

GOOGLE’S “ALPHABET SOUP” IN DELAWARE

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ABSTRACT

In this article the tax avoidance planning of Google’s “Alphabet” Delaware reorganization is explored in detail. The recent Google reorganization created an IP parent holding company in Delaware (“Alphabet”) yielding potential state corporate income tax avoidance benefits, including: (1) incremental royalty expense deductions in non-combined reporting states; (2) potential exclusion of foreign royalty income from the tax base in combined reporting states; (3) creation of a constitutional challenge to the taxation of foreign royalty income of Alphabet; and (4) domestic IP license benchmark for foreign affiliates to allow for repatriation of offshore cash by higher royalty payments. The article suggests that U.S. states are not obliged to follow a formalistic method of legal interpretation of tax transactions that lack economic substance (i.e., to recognize the Alphabet reorganization), and further addresses Google’s corporate slogan “don’t be evil” in light of its aggressive federal and state tax avoidance behavior.

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I. INTRODUCTION

On August 10, 2015, Google announced a restructuring plan resulting in a new Delaware holding company referred to as "Alphabet."¹ The new Delaware "Alphabet" holding company structure may represent the domestic tax avoidance replacement for Google's famous "Double Irish Dutch Sandwich" structure.² The official company announcement made no mention of tax avoidance.³ It did refer to executive level re-shufflings, which appears to be a proactive attempt to establish a plausible non-tax business purpose for the reorganization.⁴ The apparent mismatch between the form of the reorganization and its business objectives led to some initial head-scratching and puzzlement on Wall Street after the announcement.⁵ For its part, the Internal Revenue Service has not publicly announced any ruling in favor of Google on such reorganization. Thus, it appears unlikely Google received such a ruling given the limited time lapse between the arrival of the new CFO and the announcement of the Alphabet reorganization. Although Google

1. Press Release, Google, Google Announces Plans for New Operating Structure (August 10, 2015), <https://investor.google.com/releases/2015/0810.html>; Press Release, Google, Ruth Porat to Join Google as Chief Financial Officer (March 24, 2015), <https://investor.google.com/releases/2015/0324.html> (The restructuring followed the appointment of a new CFO); Alistair Barr and Rolfe Winkler, *Google Creates Parent Company Called Alphabet in Restructuring*, WALL STREET J. (Aug. 10, 2015, 8:17 PM), <http://www.wsj.com/articles/google-creates-new-company-alphabet-1439240645>.

2. Edward D. Kleinbard, *Stateless Income*, 11 FL. TAX REV. 699, 700 (2011) (naming the Google Irish tax avoidance structure the "Double Irish Dutch Sandwich").

3. Press Release (August 10, 2015), *supra* note 1.

Alphabet is about businesses prospering through strong leaders and independence. In general, our model is to have a strong CEO who runs each business, with Sergey and me in service to them as needed. We will rigorously handle capital allocation and work to make sure each business is executing well.

Id.

4. *Id.*

This new structure will allow us to keep tremendous focus on the extraordinary opportunities we have inside of Google. A key part of this is Sundar Pichai. Sundar has been saying the things I would have said (and sometimes better!) for quite some time now, and I've been tremendously enjoying our work together.

Id.

5. Compare Brian Fung, *How Google's Alphabet restructuring helps protect the Web as we know it*, WASH. POST (Aug. 21, 2015), <https://www.washingtonpost.com/news/the-switch/wp/2015/08/21/how-googles-alphabet-restructuring-helps-protect-the-web-as-we-know-it/>, with Dominic Rushe & Sam Thielman, *Google to restructure into new holding company called Alphabet*, THE GUARDIAN (Aug. 11, 2015), <http://www.theguardian.com/technology/2015/aug/10/google-alphabet-parent-company>.

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is not required to publicly disclose any new tax avoidance planning motivations, as explained in detail here, the primary purpose of the Alphabet reorganization appears to be aggressive state corporate tax avoidance.

Shortly after the announcement of the formation of Alphabet, a news article was published by Yahoo! Finance with the title: *No, Google's Restructuring Isn't about Cutting Taxes*.⁶ The Yahoo! Finance staff author set out apparently to dispel the idea that the Alphabet restructuring was designed to facilitate repatriation of Google's offshore cash hoard,⁷ or to potentially facilitate a corporate inversion transaction.⁸ The idea of the Alphabet restructuring as tax avoidance planning was described as follows: "It's pure poppycock, according to leading corporate tax experts, who say there's no tax benefit to the new structure over the existing set up."⁹ The potential to use a corporate restructuring by Google as a means to facilitate offshore cash

6. Aaron Pressman, *No, Google's Restructuring Isn't about Cutting Taxes*, YAHOO! FINANCE (Aug. 14, 2015), <http://finance.yahoo.com/news/no—google-s-restructuring-isn-t-about-cutting-taxes-173848574.html>.

7. *Id.*

Maybe Alphabet could help, some analysts and others have suggested. "While we are reluctant to detail potential specifics, we believe under a new holding company structure, Google could better position itself with respect to its tax efficiency and possibly employ novel cash repatriation strategies to the benefit of shareholders," Nomura analyst Anthony DiClemente wrote after the Alphabet announcement.

Id.

8. *Id.* ("Many of the tax-related scenarios involve Google, or really Alphabet, ultimately spinning off one of its new units or combining a unit with a foreign-headquartered company. But Google doesn't need to create a holding company structure to complete a spin off or merger.")

9. *Id.*

"I know there is a feeling on Wall Street that this maneuver was somehow tax motivated, but the consensus among tax professionals is just the opposite," says Bob Willens, one of the best-known corporate tax advisers on Wall Street for decades. "We do not see any tax advantage to be gained from forming a holding company." . . . To be sure, the split structure could reduce the public relations headaches somewhat from a controversial tax saving deal. Dick Harvey, a law professor at Villanova University who previously worked at the Internal Revenue Service and Treasury Department, says it's "not beyond the realm of possibility" that the restructuring could make some tax moves easier to pull off. But such benefits seem rather hard to fathom at this point. "It does not appear to be a tax-motivated restructuring," says Harvey.

Id.

repatriation was also taken into account.¹⁰ The article then made a quick mention of a separate piece appearing in the Guardian newspaper, which identified the potential for the use of Delaware tax code § 1902(b)(8) to obtain a tax benefit by reducing state tax.¹¹

To the contrary, the Alphabet entity is designed as a Delaware intellectual property (hereafter "IP") holding company designed to reduce taxation by the deduction of royalty payments as an expense.¹² The issue then is to explain exactly how Google may use the Delaware IP holding company regime to achieve an ongoing reduction in state corporate taxation. To this end, several potential corporate tax advantages to the Alphabet restructuring are summarized here, as follows:

- (1) The intercompany IP licensing agreement between Google affiliates and Alphabet will create non-taxable royalty income in the state of Delaware, and additional royalty expense deduction in all the various U.S. states to which Google files a corporate tax return. For any U.S. state that does *not* apply combined reporting the corporate tax base will thereby be automatically diminished.¹³
- (2) Google will presumably argue that incoming foreign royalty payments to Alphabet in combined reporting states are excludable from the unitary group.
- (3) For any U.S. state which may attempt to tax Alphabet's income, Google gains the opportunity to file a constitutional challenge to the right of any state to tax Alphabet in Delaware.
- (4) Google may intend to use the domestic IP licensing agreement as a benchmark for foreign IP licensing

10. *Id.* ("I don't get what they're hinting at," responds Edward Kleinbard, a professor at USC's Gould School of Law and the former chief of staff of Congress's Joint Committee on Taxation. "The company is still (based in the) U.S., and foreign earnings remain subject to all the same rules.").

11. *Id.* ("Reporters have also speculated on the possible tax motivation. Google's Alphabet restructuring could get a boost from a Delaware tax loophole, according to a story in The Guardian."); see also Louis Bedigian, *What are the Tax Implications for Google's Alphabet?*, YAHOO! FINANCE (Aug. 14, 2015, 3:55 PM), <http://finance.yahoo.com/news/tax-implications-googles-alphabet-195538641.html> (quoting Dan Lundenberg "When we think about companies that announce something like what Google did, we think about the impact on the company and on its shareholders . . . From what I've seen there's not going to really be any impact on either.").

12. See Xuan-Thao Nguyen, *Holding Intellectual Property*, 39 GEORGIA L. REV. 1155, 1164 (2005), reprinted in 38 ST. TAX NOTES 699, 703 (Nov. 21, 2005).

13. See Sheldon Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing that which Enriches*, 22 AKRON TAX J. 1, 5-6 (2007); Michael T. Petrik & Ethan D. Millar, *State and Local Tax Aspects of Corporate Acquisitions*, 8 CORP. BUS. TAX. MONTHLY 13, 18 (Dec. 2006).

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agreements as a matter of transfer pricing practice. If the amount of foreign royalty payments is thereby increased, then this will result in automatic repatriation of foreign cash resulting in potential federal corporate tax avoidance.

II. GOOGLE'S DELAWARE SINGLE-DUMMY "ALPHABET" SOUP.

The Google Inc. 8-K as filed with the SEC on October 2, 2015, had as an attachment Exhibit 2.1 the "Agreement and Plan of Merger" which provided that Google intended the transaction to qualify as a § 351 transaction under the Internal Revenue Code.¹⁴ Very generally, a § 351 transaction refers to both the initial transfer of property into a corporation, and also any subsequent transfers, where the transferor receives shares of company stock in exchange for the transfer.¹⁵ Such transfers into corporate form are generally not a taxable event; however, as discussed in detail here the Google transaction is not a typical § 351 transaction and is designed instead to create a holding company structure where the former Google parent becomes a subsidiary of the new Alphabet.

A. *Applicable Corporate Law: Delaware § 251(g).*

As a matter of state law, the Google Inc. 8-K also provided that the transaction was intended to qualify under Delaware Code ("DGCL") § 251(g).¹⁶ Under DGCL § 251(g), a reorganization involving a swap of publicly traded stock for the stock of a newly-formed Merger Sub is allowed without requiring the vote of shareholders.¹⁷ Hence, if the transaction simultaneously qualified under I.R.C. § 351 and DGCL § 251(g)

14. Google Inc., Current Report (Form 8-K) (Oct. 2, 2015).

15. I.R.C. § 351 ("(a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.").

16. Form 8-K, *supra* note 14.

17. Corporations, DEL. CODE ANN. tit. 8, § 251(g).

Notwithstanding the requirements of subsection (c) of this section, unless expressly required by its certificate of incorporation, no vote of stockholders of a constituent corporation shall be necessary to authorize a merger with or into a single direct or indirect wholly-owned subsidiary of such constituent corporation if: (1) such constituent corporation and the direct or indirect wholly-owned subsidiary of such constituent corporation are the only constituent entities to the merger.

Id.

the Alphabet restructuring would occur without federal taxation and without a vote of the public shareholders.

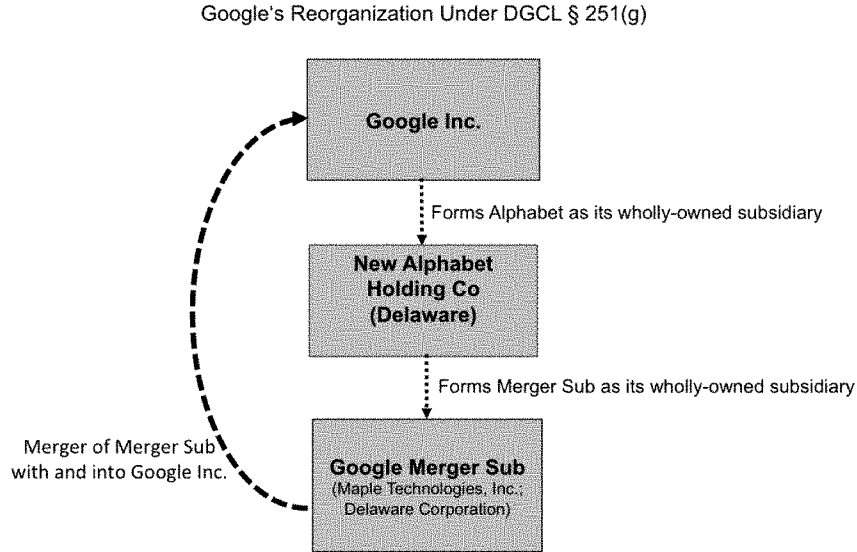
To effect the reorganization under § 251(g) DGCL, Google Inc., a Delaware corporation,¹⁸ has incorporated Alphabet Holding as a Delaware corporation and direct, wholly-owned subsidiary of Google Inc., and, in turn, caused Alphabet to form a Google Merger Sub¹⁹ (here: the Maple Technologies, Inc., a Delaware corporation) and direct, wholly-owned subsidiary of Alphabet ("Merger Sub").²⁰ The Alphabet holding company organizational structure was then implemented pursuant to § 251(g) DGCL by the merger of Merger Sub with and into Google Inc. (see Diagram 1). Upon consummation of the reorganization, Google Inc. would survive the merger as a direct, wholly-owned subsidiary of Alphabet. And as required by § 251(g)(6), Google Inc.'s directors immediately prior to consummation of the reorganization become the directors of Alphabet immediately upon consummation of the reorganization.

