INTERNATIONAL TAXATION 101: THE REVENUE PROPOSALS THAT WILL KEEP THE STATUS QUO AND A FORMULARY APPROACH THAT WON'T

Robert C. Goodwill Jr & Dr. Janie Whiteaker-Poe***

I. HISTORY OF THE U.S. INTERNATIONAL TAXATION SYSTEM 152
II. OVERVIEW OF INTERNATIONAL TAXATION REGIMES 153
  A. *Basics of Territorial Tax System* 156
  B. *Basics of U.S. Worldwide Tax System* 156
III. INTRODUCTION TO AUTHORITATIVE GUIDANCE AND KEY MECHANIMS OF THE U.S. INTERNATIONAL TAX REGIME 157
  A. *Section 952-964 of The Code (Subpart F)* 157
  B. *Deferral and Repatriation* 158
  C. *Permanent Establishment* 159
IV. CONSTITUENCY FRAMEWORK 164
  A. *United States Taxpayer* 165
  B. *United States Government* 165
  C. *U.S. Multinational Corporations* 165
  D. *Academics and Experts* 165
V. THE PERCEIVED PROBLEM: TAX AVOIDANCE AND TAX BASE EROSION 166
  A. *Profit Shifting and Tax Base Erosion* 166
    i. Explanation of Dharmapala's Model 168
    ii. Dharmapala's model: 168
    iii. Explanation of Dharmapala's Model 169
  B. *Stateless Income* 169
    i. Double Irish Dutch Sandwich Comprehensive Example 171
  C. *Corporate Inversions* 173
VI. CONGRESSIONAL SOLUTION: REASONING AND INTENT OF THE REVENUE PROPOSALS 173

---

* Robert C. Goodwill Jr. is a 2018 doctoral candidate at The University of Houston Law Center and is a member of both the Houston Business and Tax Law Journal and the Interscholastic Mock Trial Team. Prior to joining UHLC's doctoral program, he obtained a Master of Accountancy and B.B.A. in accountancy from Baylor University in late 2014. To my family, thank you for your unwavering support and more importantly for the catharsis you provide through constant hilarity. To Reid S. Goodwill, may the day come where you discover airplanes are for flying. I give special thanks to the immensely talented future Dr. Liliana Espinoza for adding a shine to this paper that only she is capable of. For GR Goodwill, affectionally known as, "Poppy," always.

** Dr. Janie Whiteaker–Poe is an assistant professor in the Hankamer School of Business at Baylor University.

A. Public Policy Issues ... 174
B. Economic Considerations ... *175*
i. Tax Havens ... 175
ii. Brief History of Tax Havens ... 176
iii. The Problem with Tax Havens ... 178
iv. Tax havens, Multinational Corporations and Tax Law 179
v. Effective tax rates ... 182
vi. Political Economy of Tax Havens and Tax Reform ... 183
vii. Current Reform Proposals ... 185
C. Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income ... 188
D. Impose a 19 Percent Minimum Tax on Foreign Income ... 188
i. Congressional Solution ... 189
VII. AUTHOR PROPOSED SOLUTION: A FORMULARY APPROACH ... 190
A. Purpose of a Formulary Approach ... 190
B. Simplified Example ... 191
C. Comprehensive Example ... 191
i. Analysis of a 14 Percent One Time Tax on Previously Untaxed Foreign Income ... 193
ii. Analysis of a 19-Percent Minimum Tax on Foreign Income ... 193
iii. Formulary Apportionment ... 194
VIII. CONCLUSION ... 201

I. HISTORY OF THE U.S. INTERNATIONAL TAXATION SYSTEM

The standard framework for creating balanced tax policy is commonly simplified to three competing pillars of taxation: (1) simplicity (2) efficiency; and (3) equity.[1] Simplicity is the desire to create tax laws that can be complied with while not expending a superfluous amount of resources.[2] Efficiency is attained when a tax system does not hinder or stagnate an economy.[3] Equity, although a seemingly nebulous principle, is achieved when similarly situated taxpayers are taxed at the same rate.[4] However, emphasis on any one of these pillars will make it more difficult to achieve another.[5] Therefore, the proper method of creating good tax policy is to maintain a proper balance between the competing pillars of taxation.[6]

The Sixteenth Amendment granted Congress the ability to tax income "from whatever source derived."[7] In response to the overly-inclusive Sixteenth Amendment, Congress passed the Revenue Act of 1918, from which emerged the concept of a foreign tax credit (FTC).[8] The FTC is a credit that is applied against U.S. income for taxes paid in foreign jurisdictions.[9] Promptly, the Revenue Act of 1921 limed the FTC by utilizing a foreign tax credit limitation (FTCL).[10] The Sixteenth Amendment created a blanket (albeit, intended) income-capturing provision.[11] Congress responded to the overbreadth of the all-inclusive

---

1. *See* TAX DIVISION, AM. INST. OF CERTIFIED PUBLIC ACCOUNTANTS, GUIDING PRINCIPLES OF GOOD TAX POLICY: A FRAMEWORK FOR EVALUATING TAX PROPOSALS 10 (2017) [hereinafter AICPA 2017] (noting the non-simplified ten key principles of good tax policy that is beyond the purview of this article); ALAN D. CAMPBELL ET AL., PRINCIPLES OF BUSINESS TAXATION 105.01-.02 (Linda M. Johnson, 2013); ORG. FOR ECON. CO-OPERATION AND DEV., ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY 30-31 (2014) [hereinafter OECD 2014].

2. AICPA 2017, *supra* note 1, at 8; OECD 2014*, supra note* 1, at 30; CAMPBELL ET AL., *supra* note 1, at 22.

3. AICPA 2017, *supra* note 1, at 9; OECD 2014*,* supra note 1, at 30; CAMPBELL ET AL., *supra* note 1, at ¶ 105.02.

4. AICPA 2017, *supra* note 1, at 6; OECD 2014*,* supra note 1, at 31; CAMPBELL ET AL., *supra* note 1, at 105.01.

5. Simplicity would be achieved at the detriment of equity if "Corporation A" earns $100 in taxable income per fiscal year and "Corporation B" earns $10,000 in taxable income per fiscal year while each corporation is taxed at a rate of exactly $50. *See* AICPA 2017, *supra* note 3, at 14.

6. *See* AICPA 2017, *supra* note 1, at 14.

7. U.S. CONST. amend. XVI; *See* Michael J. Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L. J. 1021, 1022 (1997) (discussing the sixteenth amendment, which created taxation of worldwide income derived by U.S. persons).

8. The sixteenth amendment is intentionally over-inclusive because the Act includes income from all sources derived. However, blanket legislation tends to "catch extra in the net". *See* Graetz & O'Hear, *supra* note 7.

9. *See* Graetz & O'Hear, *supra* note 7.

10. *See* Graetz & O'Hear, *supra* note 7.

11. *See* I.R.C. § 63 (2017) (citing to Congress codification of an all-encompassing income provisions).

income provision by enacting an exception, the FTC.[12] The FTC was subsequently limited by the FTCL.[13]

In 1928, the League of Nations created the first model income tax treaties to alleviate double taxation of foreign derived income.[14] The treaties introduced by the League of Nations are virtually the same—with the addition of more complex clauses—as the model income tax treaty that is used presently by the U.S.[15] The tax regime created in the 1920s is extremely similar to the U.S. tax regime in the year 2016.[16] In essence, modern U.S. multinational enterprises, participating in a substantially larger global economy nearly 100 years later, are still taxed based on the original tax regime contemplated at the onset of international economic activity.[17] The lack of monumental alteration to the U.S. international tax regime has been largely praised and criticized alike.[18]

II. OVERVIEW OF INTERNATIONAL TAXATION REGIMES

The U.S. tax regime derived over the course of several decades from various philosophies and policy objectives.[19] Equity and neutrality are two key objectives of the U.S. international tax regime.[20] Equity, under the tax frame work, is separated into horizontal equity and vertical equity.[21] Horizontal equity is achieved when taxpayers of similar economic situations are taxed similarly while vertical equity is

---

12. *See* Graetz & O'Hear, *supra* note 7, at 1022.

13. The Congressional process of expanding taxable income, extending a credit against the income, and then limiting the credit, is a prime example of Congress attempting to balance the three pillars of taxation. *See* Graetz & O'Hear, *supra* note 7, at 1022-23.

14. *See* Graetz & O'Hear, *supra* note 7, at 1023. Prior to international income tax treaties, a taxpayer that generated foreign income would pay a marginal rate with the U.S., pay foreign tax, and receive a nominal FTC. The increased tax paid on foreign derived income incentivized taxpayers to avoid international economic activity, which violates the principle of tax efficiency. *See generally* Graetz & O'Hear, *supra* note 7, at 1022.

15. *See* Graetz & O'Hear, *supra* note 7, at 1023.

16. The lack of change to the international tax regime, for over almost a decade, could serve to evidence a fleshed-out system or the absence of needed attention to a poorly-oiled machine. *See id.*

17. *See* Graetz & O'Hear, *supra* note 7, at 1023.

18. *See* Vanessa Bradford & Gerry Holt, *Google, Amazon, Starbucks: The Rise of Tax Shaming*, BBC (May 21, 2013), http://www.bbc.com/news/magazine-20560359 (citing three companies that rely heavily on the U.S. international tax system as well as the new phenomenon of "tax shaming" by those who are unhappy about perceived abuses of the international tax system).

19. *See* ROBERT J. MISEY, JR. & MICHAEL S. SCHADEWALD, PRACTICAL GUIDE TO U.S. TAXATION OF INTERNATIONAL TRANSACTIONS ¶ 105 (7th ed. 2009); AICPA 2017, *supra* note 1, at 9; OECD 2014, *supra* note 1, at 30.

20. MISEY & SCHADEWALD, *supra* note 19, at 19; AICPA 2017, *supra* note 1, at 67; OECD 2014, supra note 1, at 30; CAMPBELL ET AL., *supra* note 1, at ¶ 105.01.

21. *See* MISEY & SCHADEWALD, *supra* note 19, at 19 (illustrating horizontal equity is achieved when taxpayers of similar economic situations are taxed similarly while vertical equity is achieved when higher-income taxpayers bare a higher burden of tax).

achieved when higher-income taxpayers bear a higher tax burden.[22] Vertical equity is also known as the "ability to pay doctrine."[23] Horizontal and vertical equity can be achieved with relative ease but major issues arise when attempting to balance equity with neutrality under either a territorial or worldwide tax system.[24]

Understanding "neutralities," a tax concept for the purpose of analyzing international taxation, is necessary to create and revise ideal tax policy.[25] The concept and application of neutralities for the purpose of evaluating international tax policy dates back to 1963. The original neutralities created to evaluate international taxation policy are Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).[26] CEN is achieved when an international tax regime places the same tax burden on individuals regardless of where they invest.[27] The goal of CEN is for investors to base their investment choices on pre-tax factors.[28] CEN philosophies tend to suggest a purely residence-based tax regime or a worldwide tax regime coupled with an unlimited foreign tax credit.[29]

---

22. *See* MISEY & SCHADEWALD, *supra* note 19, at 19.

23. The ability to pay doctrine (a philosophy derived from utilitarian principles) postures that a taxpayer with a higher ability to pay should bare a higher burden of tax because, all other factors held equal, the taxpayer with a higher ability to pay in essence "feels" the burden less. *See* AICPA 2017, *supra* note 1, at 10; OECD 2014, *supra* note 1, at 31.

24. *See generally* MISEY & SCHADEWALD, *supra* note 19, at 19 (illustrating neutrality is achieved when taxpayers will not alter their investment behavior between domestic or foreign investment based on the tax regime in which the taxpayer is subject); OECD 2014, *supra* note 1, at 31-32; Campbell ET AL., *supra* note 1, at ¶ 105.01.

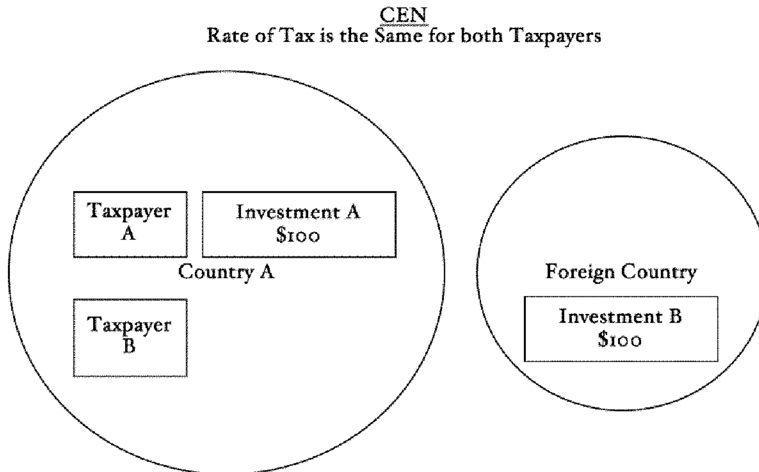
25. David A. Weisbach, *The Use of Neutralities in International Tax Policy*, 3 (Coase-Sandor Institute for Law and Economics Working Paper No. 697, 2014).

26. *Id.*

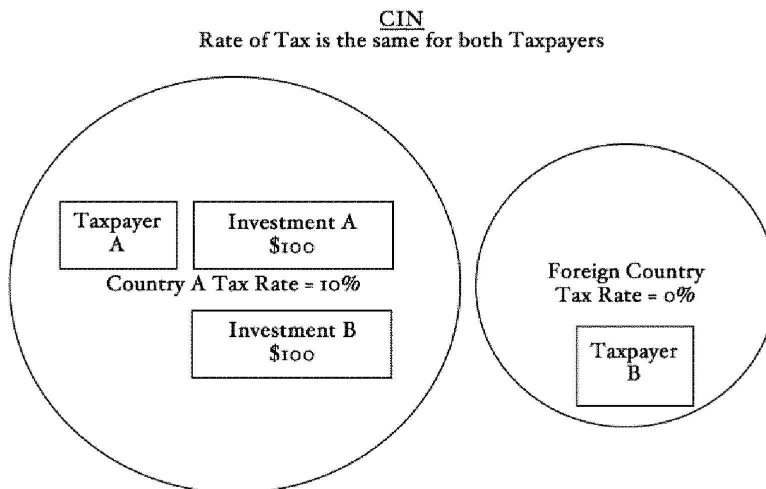
27. CEN example, "Taxpayer A" from "Country A" earns $100 from domestic activity and "Taxpayer B" from "Country A" earns $100 from foreign activity while each is taxed at the same rate. *See id.*

28. *See id.*

29. *See id.*



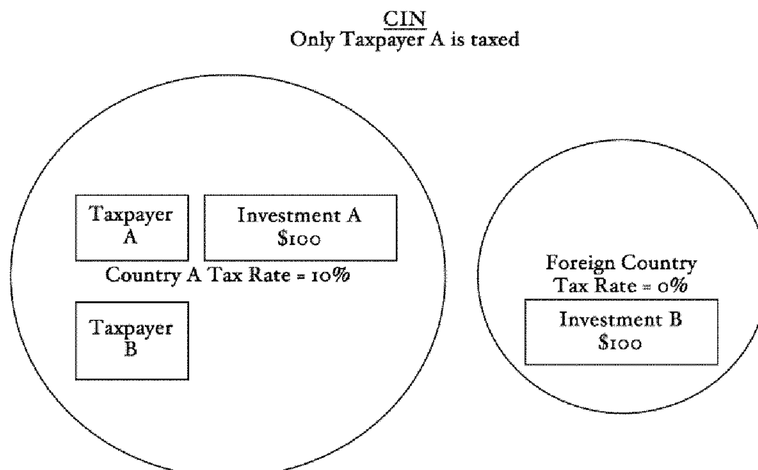
Contrastingly, CIN is achieved when investors pay the same rate of tax on income derived from a given territory.[30] Investors domiciled in a different territory than the location of their investment will pay the same tax rate as investors domiciled in the same territory of their investment.[31] Consequently, CIN philosophies typically suggest a purely source based tax regime coupled with a residence country exemption for foreign earned income.[32]



30. *See id.*

31. CIN example, "Taxpayer A" from "Country A" earns $100 from an investment in "Country B" and "Taxpayer B" from "Country B" earns $100 from an investment in "Country B" while each is taxed at the same rate. *See id.*

32. *Id.*



Capital Ownership Neutrality (CON), an alternative neutrality to CEN or CIN, was created in 2004.[33] CON philosophies typically suggest taxation should not distort ownership of assets.[34] Lastly, Market Neutrality (MN) suggests that entities competing within the same market should be taxed similarly.[35]

A. *Basics of Territorial Tax System*

A territorial tax system is a system in which only income derived within the borders of a territory is taxed.[36] Territorial systems tend to coincide with general notions of CIN philosophies.[37]

B. *Basics of U.S. Worldwide Tax System*

According to scholars, the primary motive behind the use of a worldwide tax regime was to prevent wealthy individuals from avoiding military duty by fleeing the country.[38] For this reason, the U.S. taxes individuals on their worldwide income.[39] However, the issue of

---

33. *Id.*

34. *See id.* (explaining CON is focused on asset ownership because whether you choose to place an income producing asset in Africa or Australia should not be affected by tax policy).

