

**TESTIMONY OF PROF. EDWARD D. KLEINBARD**

**HEARING TITLED**

**“TAX REFORM: TAX HAVENS, BASE EROSION AND PROFIT-SHIFTING”**

**U.S House of Representatives Committee on Ways and Means**

**June 13, 2013**

Chairman Camp, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard; I am a Professor of Law at the University of Southern California’s Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress’s Joint Committee on Taxation.

**I. SUMMARY OF TESTIMONY.**

- U.S. multinational firms, as well as multinational firms resident in other countries, today engage in large-scale base erosion and profit-shifting – what in my academic papers I have labeled the generation of “stateless income.”
- The existence of proposed anti-abuse rules in this Committee’s international tax reform Discussion Draft, and this hearing itself, stand as testament to the Committee’s insistence on precluding what I think of as “unprotected territoriality.” But recent developments suggest that the Committee, and fiscal authorities around the world, have underestimated the magnitude of the problem, and that stronger anti-abuse measures are urgently required.
- For example, working directly with tax return data, Harry Grubert and Rosanne Altshuler recently found that foreign subsidiaries of U.S. firms today enjoy effective tax rates of *less than five percent* on nearly 37 percent of their total income. *Fifty-four percent* of U.S. controlled foreign corporations’ total income is taxed at effective rates of 15 percent or lower.

- My own new paper looks at Starbucks Corporation, a classic bricks and mortar retail business model, with direct customer interactions in thousands of “high street” locations in high-tax countries around the world. Nonetheless, it appears that Starbucks has successfully reduced its foreign tax liabilities to surprisingly low levels. To put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can.
- The recent Senate PSI hearing focusing on Apple Inc. also is consistent with the seriousness of the situation. What was most remarkable was the baldness of Apple’s tax planning. The entirety of the business arrangements that explain why Apple paid virtually no tax anywhere in the world on tens of billions of dollars of income attributable to U.S. R&D boils down to this: in 1980 Apple created a shell company subsidiary in Ireland, capitalized it, and entered into a special kind of contract with this shell company (a “cost sharing agreement”), in which the shell company returned to Apple some of the capital seeded to it by Apple, thereby first purportedly acquiring ownership in all of Apple’s intangible assets outside the Americas. This description is a bit simplified, but in essence, that is the entirety of the story.
- The Apple hearing, press articles and comments filed with this Committee in response to its Discussion Draft all represent a healthy and widely-shared interest in improving the current system, even if proposed solutions vary. But current debates often are marred by the injection into the arguments of some recurring myths and misunderstandings. I wish to address three of these.
- Myth I: We Should Cheer When Our Companies Avoid Foreign Taxes. It is intuitively appealing to argue that when “our” multinationals employ stateless income technologies to minimize their foreign tax liabilities, the outcome is something we should cheer rather than criticize. But this is false. That apparently foreign income often in fact is U.S. income traveling incognito. The stream of tax-free foreign income encourages U.S. firms to engage in tax arbitrage, by leaving all their global interest expense in the U.S. parent, where it erodes the domestic tax base (by reducing wholly domestic taxable income). The prospect of stateless

income distorts investment decisions, by offering U.S. firms the possibility of supersized returns (what I call “tax rents”) on foreign investments. And finally, promoting our national champions to avoid the tax systems of other countries leads to the mirror image response from them, and a beggar-thy-neighbor race to the bottom, where multinational firms are the winners and every taxing jurisdiction the loser.

- Myth II: Firms’ Money is Trapped Abroad, to Our Great Detriment. U.S. firms today have nearly \$2 trillion in offshore so-called “permanently reinvested earnings.” Some of that \$2 trillion is invested in real businesses around the world, but a large fraction is held in cash. It is intuitively appealing to argue that all of this “trapped” cash is lying fallow, as if it were buried in a backyard in Zug. But again this is false. The money in fact already is at work in the United States, in the form of loans to the U.S. government or U.S. businesses. What is more, as I explain in my detailed comments, firms like Apple have demonstrated how easy it is to engage in a virtual repatriation of offshore cash on a tax-free basis, and use that virtual transaction to fund current stock buy-backs.
- Myth III: Everything That U.S. Firms Do is “Legal.” U.S. multinational firms have not done anything remotely illegal in their stateless income planning. But observers then wrongly conclude that everything that U.S. firms have done in this area must therefore be “legal.” This is a meaningless phrase in this context. Every large U.S. firm is audited by the Internal Revenue Service on a continuous basis. Firms take tax return positions that they expect to be challenged, they establish accounting reserves for uncertain tax positions, and they often settle tax disputes (most commonly at the administrative level) by paying additional tax. The question is not whether a particular firm’s stateless income planning is “legal,” but rather whether that planning is inappropriately aggressive. By being aggressive, some large multinational firms achieve tax results that they would not obtain if the energies available to the two sides of the argument were more evenly matched. This in turn has important repercussions for tax system design. It means that a complex and highly fact-driven international corporate tax system

invariably will lead to lower tax revenues than might be expected under more neutral terms of engagement, and it means that the corporate tax system in turn will have a negative spillover into personal tax collections, through a degradation of individuals' confidence in the fairness of the tax system.