18. Google Inc. was incorporated in California in September 1998 and re-incorporated in the State of Delaware in August 2003. Google Inc., Annual Report (Form 10-K) (Dec. 31, 2009).

19. The Merger Sub is a Delaware LLC or corporation. Google Inc., Current Report (Form 8-K) (Oct. 2, 2015).

20. See Matt Weinberger, *Google created this company only to destroy it*, BUS. INSIDER (Oct. 2, 2015, 5:12 PM), <http://www.businessinsider.com/google-maple-technologies-spinoff-alphabet-2015-10?IR=T>.

Diagram 1:



B. Background on § 351 Reorganization.

In the Alphabet restructuring, the Google corporation that was initially on the top of the corporate structure ends up as a subsidiary of the new Alphabet IP holding company. Notably, the original Google corporate entity which presumably had to be the surviving corporate entity for non-tax purposes because third-party contracts would be with Google itself. So, the transaction was structured so that Google would survive as a subsidiary of Alphabet with all the existing third-party contracts intact. A diagram of the structure with the location of the IP before and after the transaction is provided here:

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Diagram 2:

Google's Structure 2014-2015 (Before Reorganization)

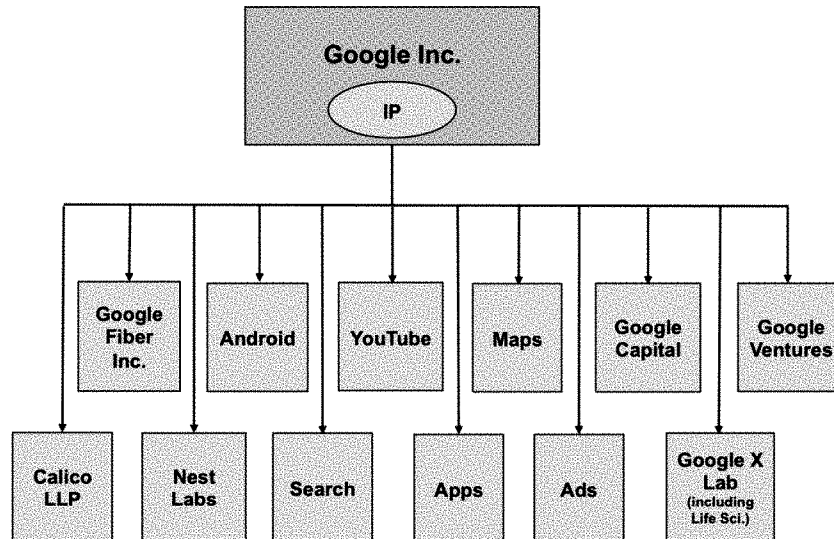
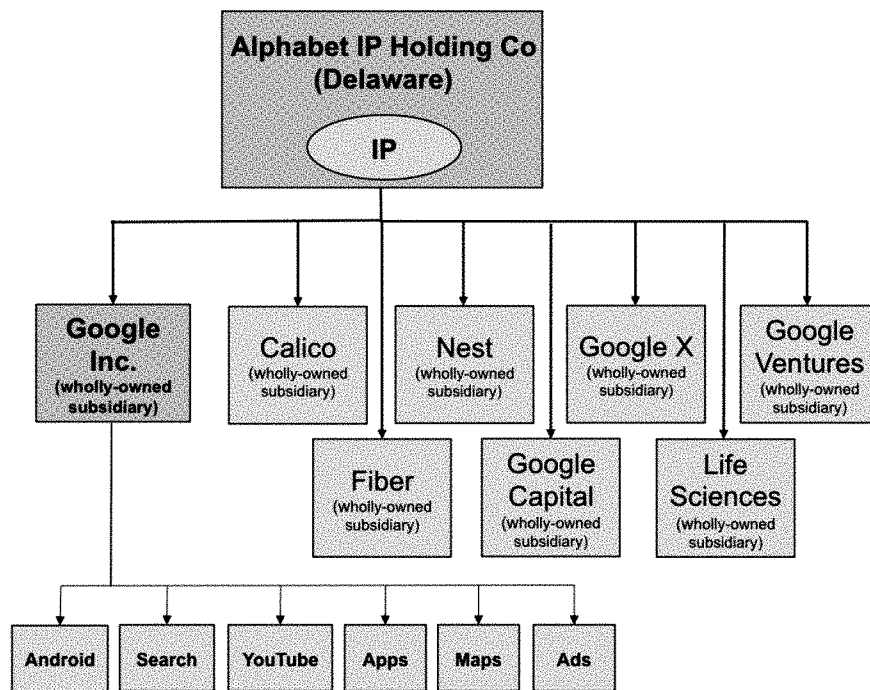


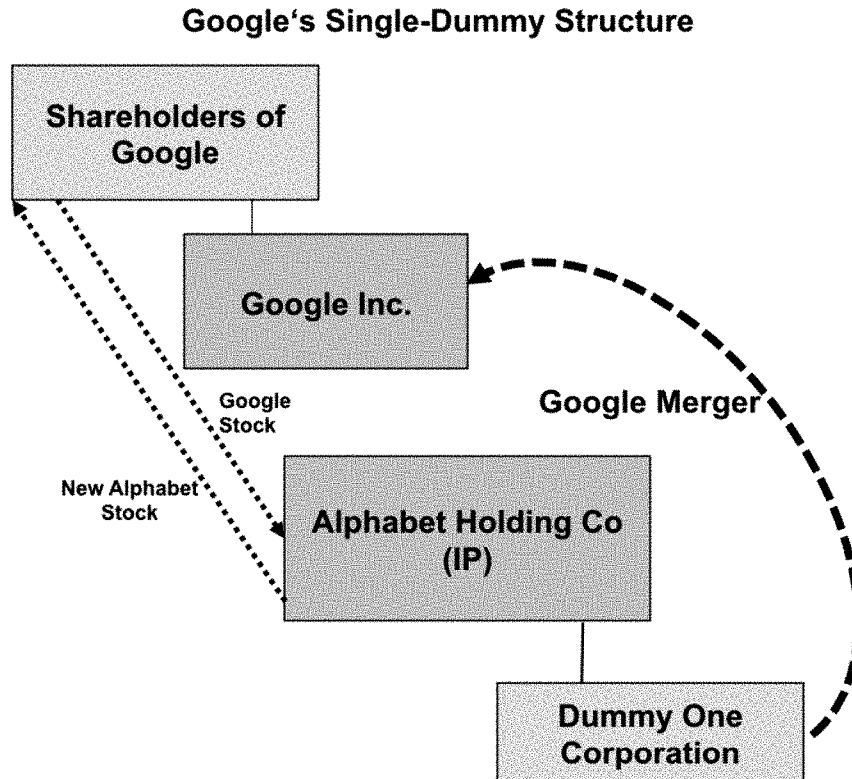
Diagram 3:

Alphabet's Structure (After Reorganization)



The reorganization of Google Inc. under § 351 was accomplished by using a “single-dummy” structure. In the single-dummy structure, Google Inc. formed a new holding corporation (Alphabet Holding), which, in turn, formed a single new subsidiary (the “dummy one corporation”). Dummy one corporation then merged into Google Inc. (the Google merger), with Google Inc. surviving the merger as wholly-owned subsidiary of new Alphabet Holding. In the Google merger, the Google shareholders received solely new Alphabet stock in exchange for their Google stock. Because Google Inc. survived the merger, the transitory existence of the dummy one corporation is disregarded and the transaction is treated as if the Google shareholders transferred their stocks to New Alphabet in exchange for New Alphabet stock. A diagram of the “single-dummy” structure is provided here:

Diagram 4:



1. Google's Purported Business Purposes for Alphabet Holdco.

The general purpose of the Alphabet restructuring was given in the Google Press Release on the Alphabet reorganization as: "[T]o allow us to keep tremendous focus on the extraordinary opportunities we have inside of Google."²¹ The announcement then proceeds on a series of insider references to the performance of Sundar Pichai who will act as the CEO of Google in the revised structure. The announcement then claims the name "Alphabet" was chosen because Alphabet means a "collection of letters" and is one of humanity's most important inventions, and also because "alpha" refers to an investment return above benchmark.²² Then, the announcement makes a list of claims that Page and Brin are "excited about" which appear to be purported business purposes for the Alphabet restructuring, as follows:

We are excited about . . .

- Getting more ambitious things done.
- Taking the long-term view.
- Empowering great entrepreneurs and companies to flourish.
- Investing at the scale of the opportunities and resources we see.
- Improving the transparency and oversight of what we're doing.
- Making Google even better through greater focus.
- And hopefully . . . as a result of all this, improving the lives of as many people as we can.²³

In general, Google's announcement of the Alphabet reorganization appears to be perhaps the *least* specific statement of a business purpose for any transaction in the modern era, or, the minimum of what a statement of business purpose could be as a theoretical matter. As a matter of linguistics, the reference to the name "Alphabet" as a series of letters is also the most general statement of what a name could be in theory. Likewise, as a matter of business administration, the reference to "alpha" as an investment return above benchmark is the most general statement of what a business plan could be in theory. Accordingly, the announcement may, or perhaps must be, interpreted to say principally that the holding company structure allows for "greater focus" by various executives as to the business purpose for Google.

21. Press Release (August 10, 2015), *supra* note 1.

22. *Id.* ("We also like that it means alpha-beta (Alpha is investment return above benchmark), which we strive for!").

23. *Id.*

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As a matter of “business purpose” in taxation, the statement of such business purpose as “greater focus” would appear to be designed as the “grain” of purpose required under Treasury Regulations § 1.368-1(c).²⁴ Tax commentators describe this as the “minor” business purpose, which can be sufficient to justify a § 368 reorganization even in the case of significant federal and state tax savings resulting from the transaction.²⁵ However, the immediate observation is that the Alphabet restructuring is not a § 368 reorganization, and accordingly, the persuasive argument by Jack Cummings that a stand-alone business purpose should not be required in the acquisition of a third-party business does not apply on these facts simply because there is no such corporate acquisition here.²⁶ Therefore, the Alphabet restructuring is a § 351 transaction and more than a “grain” of business purpose may be required, at least where:

- i) The purpose of the transaction is not as designed by Congress under the statute;²⁷

24. Treas. Reg. § 1.368-1(c) (2015).

A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

Id.

25. Jasper L. Cummings, Jr., *Reorganization Business Purpose*, TAX ANALYSTS (August 30, 2012) (citing *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991); Arthur Michaelson, *Business Purpose and Tax Free Reorganizations*, 61 YALE L.J. 13 (1952)), <http://www.taxanalysts.com/www/features.nsf/Articles/461B46DF420E912985257A6A00670417?OpenDocument>.

26. *Id.* (“The IRS should confirm that acquiring a business or assets to be used in a business that satisfies the continuity of business enterprise (COBE) requirement is, by itself, a qualifying business purpose, in cases of normal combinative reorganizations.”).

27. I.R.C. § 7701(o).

Clarification of economic substance doctrine.

(1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Id.