35. *Id.* at 4

36. Phillip Dittmer, *A Global Perspective on Territorial Taxation 2*, TAX FOUNDATION (AUG. 10, 2012), https://files.taxfoundation.org/20170330162854/sr202_0.pdf.

37. *See* Weisbach, *supra* note 25, at 3.

38. John D. McKinnon, *Tax History: Why U.S. Pursues Citizens Overseas*, THE WALL STREET JOURNAL (May 18, 2012, 4:39 PM). https://blogs.wsj.com/washwire/2012/05/18/tax_history_why_u_s_pursues_citizens_overseas/.

39. *See id.* (illustrating the U.S. taxes individuals and U.S. corporations on all income derived from domestic or foreign activities).

potential double-taxation arises if income was taxed both within the U.S. and a foreign jurisdiction.[40] The U.S. offers a foreign tax credit on all taxes paid in foreign jurisdiction to alleviate double-taxation.[41] Furthermore, U.S. corporations can elect to defer income earned in foreign jurisdictions, which will not be taxed for U.S. purposes until that money is remitted.[42] Worldwide tax regimes tend to coincide with general notions of CEN philosophies.[43]

III. Introduction to Authoritative Guidance and Key Mechanisms of the U.S. International Tax Regime

Below is a general discussion and summary of the mechanisms utilized within the U.S. international tax regime. These mechanisms can be conceptualized as a pin on a spectrum extending from a fully territorial system on one end to a worldwide system on the other end. The ideologies intrinsically engrained within the three competing pillars of taxation are littered throughout these various code sections and mechanisms. Whether these mechanisms force the balance of the tax regime to an undesirable end of the spectrum remains a topic to be contested.

A. *Section 952-964 of The Code (Subpart F)*

26. U.S. Code § 952 defines "subpart F income" as the sum of income from a controlled foreign corporation generated by insurance income; foreign base company income; illegally derived income; and income that is attributable to earnings and profits of the foreign corporation included in the gross income of the U.S. person under 26 U.S. Code § 951.[44] A foreign controlled corporation is a corporation—on any day in a given year—comprised of an ownership structure made up of 50% U.S. shareholders.[45] The purpose of this mechanism is to keep U.S. shareholders from shifting subpart F income to controlled foreign corporations in low-tax jurisdictions.[46] For example, some controlled foreign corporations (in the service industry) would locate their facility

---

40. U.N. Committee of Experts on Int'l Cooperation in Tax Matters, 7th Sess., U.N. Doc. E/C.18/2011/CPR.11 (Oct. 19, 2011).

41. Rosanne Altshuler & Harry Brubert, *Formula Apportionment: Is it Better Than the Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1149 (2010).

42. *See id.*

43. *See* Dittmer, *supra* note 36, at 4.

44. § 952 is an extremely technical code section that essentially lists various forms of highly mobile income, in which is easily attributed to lower tax jurisdictions for tax avoidance or minimization. *See* 26 U.S.C. § 952 (2007).

45. I.R.S. Practice Units, USB_C_14_02_01_05, 7 (October 14, 2016).

46. *Id.* at 8 (explaining the purpose of relocating service income is based on tax considerations and the fact that service income is generally easier to shift the tax nexus to a low-tax jurisdiction).

in a low-tax jurisdiction but perform the services in a high-tax jurisdiction.[47] In relation to the three competing pillars of taxation, subpart F restrictions favor equity at the expense of simplicity.[48] Additionally, subpart F restrictions tend to promote a worldwide tax regime where an entity is located in one jurisdiction but income is allocated to the jurisdiction in which the income was derived. [49] Lastly, subpart F restrictions coincide with CIN principles because income is allocated to the territory in which the income was derived without concern for the location of the entity.[50]

B. Deferral and Repatriation

Deferral is an elective option of a U.S. multinational corporation to defer tax liability on earnings derived from a foreign jurisdiction until those earnings are transferred back into the U.S.[51] The process of transferring previously untaxed earnings to the U.S. is called repatriation.[52] Deferral is one of the key mechanisms used by U.S. multinational corporations to remain competitive with foreign corporations that are taxed under a territorial system.[53] The importance of deferral stems from the fact that the U.S. tax rate on corporations is generally higher than the tax rate imposed by foreign jurisdictions.[54] In the past, U.S. multinationals did not struggle to compete because other jurisdictions also taxed foreign earnings which created economic equilibrium.[55] However, over 80% of OECD nations have moved to a territorial system, which exempts foreign earnings from taxation—a benefit that is not extended to U.S. multinational corporations by the U.S.[56] The concern with eliminating deferral is the notion that the U.S. would be forced to move to a territorial system that would enable U.S.

---

47. *See id.* at 9 (describing Foreign Base Country Services Income).

48. *See generally* Tax Division, Am. Inst. of Certified Public Accountants, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals at 10 (2001) [hereinafter AICPA 2001] (illustrating that equity is attained at the detriment to simplicity when similarly, situated taxpayers are taxed similarly but the methods utilized to achieve that goal are overly complex); CAMPBELL ET AL., *supra* note 3, at ¶ 105.01-.02; OECD 2014, *supra* note 1, at 30-31.

49. *See* McKinnon, *supra* note 38.

50. *See* Weisbach, *supra* note 25, at 3.

51. ROBERT CARROL ET AL., TAX FOUNDATION, THE IMPORTANCE OF TAX DEFERRAL AND A LOWER CORPORATE TAX RATE, PUB. NO. 174, 1 (2010).

52. *See id.* (illustrating previously untaxed are earnings are taxed upon being transferred back to the United States).

53. *See id.* at 2.

54. *Id.*; *See generally Corporate Tax Rates Table*, KPMG (Jan. 17, 2017), http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.html.

55. CARROL, *supra* note 51, at 2.

56. *See* CARROL, *supra* note 51, at 2.

multinationals to compete on a global scale.[57] Deferral, a seemingly unpopular mechanism to all who do not reside within the gaudy chambers of Google and Apple C-Suites, has been sharply criticized by politicians and academics alike.[58]

The mechanism of deferral creates simplicity at the potential detriment to equity and efficiency.[59] Deferral—absent subsequent repatriation—is akin to a territorial system in which the entity is only taxed on income derived within the borders of the entity's host country.[60] Permanent deferral reflects CEN principles; deferral allows for two entities located in separate jurisdictions to invest freely and pay tax only on income derived in their resident jurisdictions.[61]

C. Permanent Establishment

The concept of a permanent establishment was first introduced in the original U.S. tax treaty in 1932.[62] Surprisingly, the definition of a permanent establishment has remained relatively stable.[63] The stability is primarily due to the OECD's and the U.S.' reluctance to change the definition of the permanent establishment.[64] Reluctance is not unfounded, because even a small change to the definition would dramatically affect all parties.[65] Classifying a physical site of a business as a permanent establishment is a mechanism that is utilized when two

---

57. *See* CARROL, *supra* note 51, at 2 (suggesting that foreign entities would be able to outperform U.S. multinationals because they would be able to pay no tax on earnings from a foreign jurisdiction while the U.S. multinational would still be subject to U.S. tax).

58. *See generally* Helene Mulholland et al., *Tax-Avoiding Firms Should Not Be Named and Shamed, Says Minister*, THE GUARDIAN (Dec. 3, 2012, 5:30 PM), https://www.theguardian.com/business/2012/dec/03/tax-avoiding-firms-not-named-shamed; *see generally* Vanessa Barford & Gerry Holt, *Google, Amazon, Starbucks: The Rise of 'Tax Shaming'*, BBC News Magazine (May 21, 2013), http://www.bbc.com/news/magazine-20560359 (alluding to the malice against corporate executives and the corporations that have benefited heavily from deferral, which is captivated with my comment on the "gaudy chambers" demonstrating the effect rudimentary language can have on the public opinion and their undoubtedly thorough examination of tax policy).

59. *See* AICPA 2001, *supra* note 48, at 10 (noting the non-simplified ten key principles of good tax policy that is beyond the purview of this article); CAMPBELL ET AL, *supra* note 1, at ¶ 105.01-.02; OECD 2014, *supra* note 1, at 30-31; Alternatively, it is quite simple administratively to defer income but whether it is fair to U.S. taxpayers as a whole is the question.

60. Weisbach, *supra* note 25, at 34.

61. *See* Weisbach, *supra* note 25, at 3.

62. J. Ross Macdonald, *"Songs of Innocence and Experience": Changes to the Scope and Interpretation of the Permanent Establishment Article in U.S. Income Tax Treaties, 1950-2012*, 63 no. 2 TAX LAWYER 285, 285 (2010).

63. *Id.*

64. *See id.* at 288.

65. *Clear Guidance on Permanent Establishment Proves Elusive*, THOMSON REUTERS, (Oct. 4, 2012), https://blogs.thomsonreuters.com/answerson/clear-guidance-permanent-establishment-elusive/ [hereinafter Clear Guidance].

countries enter into a tax treaty.[66] The U.S. model treaty excludes income from taxation within its territory unless the income is derived from a permanent establishment.[67] The concept of a permanent establishment can be a helpful tool to alleviate double-taxation.[68] Double-taxation occurs when an individual is a resident of one territory but derives some or all of their income from another territory.[69] Absent a treaty, the individual might be liable for taxes in their resident territory and in the territory where the income is derived.[70] As a general rule, countries should try and avoid double-taxation to promote growth and alleviate the heavy burden double-taxation bares on a taxpayer.[71] One solution to eliminate double taxation is to limit taxation of income derived from a permanent establishment.[72] Simply put, a permanent establishment is: (1) a fixed place of business; (2) in a specific territory; (3) that gives rise to income.[73]

According to the U.S. Model Treaty, a fixed place of business is designated as a permanent establishment if it is a place of management, a branch, an office, a factory, a workshop, a mine, a well, or a quarry.[74] However, the U.S. Model Treaty excludes certain types of physical entities from being classified as a permanent establishment.[75] Excluded from the permanent establishment classification are physical sites primarily used for storage of inventory and other preparatory or auxiliary functions that are not specifically classified as the entity's core business functions.[76] The ambiguity in the law compounds the incentive of taxpayers to shift income to another source.[77] Taxpayers are able to shift income sourcing in a single step if they can alter their physical site's permanent establishment classification.[78] Taxpayers go to great lengths to circumvent establishing a permanent establishment in order to avoid taxes.[79] The inequitable effects of classifying a physical site as a

---

66. Macdonald, *supra* note 62, at 293.

67. Macdonald, *supra* note 62, at 293.

68. Macdonald, *supra* note 62, at 293.

69. *See* Macdonald, *supra* note 62, at 293.

70. *See* Macdonald, *supra* note 62, at 293.

71. *See generally* AICPA 2001, *supra* note 48, at 10 (avoiding double-taxation ensures equitability).

72. Macdonald, *supra* note 62, at 293.

73. Macdonald, *supra* note 62, at 293 (summarizing the concept of a permanent establishment).

74. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S. Model, art. V, Nov. 15, 2006.

75. *Id.*

76. *Id.*

77. *See generally* Macdonald, *supra* note 62, at 288 (summarizing how ambiguity in the definition of a permanent establishment leads to income sourcing issues).

78. *See* Macdonald, *supra* note 62, at 288.

79. *See* Macdonald, *supra* note 62, at 288.

permanent establishment has led to debates, regulation changes, and pleads for clarity from the tax profession as a whole.[80]

The permanent establishment has been an integral part in the development of international tax treaties in an attempt to promote growth and prosperity for all parties involved.[81] However, the development surrounding the determination standards of a permanent establishment is far from over.[82] Richard Vann, a professor at the University of Sydney Law, summarized the struggle of developing the permanent establishment standard when he stated before the 66th Congress, "I don't think anybody is happy with where we're at with the [permanent establishment] test."[83]

For years a permanent establishment was created by a physical location or presence.[84] The physical presence aspect of the permanent establishment classification has fared well until technology rendered physical presence unnecessary to conduct an active trade and business.[85] A taxpayer can physically remain in one territory and conduct the same trade or business as a taxpayer physically located in another territory.[86] The taxpayer utilizing online activity is at an advantage because they have avoided establishing a permanent establishment within the non-domiciled territory.[87]

The complications created by technology and the ever-expanding reach of the internet have challenged the traditional meaning of a permanent establishment.[88] The old standard, requiring a geographical physical presence in a country as a necessary element to establish a permanent establishment, has become out of touch with the technological reality of the world today.[89] In 1999, the OECD Committee on Fiscal Affairs set up the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (TAG) to respond to the problems arising out of e-commerce activities.[90] Since its creation, TAG has provided technical reflection on topics governing

---

80. *See* Clear Guidance, *supra* note 65.

81. *See* Clear Guidance, *supra* note 65.

82. *See* Clear Guidance, *supra* note 65.

83. Clear Guidance, *supra* note 65.

84. Macdonald, *supra* note 62, at 299.

85. Macdonald, *supra* note 62, at 288.

86. Macdonald, *supra* note 62, at 288.

87. *See generally* Macdonald, *supra* note 62, at 288 (illustrating how technology can render physical presence moot).

88. Leonardo F.M. Castro, *Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy*, 2 GLOBAL BUS. L. REV. 125, 150 (2012), http://engagedscholarship.csuohio.edu/gblr/vol2/iss2/3.

