementing comparable subsidies.[246]

As the erosion of domestic source country tax revenues through the phenomenon of stateless income becomes better appreciated throughout the world's major economies, one can expect increased focus in particular on developing more robust domestic earnings stripping rules. As source countries slowly become more adept at designing earnings stripping rules, any remaining gap in competitiveness between U.S. and foreign firms will narrow.

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

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