- ii) The purpose of the transaction appears to be principally state tax avoidance;²⁸
- iii) The federal and state tax avoidance is greater than the purported "business purpose";²⁹ and
- iv) The transaction could be achieved by other simpler means.³⁰

III. TAX BENEFIT IN NON-COMBINED REPORTING STATES.

The newly formed "Alphabet" holding company with subsidiaries including Google Inc., Calico, Google Fiber, Nest, Google X, Google Capital, Google Ventures, and Life Sciences is domiciled in Delaware.³¹ Delaware is a tax-haven jurisdiction, very well known for its favorable rules on the taxation of passive income.³² In particular, § 1902(b)(8) of the Delaware corporation income tax code, dealing with the imposition of tax on corporations, provides that a Delaware corporation (often referred to as Delaware holding company) shall be exempt from state taxation if its sole activity within Delaware is the maintenance and management of their intangible investments or of the intangible investments of corporations and the collection and distribution of the income (e.g., interest, dividends, royalties, etc.) from such investments or from tangible property physically located outside Delaware.³³ In other words, due to this state

28. I.R.C. § 7701(o) (3) ("State and local tax benefits. For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.").

29. Cummings, *supra* note 25 ("But a competing purpose is irrelevant unless it wholly negates the COBE business purpose" (citing *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935))).

30. See generally Nguyen, *supra* note 12.

Evidence of a sham arrangement may include the parent company holding majority control of the stock in an IP holding company, the relatively unchanged states of the intellectual property rights management and control before and after the transfer and license-back relationship, and the lack of a coherent business purpose behind the establishment of the IP holding company.

Id. at 1192–93.

31. Barr & Winkler, *supra* note 1.

32. Michael J. McIntyre, Paull Mines & Richard D. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 La. L. Rev. 699, 707 (2001).

33. State Taxes, DEL. CODE ANN. tit. 30, § 1902(b)(8).

The following corporations shall be exempt from taxation under this chapter: . . . Corporations whose activities within this State are confined to the maintenance and management of their intangible investments or of the intangible investments of corporations or statutory trusts or business

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corporate tax exemption on dividends, royalties or other investment income in Delaware, when earned by a Delaware holding company, Google may use this “Delaware loophole” to generate several tax benefits via Alphabet as a tax-exempt holding vehicle in Delaware.

The primary “Alphabet” tax strategy relies on the fact that Alphabet became the owner of the IP after the restructuring. Such IP licensing agreements seem to be advantageous for Google as they may yield a preferential state tax treatment of Google in Delaware and in separate reporting states. By concluding intercompany IP licensing agreements with Google affiliates (licensees) guaranteeing them the right to use the IP in exchange for royalty payments, Alphabet (licensor) may yield several tax benefits, as follows:

1. Royalty Income – Since Alphabet is now a Delaware-based corporation whose activities in Delaware are limited to maintaining and managing intangible assets that generate income such as capital gains, dividends, interest and royalties, and as such it is exempt from taxation under § 1902(b)(8) of the Delaware law, the corresponding royalty income of Alphabet received from the use of these intangibles will be exempt from Delaware income tax.
2. Royalty Deduction – Alphabet’s IP licensing agreements create royalty expense that is deductible as operating expense in all the various U.S. states to which Google files a corporate tax return and these expenses automatically diminish the corporate tax base in those separate reporting states. This is possible because separate reporting states (i.e., U.S. states which do not apply combined reporting)³⁴ calculate the taxable income and apportionment percentage of each corporate affiliate doing business within the state as

trusts registered as investment companies under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 et seq.) and the collection and distribution of the income from such investments or from tangible property physically located outside this State. For purposes of this paragraph, ‘intangible investments’ shall include, without limitation, investments in stocks, bonds, notes and other debt obligations (including debt obligations of affiliated corporations), patents, patent applications, trademarks, trade names and similar types of intangible assets.

Id. See also Sheldon Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing that which Enriches*, 22 AKRON TAX J. 1, 6 n.15 (2007).

34. See *infra* Appendix A.

if those affiliates were unrelated persons.³⁵ Thus, the separate reporting regime prevents offsetting income from one affiliate with royalty expense deductions from other affiliates, as this would be the case in a combined reporting group.

In recent years, states have derived various methods to potentially nullify these sort of tax avoidance strategies in addition to enacting combined reporting.³⁶ One of these tools is the "addback" of intercompany royalties, i.e., the disallowance of a deduction for the intercompany royalty expense for purposes of computing state taxable income.³⁷ Currently, about twenty states have enacted legislation that disallows royalty or interest payment deductions to related companies, including IP holding companies.³⁸ Separate reporting states such as Missouri and Oklahoma do not require an addback of related-party royalty and licensing payments, and each of these are states in which Google has chosen to open up affiliates.³⁹ Since these Google affiliates are taxed separately and without an "addback" provision, Google is able to minimize (and avoid) state taxes in such separate reporting states (but whether Google has taken advantage of the Delaware loophole is unknown, because Delaware does not require the filing of public accounts for private companies).⁴⁰

35. In contrast to a typical combined report, in which the business income of members of a unitary group is combined, intercompany transactions are eliminated, and the combined business income is apportioned among the states based on group-level apportionment percentages. See generally Timothy C. Kimmel, Symposium Edition, *An Overview of the Group Reporting Regimes in Use Today*, ST. & LOC. TAX LAW. 21 (2008).

36. See WILLIAM F. FOX AND LEANN LUNA, NCSL TASK FORCE ON STATE & LOCAL TAXATION OF COMMUNICATIONS, COMBINED REPORTING WITH THE CORPORATE INCOME TAX: ISSUES FOR STATE LEGISLATURES 3 (November 2010), <http://www.ncsl.org/documents/standcomm/scomfc/combinedreportingreport.pdf>.

37. See *id.* at 8 for an investigation of the effects of addback requirements on state GDP.

38. Royalty or interest addback laws have been adopted (with some exceptions to addback rules and a large degree of variation in the rules) in the District of Columbia and the states of Alabama, Arkansas, Connecticut, Georgia, Indiana, Illinois, Iowa, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Tennessee, Virginia, and Wisconsin. See *infra* Appendix A. *E.g.*, Charles F. Barnwell, Jr., *Addback: It's Payback Time*, ST. TAX NOTES, Exhibit 1 (Nov. 17, 2008); Mark J. Cowan & Warren Newberry, Jr., *Reevaluating the Intellectual Property Holding Company*, 14:3 MGT ACCT'G Q. 25, Table 1; MASS. GEN. LAWS ch. 63, § 311(b) (2003); MISS. CODE ANN. § 27-7-17(2) (1972); OHIO REV. CODE § 5733.042 (1997); R.I. GEN. LAWS § 44-11-11 (1956).

39. See *infra* Appendix A.

40. Another reason for this restructuring could be the favorable tax treatment of dividend income in Delaware and in other separate reporting states: As Alphabet appears to be a tax exempt corporation under § 1902(b)(8) of the Delaware law, Delaware would not levy corporate income taxes on Alphabet's dividends received from its subsidiaries such as Google X, Life Sciences, NestLab Inc., and so forth. In the reorganization of

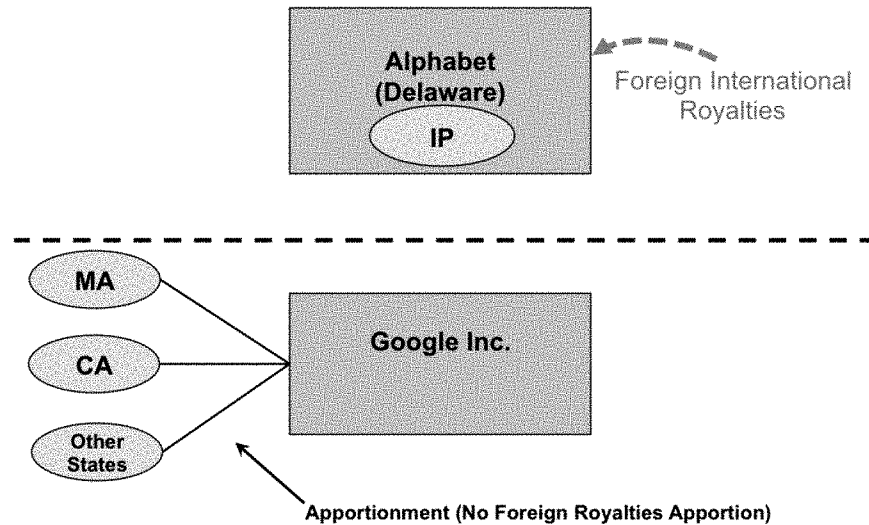
IV. TAX BENEFITS IN COMBINED REPORTING STATES.

Even though combined reporting states are not as vulnerable to the before-mentioned tax avoidance of Alphabet as separate reporting states, combined reporting states, such as California, remain vulnerable to Alphabet's structure because Google may use the "hallmarks" of unitary business to claim that Alphabet is not engaged in a unitary business with its operating subsidiaries, and, thus, Alphabet (and its income) is ineligible for inclusion on the combined report of combined reporting states.⁴¹ This tax planning strategy would thus exclude incoming foreign royalty income from the apportionable tax base, as illustrated in the following:

Google, Google X (previously the research department of Google Inc.) and Life sciences, a former subdivision of Google X, have become separate companies, incorporated in California and wholly-owned subsidiaries of Alphabet. An interesting factual question is whether there is some business explanation for why these divisions have become direct subsidiaries of Alphabet as well as Nest Labs, Calico, Fiber and the others (see diagrams 2 and 3) and have not remained departments of Google.

41. In *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164–65 (1983), the U.S. Supreme Court reviewed the constitutionality of combined reporting and had made clear why combined reporting is a better measure of net income than separate reporting. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438–39 (1980), the U.S. Supreme Court stated that separate accounting does not adequately capture "subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."

Diagram 5:

Google and Foreign Royalties (After Restructuring)

Combined reporting is a method used by combined reporting states to calculate multistate corporations' state-level corporate income taxes.⁴² This method requires a business that is part of a group of affiliated businesses to both determine the business affiliates' total income as though they were one group and apportion a share of that combined (unitary) income to each taxing state.⁴³ The share is calculated by a formula that takes into account the corporate group's in-state-activity level as compared to its activity in other states. In other words, combined reporting effectively treats a group of entities involved in a "unitary business" as one single economic enterprise for state corporate income tax purposes by disregarding the legal

42. States requiring combined reporting for corporation income taxes are: Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Mexico, New York, North Dakota, Rhode Island, Utah, Vermont, West Virginia, and Wisconsin. See JOHN RAPPA, OFFICE OF LEGISLATIVE RESEARCH, ADOPTION OF COMBINED REPORTING IN SELECTED STATES, 2015-R-0163 2, 18 (Sept. 8, 2015), <https://www.cga.ct.gov/2015/rpt/pdf/2015-R-0163.pdf>; also *infra* Appendix A for an overview of combined reporting states in which Google's physical offices are located. For a brief overview of the history of the development and adoption of combined reporting see Joe Huddleston and Shirley Sicilian, *History and Considerations for Combined Reporting: Will States adopt a model combined reporting statute?*, ST. & LOC. TAX LAW (forthcoming), <http://www.ncleg.net/DocumentSites/committees/revenuelaws/2007-2008/Meeting%20Documents/Meetings%20for%20Report%20to%202009%20Session/19%20November%202008/History%20and%20Considerations%20for%20Combined%20Reporting%20-%20MTC.pdf>.

43. See Rappa, *supra* note 42, at 1.

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existence of affiliates and reporting on a combined basis the operations of all related entities involved in this unitary business.⁴⁴

However, defining the unitary business (group) is a surprisingly intricate process. As there is no bright line test of “unitary,” and no simple, objective definition of what constitutes a unitary business, states employ varying unitary business definitions⁴⁵ that could lead to the situation where a group of corporations may be considered to be unitary in one state but non-unitary in others.⁴⁶ Furthermore, combined reporting states are limited by U.S. constitutional principles when determining which entities are unitary.⁴⁷ One of those principles is the unitary business principle⁴⁸ that prohibits a state from requiring a taxpayer to include in its apportionment calculation the income and factors of any entities that are not engaged in a unitary business with the taxpayer.⁴⁹ In addition, the application of the unitary business principle in combined reporting context can become very complex in a situation in which a clear vertically integrated business structure (e.g., a group of affiliated entities engaged in manufacturing, distribution, and sales of the same products) is replaced by multiple investment portfolios including entities engaged in very different lines of business and often located in different states.⁵⁰

44. See Fox & Luna, *supra* note 36, at 4.

45. See Catherine A. Battin et al., *Decoding Combination: What is a Unitary Business*, ST. TAX NOTES 455, 457 (Feb. 23, 2015); also Fox & Luna, *supra* note 36, at 4–5.