89. *See id.* at 150.

90. *Id.*

the taxation of e-commerce that have been discussed and adopted by the Committee to the Commentaries to the OECD Model Convention.[91]

Although the principle of a permanent establishment has remained relatively constant over time, significant changes to the meaning of permanent establishment are starting to materialize.[92] The U.S. and other OECD member states have moved toward an economic presence test for cross-border e-commerce income tax purposes.[93] The trend towards an economic presence test reflects a significant departure from traditional international tax principles which originally focused on the need for a physical presence within a taxing state.[94] In the revised Commentary to the OECD Model Convention, OECD members significantly altered the traditional permanent establishment principles for e-commerce activities by agreeing that certain physical aspects of the network can lead to a taxable presence within a foreign country.[95]

A server generally will not be considered a permanent establishment but the place where it is located along with the server can constitute a place of business.[96] Therefore, a permanent establishment may be established in a jurisdiction based on the presence of computer equipment in a fixed location.[97] Although a permanent establishment can be created in a jurisdiction by the presence of computer equipment, it is necessary to distinguish between the location of the computer equipment and the non-physical aspects utilized by the equipment.[98] Under the current definition of a permanent establishment, a website would not have a fixed place of business and thus would not be considered a permanent establishment even though the server does have a physical location.[99]

Most individuals on the committee agree websites do not qualify as permanent establishments, but disagreement arises around whether the presence of web servers qualify as a sufficient "place of business" to establish a permanent establishment.[100] The OECD clarification stated "the issue [of] whether computer equipment at a given location

---

91. *Id.*

92. Benjamin Hoffart, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach*, 6 NW. J. TECH. & INTELL. PROP. 106, 112 (2007).

93. *See id.*

94. *See id.* at 106–07.

95. *See id.* at 113. (explaining the presence of a "network server" and how a network alters the traditional meaning of the permanent establishment).

96. *See id.* at 113–14 (noting that the mere presence of a server will not give rise to a place of business in the absence of software and utilization to produce economic activity).

97. Castro, *supra* note 88, at 151; *See also* THE ORG. FOR ECON. CO-OPERATION AND DEV., COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION, 110 (2010) [hereinafter OECD 2010].

98. Castro, *supra* note 88, at 151.

99. *See generally* Castro, *supra* note 88, at 151 (illustrating the paradigm between the physicality of a server but the lack of economic activity in the absence of software or business use).

100. Castro, *supra* note 88, at 151.

constitutes a permanent establishment will depend on whether the functions [already] performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis".[101] Examples of computer functions that exceed the preparatory or auxiliary threshold can be found in paragraph 42.9 of the OECD 2008 Model Convention Commentary to Article 5.[102]

As technology becomes more advanced and features like cloud computing and high-speed broadband become globally accessible, the applicability of the current permanent establishment guidelines become increasingly obsolete.[103] The permanent establishment principle based on physical location is becoming less applicable because new technology is enabling companies to conduct business through the cloud across multiple jurisdictions without even establishing a physical server in each jurisdiction.[104]

According to the World Trade Organization, over 2 billion people currently have access to the internet and global business-to-consumer sales through e-commerce are set to pass the USD 1.25 trillion mark.[105] As these numbers increase with the development of new technologies, it is essential that international tax laws adapt to keep balance within the U.S. tax regime.

In order to combat the current revenue leakage, due to permanent establishment avoiding e-commerce activity, the concept of the permanent establishment will likely be expanded to include "Digital Permanent Establishments."[106] The concept of a digital permanent establishment was first introduced in the 2012 Spanish Dell case.[107] In this case, the Spanish court ruled that an online store meets the Spanish definition of permanent establishment even though the server was located outside Spain and no activity was performed by people or with assets located in Spain.[108] In addition to Spanish Dell, the French government recently announced that it intends to propose digital

---

101. Castro, *supra* note 88, at 151.

102. Castro, *supra* note 88, at 133.

103. *See generally* Hoffart, *supra* note 92, at 107.

104. *See* Hoffart, *supra* note 92, at 107.

105. WTO Secretariat, *e-commerce in Developing Countries: Opportunities and Challenges for Small and Medium Sized Enterprises*, ¶ 2-3, WTO Doc. (2013), https://www.wto.org/english/res_e/booksp_e/ecom_brochure_e.pdf.

106. Sagar Wagh, *Digital Permanent Establishment: Road Ahead for E-commerce Taxation*, Academia (June 2013), https://www.academia.edu/3797/885/Digital_Permanent_Establishment_Digital_PE_A_Road_Ahead_for_E-Commerce_Taxation.pdf.

107. *Permanent Establishments 2.0: At the heart of the matter*, PWC (2013), https://www.pwc.com/gx/en/tax/publications/assets/pwc-permanent-establishment-at-the-heart-of-the-matter-final.pdf [hereinafter *Permanent Establishments 2.0*].

108. *Id.*

economy related issues during upcoming international meetings.[109] The OECD has indicated that they too are working towards a solution to the challenges e-commerce creates.[110] The head of the OECD's Center for Tax Policy and Administration recently said, "[a]t the level of the States, there seems to be agreement that the world has changed and the international tax rules will need to be adapted."[111]

One potential method of melding the digital permanent establishment to the current permanent establishment principles is based on the number of transactions a website conducts in a jurisdiction.[112] In this context, a website will trigger a permanent establishment in a jurisdiction if the number of transactions it conducts in that jurisdiction exceeds a certain threshold.[113] The transactional threshold proposal would protect the interests of both businesses and source jurisdictions by allowing a relatively insignificant number of e-commerce transactions to occur before triggering a permanent establishment.[114] Therefore, a permanent establishment will only be established if a website has a substantial presence in a jurisdiction. This is a logical solution to the problem that is fair to both businesses and taxing jurisdictions and is relatively easy to measure and control.

Since 1932, the tax treaties of the U.S. and OECD countries have used a relatively stable definition of the permanent establishment, which relies on physical location.[115] New technology has provided companies with the ability to conduct business across multiple source jurisdictions without being physically present in each location.[116]

IV. CONSTITUENCY FRAMEWORK

To properly analyze tax policy, we must first consider various vantage points and competing interests. Conflicts of interest between constituency groups provide the fundamental basis for contemplating the pros and cons of altering the international tax regime. Although a seemingly cursory matter, it is an important first step in creating good tax policy. Constituency interests change and adapt overtime; however, below you will find a list of the general considerations of each constituency as of 2018.

---

109. *Id.*

110. *See generally* Wagh, *supra* note 106, at 7 (recognizing that the internet does not have a fixed place of business for purposes of determining where sales take place).

111. *Permanent Establishments 2.0*, *supra* note 107, at 15.

112. Wagh, *supra* note 106, at 13.

113. Wagh, *supra* note 106, at 113.

114. *See* Wagh, *supra* note 106, at 21.

115. *See* Wagh, *supra* note 106, at 6, 10.

116. *See* Wagh, *supra* note 106, at 9-10.

A. United States Taxpayer

The first constituency group that comes to mind, under the domain of tax, is probably the U.S. taxpayer (unless you work for the IRS). The U.S. taxpayer is the ultimate constituent—under the tax framework—since the taxpayer bears the financial burden and receives the uncorrelated benefits of what is purchased with tax dollars, at least theoretically.[117] As a matter of basic economic incentive, the U.S. taxpayer seeks the highest quality of government services while desiring a low tax bill.[118]

B. United States Government

The U.S. government is incentivized to receive the highest amount of funding while managing taxpayer backlash in relation to increased taxes.[119] The U.S. Government is the receiver of tax funds, and subsequently, the distributer of benefits.[120]

C. U.S. Multinational Corporations

U.S. multinational corporations serve as a subset of the taxpayer constituency. Like U.S. taxpayers, U.S. multinationals desire the highest quality of government protections, services, and benefits while desiring a low tax bill.[121] However, U.S. multinationals as an entity seek to shift the tax burden to the individual taxpayer and away from the entity itself.[122]

D. Academics and Experts

Academics and experts are charged with the task of criticizing, researching, and proposing methods to reform the tax system.[123]

---

117. *See generally* CAMPBELL ET AL, *supra* note 3, at ¶ 105.01-105.02 (illustrating the basics of the tax system and the importance of the U.S. taxpayer).

118. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 36 (R.H. Campbell et al. eds., LibertyClassics 1981) (1776) [hereinafter WEALTH OF NATIONS].

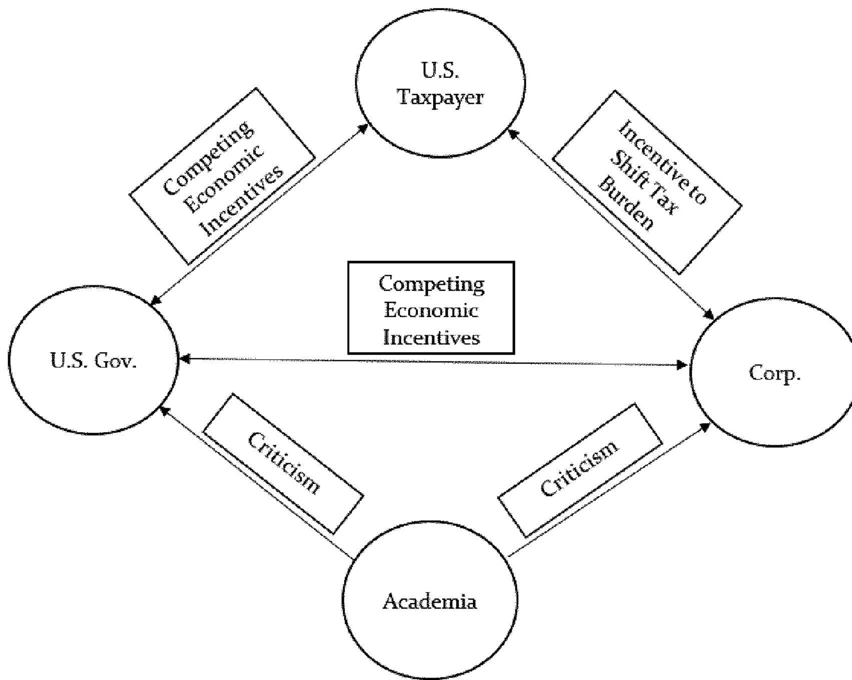
119. *See id.*; *See generally* CAMPBELL ET AL, *supra* note 1, at ¶ 106.01 (discussing the U.S. government's aim to collect taxes from taxpayers who are more likely to comply with tax laws).

120. *See generally* CAMPBELL ET AL, *supra* note 1, at ¶ 105 (explaining how the tax system achieves collection and distribution of tax funds).

121. *See* WEALTH OF NATIONS, *supra* note 188, at 36.

122. *See generally* Campbell, *supra* note 1, at ¶ 106.01 (describing the government's aim to collect taxes from individual taxpayers with the greatest ability to pay).

123. *See generally* Campbell, *supra* note 1, at ¶ 105.02 (inferring that the tax system is constantly in need of reformation to achieve efficiency for all participants in the market).



V. THE PERCEIVED PROBLEM: TAX AVOIDANCE AND TAX BASE EROSION

A. *Profit Shifting and Tax Base Erosion*

Business activity related to multinational enterprises has increased significantly over the past 20 years.[124] Foreign direct investment by multinational enterprises has grown at a rate of about 12.4 percent per year, which is far greater than the 5 percent annual rate of economic growth.[125]

Multinational enterprises are shifting investment at an increasing rate out of the U.S. and into foreign territories.[126] Furthermore, multinational enterprises are parking billions of dollars in tax neutral territories where the multinational enterprises may never repatriate any of the earnings.[127] The literature suggests that a lack of repatriation of earnings is primarily related to tax-motivated incentives.[128] Multinational enterprises' tax-motivated incentives can be illustrated

124. Dhammika Dharmapala & Nadine Riedel, *Earnings Shocks and Tax-Motivated Income-Shifting: Evidence from European Multinationals* 2 (Ill. Program in Law, Behavior & Soc. Sci., Working Paper No. LBSS11-09, 2012), http://ssrn.com/abstract=1629792.

125. *Id.*

126. *Id.*

127. *See id.*

128. *See id.*

by looking at both low and high-tax multi-national affiliates; shifting of earnings should be relatively homogenous across both low and high tax affiliates if the optimization of tax liability is not the true motive.[129] Multinational enterprises' preference to shift earnings to low tax affiliates creates identifiable traits that would allow the detection of aggressive tax planning strategies.[130] The issue of detection is related to the difficulty of segmenting affiliate earnings per multinational enterprises since U.S. MSE's file a consolidated return.[131] However, a large European micro data set (the AMADEUS data from the Bureau van Dijik) provides detailed accounting information on an unconsolidated basis.[132] The availability of this information would facilitate the detection of tax-motivated income shifting.[133]

The model (Dharmapala's model), is based on the hypothesis that aggressive tax strategies will un-proportionally push earnings towards low-tax subsidiaries as opposed to high-tax subsidiaries.[134] Statistical analysis can then be calculated comparing the low-tax subsidiaries and high-tax subsidiaries to see if the difference is statistically significant.[135] Multinational enterprises have a right to structure their activities in the most effective structure within the law.[136] However, aggressive strategies serve to erode the tax base of certain high-tax countries.[137] Dharmapala's model allows for detection in the event of a change in the tax code.[138]

Dharmapala's model, using accepted statistical analytical tools, determined that the coefficient related to profit shifting towards low-tax subsidiaries is both positive and statistically significant.[139] According to Dharmapala, "[p]ut differently, low-tax subsidiaries receive extra profits in wake of positive earnings shocks at the parent level, consistent with the income shifting hypothesis."[140] According to the results, the model is effective at detecting profit shifting and is statistically significant enough to draw attention as a possible solution.[141] Multinational enterprises' profit shifting activities create the

---

129. *See id.* at 3–4.

130. *See id.*

131. *See id.* at 4 (a change in the filing standards could require the submission of a breakdown of earnings per affiliate).

132. *Id.* at 4.

133. *See id.* at 4–5.

134. *Id.* at 5.

135. *See id.* at 6.

136. *See id.* at 7.

137. *See id.*

138. *See id.* at 11.

139. *Id.* at 15.

140. *Id.*

141. *Id.*

ability to erode the tax base of high-tax countries.[142] However, identifying aggressive tax-planning strategies can be possible through the detection of "isolated exogenous earnings shocks" to a parent company that would be expected to propagate proportionally to low and high-tax subsidiaries.[143]

i. Explanation of Dharmapala's Model

Perceived abuses to the international taxation system is a key reason why such publicity has been generated.[144] Dharmapala's model seeks to present empirical data related to the recent popularity of base erosion and profit shifting (BEPS).[145] The discussion related to base erosion is further enflamed in the U.S. where multinational corporations (MNCs) heavily rely on deferral as a method of reducing the MNCs' effective tax rate.[146] The ability of MNCs to create economic substance in one territory and effectively shift the profits to another country is one of the primary reasons why the topic of base erosion is so popular.[147] The effect of BEPS is relatively large when you consider the limited amount of attention BEPS had drawn prior to 2014.[148] However, the tax literature provides contradictory information as to the severity of profit shifting.[149] The discrepancy stems from the viewpoint in which the empirical data was drawn.[150] Researchers have studied the phenomenon from a firm-level viewpoint as well as from a nationwide viewpoint.[151] According to research from Heckemeyer and Overesch (2013), a 10-percentage point decrease in the tax rate faced by an affiliate would increase the pretax income reported by the same affiliate by 8 percent.[152]

ii. Dharmapala's model:

$$\log \pi_i = \beta_0 + \beta_1 \tau_i + \beta_2 \log K_i + \beta_3 \log L_i + \mathbf{X}_i \gamma + \varepsilon_i$$ [153]

142. *Id.* at 27.

143. *Id.* at 28.

144. *See* Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of Empirical Literature* 1 (Ctr. for Econ. Studies & Ifo Inst., Working Paper No. 4612, 2014), https://ssrn.com/abstract=2373549.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *See id.*

151. *Id.* at 1–2.

152. *Id.* at 2.

153. *See id.* at 8 (Dharmapala's model is based on the Hines-Rice Model).

iii. Explanation of Dharmapala's Model

log = (Sensitivity of affiliate i to tax rate differential)log(Income Shock)+(Extent of Income Shock present in low-tax affiliate)(Indicator Variable 1 for higher rate, 0 for lower*log Income Shock)+various control variables[154]

The log of coefficient B1 represents the effect of a 1-unit change in the tax rate differential (1 percentage point). Therefore, an estimate that B1 = .8 would signify that a 10 percent change in the tax rate would increase the low-tax affiliate's reported pretax income by 8 percent.[155]

For example, "affiliate A" situated within a 35 percent rate territory would report pretax income of $100,000 while "affiliate B," located within a 25 percent rate territory, would report a pretax income of $108,000.[156] The research points to a relatively small magnitude of BEPS when compared to U.S. tax revenue.[157] Conversely, Clausing proposes that revenue lost from profit shifting amounts to about one third of corporate tax revenue.[158] The magnitude of the nationwide findings is relatively large when compared to that of the firm-level studies.[159] Dharmapala's model uses unexpected income at the parent level (income shocks) to determine if a parent is shifting income to low-tax affiliates.[160] The basic strategy of Dharmapala's model is to compare the impact of an income shock from both low and high-tax affiliates to the same parent and control for factors that might otherwise affect the affiliates' reported profits.[161]

B. *Stateless Income*

Dr. Edward Kleinbard defines "stateless income" as,

> [I]ncome derived by a multinational group from business activities in a country other than the domicile (however defined) of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company.[162]

In the event that non-tax practitioners have accidently found themselves reading this article, stateless income can be summarized as

---

154. Formula explanation is author created for the purpose of breaking down Dharmapala's model.
155. Dharmapala, *supra* note 146, at 2.
156. *Id.* at 16.
157. *Id.*
158. *Id.* at 26.
159. *Id.*
160. *Id.* at 13.
161. *Id.*
162. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 701 (2011).

income generated in a high-tax jurisdiction that is shifted to a low-tax jurisdiction by legally shifting the non-physical tax nexus.[163]

The benefits and detriments of stateless income tax planning are highly debated; however, the quantifiable effects are evident.[164] The existence of stateless income fundamentally violates the equitability prong of the U.S. tax framework by overly incentivizing low-tax jurisdictions. Stateless income tax planning is advantageous to large multinationals that have the resources to create a plethora of foreign parents and subsidiaries for the sole purpose of tax optimization.[165]

Stateless income effectively incentivizes parking billions of taxable dollars outside of the U.S.[166] The sizable amount of deferred funds enjoyed by U.S. multinationals also serves to keep earnings and profits from reaching the hands of shareholders through dividends.[167] Tax dollars are then reinvested in foreign jurisdictions where a low-tax compounding effect incentivizes multinational enterprises to permanently leave earnings outside of the U.S.[168]

---

163. Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 99 (2011).

164. *See generally id.* at 125–26 (illustrating multinationals that employ these entity structures quantifiably pay a lower effective tax rate).

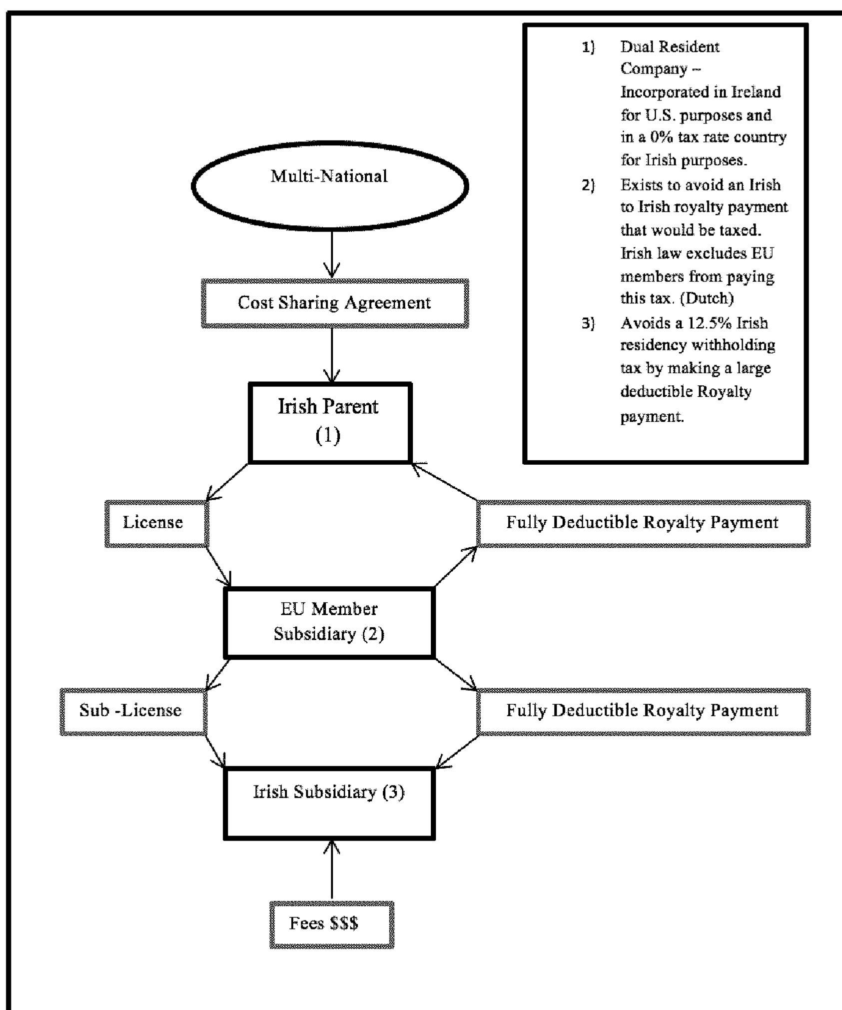
165. *See generally* Kleinbard, *supra* note 163, at 99 (noting resource requirements to set up complex entity structures).

166. Kleinbard, *supra* note 162, at 763.

167. Kleinbard, *supra* note 162, at 715; the desire of repatriation by shareholders for the purpose of dividends is a contention that is commonly asserted. The economic aspects of this assertion will be discussed infra.

168. Kleinbard, *supra* note 162, at 715; However, it cannot be arbitrarily assumed that shareholders are disadvantaged from tax arrangement. Anton Chekhov once said, "[d]on't tell me the moon is shining; show me the glint of light on broken glass.".

i. Double Irish Dutch Sandwich Comprehensive Example



The most notable entity structure utilized by large multinational enterprises is called the "Double Irish Dutch Sandwich."[169] Familiars of this tax structure may question why a discussion of Double Irish is necessary. Still, one could postulate that a discussion of an outdated entity structure is useful for the purpose of illustrating where the U.S. international tax regime has figuratively been and where it is headed. Further, the Double Irish is still being employed.[170] In response to great pressure, Ireland announced changes to residency rules that were

169. *See* Michael Pesta, *Reports of the Double Irish's Death Are Greatly Exaggerated*, THE TAX ADVISOR, (May 1, 2015), https://www.thetaxadviser.com/issues/2015/may/tax-clinic-04.html.

170. *See id.*

targeted at minimizing the Double Irish.[171] However, the Irish regulations do not affect tax treaties.[172] Therefore, many companies are still able to utilize the popular Double Irish structure.[173] The cycle of the structure begins when a U.S. multinational establishes a parent company in Ireland that is considered an Irish corporation for U.S. tax purposes, but is considered incorporated in the Cayman Islands—or any territory with a low tax rate—for Irish tax purposes.[174] The U.S. multinational enters into a cost sharing agreement with the Irish parent, thereby allowing the Irish parent to license the use of intangibles.[175] The multinational then establishes an Irish subsidiary and a European Union member subsidiary.[176] The intangibles are licensed to the EU member subsidiary and then sub-licensed to the second Irish subsidiary.[177] The second Irish subsidiary is fully staffed and collects fees for the use of the sub-licensed intangibles.[178] The second Irish subsidiary would normally be taxed at a 12.5 percent rate because Ireland imposes a tax on Irish resident companies.[179] However, the second Irish subsidiary makes a very large and fully deductible royalty payment to the EU member subsidiary for the use of the sub-licensed intangibles.[180] Therefore, the 12.5 percent Irish residency tax is almost entirely eliminated.[181] Next, the European Union member subsidiary makes another very large and fully deductible royalty payment to the original Irish parent.[182] The transfer of the royalties to the EU member eliminates an Irish withholding tax, which is placed on earnings that stem from royalty payments from one Irish company to another.[183] Ireland has an exemption for royalties paid to and from an EU member company.[184] According to Irish tax law, the subsidiary incorporated in another country has a zero percent tax rate; therefore, eliminating any ability by Ireland to tax income.[185]

---

171. *Id.*
172. *Id.*
173. *Id.*
174. *See id.* (explaining that Ireland considers a company's residency to be where its "mind and management" is located).
175. Kleinbard, *supra* note 162, at 711.
176. Kleinbard, *supra* note 162, at 712.
177. Kleinbard, *supra* note 162, at 711.
178. Kleinbard, *supra* note 162, at 710–712.
179. Kleinbard, *supra* note 162, at 712.
180. Kleinbard, *supra* note 162, at 712.
181. *See* Kleinbard, *supra* note 162, at 712.
182. Kleinbard, *supra* note 162, at 712.
183. Kleinbard, *supra* note 162, at 712.
184. Kleinbard, *supra* note 162, at 712.
185. Kleinbard, *supra* note 162, at 712.

From a U.S. tax standpoint, almost zero tax is paid on the earnings.[186] The U.S. does not "see" the European Member subsidiary or the Irish subsidiary because of "Check-The-Box" regulations that allow subsidiaries to collapse into the parent.[187] The earnings are now being held by the Irish parent and will not be taxed until the earnings are repatriated into the U.S.[188]

C. *Corporate Inversions*

Stateless income contributes to the erosion of residence tax base through the dissociation of tax nexus and the location in which the economic substance of an intangible was created.[189] Territorial tax systems place emphasis on "where" the economic substance of a product or service is created.[190] A territorial system figuratively expects that an income source territory can ask for something in return (tax) from an entity that enjoyed the territory's infrastructure, protection, and various resources.[191] However, stateless income tax planning erodes the tax base of a territory by pushing earnings to territories where the true economic substance did not occur, thereby eliminating the originating territory's claim to tax earnings and profits.[192]

VI. CONGRESSIONAL SOLUTION: REASONING AND INTENT OF THE REVENUE PROPOSALS

Finding a solution to aggressive international tax strategies has been relatively difficult to date. For example, distinguished University of Southern California Law Professor, Edward D. Kleinbard, has revised his proposed solutions in multiple papers.[193] Kleinbard's work, *Stateless Income*, published in the 2011 *Florida Tax Review* proposed a territorial system, which featured rational sourcing rules and would therefore maintain capital import neutrality.[194] However, in Kleinbard's 2013 work, *Through a Latte Darkly: Starbucks's Stateless Income Planning*, he proposes a worldwide tax consolidation solution. Kleinbard reaches this

186. Kleinbard, *supra* note 162, at 712.
187. Kleinbard, *supra* note 162, at 712.
188. Kleinbard, *supra* note 162, at 712.
189. Kleinbard, *supra* note 162, at 706.
190. *See* Kleinbard, *supra* note 162, at 706 (illustrating the nature of territorial tax systems and the means by which income is attributed to certain territories which is commonly referred to as "sourcing").
191. Kleinbard, *supra* note 162, at 706.
192. Kleinbard, *supra* note 162, at 706.
193. Kleinbard, *supra* note 162, at 706.
194. Kleinbard, *supra* note 162, at 770.

conclusion based on his opinion that a territorial system with teeth is "so unrealistic."[195]

Kleinbard's proposals are based on the ever-shifting preference for either a territorial system or a worldwide system.[196] Kleinbard's proposal suggests that rational sourcing rules be applied to intangibles.[197] However, applying rational sourcing rules to intangibles would be incredibly complicated and costly to the U.S.[198] Further, one of the effects of a territorial system is the U.S. would lose the right to tax foreign earnings.[199] The negative implications of a territorial system could potentially exceed the benefits of a reduction in the generation of low-tax income.[200]

In comparison, the current congressional revenue proposals opt to keep the current worldwide tax system with a set tax on foreign earned income as well as a one-time tax imposed on previously untaxed foreign earned income.[201]

A. Public Policy Issues

Starbucks, Google, Amazon, and Apple have been widely attacked over their use of what many consider to be highly unethical tax practices[202] Headlines accused these companies of robbing the public of services, engendering tax protests in 2013.[203] Notions of improper tax strategies by large corporations transcended the majority of public opinion.[204] The negative public opinion over these tax avoidance strategies was strongly upheld, eventually giving rise to coined phrase, "tax shaming."[205]

---

195. *See* Edward D. Kleinbard, *Through a Latte Darkly: Starbucks Stateless Income Planning*, TAX NOTES, 1517, 1518 (July 15, 2003) (quoting Dr. Kleinbard's somewhat humorous quote on the plausibility of the U.S. utilizing a territorial tax regime as opposed to a worldwide tax regime).

196. *See id.*

197. *See id.* at 1519.

198. *See id.* at 1518, 1519 (explaining that a territorial tax system is unrealistic and worldwide tax consolidation is imperfect).

199. *See id.* at 1518.

200. *See id.* For example, the U.S. is considering a minimum tax because earnings have been shifted overseas and a territorial system would serve to exacerbate this perceived issue.

201. U.S. DEP'T OF TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 9 (2016)[hereinafter Greenbook].

202. Vanessa Barford & Gerry Holt, *Google, Amazon, Starbucks: The rise of 'tax shaming'*, BBC NEWS MAGAZINE, (May 21, 2013), http://www.bbc.com/news/magazine-20560359.

203. *Id.*

204. *Id.*

205. *Id.*

B. *Economic Considerations*

i. Tax Havens

A tax haven is a country that offers foreign individuals and businesses little or no tax liability in a politically and economically stable environment. A tax haven country does not require that an individual reside in, or a business operate out of, that country in order to benefit from its tax policies. Tax havens also provide little or no financial information to foreign tax authorities.