46. A group of corporations may also be unitary in one year but not the next. Fox & Luna, *supra* note 36, at 5. The complexity of defining the unitary business group increases through business ownership of interests in flow through entities (such as partnership and LLCs) and business acquisitions or start-ups of new businesses. *Id.* Furthermore, in most combined reporting states, the composition of a unitary business group is not the same as the federal consolidated group. This also makes it more complex.

47. See, e.g., Huddleston & Sicilian, *supra* note 42, at 27.

48. The unitary business principle is seen as the foundation of combined reporting and was developed by the U.S. Supreme Court as a constitutional restraint “on a State’s power to tax value earned outside of its borders.” *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 784 (1992). In *Mobil Oil*, this principle was ordained as the “linchpin of apportionability in the field of state income taxation” by the U.S. Supreme Court. 445 U.S. at 439. For a brief overview of the historical development of the unitary business principle see Battin et al., *supra* note 45. As regards the applicability of the unitary business principle to more than income-based taxes, see Paul H. Frankel et al., *The Unitary Business Principle Applies to More Than Corporate Net Income Taxes*, TAX ANALYSTS 563, 565 (May 21, 2012) (stating that this principle “originated in property tax cases that involved railroads and telegraph companies operating in interstate commerce.”).

49. See, e.g., Huddleston & Sicilian, *supra* note 42, at 27.

50. See Battin et al., *supra* note 45; also Rappa, *supra* note 42, at 5.

State courts have developed a number of different requirements and tests for determining the scope of the unitary business.⁵¹ For example, the California Supreme Court first contoured the unitary business concept in its two landmark cases *Butler Brothers v. McColgan*⁵² and *Edison California Stores, Inc. v. McColgan*.⁵³ In *Butler Brothers*, the court held that the unitary nature of the taxpayer's business was established by unity of ownership (as evidenced by direct or indirect control over 50% of voting stock), unity of operation (as evidenced by central purchasing, advertising, accounting, and management divisions), and unity of use in its centralized executive force and general system of operation (three unities test).⁵⁴ In *Edison*, the court further developed its unitary business concept by creating the "contribution and dependency" test. According to this test, a unitary business exists when the "business done within the state is dependent upon or contributes to the operation of the business without the state."⁵⁵

In 1980, the U.S. Supreme Court set forth its views of a unitary business in *Mobil Oil Corp. v. Commissioner of Taxes*⁵⁶ by providing (i) functional integration, (ii) centralization of management, and (iii) economies of scale as the "hallmarks" of unitary business.⁵⁷ Although the Court has held that there is no single test for determining whether a unitary business exists, it has consistently reiterated⁵⁸ this test, now commonly referred to as the *Mobil* test.⁵⁹ In *Container Corp. of America v. Franchise Tax Board*, the Supreme Court further established a fourth test, the flow-of-value test, for determining the existence of a unitary

51. See JOHN C. HEALY AND MICHAEL S. SCHADEWALD, MULTISTATE CORPORATE TAX COURSE 36 (2009).

52. *Butler Brothers v. McColgan*, 111 P.2d 334 (Cal. 1941), *aff'd*, 315 U.S. 501 (1942).

53. *Edison Cal. Stores, Inc. v. McColgan*, 183 P.2d 16, 21 (Cal. 1947).

54. See Carley A. Roberts et al., *What New York Can Learn From California's Combined Reporting History*, ST. TAX NOTES, Sept. 29, 2014, at 859.

55. See JOHN C. HEALY & MICHAEL S. SCHADEWALD, MULTISTATE CORPORATE TAX COURSE 37 (2009) ("Examples of factors that suggest contributions by or dependency among commonly controlled corporations include: intercompany loans; intercompany sales of goods or services; exchange of products or expertise; a share executive force and staff functions.").

56. See *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).

57. See *id.*; also *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 30 (2008) (reiterating that these three factors are the "hallmarks of a unitary relationship").

58. See, e.g., *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 223–24 (1980); *F.W. Woolworth Co. v. Taxation & Rev. Dep't*, 458 U.S. 354, 362 (1982); *Allied Signal Inc. v. Div. of Taxation*, 504 U.S. 768, 780 (1992); *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 1498, 1506 (2008).

59. Roberts et al., *supra* note 54, at 860.

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business.⁶⁰ Under this test, a parent corporation and its subsidiary are unitary if “there [is] some sharing or exchange of value not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive investment or a distinct business operation.”⁶¹ The Court also held that the “prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods” as evidenced by the components of the *Mobil* test.⁶²

As most of the newly created subsidiaries of Alphabet such as Google X, NestLab, Inc., and Google Life Sciences are legal entities incorporated in California and doing business there, it may be worthwhile to briefly explore how the Californian courts and the Franchise Tax Board (FTB) have applied these tests over the time. The Franchise Tax Board relies upon the three unities test and the contribution and dependency test, but sees the two as alternative tests.⁶³ Californian Courts also have ignored⁶⁴ the *Mobil* test during the last 30 years by having applied either the three unities or the contribution and dependency test.⁶⁵ They have occasionally been divided over which of the two tests is best suited to determine the existence of a unitary business.⁶⁶ Interestingly, on March 6, 2014, a Los Angeles Superior Court decided in *Comcon Production Services I, Inc. v. Franchise Tax Board*⁶⁷ to follow the lead of the U.S. Supreme Court’s *Mobil* decision.⁶⁸ The issue before the court was whether Comcast, a parent cable television company, was unitary with its subsidiary,

60. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 178 (1983).

61. *Id.* at 166.

62. *Id.* at 178.

63. See California FTB Notice No. 92-4 at 1–2 (Aug. 18, 1992). Only in its Notice No. 89-713, dating back from 1989, the California FTB recommended the *Mobil* test as “primary standard” for the FTB’s determination of a unitary business; FTB Notice No. 89-713 (Oct. 31, 1989) at 2; FTB, 2013 Guidelines for Corporations Filing a Combined Report, FTB Publication 1061, 2013, at 4.

64. See, e.g., *Richmond Wholesale Meat Co. v. Franchise Tax Bd.*, 36 Cal. App. 4th 990 (Cal. Ct. App. 1995); *Dental Ins. Consultants, Inc. v. Franchise Tax Bd.*, 1 Cal. App. 4th 343 (Cal. Ct. App. 1991); *Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.*, 229 Cal. App. 3d 784 (Cal. Ct. App. 1991).

65. See *A.M. Castle & Co. v. Franchise Tax Board*, 36 Cal. App. 4th 1794 (1995). Even according to the California FTB Notice No. 92-4 (Aug. 18, 1992), the two tests were treated as alternative tests. In *Appeal of Leland Corp.*, the California State Board of Equalization argued that either the three unities test or the contribution and dependency test, but not both tests, must be met to determine whether a unitary business exists (No. 94A-0915, Cal. St. Bd. of Equal. 1997).

66. *Roberts et al.*, *supra* note 54, at 860.

67. California FTB, Decision No. BC 489779 (Mar. 6, 2014).

68. *Id.* at 11.

QVC, a company that operated a retail shopping channel.⁶⁹ Comcast focused chiefly on the three factors of the *Mobil* test in order to support its position whereas the Franchise Tax Board relied on the "contribution and dependence test" to justify its position. The court decided in favor of the *Mobil* test by ruling that Comcast and QVC were not a single unitary business, because evidence did not establish any of the hallmarks of the *Mobil* test.⁷⁰ It appears that with the *Comcon* decision the ongoing confusion among Californian courts, the Franchise Tax Board and taxpayers about which of the tests might be the correct test to use for determining the existence of an unitary business, could come to a provisional end, as the court's ruling may provide much-needed guidance to taxpayers and the Franchise Tax Board on the correct test for future unitary business analyses.

By referring to *Comcon* and interpreting its findings as meaning that the *Mobil* indicia ought to be the sole factors used to determine whether an unitary business exists, Google could now take (tax) advantage of this decision by arguing that none of the *Mobil* indicia appears to be present with regard to Alphabet and e.g., Google X, and its subsidiaries, because a fact-dependent analysis could show that there is no centralized management, no functional integration, no economies of scale, and no other non-trivial alleged flows of value between these two entities.⁷¹

To justify its position, Google may first claim that there is no evidence for a centralized management between these two companies. As centralization of management is indicated by interlocking directors and officers, exchange of upper-level management, and required parent corporation approval of major policy decisions, Google could argue that Alphabet and Google X have no shared directors or officers, as they both are run by its

69. *Id.* at 1. The other issue before the court was whether an early termination fee received by Comcast as a result of a failed merger with MediaOne was business income subject to apportionment, or non-business income allocable outside California. *Id.*

70. *Id.* at 10–11. As QVC's personnel made all meaningful business decisions without direction or shared expertise from Comcast, centralized management was lacking. As Comcast and QVC maintained separate headquarters and separate departments for the operation of their respective businesses, they did not become functionally integrated either. Due to the lack of centralized management and functional integration, there also were no economies of scale resulting from Comcast's ownership of QVC. *Id.* See also 2015 Guidebook to California Taxes, at 623.

71. Furthermore, Alphabet might also claim that it is neither unitary to, e.g., NestLabs, Inc., nor to Google Life Sciences, or Google Fiber or to other subsidiaries by applying these tests as well. Due to limited space in this article, Google X (and California) is taken as sample to demonstrate Google's tax benefit from combined reporting states.

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own independent CEOs and have different kind of employees.⁷² With its “moonshot” projects, including Google Glass and the self-driving car, Google X, e.g., employs a wide variety⁷³ of software engineers, oncologists, and optics experts which to share with Alphabet, this approach is highly questionable. Despite Alphabet being Google X’s sole shareholder with the power to appoint Alphabet board members to Google X’s board, Google could further argue that centralized management is lacking, as Google X does not have common purchasing, recruiting,⁷⁴ advertising or marketing with Alphabet.⁷⁵ Google can also show that Alphabet’s control over appointments to Google X’s board will not result in actual control over Google X’s operations, because Google X is making its own operating decisions. As stated by Larry Page in his announcement on August 10, 2015, their model is “to have a strong CEO who runs each business,” with Sergey and Larry “in service to them as needed.”⁷⁶

Second, Google could argue that Alphabet and Google X are not functionally integrated because Alphabet (with its investment/holding business) and Google X (with its R&D business) are operating in different lines of business. In fact, Google X is engaged in diverse activities such as Google Glass, long-term risky projects like self-driving car, and a drone delivery service, that are completely unrelated to Alphabet’s holding

72. Barr & Winkler, *supra* note 1. (“Google said each Alphabet subsidiary would have its own CEO, reporting to Mr. Page, a structure similar to Warren Buffett’s Berkshire Hathaway Inc.”). Google Life Sciences has named Andy Conrad as its CEO. Matt O’Brien, *Google X life-sciences division awaits name as it becomes Alphabet subsidiary*, SILICON BEAT (Aug. 21, 2015, 11:13 AM), <http://www.siliconbeat.com/2015/08/21/google-x-life-sciences-division-awaits-name-as-it-becomes-alphabet-subsiary/>.

73. Steven Loeb, *Google X becomes its own company under Alphabet*, Aug. 21, 2015, <http://vator/tv/news/2015-08-21-google-x-becomes-its-own-company-under-alphabet> (citing Sergey Brin saying that the “team is relatively new but very diverse including software engineers, oncologists, and optics experts. This is the type of company we hope will thrive as part of Alphabet and I can’t wait to see what they do next.”).

74. Alistair Barr, *Google Parent to Ask Subsidiaries to Pay for Corporate Services - Alphabet says it wants “bet” companies to be more accountable on spending*, WALL STREET J. (Nov. 23, 2015, 7:39 PM), <http://www.wsj.com/articles/google-parent-to-ask-subsidiaries-to-pay-for-corporate-services-1448325619> (saying that under Alphabet’s new system, leaders of companies such as Google X, Google Fiber, Nest and Google Life Sciences “will have more freedom to develop their own services in areas like recruiting and marketing”).

75. *Id.* (“Nest, which makes Internet-connected home devices, has its own legal and marketing teams and rents computer services from Google rival Amazon.com Inc.”)

76. Davin O’Dwyer, *Why Google played the Alphabet card*, IRISH TIMES (Aug. 11, 2015, 1:22 PM), <http://www.irishtimes.com/business/technology/why-google-played-the-alphabet-card-1.2313509>.

business.⁷⁷ Google could presumably also provide evidence that intercompany flows of goods, services, joint purchasing or other common activities, are almost nonexistent or minimal.

Third, with the new Alphabet structure, Google could argue that there are no economies of scale between Alphabet's business and Google X's dissimilar R&D businesses. In addition to that, Google may argue that the flows of value between Alphabet and, e.g., Google X are not substantial, as Alphabet neither derives the entirety of its income from valuable property received from Google X, nor earns almost all of its income from intercompany transactions with Google X. It can easily be argued that a huge portion of Alphabet's income comes from licensing IP to foreign international subsidiaries, and by no means third parties.

If all these indicia appear to be not sufficient to establish the existence of a unitary relationship between Alphabet and Google X, Alphabet could argue that it will not be deemed to be part of the unitary group of California as a combined reporting state and, thus, Alphabet's received income (e.g., from U.S. or foreign international royalty payments) must not be included in the combined return. With this new fact pattern implemented through the reorganization, Alphabet may also gain an advantage in combined reporting states.

A. *Potential Disallowance of Addback Remediation.*

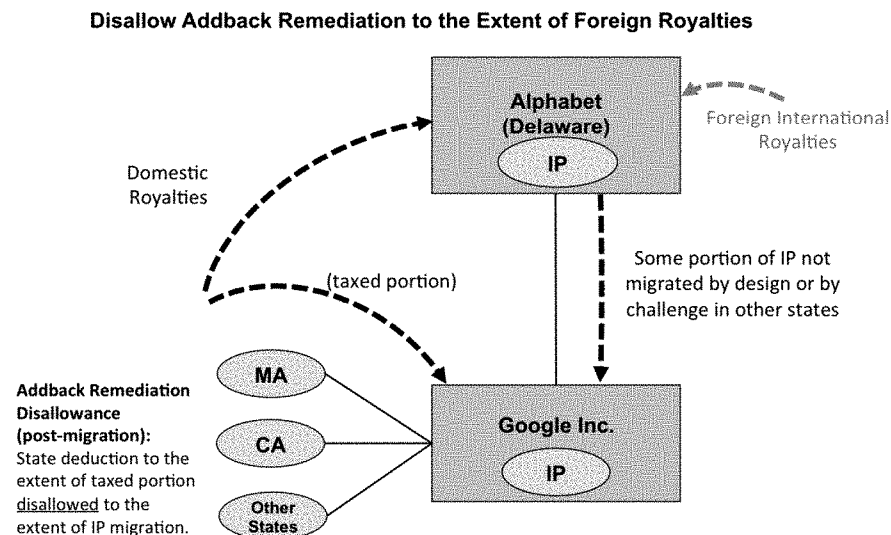
"Addback Remediation" refers to the partial deduction allowed for royalty income that is subject to tax in another state. Addback Remediation is a voluntary benefit granted by states as an equitable rule to companies such as Google. An illustration of such an approach was given in Massachusetts in the technical information release by the taxing authority after the negative decision in *Sherwin Williams*.⁷⁸ Accordingly, in the situation where Google has achieved migration of the IP and exclusion of foreign royalties from the state tax base, a state may wish to rethink the provision of such voluntary benefits to companies

77. Press Release (August 10, 2015), *supra* note 1, (in which Larry Page refers to the new creation of subsidiaries of Alphabet such as Google Life Sciences and Calico by stating: "we believe this allows us more management scale, as we can run things independently that aren't very related").

78. Thomas C. Carey & Julia Huston, *The Death of Intellectual Property Holding Companies? Massachusetts Joins a Growing Number of States Eliminating the State Tax Advantages of IPHCs*, at 272, http://sunsteinlaw.com/media/hottopics_intprop.pdf ("In general, the taxpayer's evidence must prove that its transaction was not for tax avoidance purposes, as discussed in more detail below. Clear and convincing evidence is evidence that is so 'clear, direct and weighty' that it will permit the Commission to 'come to a clear conviction, without hesitancy' of the validity of the taxpayer's claim.").

that engage in aggressive tax avoidance, and disallow Addback Remediation entirely, or perhaps to the extent of the tax benefit obtained by the Alphabet restructuring, for example. The disallowance of Addback Remediation should not be subject to constitutional challenge and thus represents an easy means for states to cancel the effect of Google's aggressive state tax avoidance planning.

Diagram 6:



V. CONSTITUTIONALITY OF TAXATION OF ALPHABET ROYALTIES.

What might be regarded as the “classic” constitutional issue arises on the potential for taxation of *what will be in the future* Alphabet’s non-domiciliary foreign royalty income in Delaware by a state in which Alphabet does *not* have a separate physical presence. The constitutional challenge on these facts has historically been broken down into Due Process challenge⁷⁹ versus Commerce Clause challenge.⁸⁰ The formation of Alphabet in Delaware greatly increases the potential for raising such a constitutional challenge because Google does have physical

79. U.S. CONST., amend. XIV. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992); *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

80. U.S. CONST., art. 1, §8. See, e.g., *Geoffrey, Inc. v. Comm’r of Revenue*, 899 N.E.2d 87, 88 (Mass. 2009).

presence in many U.S. states.⁸¹ A list of the states in which Google maintains a physical presence is set forth at Appendix A. With the new Alphabet structure, Alphabet will argue it is a separate and distinct legal entity from Google that does not have presence in the non-domiciliary state and its royalty income should not be subject to tax. Notably, that argument would not have been available to Google itself upon the receipt of royalty income in the structure prior to the Alphabet reorganization.

In general terms, the Commerce Clause challenge to the levy of a tax on foreign income is that a state which seeks to tax such income unduly burdens commerce between the states. Accordingly, the "classic" legal argumentation, which has been developed based in part on the famous *Kmart*⁸² and *Capital One* cases of state taxation based on intangibles.⁸³ For example, based on this precedent, Vivian Lei argues for a bright-line test based on physical presence for taxation.⁸⁴ Indeed, this line of reasoning will presumably be Google's primary argument in subsequent litigation and would result in Google's royalty income not being subject to state level tax. Sheldon Laskin takes a more nuanced view with the argument that the *Situs* rule needs to take into account the role of intangibles in the modern economy.⁸⁵ Such a refined line of reasoning will presumably be the response by the state taxing authority in any subsequent litigation regarding the taxation of Alphabet. Irrespective of which line of reasoning might ultimately prevail in various courts, Google gains the advantage of raising the issue and forcing the state to litigate the question in order to collect tax.

81. The appropriate state corporate tax policy is complex in light of intellectual property holding companies such as Alphabet. For a further discussion of the tax rate versus tax base "paradox" analysis as a matter of tax policy in capital investment see Bret N. Bogenschneider, *The Tax Paradox of Capital Investment*, 33:1 J. TAX'N INV. 59 (2015).

82. See *Kmart Props., Inc. v. N.M. Taxation & Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001).

83. See *Capital One Bank v. Comm'r of Revenue*, 899 N.E.2d 76 (Mass. 2009).

84. See Vivian Lei, Geoffrey v. Commissioner: *The Fall of "Toys R Us" and the Rise of "Tax R Us"*, 10 HOUS. BUS. & TAX L.J. 340, 362 (2010) ("Even if there are ambiguities over whether Quill's physical presence test should be applied to income-based tax, Quill's bright-line physical presence test should be applied to all taxes given the non-uniformity in current state and local tax systems.").

85. See Laskin, *supra* note 33, at 43 ("The Supreme Court got it right in promulgating the business situs rule for taxing intangibles; a state's authority to tax intangibles cannot be limited by considerations of the intangible's non-existent physical location.").

A. *The Method of Legal Interpretation Under the Tax Laws.*

In this article we argue that the tax analysis depends on the method of legal interpretation. For example, absent a formalistic method of legal interpretation, a § 351 transaction does not automatically create a “springing” constitutional right to avoid state level taxation. If a state, such as Massachusetts, was able to tax the royalty income of Google as consistent with the Commerce or Due Process clauses *before* the Alphabet reorganization, then that state ought to be able to tax the same royalty income of Alphabet *after* the Alphabet reorganization, in particular, where such state does not recognize the Alphabet restructuring for tax purposes. In other words, the substance (i.e., facts) of any arrangement, or lack thereof, must govern as a matter of law and not merely the legal form.⁸⁶ A similar issue was addressed by the Massachusetts Supreme Court under the “sham transaction” doctrine, which we think is a separate issue from the underlying method of legal interpretation applied under the tax laws.⁸⁷ A substantive method of legal interpretation simply does not cognize formalistic tax planning without substance irrespective of whether it may be a complete “sham.”

Since the development of the “sham transaction” doctrine, the Congress of the United States has clearly established the “economic substance” doctrine as the applicable method of legal interpretation for tax law at least in the United States.⁸⁸ The economic substance doctrine reflects a substantive method of legal interpretation (i.e., not pure formalism). As a contrary example, the European Union’s approach to tax law reflects a tradition of formalistic legal interpretation in the tax laws particularly common in Continental Europe.⁸⁹ Multinational

86. See generally I.R.C. § 7701(o) (2015) (codifying the judicial “economic substance” doctrine as a matter of U.S. Federal tax law).

87. See *Sherwin-Williams Co. v. Comm’r of Revenue*, 778 N.E.2d 504, 522 (Mass. 2002); *Syms Corp. v. Comm’r of Revenue*, 765 N.E.2d 758, 762 (Mass. 2002) (citing *Rice’s Toyota World, Inc. v. Comm’r of Internal Revenue*, 752 F.2d 89 (4th Cir. 1985)).

88. See *Sherwin-Williams Co. v. Comm’r of Revenue*, 778 N.E.2d at 508; *Syms Corp. v. Comm’r of Revenue*, 765 N.E.2d at 762 (citing *Rice’s Toyota World, Inc. v. Comm’r of Internal Revenue*, 752 F.2d 89 (4th Cir. 1985)).

89. See generally Brian Leiter, *Legal Formalism and Legal Realism: What is the Issue?*, 16:2 LEGAL THEORY 111 (2010).

‘Formalist’ theories claim that . . . the law is ‘rationally’ determinate, i.e., the class of legitimate legal reasons available for a judge to offer in support of his decision justifies one and only one outcome . . . the majority of “Realists” advanced a descriptive theory of adjudication according to which (1) legal reasoning is indeterminate (i.e., fails to justify a unique outcome) in those cases that reach

firms in the European Union are accordingly engaged in incorporation and reincorporation strategies in different Member States to claim the benefits of the EU Constitution under specious circumstances under the premise that there is such a "springing" constitutional right. As a matter of tax policy, neither the Supreme Court of the United States, nor a reviewing U.S. state court, should move further towards this European approach which has been a disastrous tax policy as applied in Europe. The prior tax literature often takes the existence of the economic substance doctrine in U.S. law as an afterthought to the determination of the constitutionality of taxation of non-domiciliary intangible income. However, the economic substance doctrine is *not* an afterthought as it establishes the applicable method of legal interpretation in the United States. Thus, individual states in the United States are not obliged to follow a non-substantive method of formalism in applying their own corporate tax laws, irrespective of how the Internal Revenue Service may view the Alphabet restructuring.