Various governmental, international, and academic sources use the terms *tax haven*, *secrecy jurisdiction*, or *offshore financial center* to refer to jurisdictions with a disproportionate amount of foreign investment. Three institutions created frameworks for identifying these jurisdictions. The Organization for Economic Co-Operation and Development (OECD) established criteria for analyzing harmful tax practices in 1998 to encourage fair competition.[206] The OECD initial report included 47 (reduced to 35 shortly thereafter) tax havens.[207] The private, nonprofit, and nonpartisan National Bureau of Economic Research (NBER) adopted a list of 41 countries that were acknowledged as having low tax rates and identified "as a tax haven by multiple sources."[208] In 2006, the Northern District Court in California granted leave to the Internal Revenue Service (IRS) to serve "John Doe"[209] summonses in 34 tax haven jurisdictions.[210] Research relies on the OECD, NBER, and John Doe lists to examine tax haven usage. Table 1 contains a list of all countries identified by any of the three lists as a tax haven. There is substantial overlap between the OECD, NBER, and John Doe tax haven lists.

Table 1: Identified Tax Haven Countries

Alderney	Andorra	Anguilla
Antigua & Barbuda	Aruba	Bahamas
Bahrain	Barbados	Belize

206. *See generally* OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, 1–84 (1998), http://dx.doi.org/10.1787/9789264162945-en (last visited Jan 13, 2018) (explaining the overall objective of the 1998 OECD report).

207. OECD, TOWARDS GLOBAL TAX CO-OPERATION: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES, 12–14 (2000), http://www.oecd.org/ctp/harmful/2000progressreporttowardsglobaltaxco-operationprogressinidentifyingandeliminatingharmfultaxpractices.htm (last visited Jan 13, 2018).

208. DHAMMIKA DHARMAPALA & JAMES R. HINES, WHICH COUNTRIES BECOME TAX HAVENS?, 8 (2006).

209. *See generally* INTERNAL REVENUE MANUAL 25.5.7, INTERNAL REVENUE MANUAL 25.5.7, https://www.irs.gov/irm/part25/irm_25-005-007 (last visited Jan 13, 2018) (explaining that when the identity of a taxpayer under investigation is unknown, the IRS requests approval from a Federal court for permission to serve a John Doe summons).

210. *See generally Ex Parte* Petition for Leave to Serve John Doe Summons, *In the Matter of the Tax Liabilities of John Does,* No. CV 02-0046 (2002), 2002 WL 32153658 (N.D.Cal.).

Bermuda	Botswana	British Virgin Islands
Brunei Darussalam	Cape Verde	Cayman Islands
Cook Islands	Costa Rica	Cyprus
Dominica	Gibraltar	Grenada
Guernsey	Hong Kong	Ireland
Isle of Man	Jersey	Jordan
Latvia	Lebanon	Liberia
Liechtenstein	Luxembourg	Macau (or Macao)
Malaysia (or Labuan)	Maldives	Malta
Marshall Islands	Mauritius	Monaco
Montserrat	Nauru	Netherlands
Netherlands Antilles	Niue	Palau
Panama	Saint Kitts & Nevis	Saint Lucia
Saint Vincent & Grenadines	Samoa	San Marino
Seychelles	Singapore	Switzerland
Tonga	Turks & Caicos	U.S. Virgin Islands
Uruguay	Vanuatu	

ii. Brief History of Tax Havens

The use of tax havens—such as the Channel Islands, the Bahamas and Panama—by individuals and corporations (through the use of holding companies) dates back to the 1920s and 1930s, becoming increasingly prevalent after 1950.[211] Following World War I, governments created new programs to compensate veterans for their service. These programs increased public debt and forced many countries to significantly raise income tax rates. Some wealthy individuals chose to transfer their holdings to Swiss banks, where formal banking secrecy ensured that they could escape taxation by their home countries. Due to its strict banking secrecy law enacted in 1935, Switzerland dominated the international wealth-management market until the 1980s, when the liberal trade and finance policies of the Reagan and Thatcher administrations allowed other jurisdictions to jump into the game.[212] Hong Kong, Singapore, Jersey, Luxembourg, and the Bahamas established regulatory regimes, backed up by existing financial infrastructure, which made them attractive locations for hiding

---

211. *See* SOL PICCIOTTO, REGULATING GLOBAL CORPORATE CAPITALISM, 237 (Cambridge University Press) (2011).

212. *See* David A. Mayer-Foulkes, *Long-Term Fundamentals of the 2008 Economic Crisis*, 4 GLOBAL ECON. J. 6, 7 (2009).

assets.[213] Today the number of jurisdictions identified as tax havens ranges from 34 to as many as 60 depending on the source (see Table 1).

As the use of tax havens became more prevalent in the late 20th and early 21st centuries, the jurisdictions began to specialize in order to be better equipped to compete for foreign direct investment. Frank and Mattingly divide tax havens into three categories: base havens, intermediary havens and industry havens.[214] Palan et al. identifies seven categories of tax havens: incorporation locations, registration centers, secrecy locations, specialist service providers, market entry conduits, high net worth providers, and tax raiders.[215] This taxonomy of tax havens demonstrates the measures that these jurisdictions have taken in order to attract foreign domestic investment. It also provides regulators with alternative paths to alleviate the impact of both tax evasion by the wealthy, and tax avoidance by multinational corporations. One example is the Foreign Account Tax Compliance Act (FATCA) enacted by the U.S. in 2010. Under FATCA, foreign banks and financial firms are required to provide financial information of U.S. taxpayers to the Internal Revenue Service (IRS). Those that choose not to comply face a 30 percent withholding rate on U.S. source dividends and interest. FATCA also requires individuals with specified offshore holdings to report those holdings when they exceed $50,000 at year-end or $75,000 at any point during the tax year.[216]

---

213. Gabriel Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. OF ECON. PERSP. 121, 137-238, 141 (2014).

214. Base havens typically have no income taxes and strict nondisclosure rules. Examples include Bermuda, the Cayman Islands, and the Bahamas. Intermediary havens allow for the use of holding companies and include Luxembourg, the Netherlands, and Switzerland. These havens allow companies that conduct no actual business in their jurisdiction to pay only registration fees, initial capital taxes, and often a small annual fee. Industry havens provide special legislation that favors a specific industry or activity but do not provide uniform tax benefits; George Mattingly & Mary Margaret Frank, *Taxation in a Global Economy*, DARDEN BUS. PUB., Nov. 4 2011 at UV5244.

215. Palan, R., Murphy, R. and Chavagneux, C., *Tax Havens: How Globalization Really Works* (Ithaca: Cornell University Press, 2010). Incorporation locations do not have an offshore financial center but are used in tax planning to establish entities that are then used in transactions with other tax havens (e.g., Montserrat and Anguilla). Entities in registration centers are typically used for what is referred to as "round tripping" where the parent sends money to the tax haven subsidiary which is then reinvested in the parent's country of origin. In secrecy jurisdictions, such as Liechtenstein or Singapore, confidentiality is heavily protected. Specialist service provider havens enact legislation aimed at a particular industry. Market entry conduits facilitate routing transactions through their jurisdiction. High net worth providers cater to the uber-wealthy by providing fund managers and trust vehicles to hide assets and income. Tax raiders adopt tax policies aimed at the relocation of profits to their territory.

216. FATCA INFORMATION FOR INDIVIDUALS, https://www.irs.gov/Businesses/Corporations/FATCA-Information-for-Individuals (last visited Aug. 12, 2017).

iii. The Problem with Tax Havens

Some scholars contend that the use and abuse of tax havens by Multinational Corporations (MNCs) bears most of the culpability for current societal and economic issues. Zucman estimates that 31 percent of U.S. corporate profits is attributable to foreign source income.[217] Of that 31 percent, 55 percent of the income—or 20 percent of total U.S corporate profits—is attributable to operations in five tax havens: the Netherlands, Bermuda, Luxembourg, Ireland, and Switzerland.[218] This profit-shifting may cost the U.S. government as much as $100 billion per year in lost revenue.[219] In recent years government expenditures have exceeded tax revenues, constraining the amount of public goods that governments can supply. The U.S. budget deficit amounted to almost $500 billion at the end of 2014,[220] strengthening arguments that the aggressive tax planning strategies of MNCs, which involve the use of tax havens, contribute to government revenue shortfalls.

The amount of individual wealth stashed in tax havens is also economically significant. By analyzing anomalies in national accounts and balance of payments data, Zucman conservatively estimates that eight percent, or $7.6 trillion, of the financial wealth of the uber-rich is located in tax havens.[221] Other estimates are generally higher and range from $8.5 trillion to $32 trillion.[222] Zucman posits that his estimate is lower because it only considers financial wealth and not real assets. Even on the low end however, the global cost of tax evasion is $200 billion per year.[223] The U.S. alone loses $36 billion to offshore tax evaders.[224] Thus, the use of tax havens by U.S. MNCs and individuals amounts to revenue losses of $136 billion per year, conservatively.

---

217. Gabriel Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. OF ECON. PERSP. 121, 128 (2014) (Zucman relies on national accounts and balance of payments data to estimate the amount of MNC foreign source income.).

218. *Id.* at 121.

219. Jane G. Gravelle, CONGR. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION (2015).

220. Jonathan House, *Budget Deficit Returns to Prerecession Levels,* WALL ST. J. https://www.wsj.com/articles/u-s-budget-deficit-in-2014-narrows-to-lowest-level-in-six-years-1413385493?cb=logged0.37574527319353484 (last visited Nov. 15, 2017).

221. Gabriel Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. OF ECON. PERSP. 121, 139 (2014).

222. Brent Beardsley, et al., GLOBAL WEALTH 2013: MAINTAINING MOMENTUM IN A COMPLEX WORLDWWW.BCGPERSPECTIVES.COM (2013), https://www.bcgperspectives.com/content/articles/financial_institutions_growth_global_wealth_2013_maintaining_momentum_complex_world/ (last visited Jan 13, 2018); *see* James S. Henry, *The Price of Offshore Revisited* (Jan. 21, 2018), https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf.

223. Gabriel Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. OF ECON. PERSP. 121, 140 (2014).

224. *Id.* at 131.

The magnitude of foregone revenues in an era when governments are adopting austerity measures make tax havens easy targets for policy makers. The U.S. adopted FATCA in 2010 and it began exchanging information with other jurisdictions in 2015. These information exchange measures are likely to be effective for curbing tax evasion by wealthy individuals but will not have as much of an impact on the behavior of MNCs.

iv. Tax havens, Multinational Corporations and Tax Law

Multinational corporations are currently able to legally reduce their tax bills through tax arbitrage. In layman's terms, tax arbitrage is exchanging a high-tax rate for a low-tax rate. How do MNCs accomplish this? Through the interaction of U.S. tax law and tax treaties. Although the U.S. taxes worldwide income of domestic corporations, subsidiaries that are separately incorporated in other jurisdictions are treated as separate independent entities for tax purposes. As such, when earned income is sourced to the foreign subsidiary, it is not subject to taxation in the U.S.[225] Foreign sourced income of separately incorporated entities is not taxed in the U.S. until it is repatriated to the parent corporation in the form of a dividend.[226] The "privilege of deferral" allows entities to assign more income— for tax purposes—to a foreign subsidiary in a low-tax country, to lower its overall tax burden. In August 2014, the Joint Tax Committee estimated that deferral of active income of foreign controlled corporations would cost $418 billion in lost revenue for budget years 2014 through 2018.[227] Recent estimates of the amount of foreign source income that has not been repatriated are almost $2 trillion.[228]

Even though the U.S. does not tax the foreign source income until repatriated, that income is likely to be subject to taxation in the jurisdiction where it is earned. Corporations can further lower tax bills by locating revenue in a tax haven that has no corporate income tax. Approximately 20 percent of U.S. corporate profits are shifted to tax havens.[229] This is largely accomplished through transfer pricing. Transfer pricing is the process of allocating income and expenses

---

225. CARROL, *supra* note 51, at 2.

226. CARROL, *supra* note 51, at 2.

227. ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, 1, see Table I (2014).

228. *See* Richard Rubin, *Cash Abroad Rises $206 Billion as Multinationals Avoid U.S. Taxes*, BLOOMBERG (Mar. 12, 2014), http://my.bna.com/xpdt/7010/split_display.adp?fedfid=42855440&vname=dernotallissues&wsn=775586000&searchid=30815414&doctypeid=1&type=xpdate4news&mode=doc&split=0&scm=7010&pg=0

229. *See* Zucman, *supra* note 210, at 121. If the entity was simply a branch of the U.S Corporation it would be taxed immediately.

between related affiliates for intracompany transactions.[230] Corporations often use complex subsidiary structures involving many intermediaries, holding companies, and jointly owned companies.[231] The resulting haphazard structure heavily engages in intracompany transactions. Estimates place the intrafirm flow of goods at 40 to 50 percent of world trade.[232]

One popular transfer pricing scheme is referred to by practitioners as a Double Irish with a Dutch Sandwich. This practice was spotlighted in a 2010 article by Jesse Drucker of *Bloomberg*, who reported that Google was able to achieve an overseas effective tax rate of only 2.4 percent by using this tax planning strategy.[233] Google established two Irish subsidiaries: one in Ireland and the other in Bermuda.[234] Google then transferred intellectual property from the U.S. to the Bermuda entity.[235] That entity leased the right to use the intellectual property to the Irish subsidiary. Google Ireland paid royalties to the Bermuda subsidiary. However, to avoid paying withholding taxes of 30 percent that would be due if the payment was made directly to Bermuda, the money is routed through a third subsidiary located in the Netherlands (the Dutch Sandwich). Under a tax treaty among European Union countries, there is no withholding tax required on royalty payments between Ireland and the Netherlands. Although Ireland's corporate tax rate is 12.5 percent, the royalty payment provides a significant deduction against revenue generated in Ireland. The result is that the revenue generated by Google Ireland ends up in Bermuda—a tax haven with no corporate income taxes—virtually tax free.

Still, corporate transfer pricing is not solely to blame for our current economic conditions. Scholars have shown that Treasury regulations implemented in 1998 have also had a negative impact on

---

230. *See* Dittmer, *supra* note 36, at 4.

231. *See* SOL PICCIOTTO, REGULATING GLOBAL CORPORATE CAPITALISM, 237–243 (Cambridge University Press)(2011).

232. *See id.*

233. Jesse Drucker, GOOGLE 2.4% RATE SHOWS HOW $60 BILLION IS LOST TO TAX LOOPHOLESBLOOMBERG.COM (2010), https://www.bloomberg.com/news/articles/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes (last visited Jan 14, 2018).

234. See Kelly Phillips Erb, *Ireland Declares 'Double Irish' Tax Scheme Dead*, FORBES (Oct. 15, 2014), https://www.forbes.com/sites/kellyphillipserb/2014/10/15/ireland-declares-double-irish-tax-schemedead/#489bc193fffd (Ireland abandoned the rule that allows a firm to incorporate in Ireland but elect to have its tax home elsewhere, allowing companies currently relying on the rule to wind up operations in five years.).