The Alphabet reorganization is accordingly best viewed not as a formalistic determination of a state's ability to levy tax on a business using intangibles within its borders without a physical presence, but instead a question of whether the federal government can force a state to treat a taxpayer differently based on a transaction recognized only for federal tax purposes (i.e., a § 351 transaction) and under a different state's general corporate law (i.e., a Delaware § 251(g) reorganization). The constitutional issue might then be decided solely on whether the state taxing law of Massachusetts must recognize the federal or Delaware transaction which gave rise to Alphabet as a separate and distinct taxpayer from Google. If Massachusetts, for example, says it does not recognize Alphabet under these circumstances as a matter of substantive review (*not* formalism), then it must be able to levy tax on Google as it had the right to do before the federal and Delaware reorganization. And, the implementation of a substantive version of legal interpretation in the United States is in stark contrast to the European formalistic approach to tax law, where the European Commission now operates what amounts to a policing function to prevent states such as Ireland

the stage of appellate review; (2) appellate judges, in deciding cases, are responsive to the "situation-types"—recurring factual patterns . . . that elicit predictable normative responses.

Id.

and Luxembourg to operate by granting “state aid” to corporations in the Member States.⁹⁰

If the United States allows Delaware to proceed, similar to Luxembourg, without a corollary substantive review of the tax laws (i.e., “state aid” review) this could end with the *de facto* exemption of certain corporations from state level corporate tax. In that case, the state tax system in the United States would become a European-style formalistic system without any checks or balances against the rights of tax havens, principally Delaware.⁹¹ The recent decisions by the European Commission with regard to “state aid” issued to Starbucks and Fiat indicate that even in the European Union some form of substance in transfer pricing (i.e., advance pricing agreements) must also be taken into account.⁹² The bottom line is that a purely formalistic method of legal interpretation without checks and balances does not work as tax policy, and Massachusetts, and any other U.S. states, are not required by the Constitution of the United States to apply this flawed (or incomplete) method of legal interpretation.

B. *Business Purpose in Formation of Foreign IP Holding Companies.*

One aspect of the constitutional challenge on a state level thus involves Google’s purported business purpose for the IP holding company (Alphabet). This is perhaps similar to the federal business purpose requirement in a § 351 transaction, but also different in that it is not necessarily the transaction that gave rise to the holding company at issue, rather the purpose of the holding company itself. Of course, many large companies use a holding company structure particularly where different stand-alone businesses may be commonly owned. The idea of executive-level “focus” in the Alphabet structure explanation seems quite limited when viewed from this perspective because it in no way explains why a Google affiliate in one U.S. state should

90. See Romero J.S. Tavares, Bret N. Bogenschneider & Marta Pankiv, *The Intersection of EU State Aid Cases & U.S. Tax Deferrals: A Spectacle of Fireworks, Smoke and Mirrors*, FL. TAX REV. (forthcoming, 2016).

91. See Bret N. Bogenschneider & Ruth Heilmeier, *Update on Key Issues in European Taxation*, 123:6 J. TAX’N 276 (2015).

92. See European Commission Press Release IP/15/5880, Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules (Oct. 21, 2015), http://europa.eu/rapid/press-release_IP-15-5880_en.htm (“The European Commission has decided that Luxembourg and the Netherlands have granted selective tax advantages to Fiat Finance and Trade and Starbucks, respectively. These are illegal under EU state aid rules.”).

pay a royalty to the IP holding company in Delaware. The payment of an IP royalty is a back-end function and simply does not enhance "focus" any more than any other accounting entry on the corporate books and records.

1. State Tax Avoidance as the Primary Business Purpose.

It is not entirely clear that Google should be allowed to claim state tax avoidance as a business purpose in a subsequent tax proceeding before the IRS or in a state tax case. This is because it has represented to the SEC that the business purpose of the transaction was "focus[ed] on extraordinary opportunities." Hence, Google may argue in a subsequent state tax court proceeding that "no, no we really were engaged in state tax avoidance," and such *state* tax avoidance gives us a *federal* tax business purpose, and, of course, the IRS or reviewing state court must respect our federal business purpose for the reorganization. Then, perhaps the response in litigation should be simply whether Google misrepresented the *true* business purpose to the SEC and its shareholders on August 10, 2015.⁹³

Nonetheless, we will proceed under the assumption that large corporations are afforded incremental and *special* procedural and substantive due process rights in any sort of legal proceeding *not* appearing in any written laws and *not* otherwise afforded to individual or small business taxpayers.⁹⁴ In that case, it becomes potentially necessary to weigh the state tax avoidance purpose against the purported other business purpose given as: "focus on extraordinary business opportunities." The relevance of non-tax considerations in the "sham" transaction context were cited by the Massachusetts Supreme Court as potentially also relevant to the decision in *Sherwin-Williams*.⁹⁵

93. See Press Release (August 10, 2015), *supra* note 1.

94. See Bret N. Bogenschneider, *Foucault and Tax Jurisprudence: On the Creation of a "Delinquent" Class of Taxpayer*, 8:1 WASH. U. JURIS. REV. 59 (2015).

This might be appropriately referred to as 'creative' due process (i.e., the special ability of large corporations to create and define the substantive tax procedure to which they are expected to comply). Small businesses and individuals are afforded no such 'creative' due process. The closest historical corollary for special rights afforded to large corporations in the modern United States may be the special legal rights of the nobility and property owners in feudal societies.

Id.

95. Carey & Huston, *supra* note 78, at 260.

However, before proceeding to this comparative analysis of weighing the purported business purpose with the state tax avoidance, the federal tax avoidance via transfer pricing benchmarking to enhance tax free repatriation on the Google intangibles is also potentially significant in avoiding federal corporate level taxes upon repatriation of foreign cash. Hence, a reviewing court would not necessarily be obliged to proceed to the state tax avoidance purpose, and could simply take into account the federal tax avoidance motivation for the transaction, and *even if* the IRS denies any such benefit with a § 482 adjustment.⁹⁶ This approach should be plausible because it will be obvious upon review in the rear-view mirror that Google misrepresented the actual purpose of the Alphabet reorganization in its SEC filings, and therefore, any plausible federal tax avoidance purpose might then be inferred in addition to the state tax avoidance.

In the third place, we finally arrive on the horns of the dilemma, which is whether *state* tax avoidance is valid as the primary business purpose for a *federal* transaction. This issue is sometimes given as a “non-tax” business purpose.⁹⁷ For its part, the Internal Revenue Service seems to view a business purpose as necessary for any transaction, and determines this on a case-by-case basis.⁹⁸ In terms of “economic substance” analysis the argument may be that state tax avoidance gives the federal substance for the transaction. And, with federal substance then state substance is inferred so state tax avoidance gives the federal substance which gives the substance for state tax purposes. The word for that sort of circular reasoning in the

(1) improvement of quality control oversight; (2) increased efficiencies by virtue of having profit centers separate from it; (3) easier profit analysis by having profit centers for the marks that were separate from it; (4) enhanced ability to enter into third-party licensing arrangements at advantages royalty rates; (5) maximized investment returns associated with the marks due to separate and centralized investment management; (6) enhanced borrowing capacities; (7) subsidiaries could be used in certain instances to acquire businesses; (8) provided ability to take advantage of the well-developed body of corporate law and expeditious legal system in Delaware; (9) insulated the marks from parent company liabilities; (10) increased flexibility in preventing a hostile takeover; and (11) increased liquidity.

Id. (citing *Sherwin-Williams*, 778 N.E.2d 504).

96. See generally I.R.S. Internal Revenue Manual, Allocation of Income and Deductions – I.R.C. Section 482.

97. Cummings, *supra* note 25 (“Random discussions of a nontax business purpose in a few court cases, letter rulings, and technical advice memorandums are either distinguishable, adopted voluntary statements by taxpayers, sloppy, or just wrong.”).

98. See, e.g., I.R.S. Tech. Adv. Mem. 8803001.

context of tax law was previously given as "incomprehensibility."⁹⁹

VI. ROYALTY BENCHMARKING TO INCREASE FOREIGN CASH REPATRIATION.

The series of Yahoo Finance! articles on the Alphabet restructuring suggested that there was no international tax planning or repatriation benefit to the new structure. To the contrary, Google has foreign controlled corporations that use the Google IP (presumably developed in the United States) in all other foreign jurisdictions. Some of this IP Google has transferred to Ireland apparently for tax avoidance purposes, but without regard to the value of the IP upon the intercompany transfer out of the United States to the foreign jurisdiction, which might otherwise be considered gain. Accordingly, on the unwind of the Irish Double-Dutch structure—since there does not appear to be any market valuation of the intercompany IP transfer by the taxing authorities—Google is able to shift the jurisdiction of the underlying IP apparently at will.¹⁰⁰ Alternately, instead of shifting existing IP, Google could simply announce that it has created new IP in the United States for tax purposes and assign value to the new IP rather than to the old IP. This sort of tax planning is possible because Google is not subjected to any sort of "real" corporate-level audit on assigning the value of its IP and related businesses.¹⁰¹

As such, any IP in the United States creates an automatic cash repatriation strategy from foreign controlled corporations into the United States. The royalty payments are recognized as income in the United States, but are presumptively deductible in the foreign jurisdiction, which may create a tax benefit if the foreign tax rate is higher than the United States. This renders the Delaware IP Holdco (i.e., Alphabet) strictly necessary because it avoids the potential for state level corporate income taxation on the foreign royalty payments. But, the fundamental point is that the international *cash flows* into the United States from the royalty payment. Google thus has an incentive to make such royalty payments into the United States as high as possible. The domestic tax planning can accordingly be used as a form of

99. See John Prebble, *Why Is Tax Law Incomprehensible?*, 1 BRIT. TAX REV. 380 (1994); Bret N. Bogenschneider, *Wittgenstein on Why Tax Law Is Comprehensible*, 2 BRIT. TAX REV. 252 (2015).

100. See Kleinbard, *supra* note 2.

101. See generally Bret Wells, *Voluntary Compliance: "This Return Might Be Correct but Probably Isn't"*, 29 VA. TAX REV. 645 (2010).

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benchmark to establish the rate of foreign royalty payments. The actual form of the benchmarking would depend on Google's slicing and dicing of the IP amongst its various business which is presumably extremely complex. However, the Alphabet restructuring will allow an additional layer of complexity to enhance the slicing and dicing as a matter of foreign tax planning. The Alphabet restructuring is accordingly a domestic plan that will yield foreign tax benchmarking benefits on the amounts of royalty payments to facilitate cash repatriation.

VII. TAX PITFALLS IN THE ALPHABET SOUP REORGANIZATION.

The IRS position is that a § 351 transaction requires a non-tax business purpose.¹⁰² R. David Wheat has argued that the case law is mixed but on balance a business purpose requirement for a § 351 transaction is the better view.¹⁰³ Accordingly, the potential pitfall to Google is that the § 351 transaction is *not* respected by the IRS because the "focus on extraordinary business opportunities" explanation given by Google is not accepted by the IRS as a legitimate or bona fide business purpose. In other words, the IRS would take the view that the § 351 transaction was undertaken primarily for federal and state tax avoidance purposes and that the "focus on extraordinary business opportunities" explanation was either ancillary or nonexistent in fact.

In the classic case as discussed by Wheat, a § 351 transaction could be used as a means to transfer a loss on an asset to a corporation by contributing it into corporate form and then having the corporation recognize the loss by immediately selling the asset.¹⁰⁴ In this case, Google does not wish to sell the asset, but to use the § 351 transaction as a device to allow for the licensing of the asset by Alphabet back to Google. Hence, the tax analysis upon the failed § 351 transaction is effectively the same where in this case the IP assets have been disposed by Google to

102. Rev. Rul. 76-123, 1976-1 C.B. 94; Rev. Rul. 68-349, 1968-2 C.B. 143; Rev. Rul. 60-331, 1960-2 C.B. 189; Rev. Rul. 55-36, 1955-1 C.B. 340.

103. See R. David Wheat, *Section 351 Transactions and Related Issues*, State Bar of Texas, 24th Annual Advanced Tax Law Course (Sept. 28-29, 2006) (citing *Estate of Kluener v. Comm'r*, 154 F.3d 630 (6th Cir. 1998); *Caruth v. United States*, 688 F. Supp. 1129, 1141 (N.D. Tex. 1987), *aff'd on other grounds*, 865 F.2d 644 (5th Cir. 1989); *Stewart v. Comm'r*, 714 F.2d 977, 989 (9th Cir. 1983); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1178 (3d Cir. 1974)).