235. Brian Wolmack, *Google questioned by SEC over earnings in low tax countries*, BLOOMBERG (Mar.21, 2011), http://www.bloomberg.com/news/articles/2011-03-21/google-questioned-by-sec-over-earnings-in-low-taxcountries-1- (This transaction was sanctioned by an Advanced Pricing Agreement (APA) between Google and the IRS which established the methodology for determining the price Google Ireland Holding (located in Bermuda) would pay Google, Inc. (in the U.S) for the right to use Google's intangible property in Europe, the Middle East and Asia.).

government revenue. Altshuler and Grubert utilized data from the Bureau of Economic Analysis (BEA) to demonstrate that check-the-box regulations significantly increased corporate tax savings on foreign source income.[236] The purpose of check-the-box provisions was to make it easier for eligible taxpayers to indicate whether they were to be taxed as a partnership or a corporation; however, there were unintended consequences associated with foreign activities of domestic corporations. Multinational corporations can use the provisions to create hybrid entities where an entity can be recognized as a corporation by one jurisdiction, but as a branch by another. Corporations structure transactions between subsidiaries in low-tax countries with subsidiaries in high-tax countries, which subsequently transfer income to the low-tax country and deductions to the high-tax country. The corporation elects "checks-the-box" status indicating that the subsidiary in the high-tax country be treated as a branch of the low-tax country subsidiary. The high-tax jurisdiction treats the subsidiary located there as a corporation, and allows a deduction; however, the income to the low-tax subsidiary is not recognized. Altshuler and Grubert estimate that "multinational corporations saved about $7 billion in taxes in 2002 compared to what they would have paid if they continued to behave the same way as in 1997."[237]

The international network of tax treaties plays a crucial role in the strategies MNCs use to manage tax burdens. The intent of most tax treaties is to minimize double taxation. All countries have the right to tax income generated in their jurisdiction. Countries also retain the right to tax their citizens and residents. When income is generated in one jurisdiction and earned by a citizen or resident of another jurisdiction, it may be subject to tax in both jurisdictions. Tax treaties seek to alleviate this double taxation. Most countries, including the U.S., impose a 30 percent withholding tax on dividend, interest, and royalty income that is generated in their jurisdiction, but is paid to a foreign entity or person. However, tax treaties reduce or eliminate the withholding tax. Under the 2006 U.S. Model Treaty, the withholding rate on dividends is between 5 to 15 percent.[238] Interest and royalty payments are only subject to taxation in the "other state."[239] MNCs structure subsidiary networks to take advantage of these treaty provisions. Google's Double Irish with a Dutch Sandwich, discussed above, is just one example of how MNC's are able to use tax treaties to their advantage.

---

236. Rosanne Altshuler & Harry Grubert, *Governments and Multinational corporations in the Race to the Bottom*, 41 Tax Notes International (2006).

237. Id.

238. U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION, 1 Tax Treaties (CCH) Art. 10 (Nov.15, 2006) [hereinafter 2006 U.S. MODEL TREATY].

239. 2006 U.S. MODEL TREATY Art. 11 & Art. 12.

v. Effective tax rates

U.S. MNCs face a statutory corporate income tax of 35 percent on worldwide income. In contrast, most countries—particularly Europe—have lower rates and only tax income earned within their borders. (Table 2 lists the G20 countries and current statutory tax rates.)

Table 2: G20 Countries and Statutory Tax Rates[240]

Country	Statutory Tax Rate (%)
Saudi Arabia	20
Turkey	20
Russia	20
United Kingdom	20
South Korea	24.2
China	25
Indonesia	25
Canada	26.5
South Africa	28
Germany	29.72
Mexico	30
Australia	30
Italy	31.4
Japan	30.86
France	33.33
Brazil	34
India	34.61
Argentina	35
United States	35

Despite the 35 percent statutory rate, the worldwide effective tax rates (ETRs) for U.S. corporations was just 22.7 percent.[241] U.S. MNCs with significant tax haven subsidiaries ETRs are, on average, 1.5 percent lower than those of U.S. corporations without a tax haven subsidiary. This saves U.S. corporations approximately $64 billion a year.[242] From 1998 to 2015 the average effective tax rate of U.S. MNCs fell from 30 percent to 20 percent. Approximately two-thirds of the decline in the

---

240. Corporate Tax Rate Table, KPMG INTERNATIONAL, https://home.kpmg.com/xx/en/home/services/tax/taxtools-and-resources/tax-rates-online/corporate-tax-rates-table.html (accessed January 17, 2017).

241. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, CORPORATE INCOME TAX: EFFECTIVE TAX RATES CAN DIFFER SIGNIFICANTLY FROM THE STATUTORY RATE, 1, 1 (2013).

242. Scott D. Dyreng & Bradley P. Lindsey, *Using Financial Accounting Data to Examine the Effect of Foreign Operations Located in Tax Havens and Other Countries on U.S. Multinational Firms Tax Rates*, 47 JOURNAL OF ACCOUNTING RESEARCH 1283, 1303 (2009).

effective corporate tax rate U.S. MNCs face can be attributed to tax havens where they incur a tax expense of only 3 percent.[243] These significant tax savings encourage corporations to locate subsidiaries in tax havens.

vi. Political Economy of Tax Havens and Tax Reform

During the 1990s, not only did capital mobility increase, but the potential for capital mobility increased with the adoption of liberal economic policies. Capital mobility exists when resources and labor move freely across borders. Liberalization refers to the reduction or elimination of national and local restrictions on cross-border economic transactions.[244] Examples of economic liberalization include the North American Free Trade Agreement and the creation of the Eurozone.[245] In addition to the liberalization of the larger economies of Europe and North America, "stabilize, privatize, and liberalize" became the mantra of leaders in developing countries in Sub-Saharan Africa, Latin America and Eastern Europe.[246] Smaller jurisdictions like the Cayman Islands abolished capital controls and offered their territories as offshore financial centers.[247] All the while, firms and national governments responded to pressures to compete in a global economy by refusing to make alterations to their international tax regime.[248]

As capital began to freely flow across borders, multinational corporations adapted to the new environment by optimizing the allocation of their factors of production. The main components of the recent expansion in globalization are international trade and cheap-factor-seeking foreign direct investment (FDI), which allow production to be assigned according to comparative advantage.[249] MNCs can both locate production in jurisdictions where labor is cheap, and transfer profit-generating intellectual property to tax havens. This allows U.S. MNCs to defer taxation on their foreign source income by not making dividend distributions to their home government. The result is a global savings glut that in turn lowers long-term interest rates, leading to a

---

243. *See* Zucman, *supra* note 213, at 121.

244. *See* SOL PICCIOTTO, REGULATING GLOBAL CORPORATE CAPITALISM, 2 (Cambridge University Press) (2011).

245. M. ANGELES VILLARREAL & IAN F. FERGUSON, CONG. RESEARCH SERV., R42965, THE NORTH AMERICAN FREE TRADE AGREEMENT (2017) (NAFTA came into force on January 1, 1994 and the Eurozone was created in 1999).

246. Dani Rodrik, *Goodbye Washington Consensus, hello Washington confusion?: A review of the World Banks Economic growth in the 1990s: Learning from a decade of reform*, 55 PANOECONOMICUS 973-987, 973 (2008).

247. JOHN RAVENHILL, GLOBAL POLITICAL ECONOMY, 242 (3rd ed. 2011).

248. *See id.* at 207.

249. *See* David A. Mayer-Foulkes, Long-Term Fundamentals of the 2008 Economic Crisis, 4 Global Econ. J. 6, 2 (2009).

housing bubble in many countries. The Great Recession of 2008 was a direct result of that bubble bursting.[250]

The Great Recession renewed the debate over tax havens and tax motivated transfer pricing, although the regulatory battle against tax havens and abusive transfer pricing is almost as old as the tax code itself. The War Revenue Act of 1917 gave the revenue authority the power to require related corporations to file consolidated returns "whenever necessary to more equitably determine the invested capital or taxable income."[251] The Fiscal Committee of the League of Nations commissioned a study pertaining to the issues of 'allocation of business income' (now known as transfer pricing) in 1928.[252] The resulting report (the Carroll report) called for each component of an MNC to be treated as a separate independent entity and concluded that intrafirm transactions should be carried out based on the arm's length criterion—the price at which the transaction would have taken place in the absence of related parties. Following the Carroll report, the U.S. adopted Sec. 45, the precursor to Sec. 482, which allowed the Commissioner to "distribute, apportion, or allocate gross income or deductions between or among [related] trades or businesses."[253] Section 482, the current provision in the Code intended to combat tax motivated transfer pricing, was part of the Internal Revenue Act of 1986. It provides the IRS with the authority to adjust the accounts of related parties "in order to prevent evasion of taxes or clearly to reflect the income" of related entities.[254]

Along with the broad authority of the IRS to adjust the accounts of related parties, Subpart F, enacted in 1962, subjects certain undistributed foreign income to immediate taxation. The provision applies to Controlled Foreign Corporations (CFCs) of domestic corporations.[255] The purpose of subpart F was to limit the ability of MNCs to curb "tax haven deferral." However, the legislation did not

---

250. Joel Slemrod, Lessons for Tax Policy in the Great Recession, 62 National Tax Journal 387–397 (2009).

251. Reuven S. Avi-Yonah, *The Rise and Fall of Arms Length: A Study in the Evolution of U.S. International Taxation* 3 (Pub. Law and Legal Theory Working Paper Series, Working Paper No. 92, 2007).

252. *See* Report to the Council on the Fifth Session of the Comm., League of Nations Dec. C.252.M.124 1935. II. A (1935); *see also* Graetz & O'Hear, *supra* note 7, at 1023.

253. Reuven S. Avi-Yonah, *The Rise and Fall of Arms Length: A Study in the Evolution of U.S. International Taxation* 3 (Pub. Law and Legal Theory Working Paper Series, Working Paper No. 92, 2007).

254. 26 U.S.C. § 482 (2007).

255. I.R.C. § 957(a) (2017) (As enacted, subpart F defined a controlled foreign corporation (CFC) as a foreign corporation more than 50 percent of the total combined voting power of which was owned, actually (directly or indirectly) or constructively, by U.S. shareholders); I.R.C. § 951(a) (2017) (A "U.S. shareholder" was a specifically defined term meaning a U.S. person that owned, directly, indirectly or constructively, 10 percent or more of the voting power of the foreign corporation).

attempt to identify tax havens. Instead, it identified the types of income typically sourced to tax haven jurisdictions as "tainted income."[256] All current categories of income enumerated in Subpart F are generated (1) from sources outside of the CFC's location of incorporation and (2) from transactions with related parties.[257] The Tax Reform Act of 1986 contained additional anti-deferral provisions to combat tax strategies where U.S. persons do not "control" the foreign corporation.[258] Congress' response to the tax benefits available to U.S. persons earning Subpart F income through non-controlled corporations was to enact the passive foreign investment company (PFIC) provisions.[259]

Although, Both Subpart F and the PFIC rules were enacted to prevent companies from creating artificial transactions lacking a business purpose other than the avoidance of taxes, legislation aimed at tax haven jurisdictions have proved mostly unsuccessful. In 2007, Senator Carl Levin introduced the *Stop Tax Haven Abuse Act*.[260] Under the *Act*, U.S. persons "who directly or indirectly formed, transferred assets to, was a beneficiary of, or received money or property or the use thereof from an entity . . . formed, domiciled, or operating in an offshore secrecy jurisdiction" are presumed to control the entity (proposed Chapter 76, Subpart F, Sec. 7492 (a)).[261] The *Act* included an "initial list of offshore secrecy jurisdictions" (proposed amendment to I.R. Code Sec. 7701(a)(50)(E)).[262] Although the *Act* has been introduced in each subsequent session of Congress, it has yet to be enacted.[263]

vii. Current Reform Proposals

The national debate regarding reforming corporate tax policy focuses on the ability of MNCs to avoid home country income tax through tax motivated transfer pricing and deferral. Alternative anti-deferral measures include (1) repeal deferral and subject all foreign income to current taxation; (2) tax all foreign income currently but at a lower tax rate; and (3) retain Subpart F and include an effective tax rate

---

256. The deferral of income earned through U.S. controlled foreign corporations: a policy study (2000).

257. 26 U.S.C. § 951-954 (2007).

258. Tax Reform Act of 1986, H.R. 3838, 99th Cong. (1986) (enacted).

259. I.R.C. § 1297 (2017) (A PFIC was defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consisted of passive income or if 50 percent or more of the average value of its assets consisted of assets that produce passive income).

260. Stop Tax Haven Abuse Act, S. 681, 110th Cong. (2007).

261. *Id.*

262. *Id.*

263. *See* S. 506, 111th Cong. § 1 (2009); *see also* S. 1346, 112th Cong. § 1 (2011); *see also* S. 1533, 113th Cong. § 1 (2013) (The list of secrecy jurisdictions was removed by the 112th session of Congress).

test for active income.[264] In 2013, then Senate Finance Committee Chair Max Baucus proposed ending deferral and taxing foreign-earned income when earned, but some at a lower rate than the current statutory rate. He also proposed a current 20 percent tax on unrepatriated income.[265] President Obama and former Chair of the House Ways and Means Committee prefer moving toward a territorial regime.[266] The President's Fiscal Year 2010 Budget Proposal included a provision to eliminate check-the-box.[267] Despite Congress' success in enacting FATCA (discussed above), given the disparity of opinions on how to address corporate tax avoidance, it is unlikely that the U.S. Congress will pass a major tax reform bill in the near future.

There has been success, however, in multinational efforts to limit the ability of MNCs to take advantage of loopholes in corporate tax law and income tax treaties. In 2012, the Group of 20 Nations, requested that the OECD develop an action plan aimed at eliminating corporate mischief. The OECD's final *Base Erosion and Profit Shifting (BEPS)* report, published in October 2015, includes 15 action items that potentially represent "the biggest shake-up of multinational taxation since the basics of the current framework were put into place in the 1920s."[268] However, the OECD does not possess the authority to enact tax legislation. This holds true with each sovereign territory and this premise underlies sourcing rules contained in tax treaties and the tax policy of individual countries. Given current Congressional inaction with previous tax reform proposals, it is unlikely that changes are imminent. In June 2016, the Treasury Department released final regulations—addressing BEPS Action 13—requiring annual country-by-country reporting by U.S. entities that are the ultimate parent of a multinational enterprise with annual revenue of at least $850 million.[269] As of January 2017, there are seven tax treaties pending consent of the

---

264. *See* OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS (2000).

265. Tony Nitti, *International Tax Reform For Dummies*, FORBES (Nov. 20, 2013), https://www.forbes.com/sites/anthonynitti/2013/11/20/international-tax-reform-for-dummies/2/#c1f40a26dbd8.

266. 24 International Tax Experts Address Current Reform Issues (Sep. 25, 2015), https://americansfortaxfairness.org/files/24-International-Tax-Experts-Letter-to-Congress-9-25-15-FINAL-for-printing.pdf.

267. Jane G. Gravelle, CONGR. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES (2010).

268. *Corporate Taxation: New Rules, Same Old Paradigm*, THE ECONOMIST, https://www.economist.com/news/business/21672207-plan-curb-multinationals-tax-avoidance-opportunity-missed-new-rules-same-old (last visited Feb. 11, 2018).

269. *Final Country-by-Country Reporting Regulations Analyzed In-Depth*, ERNST & YOUNG: TAX NEWS UPDATE, (July 6, 2016), https://taxnews.ey.com/news/2016-1166-final-country-by-country-reporting-regulations-analyzed-in-depth.