104. See Wheat, *supra* note 103, at 7 ("Importantly, a short interval of time between the transfer of the asset to the corporation and its subsequent sale by the corporation may weaken an otherwise bona fide business purpose because the short time interval may show that the subsequent sale was preconceived.").

Alphabet and then re-licensed back to Google. The failed § 351 would accordingly simply give tax effect to the legal transaction claimed by Google which is to “manufacture” an intercompany licensing arrangement between Google and Alphabet using a § 351 transaction.

With the Google § 351 transaction, the indicia of the intent to use the Alphabet reorganization as a means to use the tax section as a device would be indicated by the *immediate* licensing of the IP with the reorganization. All indicia from the SEC filings indicate that Google treated the transaction as a “pre-packaged” deal (i.e., a microwaveable version of Alphabet soup to go with the Irish sandwich). Accordingly, the case law cited by Wheat involving situations where the time between the § 351 contribution by the shareholder and the subsequent sale by the corporation would also be applicable here because Google claimed to dispose the IP to Alphabet and then immediately license it back Google without any intervening time lapse. Simply put, Google made no attempt to disguise the § 351 transaction as anything other than a device to set up the intercompany licensing arrangement with immediate effect, and in fact, Google actually concealed the tax avoidance feature of the transaction in its SEC filings.

A. *Business Reasons for Google Not to Form Alphabet IP Holdco.*

An appropriate line of reasoning is then to evaluate whether Google's “focus on extraordinary business opportunities” explanation for the Alphabet restructuring is legitimate, and further to inquire whether the same business objectives could be obtained without the restructuring and without the incumbent tax avoidance.¹⁰⁵ Notably, Wall Street analysts did not

105. Carey & Huston, *supra* note 78, at 261.

The non-tax reasons not to establish an IPHC are seldom discussed. Here are a few. First, trademarks are inextricably bound up with good will. If the good will of a parent company is transferred to a subsidiary, how is that accounted for? How is it valued? Does the transfer of the good will to the subsidiary place the good will at any special risk? Are there any intent-to-use applications that, by regulation, cannot be assigned unless the existing business associated with the mark is also transferred? 15 U.S.C. § 1060(a)(1) . . . If the IPHC receives patents from a parent that manufacturers goods covered by the patent, there is some risk that the IPHC arrangement will place in jeopardy the ability for the company to collect lost profits for patent infringement . . . the taxpayer may be setting a low

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immediately grasp the business explanation offered by Google for the Alphabet restructuring. The idea that a corporate restructuring is required to place a particular corporate executive with a role within an organization is essentially absurd. A simpler means to achieve the same effect would be to use an employment agreement between Sundar Pichai and Google establishing him as the Chief Executive. However, more typically a large corporation would assign job responsibilities or duties to its employees and such either verbally or with an organizational structure chart. The reasons not to form the Alphabet Holdco are thus to avoid additional complexity in financial and tax reporting.

VIII. CONCLUSION: SO MUCH FOR GOOGLE NOT BEING “EVIL.”

Upon its initial public offering in 2004, the founders of Google, Larry Page and Sergey Brin, made a refreshing commitment to not be “evil.”¹⁰⁶ This pledge also later became the slogan for the company.¹⁰⁷ However, the slogan was not adopted by the Alphabet holding company.¹⁰⁸

Alphabet is correct to drop the commitment to oppose “evil” to avoid the accusation of outright hypocrisy.¹⁰⁹ In fact, the Alphabet restructuring is not consistent with a mainstream set of moral values on tax ethics, and is likely premised on an idea of either Libertarian tax ideology¹¹⁰ or Posnerian wealth

threshold for a ‘reasonable royalty’ measure of damages in a subsequent patent infringement case against a third party.

Id.

106. Google 2004 Founder’s IPO Letter, <https://investor.google.com/corporate/2004/ipo-founders-letter.html>.

Don’t be evil. We believe strongly that in the long term, we will be better served-as shareholders and in all other ways-by a company that does good things for the world even if we forgo some short term gains. This is an important aspect of our culture and is broadly shared within the company.

Id.

107. See Ian Bogost, *What Is ‘Evil’ to Google?*, THE ATLANTIC (Oct. 15, 2013), <http://www.theatlantic.com/technology/archive/2013/10/what-is-evil-to-google/280573/>.

108. See Tanya Basu, *New Google Parent Company Drops ‘Don’t Be Evil’ Motto*, TIME (Oct. 4, 2015), <http://time.com/4060575/alphabet-google-dont-be-evil/>.

109. See Daniel Roberts, *Alphabet drops Google’s famous ‘Don’t Be Evil’ motto*, FORTUNE (Oct. 5, 2015, 8:40 AM), (“The new code of conduct has a close approximation of the philosophy—though perhaps more formally phrased—in the very first sentence of the preface: ‘Employees of Alphabet . . . should do the right thing – follow the law, act honorably, and treat each other with respect.’”)

110. See generally Richard A. Epstein, *Fairness in a Liberal Society*, N.Z. BUS. ROUNDTABLE (Wellington: Astra Print, Ltd., 2005); Milton Friedman, *Capitalism and Freedom* (U. Chi. Press 1962); Geoffrey P. Miller, *Economic Efficiency and the Lockean Proviso*, 10 HARV. J. L. & PUB. POL’Y 401 (1987).

maximization theory applied to taxation.¹¹¹ Indeed, Google is growing its reputation as a company that seeks to avoid corporate taxes. This result is somewhat tragic in that the future of Google ought to depend largely on its wonderfully innovative ideas and not a reputation for corporate tax avoidance. In rational terms, the payment of corporate taxes is ancillary to Google's primary business goals and ought not to define the reputation of the company.

In more practical terms, the existential problem with tax avoidance is that it tends to seek out its own limits. Thus, aggressive corporate tax planning tends toward its own destruction when it eventually breaches those limits. Because tax law is indeterminate and depends on the interpretation of facts it is not always clear when aggressive tax planning is on the verge of surpassing acceptable limits. An obvious example is the Sale-in-Lease-Out (SILO) and Lease-in-Lease-Out (LILO) transactions of the past decade.¹¹² A variety of major U.S. banks engaged in these transactions to reduce corporate taxes by artificial means, and both accounting and financial advisory firms very much thought were a *good idea* at the time. Yet, this turned out to be wrong and that bad business decision led directly to capital destruction for these financial institutions.¹¹³ *Of course*, the idea of a U.S. bank purchasing the Berlin subway system and depreciating it to avoid taxes, for example, is rightly considered absurd when viewed in retrospect. Yet, this sort of hyper-aggressive tax avoidance planning is still advocated by many banking executives notwithstanding the objections of tax experts who do not stand to earn a commission by selling the transaction.

A. *The Morality of Google's Corporate Tax Avoidance*

Google brought up corporate ethics as part of its initial public offering.¹¹⁴ Given the subsequent aggressive tax planning by Google with regard to the Irish Double-Dutch (and now the Delaware Single-Dummy) tax avoidance structures, the situation is ripe to revisit the morality of Google's behavior with regard to aggressive tax avoidance planning in general. As a preliminary

111. See Richard A. Posner, *Overcoming Law* (Harv. U. Press 1995).

112. See Robert W. Wood & Steven E. Hollingworth, *SILOs and LILOs Demystified*, TAX NOTES (Oct. 11, 2010).

113. See, e.g., *John Hancock Life Ins. v. Comm'r*, 141 T.C. No. 1, 81-82 (2013); *Consol. Edison Co. of N.Y. v. U.S.*, 703 F.3d 1367, 1381 (Fed. Cir. 2013); *BB&T Corp. v. U.S.*, 523 F.3d 461, 475 (4th Cir. 2008); also Rev. Rul. 2002-69.

114. See Google 2004 Founder's IPO Letter, *supra* note 106, at 7.

matter, we expect that Google and its executives take the moral standard for the payment of corporate taxes to be that given by Judge Learned Hand as follows that “Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one’s taxes.”¹¹⁵ “Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. . . . Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands.”¹¹⁶

But, Learned Hand’s oft-repeated claim that the taxpayer “may arrange his affairs” does not apply to the type of tax avoidance planning undertaken by Google merely because the tax law itself is deficient in some way and to which the clever tax advisor may find a means to exploit.¹¹⁷ First, both Hand, and also Lord Tomlin in similar precedent from the United Kingdom,¹¹⁸ spoke to the application of tax law to *determinate* outcomes, and not the creation of *indeterminate* outcomes by the manufacture of facts to which the taxing authority is certain to disagree.¹¹⁹ In simple terms, tax law involves the determination of facts and not just the application of law to facts that were ostensibly created by the taxpayer but not disclosed to, or accepted by, the taxing

115. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

116. *Comm’r v. Newman*, 150 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting).

117. Rick Taylor, *Rusty Pipes is Simply Rusty, Says Tax Practitioner*, TAX NOTES TODAY, July 11, 1994, LEXIS 94 TNT 135–46.

I will do everything that I can to be absolutely certain that my clients do not pay one dime more than is absolutely required! That is what I was trained to do and that is what my clients pay me to do. To accuse me or anyone else in the tax community of not ‘playing fair’ and to demand that I somehow overlook planning ideas in the name of morals is, in the words of Judge Learned Hand, ‘mere can’t.’

Id.

118. *The Commissioners of Inland Revenue v. Duke of Westminster*, 1936 App. Cas. 1 (appeal taken from Eng.).

Every man is entitled if he can to order his affairs so that the tax attracted under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

Id.

119. See Bret N. Bogenschneider, *Manufactured Factual Indeterminacy and the Globalization of Tax Jurisprudence*, 4:2 U.C. LONDON J.L. & JURIS. 250, 250 (2015).

authority.¹²⁰ The parties in legal proceedings generally disagree as to the facts, and as Karl Llewellyn averred, the finding of facts is essentially a major aspect of any legal proceeding.¹²¹ For example, the facts in Google's Alphabet restructuring will presumably involve a determination of whether the purported business purpose was legitimate, and the reasonableness of the amount of the royalty payments. Second, Hand and Tomlin each spoke to the requirements of tax law and absolutely not to the requirements of morality. As to the role of tax lawyers specifically, the intentional *manufacture* of factual indeterminacy under applicable tax laws, such as the amount of intercompany royalty payments with the Alphabet restructuring, is *not* ethical attorney conduct¹²² notwithstanding ABA Formal Opinion 85-352.¹²³

120. Bret N. Bogenschneider, *Professional Ethics for the Tax Lawyer to the Holmesian "Bad Man"*, CREIGHTON L. REV. (forthcoming 2016).

Yet, an acknowledgement is typically given that the formalistic tax planning at issue in *Gregory v. Helvering*, or similar seminal tax avoidance cases, would not fly today. And, that is because tax law is not interpreted under a purely formalistic method of legal interpretation. In other words, the *Gregory v. Helvering* decision was made under a formalistic legal methodology to reach a determinative result of tax avoidance under the terms of the statute. In the modern era, this would not be the legal methodology generally applied in the United States, nor would it yield a determinative result under the applicable statute. The case would probably not now be decided in favor of the taxpayer at all and it would be accordingly unethical for a tax lawyer to engineer a transaction under *Gregory v. Helvering*, not because the audit lottery might fail, but because the transaction does not yield a formal determinative result of lawful tax avoidance.

Id.

121. Karl Llewellyn, *The Bramble Bush: Some Lectures on Law and Its Study* (Oxford U. Press 1960); Karl Llewellyn, *Some Realism about Realism: Responding to Dean Pound*, 44 HARV. L. REV. 1222 (1931).

The Bramble Bush tells us that the law is not a self-contained set of logical oppositions; that rules of law do not explain results at law; that facts are slippery things with a nasty habit of changing shape and color . . . that the truth is not in the law books, but it is somewhere-in economics, or sociology, or anthropology, or psychology, or in the murky reaches of Freudian theory.

Grant Gilmore, *Book Review: The Bramble Bush*, 60 YALE L. REV. 1251 (1951).

122. See generally Bogenschneider, "Professional Ethics," *supra* note 120.

123. Loren D. Prescott, Jr., *Challenging the Adversarial Approach to Taxpayer Representation*, 30 LOY. L.A. L. REV. 693, 719-21 (1997).

The Committee began its reconsideration of the lawyer's duties as a tax return advisor by implicitly endorsing the conclusion of Formal Opinion 314 that the return

B. *Hayek's "Magic Beans" Argument on the Ethics of Business Taxation.*

We further expect that the Google founders may have in mind some version of the "magic beans" argument first given by Friedrich Hayek.¹²⁴ The idea is that certain persons possess an inherent quality (even a magical quality) that allows these persons to make better business decisions than just ordinary people and such persons ought to possess the capital for efficiency reasons.¹²⁵ This argument is separate from standard Libertarian tax theory, such as that given by Richard Epstein, where the argument is that it is moral to fulfill the social contract by regressive taxation.¹²⁶ Hayek claims that it is efficient (and therefore, moral) to allow certain persons to grow the "magic beans" into the "Giant Beanstalk."¹²⁷ One obvious outcome of Hayek's approach is particularly that poor people should never be allowed to "eat" the proverbial magic beans by redistributive taxation. As such, it may be that the Google founders believe they are the "chosen" ones and it is therefore efficient for society if they do not pay taxes because they are special and it would be better for everyone if they accumulate the beans. Of course, nearly every person in a capitalist society, from

preparation process should be treated as an adversarial proceeding and that the tax lawyer's duties are those of an advocate The Committee concluded that a lawyer can have a good faith belief in the validity of a position only if there is "some realistic possibility of success if the matter is litigated," but acknowledged that "[a] lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail."

Id. See also ABA Comm'n on Prof'l Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985); Theodore C. Falk, *Tax Ethics, Legal Ethics, and Real Ethics: A Critique of Formal Opinion 85-352*, 39 TAX L. 643 (1986).

124. The "magic beans" reference is to Hayek's suggestion that certain special persons possess a form of capitalist magic that causes money to be more productive in their hands as compared to "regular" people. Friedrich Hayek, *Law, Legislation and Liberty*, Vol. 2, Ch. 9: 'Social' or Distributive Justice, in *The Mirage of Social Justice* 62-106 (Routledge & Kegan, eds.) (1973).

125. See Bret N. Bogenschneider, *Wittgenstein on Why Tax Law is Comprehensible*, 2 BRIT. TAX REV. 252, 269 (2015).

But, in principal, these statements reflect Hayek's "magic beans" justification for tax policy and are not based on an ability-to-pay principle, which appears either to usually or always end in the tax result that the owners of property should not pay taxes at all, as this is inefficient and inevitable.

Id.

126. See Richard A. Epstein, *Taxation in a Lockean World*, 4:1 SOC. PHIL. & POL. 49 (1986).

127. See Hayek, *supra* note 121.

the gas station attendant, to the investment bank CEO, to the corporate executive, believes he/she is *obviously* endowed with Hayek's "magic" touch for beans and should hold beans in trust for the rest of society.

As such, there are at least three further problems with Hayek's "magic beans" argument in tax ethics. First, the general problem of the identification of special persons who might possess the "magic beans," or be able to impart beans (i.e., capital) with magical qualities since everyone will claim to be so imbued. One possibility would be to simply look and see who has capital in society and then give those persons more capital. Hayek proposed exactly this approach. However, because many wealthy people simply inherit wealth, and given the "magic beans" ability does not appear to pass genetically (indeed, experience with nepotism seems to indicate to the contrary), just looking at capital accumulations does not seem a plausible approach. There is no truly viable approach to identify the "magic beans" in advance. In any case, the idea of "pre-determination" seems to resemble more of a planned economy than capitalism anyway. The first response to Hayek is that the philosophical claim is simply mysticism in a more colorful wrapper.

The second problem is that the argument is circular: wealthy people by definition have capital, poor people do not. And, if via regressive taxation, capital is taken from potential entrepreneurs and redistributed to Google, this would presumably operate to the opposite of how Amazon, as example, got started in Jeff Bezos' California garage.¹²⁸ Notwithstanding these first two critiques, the Google founders certainly had a vision and carried it through resulting in extraordinary capital accumulation. This represents a possible inductive claim in support of Hayek, essentially we know by experience that Google did it before, and now Google wants to do it again. Obviously, the tax system should let Google, of all companies, try and not take away the beans.

And, this leads to the third problem, which is when does capital become "too much"? Simply put, Google has nearly unlimited capital. For his part, Warren Buffet regards capital deployment with declining returns to scale.¹²⁹ Accordingly, the

128. See Sandeep Krishnamurthy, *A Comparative Analysis of eBay and Amazon* (Idea Group, Inc., 2004), <http://faculty.washington.edu/sandeep/d/amazonebay.pdf>.

129. See generally Andrea Frazzini, David Kabiller & Lasse Heje Pedersen, *Buffet's Alpha* (2013), <http://www.econ.yale.edu/~af227/pdf/Bufferet's%20Alpha%20-0Frazzini,%20Kabiller%20and%20Pedersen.pdf>.

incremental question with the “magic beans” argument is determining when a bona fide entrepreneur is just accumulating “magic beans” for the sake of accumulating, versus, accumulating for the sake of more entrepreneurship at some point in the future. The accumulation and storage of “magic beans” is worse than investing the money, as explained under the New Testament “Parable of the Talents,” because accumulation ostensibly does even less for humanity than letting the non-entrepreneurial-poor eat the beans.¹³⁰ Accordingly, if Google is indeed operating for the benefit of mankind generally, then one might want to see proof before exempting Google from corporate level taxation. In lieu of proof, there are good systemic reasons, such as overall taxpayer morale, not to allow special exemptions from corporation taxation in a capitalist system—even to Google.

C. Google’s Categorical Imperative to Lead on Corporate Tax Ethics.

With great success comes great responsibility. As a matter of ethics, this represents the *actualization* of Kant’s Categorical Imperative, or the formulation of a universal law.¹³¹ In simple terms, Kant said with the Categorical Imperative one should conceive a thought experiment and imagine one’s behavior will be adopted by all others, and then evaluate the universal law.¹³² But, for Google the analysis is very much simplified. Google does not need to take the effects of its aggressive corporate tax avoidance upon society as a thought experiment. The situation is real. Other corporations will tend to behave as Google behaves with regard to tax avoidance planning. All indications are that Google’s Irish Double-Dutch structure formed the basis and inspiration for a great deal of aggressive international tax avoidance planning by multinationals. Hence, Google is in a leadership position on corporate tax ethics, and this is true whether it wants to be or not.

For several reasons, the fact that other corporations will behave as Google behaves ought to be a major business consideration for Google. First, there is a growing consensus that the U.S. tax system functions because of high levels of taxpayer

130. The Bible, Matthew 25: 14–30 (“Parable of the Talents”).

131. See IMMANUEL KANT, GROUNDWORK THE METAPHYSICS OF MORALS (Allen W. Wood, ed. trans., Yale U. Press, 2002) (1785).

132. See Christine M. Korsgaard, *Kant’s Formula of Universal Law*, 66 PAC. PHILOSOPHICAL QUARTERLY 24 (1985).

"morale."¹³³ If the "morale" of individual and small business taxpayers to pay taxes into the U.S. tax system erodes because of a *perception* of Google's failure to pay corporate taxes that eventuality risks the overall functioning of the capitalist financial system. It should go without saying that Google profits immensely from such system. Second, if there is some financial disadvantage to Google from not taking the most aggressive tax avoidance position vis-à-vis its competitors, this is likely to be mitigated as other corporations follow Google's lead on aggressive tax avoidance planning generally. In addition, Google's statement of corporate policy emphasizes that the company takes the "long-term" view¹³⁴ on business decisions which would seem to mitigate against aggressive tax avoidance planning, at least if we take the SILO and LILO transactions as illustrative.¹³⁵ Third, if the collective behavior of large corporations to "hoard" cash onshore or offshore begins to limit the ability of the Federal Reserve and European Central Bank to use monetary policy to stimulate the global economy, and the global economy sinks (or even merely stagnates) historians will certainly go looking for a villain. And, this is the problem: Any great success in politics, business, etc., yields the potential for *commensurate* blame for the perceived consequences to the system as a whole *even if* unrequited. As such, the price of great business success in capitalism actually *is* moral responsibility to the system, to include the overall system of taxation both in the United States and around the world.

133. James Alm & Benno Torgler, *Culture Differences and Tax Morale in the United States and in Europe*, 27 J. ECON. PSYCH. 224, 241 (2006); Ronald G. Cummings, Jorge Martinez-Vazquez, Michael McKee, & Benno Torgler, *Tax Morale Affects Tax Compliance: Evidence from Surveys and an Artefactual Field Experiment*, 70 J. ECON. BEHAVIOR & ORG. 447, 456 (2009); see also Ronald Inglehart et al., *Codebook for World Values Survey* (Ann Arbor, MI: Institute for Social Research, 2000).

134. GOOGLE FORM 10-K, *supra* note 19.

135. See Wood & Hollingsworth, *supra* note 112, at 199.

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IX. APPENDIX A: GOOGLE'S PHYSICAL OFFICES IN THE U.S.

US states	Location	2008 ¹³⁶ Combined vs. Separate Reporting	2015 ¹³⁷ Combined vs. Separate Reporting	State Addback Rules
Arizona	Phoenix	Combined	Combined	No addback
California	Orange County	Combined	Combined	No addback
California	Los Angeles	Combined	Combined	No addback
California	Mountain View (Global HQ)	Combined	Combined	No addback
California	San Bruno (You tube)	Combined	Combined	No addback
California	San Francisco	Combined	Combined	No addback
Colorado	Boulder	Combined	Combined	No addback
District of Columbia	Washington DC	Separate	Combined	Addback laws
Florida	Miami	Separate	Separate	No addback
Georgia	Atlanta	Separate	Separate	Addback laws
Georgia	Douglas County	Separate	Separate	Addback laws
Illinois	Chicago	Combined	Combined	Addback laws
Iowa	Council Bluffs	Separate	Separate	Addback laws
Mass- achusetts	Cambridge	Separate	Combined	Addback laws
Michigan	Detroit	Combined	Combined	Addback laws
Michigan	Ann Arbor	Combined	Combined	Addback laws
Missouri	Kansas City	Separate	Separate	No addback

¹³⁶ CCH Inc., U.S. Master Multistate Corporate Tax Guide 107-10 (2009).

¹³⁷ See John Rappa, Office of Legislative Research, Research Rep. 2015-R-0163, "Adoption of Combined Reporting in Selected States", (Sept. 8, 2015), at 2, 18.

New Mexico	Moriarty	Combined	Combined	No addback
New York	New York	Combined	Combined	Addback laws
North Carolina	Chapel Hill	Separate	Combined	Addback laws
North Carolina	Lenoir	Separate	Combined	Addback laws
Oklahoma	Mayes County	Separate	Separate	No addback
Oregon ¹³⁸	Portland	Separate	Combined	No addback
Oregon	The Dalles	Separate	Combined	No addback
Pennsylvania ¹³⁹	Pittsburgh	Separate	Separate	Addback laws
Pennsylvania	Philadelphia	Separate	Separate	Addback laws
South Carolina	Berkeley County	Separate	Separate ¹⁴⁰	No addback
Texas	Dallas	Combined	Combined	No addback
Texas	Austin	Combined	Combined	No addback
Virginia	Reston	Separate	Separate	Addback laws
Washington	Seattle	no state corporate tax		
Washington	Kirkland	no state corporate tax		
Wisconsin	Madison	Separate	Combined	Addback laws

138 Oregon rescinded related-party addback as of 2013. PricewaterhouseCoopers, LLP, Oregon Repeals related Party Addback, Retroactively Expands Safe Harbor (June 27, 2013).

139 In 2013, Pennsylvania introduced the Pennsylvania Tax Reform Code Bill (House Bill 465) requiring for taxable years beginning after December 31, 2014, a corporate net income tax addback for intangible expenses (i.e. royalties, licenses, or fees paid for acquisition) between related parties unless e.g. the transaction is "made at arm's length," and it has a valid business purpose other than tax avoidance. See 72 Pa. Stat. and Cons. Stat. Ann. § 7401(3)(t)(2) (West 2015).

140 But see *Media General v. SC Dep't of Rev.*, 694 S.E.2d 525 (2010).