Senate.[270] When and if ratified, these treaties would be steps toward implementing BEPS Action 6 (Prevent Treaty Abuse) and Action 7 (Permanent Establishment Status). Table 3 contains a summary of the BEPS action items and U.S. implementation.

Table 3: OECD Action Items and Current Status of U.S. Implementation[271]

ACTION	**U.S. Implementation**
1: VAT	The U.S. does not have a VAT and there are no proposals to introduce one.
2: Hybrids	The U.S. has dual consolidated loss rules that generally embody Recommendations 6 (deductible hybrid payment rule) and 7 (dual resident payer rule) in Part I of Action 2. U.S. law and tax treaties generally embody the treaty recommendations in Part II of Action 2.
3: CFCs	The existing U.S. CFC regime incorporates many of the recommendations from Action 3.
4: Interest deductions	An existing fixed-ratio limit on the deductibility of net interest expense generally applies to foreign-owned corporations, but the ratio is generally 50% instead of 10% to 30%.
5: Harmful tax practices	U.S. law does not have a preferential IP regime of the type discussed in Action 5. Other than unilateral APAs, the U.S. generally does not issue rulings of the type that must be spontaneously exchanged under Action 5.
6: Prevent treaty abuse	The U.S. generally meets the Action 6 minimum standard through its LOB provisions in treaties in force or in treaties or protocols awaiting ratification, and its anti-conduit rules. The Treasury Department released a revised U.S. Model income tax convention in February 2016, making the LOB model provision more restrictive. The Congress remains opposed to, and will not adopt, a PPT.
7: Permanent establishment status	Signed tax treaties have been delayed in the Senate since 2011 and may remain so indefinitely, so the timing of any changes is unknown.

270. *Treaties Pending in the Senate*, U.S. DEPARTMENT OF STATE, HTTPS://WWW.STATE.GOV/S/L/TREATY/PENDING/ (last visited Jan. 14, 2017).

271. *BEPS Actions Implementation by Country – United States*, DELOITTE, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf (last visited Jan. 17, 2017).

8 – 10: Transfer Pricing	The application of Article 9 of U.S. tax treaties is expected to generally be consistent with Actions 8 – 10.
12: Disclosure of aggressive tax planning	Existing U.S. law has statutory and regulatory disclosure rules for aggressive tax planning. There are no active proposals for change.
13: Transfer pricing documentation	Existing U.S. law has documentation requirements which are at least equivalent to Action 13.
14: County-by-Country reporting	The Treasury Department issued final regulations in June 2016 and apply to taxable years of parents of U.S. MNE groups that begin on after June 30, 2016.
15: Dispute resolution	Action 14 is broadly consistent with the existing U.S. position on dispute resolution.

C. Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income

Under the current tax regime, U.S. multinational companies do not pay tax on certain income attributed to their foreign subsidiaries.[272] Certain types of income are considered highly mobile and effectively escape taxes under Subpart F regulations.[273] As such, U.S. multinationals have accumulated significant earnings that were taxed at preferential foreign rates and remain stashed outside of the U.S.[274] The 14 percent one-time tax on previously untaxed foreign income is mandatory.[275] The proposal seeks to tax on foreign CFC earnings that were not previously subject to U.S. tax.[276]

D. Impose a 19 Percent Minimum Tax on Foreign Income

According to the Treasury Greenbook for fiscal year 2017, U.S. multinational companies do not pay U.S. tax on income derived from subsidiaries in a foreign country unless the income is repatriated.[277] If the foreign subsidiary sourced income is repatriated, a credit can be

272. Greenbook, *supra* note 201, at 13.

273. Greenbook, *supra* note 201, at 13. Even with these regulations, certain types of highly mobile income still evade Subpart F restrictions. Think of Subpart F as a band-aid on a knife wound.

274. Greenbook, *supra* note 201, at 13.

275. Jeff Mason & Kevin Drawbaugh, *Obama Targets Foreign Profits with Tax Proposal, Republicans Skeptical*, REUTERS (Feb. 1, 2015), http://www.reuters.com/article/us-usa-budget-tax/obama-targets-foreign-profits-with-tax-proposalrepublicans-skeptical-idUSKBN0L51IX20150201.

276. Greenbook, *supra* note 201, at 13.

277. Greenbook, *supra* note 201, at 9 (repatriation is the process in which U.S. multinationals transfer foreign earned funds back into the United States).

generated for any foreign taxes paid.[278] The credit is limited by a foreign tax credit limitation (FTCL).[279] Additionally, the tax code attempts to prevent abuses to the system by imposing a restriction on certain income that is deemed "Subpart F income," such as income related to controlled foreign corporations.[280] In effect, the income has already been filtered through various tax mechanisms to prevent abuses; however, perceived abuses lead Congress to further hinder the use of deferral by enacting sections 951(a) and 956.[281] 951(a) and 956 essentially limit deferral of foreign earnings attributable to individual taxpayers who are invested in controlled foreign corporations.[282] The Department of the Treasury states its reason for change:

> The opportunity to defer U.S. tax on CFC earnings, together with the ability to currently deduct expenses attributable to deferred earnings, provide U.S. multinationals with the incentive to locate production overseas and shift profits abroad, eroding the U.S. tax base. In addition, the current system discourages these companies from bringing low-tax foreign earnings back to the United States, because they would pay significant residual U.S. tax on the repatriated earnings after accounting for any foreign tax credits. At the same time, the current foreign tax credit system allows companies to utilize credits from high-tax foreign source income such as dividends to reduce U.S. tax on low-tax foreign source income such as royalties. Finally, it may be difficult for the IRS to verify that a taxpayer has exhausted practical remedies under foreign law to reduce its reasonably expected foreign tax liability over time in a manner consistent with a reasonable interpretation of foreign law.[283]

i. Congressional Solution

The Administration seeks to supplement the existing tax regime by implementing a 19 percent per-country minimum tax on foreign earnings.[284] Controlled foreign corporations with a U.S. parent would be

---

278. Greenbook, *supra* note 201, at 9.

279. Greenbook, *supra* note 201, at 9.

280. Greenbook, *supra* note 201, at 9 (discussing subpart F income, which is named after the section in which the regulations are found within the Internal Revenue Code).

281. Greenbook, *supra* note 201, at 9.

282. *See generally* Greenbook, *supra* note 201, at 9 (explaining 951(a) and 956 as well as providing the general framework for perceived abuses within the international tax regime).

283. Greenbook, *supra* note 201, at 10 (explaining, in non-simplistic terminology, how the issue of the current tax regime is related to the bright-line tests imposed to determine the proper taxation of earnings).

284. Greenbook, *supra* note 201, at 10 (noting the ominous phrase "minimum" is not a true minimum tax rate in that the maximum amount of deferred foreign income can be taxed under this new system is 19 percent).

taxed at a rate of 19 percent minus 85 percent of the per-country foreign effective tax rate.[285]

Formula:

Tax Rate for CFCs =.19-(.85(Foreign Effective Tax Rate))[286]

VII. AUTHOR PROPOSED SOLUTION: A FORMULARY APPROACH

A. *Purpose of a Formulary Approach*

Income shifting and difficulties in attributing an accurate transfer price between inter-company transactions has led to heightened interest in the international tax regime.[287] Specifically, formulary apportionment, as a solution to U.S. international tax issues, has come into the spotlight.[288] Formulary apportionment allows income shifting strategies to be ignored and opts to rely upon notable apportionment bases such as capital payrolls and sales within a foreign jurisdiction.[289]

Current transfer pricing practices encourage multinational corporations to locate highly profitable products in low-tax jurisdictions, which violates capital export neutrality.[290] Formulary apportionment allows for multinational corporations to locate various aspects of their operations across low- and high-tax jurisdictions based on pre-tax considerations.[291] In the absence of formulary apportionment, companies are able to pick and choose where to locate higher profit based activates in low-tax jurisdictions.[292] The concept of formulary apportionment—for the purpose of income allocation in relation to taxation—is not a new concept.[293] In effect, the United States has been utilizing formulary apportionment as early as the beginning of the 20th century.[294] That's right, the United States has long been utilizing formulary apportionment for the purpose of separating business activity between states. The general factors considered as

285. Greenbook, *supra* note 201, at 10.

286. "CFC A" is a subsidiary of "U.S. Parent A" positioned in a foreign territory with a foreign effective tax rate of 5 percent which translates to a 14.75 percent tax rate of any foreign income derived from "CFC A."

287. Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is it Better than the Current System and are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1145 (2010).

288. *Id.*

289. *Id.*

290. *See* Weisbach, *supra* note 25, at 3 (defining capital export neutrality as the desire for taxpayers to choose their location for investment based on pre-tax considerations and not based on varying tax rates across multiple jurisdictions).

291. Altshuler & Grubert, *supra* note 239, at 1151.

292. *Id.*

293. Clausing, *supra* note 155, at 355.

294. *Id.*

apportionment bases are the share of a firm's payroll, assets, and sales.[295]

B. *Simplified Example*[296]

To simplify how formulary apportionment works consider "Corporation A," which is a software company based out of Austin, Texas (25% income tax rate) with operations in Louisiana (10% income tax rate). Corporation A locates its primary research and coding office in Austin, Texas where fifty computer science based coders reside. However, Corporation A also employs fifteen computer engineers in Louisiana. Moreover, all of its servers and computers are located within Louisiana. Assume coders earn $100 a year while the computer engineers earn $75 a year. Additionally, all capital assets are valued at $1,000. Under this hypothetical, absent a formulary apportionment system, Corporation A would be highly motivated to shift its earnings to Louisiana because of the lower income tax rate. Corporation A—has the potential to source income in Louisiana under various tax regimes because the majority of their assets are located in Louisiana. However, under the formulary apportionment system, Corporation A's share of tax per state on $12,000 of sales in Texas would be…

Formula:

Each Apportionment Base/(payroll + assets + sales) = Percent Attributable Per State

Louisiana Payroll: $1125/($1,125 + $5000 + $1000 + $12,000) = 5.88%

Texas Payroll: $5000/($1,125 + $5000 + $1000 + $12,000) = 26.14%

Louisiana Assets: $1000/($1,125 + $5000 + $1000 + $12,000) =3.43 %

Sales Revenue: $12,000/($1,125 + $5000 + $1000 + $12,000) = 62.74%

Louisiana Attributed Income: $12,000(5.88% + 3.43%) = 1117.20

Texas Attributed Income: $12,000(26.14% + 62.74) = $10,665.60

C. *Comprehensive Example*

We use publicly available data to estimate the revenue impact of current tax reform proposals. The U.S. income tax concept of deferral allows companies to exclude earnings of foreign owned, separately

295. *Id.*

296. The example is an oversimplification for the purpose of reducing formulary apportionment to its basic form as a means of general illustration as well as to point out basic flaws with any formulary approach.

incorporated subsidiaries from taxable income until repatriated to the U.S. parent. However, Internal Revenue Code Section 6103(a) states that tax return information is confidential.[297] Generally Accepted Accounting Principles (GAAP) allows companies to designate unrepatriated foreign earnings as "indefinitely reinvested."[298] Typically, GAAP requires companies to use accrual accounting, meaning that income and expenses be recorded when incurred. The indefinitely reinvested designation is an exception to that rule. When a company designates foreign earnings as indefinitely reinvested, they are not required to record the tax expense associated with those earnings. Indefinitely reinvested earnings are disclosed in the tax footnote of companies' SEC 10-K annual filings. We use indefinitely reinvested earnings as a proxy for unrepatriated earnings in our analysis. Indefinitely reinvested earnings are reported in the AuditAnalytics dataset.

Country level company data regarding the activities of U.S. multinational enterprises (MNEs) is not publicly available. The Bureau of Economic Analysis (BEA) provides estimated country level data derived from surveys of U.S. MNEs and aggregated at the country level. We obtained country level foreign direct investment (FDI), as well as: assets, sales, and compensation by country of U.S. MNEs from the BEA.

We obtained company level data from two sources. Compustat provides financial statement data reported by companies in their SEC filings. Companies are required to include a list of their significant subsidiaries in Exhibit 21 of the annual SEC 10-K.[299] However, this data is not available in Compustat. We thank Scott Dyreng for allowing access

297. I.R.C. § 6103 (2015).

298. Accounting for Income Taxes, Statement of Fin. Accounting Standards No. 109, § 34 (Fin. Accounting Standards Bd. 1992) (later codified as ASC § 740-30-25-18(a)).

299. Publicly traded U.S. companies are required to include a list of significant subsidiaries with their annual SEC Form 10-K Exhibit 21. 17 C.F.R. § 229.601(b)(21) (2016). Regulation S-X defines an affiliate as significant if: (1) the parent company's combined direct and indirect investments exceed 10 percent of the parent company's total assets, (2) the parent company's combined direct and indirect proportionate share of the affiliate's total assets exceeds 10 percent of the consolidated firm's total assets, or (3) the parent company's combined direct and indirect proportionate share of the affiliate's pre-tax income from continuing operations exceeds 10 percent of the consolidated pre-tax income from continuing operations. 17 C.F.R §229.210.1-02(w) (2016). SEC Regulation S-K then requires registrants to combine all of the excluded subsidiaries so that they are "considered in the aggregate as a single subsidiary." 17 C.F.R. §229.601(b)(21)(ii) (2016). The combined group of subsidiaries may only be excluded from disclosure if it is not significant under all of the 10 percent thresholds above. Otherwise, all of the subsidiaries in the combined group must be disclosed. Although these SEC regulations have not changed in recent years, several instances have been documented in which multinational companies have dramatically reduced the number of subsidiaries reported in Exhibit 21. See Jeffrey Gramlich & Janie Whiteaker-Poe, Disappearing Subsidiaries: The Cases of Google and Oracle (March 6, 2013) (unpublished Ph.D dissertation) (available at: http://ssrn.com/abstract=2229576); Jessica Holzer, From Google to FedEx: The Incredible Vanishing Subsidiary, The Wall Street Journal Online (May 22, 2013, 7:38 PM), https://www.wsj.com/articles/SB10001424127887323463704578497290099032374.

to his Exhibit 21 data. The Dyreng dataset is complete through fiscal year 2013. Therefore, our country level analysis is limited to 2013.

i. Analysis of a 14 Percent One Time Tax on Previously Untaxed Foreign Income

Indefinitely reinvested earnings, also referred to as permanently reinvested earnings (PRE) is a cumulative number. Companies are only required to disclose the total amount of foreign earnings designated as PRE in their tax footnote. They are not required to report annual changes. As of the end of fiscal year 2015, the total amount of PRE reported by companies contained in the AuditAnalytics dataset was $2.727 trillion. One current tax reform proposal is to levy a one-time tax on unrepatriated earnings of 14 percent. This proposal would result in approximately $3.818 billion in revenue for the U.S. Treasury. Table 2 provides an annual list of PRE from 2006 to 2015.

Table 4: Indefinitely Reinvested Earnings (PRE) from 2006 to 2015

Year	PRE
2006	47,890
2007	1,054,000
2008	1,238,000
2009	1,448,000
2010	1,649,000
2011	1,872,000
2012	2,163,000
2013	2,365,000
2014	2,562,000
2015	2,727,000

ii. Analysis of a 19-Percent Minimum Tax on Foreign Income

GAAP does not require country-by-country reporting and, as previously noted, tax returns are confidential. We estimate income by country using BEA's estimates of foreign direct investment (FDI) by country.[300] The underlying assumption is that PRE is distributed among countries in the same proportion as FDI. Pretax foreign income is a Compustat variable reported at the company level. We matched FDI by

300. Balance of Payments and Direct Investment Data, U.S. Bureau of Economic Analysis, https://bea.gov/iTable/iTable.cfm?ReqID=2&step=1#reqid=2&step=10&isuri=1&202=1&203=30&204=10&205=1,2&200=1&201=1&207=52&208=2&209=1 (generated using 2013 data, for copies of the exact dataset contact the author).

country with subsidiary information from the Dyreng dataset.[301] We then multiplied pretax foreign income by FDI by country to obtain a country level estimate of foreign income. Using each individual countries' statutory corporate tax rate (STR) we developed a minimum foreign tax variable using the formula described above (minimum tax rate = .19 * (.85 * STR)). We then apply the minimum tax rate to the base (foreign income by country). Our results indicate that imposing a 19-percent minimum tax on foreign income would have generated an additional $4.238 billion in tax revenue in 2013. See Exhibit 1 for a description of our methodology.

Exhibit 1: Estimate of Revenue Impact with 19-Percent Minimum Foreign Tax

Step	Description
1	Pretax income by firm (Compustat variable *PI*) Multiplied by: Percent of U.S. Foreign Direct Investment by Country Estimated pretax income by country
2	Pretax income by country from Step 1 Multiplied by: Minimum tax rate (*mintax* defined in Variable List) U.S. tax revenue by country
3	Sum U.S. tax revenue by country from Step 2 Equals: Estimate of U.S. tax revenue from 19-percent minimum foreign tax

iii. Formulary Apportionment

Inferring the change in U.S. tax collections due to adopting formulary apportionment is more complicated. First, we obtained country level data regarding assets, payroll and sales from the BEA.[302] We then estimated country level company data by multiplying each countries' percent of: foreign assets, payroll, and sales by the financial statement numbers reported in each company's annual SEC Form 10-K.

301. Note that not all subsidiaries are disclosed in Exhibit 21 nor are they required to be disclosed. Therefore, our estimates only include data regarding reported subsidiaries.

302. Data on Activities of Multinational Enterprises: U.S. Direct Investment Abroad, All Majority Owned Foreign Affiliates, Total Assets; Compensation of Employees; and Total Sales, U.S. Bureau of Economic Affairs, https://bea.gov/iTable/iTable.cfm?ReqID=2&step=1#reqid=2&step=10&isuri=1&202=13&203=1&204=10&205=1,2&200=1&201=2&207=49&208=40&209=1, (generated using 2013 data, for copies of the dataset contact the author).

With this information, we are able to compute apportionment factors for each category. After apportioning pre-tax foreign income to each subsidiary based on the apportionment factors, we estimate foreign taxes by multiplying the apportioned income by the country tax rate. Back of the envelope calculations (detailed in Exhibit 2) indicate that domestic income increases by $4.126 billion in 2013 using a formulary approach. Table 5 contains country level data for those countries with FDI greater than 10 percent of the total FDI of U.S. MNEs.

Exhibit 2: Estimate of Revenue Impact with Formulary Apportionment

Step	Description
1	Country level factor (assets, revenue, or labor) Divided by: Total foreign (assets, revenue, or labor) Percent of foreign (assets, revenue, or labor) by country
2	Company level factor Multiplied by: Country percent factor from Step 1 Company level factor by country
3	Company level factor by country from Step 2 Divided by: Total factors by company (Asset, revenue or labor) factor
4	Sum of factors by company Multiplied by: Pretax income by company (Compustat variable PI) Pretax income by country
5	35 percent (U.S. statutory tax rate) Less: *AVGFORTAX* (as defined in variable list) Residual tax rate
6	Sum of pretax income by country from Step 4 Multiplied by: Residual tax rate from Step 5 Estimate of U.S. tax revenue from formulary apportionment

Table 5: Country Level Data

Country	Number of Companies	U.S. FDI	Assets	Payroll	Sales	Estimate of PRE	STR	MINTAX
Argentina	180	18,129	65,617	5,432	47,499	70,305	35	0

Australia	386	48,156	678,141	29,046	181,635	949,717	30	0
Austria	133	16,359	40,327	3,938	22,006	87,835	25	0
Belgium	203	40,542	392,033	11,955	141,841	255,120	34	0
Bermuda	175	267,374	1,182,360	1,263	60,952	1,435,596	0	19
Brazil	260	71,161	307,524	25,614	214,278	359,254	34	0
Canada	692	358,453	1,455,273	68,681	669,723	1,924,616	27	0
Chile	155	27,070	172,893	3,730	37,319	145,345	23	0
China	380	67,500	359,961	27,256	341,222	362,424	25	0
Colombia	134	7,102	32,416	2,706	25,052	38,132	25	0
Denmark	127	13,800	86,088	4,516	25,650	74,096	24	0
France	349	78,421	404,506	35,588	219,380	421,062	33	0
Germany	298	104,242	785,486	54,027	365,491	599,071	30	0
Hong Kong	353	60,466	324,513	9,276	130,278	324,657	17	4.55
Hungary	122	6,086	42,719	1,665	22,771	32,677	19	0
India	374	27,140	121,725	16,902	76,747	145,721	35	0
Ireland	244	279,730	1,294,474	9,209	354,955	1,501,939	13	7.95
Italy	215	24,328	196,637	15,957	118,077	130,623	31	0
Japan	329	100,077	911,274	27,138	232,147	537,338	33	0
Korea	248	33,453	154,281	7,647	69,227	179,617	24	0
Luxembourg	273	491456	2,148,538	1,889	61,657	2,638,747	29	0
Malaysia	201	15,172	70,788	3,694	51,153	81,462	25	0
Mexico	415	89,650	468,695	21,342	253,399	481,353	30	0
Netherlands	376	797,251	256,930	18,525	269,074	4,280,636	25	0
New Zealand	135	7,563	26,250	1,776	17,032	40,608	28	0
Philippines	123	4,549	35,054	2,966	21,618	24,425	30	0
Poland	160	11,374	66,312	4,443	41,189	61,070	19	0
Singapore	363	206,958	628,657	13,589	448,550	1,111,208	17	4.55
South Africa	153	6,144	41,158	3,415	34,897	32,989	28	0
Spain	218	35,738	172,159	10,970	86,760	191,866	28	0
Sweden	153	25,738	139,762	6,050	37,238	138,194	22	0
Switzerland	212	141,371	781,101	12,859	320,390	759,055	18	3.7
Taiwan	144	14,778	73,562	3,208	38,841	79,347	17	4.55
Thailand	173	11,669	53,212	3,146	62,468	62,654	20	0
UK	447	563,055	5,392,112	97,717	667,794	3,023,180	20	0

Our analysis assumes that U.S. multinational enterprises do not change their behavior in response to tax reform. The first proposal—imposing a one-time tax on unrepatriated foreign earnings—does not provide much of an opportunity to tax plan. However, imposing a minimum tax on foreign earnings or adopting a formulary apportionment approach, taxes prospective income and therefore gives

MNEs the chance to restructure operations. We model the impact of formulary apportionment on pre-tax domestic income with the following equation:

Eq. 1

$$PIDOM = \alpha + \beta_1 AVGFTR + \beta_2 FORAT + \beta_3 FORREV + \beta_4 FORCOMP + \beta_5 DELTAPIFO + \beta_6 FATAX + \varepsilon$$

Where *PIDOM* is pre-tax domestic income from Compustat (variable PI). Similar to other studies regarding tax planning, we limit our observations to those companies with positive pre-tax income. *FORAT*, *FORREV,* and *FORCOMP* is the sum of: foreign assets, revenue and compensation by company. *DELTAPIFO* is the difference between foreign income as reported in Compustat (variable PIFO), and foreign income as computed under formulary apportionment (see Exhibit 2). *FATAX* is the amount of foreign taxes that would be paid under formulary apportionment. All variables are defined in Table 6.

Table 6: Variable Definitions

Variable		Definition
PRE	=	Indefinitely reinvested foreign earnings as reported by AuditAnalytics
BEAFDI	=	U.S. foreign direct investment by country as reported by the U.S. Bureau of Economic Analysis, "Balance of Payments and Direct Investment Data."
FDIPCT	=	*BEAFDI*/Total FDI
PI	=	Pretax income by company as reported in Compustat
PIDOM	=	Domestic pretax income as reported in Compustat
PIFOR	=	Foreign pretax income as reported in Compustat
COUNTRYPI	=	*PIFOR* * *FDIPCT*
STR	=	Corporate statutory tax rate by country
MINTAX	=	.19 * (.85 * *STR*)
MINFORTAX	=	*COUNTRYPI* * *MINTAX*
ASSETS	=	Assets of U.S. Multinational Enterprises by country as reported by the U.S. Bureau of Economic Analysis, "Data on

		Activities of Multinational Enterprises: U.S. Direct Investment Abroad, All Majority Owned Foreign Affiliates, Total Assets”
COMP	=	Compensation of foreign employees of U.S. Multinational Enterprises by country as reported by the U.S. Bureau of Economic Analysis, “Data on Activities of Multinational Enterprises: U.S. Direct Investment Abroad, All Majority Owned Foreign Affiliates, Compensation of Foreign Employees”
SALES	=	Foreign sales of U.S. Multinational Enterprises by country as reported by the U.S. Bureau of Economic Analysis, “Data on Activities of Multinational Owned Foreign Affiliates, Total Sales”
PCTASSETS	=	*ASSETS*/Total Foreign Assets
PCTCOMP	=	*COMP*/Total Foreign Compensation
PCTSALES	=	*SALES*/Total Foreign Sales
AT	=	Total assets by company as reported in Compustat
REVT	=	Total revenue by company as reported in Compustat
XLR	=	Total labor costs by company as reported in Compustat
ATBYCOUNTRY	=	*PCTASSET* * *AT* (Company level assets by country)
COMPBYCOUNTRY	=	*PCTCOMP* * *XLR* (Company level compensation by country)
REVTBYCOUNTRY	=	*PCTSALES* * *REVT* (Company level sales by country)
ASSETFACTOR	=	*ATBYCOUNTRY/AT*
COMPFACTOR	=	*COMPBYCOUNTRY/XLR*
REVFACTOR	=	*REVTBYCOUNTRY/REVT*
APPORTIONFACTOR1	=	*ASSETFACTOR* + *COMPFACTOR* + *REVFACTOR*

APPORTIONFACTOR2	=	*ASSETFACTOR + REVFACTOR*
FORCTYINC1	=	*PI * APPORTIONFACTOR1* (Foreign pretax income by country under formulary apportionment)
FORCTYINC2	=	*PI * APPORTIONFACTOR2*
COPIFO1	=	Sum of *FORCTYINC1* by company
COPIFO2	=	Sum of *FORCTYINC2* by company
DELTAPIFO1	=	*PIFO – COPIFO1* (The difference between pretax foreign income as reported in Compustat and pretax foreign income using formulary apportionment)
DELTAPIFO2	=	*PIFO – COPIFO2* (The difference between pretax foreign income as reported in Compustat and pretax foreign income using formulary apportionment)
ETR	=	Company worldwide effective tax rate as reported in the Tax Footnote and obtained from AuditAnalytics
AVGFTR	=	The mean of the foreign countries statutory tax rates (*STR)* by company
FATAX	=	*AVGFTR * COPIFO1* (Foreign taxes under formulary apportionment)
FATAX2	=	*AVGFTR * COPIFO2*
TAXHAVEN	=	1 if country is a tax haven, 0 otherwise
HAVENPRE	=	*PREBYCOUNTRY * TAXHAVEN*
TXC	=	Current tax expense by company as reported in Compustat
TXDFED	=	Federal tax expense by company as reported in Compustat
TXDFO	=	Foreign tax expense by company as reported in Compustat

Results of our regression indicate that pre-tax domestic income is sensitive to the factors of formulary apportionment. As expected, *FORREV* and *DELTAPIFO* are significantly correlated with pre-tax domestic income (at the 1-percent level). Every dollar of foreign revenue decreases foreign domestic income by $20,000. Each one-unit increase in the difference between financial statement foreign income

and formulary apportioned foreign income results in a decrease to pre-tax domestic income of $535,000 (*DELTAPIFO*). Each dollar increase in the amount of taxes paid under formulary apportionment is significantly correlated with a decrease in pre-tax domestic income (*FATAX*). This is consistent with expectation, as it indicates that increases in foreign taxes result from increases in FDI and corresponding decreases in domestic investment. Surprisingly, however, we find that the *AVGFTR* is not significantly related to *PIDOM*. However, we noted that many of our observations were missing the compensation variable (XLR) in Compustat. Therefore, we repeated our analysis without the missing variable:

Eq. 2

$$PIDOM = \alpha + \beta_1 AVGFTR + \beta_2 FORAT + \beta_3 FORREV + \beta_5 DELTAPIFO + \beta_6 FATAX + \varepsilon$$

The results of this analysis are similar to those obtained from Equation 1. However, all of the independent variables are significantly correlated with pre-tax domestic income. Each 1 percent increase in *AVGFTR* increases *PIDOM* by over $1.5 million. Although, in both scenarios the coefficient on *FORAT* is significant and positive, these results are not necessarily contrary to expectations. Companies with high levels of FDI are likely to benefit from these investments domestically, increasing *PIDOM*.

Our results indicate that U.S. MNEs will change their behavior in response to formulary apportionment. These changes, however, are consistent with the public policy objectives of corporate tax reform: increasing domestic investment and deterring profit shifting. Real economic activity does not typically occur in tax haven jurisdictions. Therefore, when income is assigned to jurisdictions where real economic activity occurs (inferred by the apportionment factors), foreign taxes increase. As the taxes on foreign income increase, domestic investment increases. Our model explains 81–88 percent of the variability in pretax domestic income (R-Squared of 0.81 and 0.88). Regression results are reported in Table 7.

Table 7: Results of regression analysis

	PIDOM	**3-factor apportionment**		**2-factor apportionment**	
	+/- prediction	coef.	t-stat	coef.	t-stat
CONSTANT	n/a	-122.824	-0.77	-336.731	-5.67***
AVGFTR	+	869.828	1.27	1503.475	6.27***
FORAT	-	.009	17.57***	0.033	42.94***
FORREV	-	-0.020	-3.33***	0.064	110.58***

FORCOMP	n/a	0.223	14.95***		
DELTAPIFO	-	-0.535	-14.60***	-0.501	-76.11***
FATAX	-	-1.101	-9.26***	-0.488	-25.00***
R-squared		.81		.88	
N		834		10,695	

***Significant at the 1% level.

VIII. CONCLUSION

The philosophies of mankind change often. Tax policy is merely an expression of competing philosophies in economic terms. It is imperative tax regimes mirror the philosophies of those it seeks to govern. Competing parties push and pull the pin to the end of the spectrum for which they desire, taking note of where the pin is and rarely taking heed to where the pin should be. There is a better way, and that is formulary apportionment.