- What then should we do? There is something of a consensus around the idea of a territorial system with anti-abuse constraints (or a “hybrid” system, as some prefer), but I respectfully submit that there is a far simpler alternative that is more resistant to tax gaming, that is “competitive,” and that is economically defensible: genuine worldwide tax consolidation, combined with a corporate tax rate squarely in the middle of the pack of peer countries' rates – say 25 percent. Financial accounting norms of course require worldwide consolidation in presenting the results of a multinational firm's activities. The resulting system is simple and, more important, highly resistant to tax gaming, because there are no positive returns to base erosion or profit shifting. What is more, my proposed system is “competitive,” in proper sense of being competitive with the tax environment that foreign domestic firms actually face in the country in which they operate, rather than a system that, like current law, or like unprotected territoriality, heavily subsidizes foreign investment, at the expense of our own domestic economy. If it helps, one can visualize my proposal as a territorial tax system with a 25 percent worldwide (not per country) minimum tax – the economic effects are the same.
- Finally, without regard to the fate of tax reform legislation, I urge the Committee to work with other Committees of the House to put onto a fast track legislation requiring every U.S. multinational firm to publish a worldwide disclosure matrix of its actual tax burdens by jurisdiction. Tax transparency rules are not a substitute for substantive international tax reform, but they would enable tax authorities to identify possible patterns of inappropriate income shifting, thereby making better use of limited audit resources. A transparency principle further would awaken the public to the massive amounts of international tax avoidance today known only to specialists.

## II. THE PROBLEM IS REAL.

I am fortunate to have spent 30 years in private practice, where my clients largely comprised multinational firms, to have served at the Joint Committee on Taxation, where we worked on international tax law design and compliance issues, and now to work as an academic, with the time and the freedom to do research on international tax law policy from both legal and economic perspectives. Drawing on my experience and research, I am confident that U.S. multinational firms, as well as multinational firms resident in other countries, today engage in large-scale base erosion and profit-shifting – what in my academic papers I have labeled the generation of “stateless income.”<sup>1</sup>

In 2011, this Committee published a “Discussion Draft” of a possible new U.S. international tax system applicable to foreign direct investment. For the reasons developed in this testimony I do not agree with every policy that the Discussion Draft endorses, but it is unquestionable that the Discussion Draft and accompanying materials reflect a great deal of thoughtful work. In particular, I believe that the Committee should be commended for acknowledging from the start that stateless income generation is inconsistent with the premises of any well-designed territorial tax system, and for outlining some possible anti-abuse and thin capitalization rules that would address aspects of the issue.<sup>2</sup> This hearing also stands as a testament to the Committee’s determination to address the consequences of what I think of as “unprotected territoriality.” But recent developments suggest that the Committee, and fiscal authorities around the world, have underestimated the magnitude of the problem, and that stronger anti-abuse measures are urgently required.

One way to drive home the point that firms are awash in stateless income is to

---

<sup>1</sup> *Stateless Income*, 11 Florida Tax Rev. 699 (2011); *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011); *Through a Latte, Darkly: Starbucks’ Stateless Income Planning* (draft of May 28, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2264384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264384)), forthcoming, Tax Notes.

<sup>2</sup> Edward Kleinbard, *Three Cheers for Dave Camp*, 138 Tax Notes 619 (Feb. 4, 2013).

*The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011), explores in detail how stateless income technologies undermine the (usually unstated) premises of standard theoretical justifications of territorial tax systems.

look at the most recent empirical work in this area, by Harry Grubert of the U.S. Treasury and Rosanne Altshuler at Rutgers.<sup>3</sup> Working directly with tax return data, they found that foreign subsidiaries of U.S. firms today enjoy effective tax rates of *less than five percent* on nearly 37 percent of their total income. *Fifty-four percent* of U.S. controlled foreign corporations' total income is taxed at effective rates of 15 percent or less. As Dr. Grubert has noted in another context, these low rates cannot be explained as the consequence of hundreds of billions of dollars of investments in pubs in Ireland. What is more, these total income numbers include large petroleum companies and other natural resources firms, which generally are stuck with very high foreign tax rates that cannot be avoided, due to the fixed location of those resources. If natural resources firms were excluded, the proportion of super low-taxed total income would increase.

In classic academic style, Drs. Grubert and Altshuler buried the lede deep in their paper, but these hard data drawn from actual tax returns are irrefutable proof of the magnitude of stateless income generation in the wild. Corroboration can be found in firms' financial statements<sup>4</sup> and, indirectly in their extraordinary hoards of offshore cash (and the rapid rise of those cash balances), now totaling nearly \$2 trillion.<sup>5</sup>

It sometimes is argued that only high-tech and pharmaceutical firms take advantage of stateless income generation technologies, because they own high-value intangibles that they can locate in a tax haven, and thereby direct royalties to that intangibles ownership vehicle. It certainly is true that such firms are the beneficiaries of extraordinarily low effective tax rates on their foreign income – often in the single digits – and that they rely heavily on artificial arrangements that purportedly transfer the ownership of those intangibles to wholly-owned subsidiaries that conveniently claim residence in very low-tax jurisdictions (or in the case of Apple, claim to be resident nowhere at all – thereby extending the concept of stateless income to include stateless

---

<sup>3</sup> Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, draft of May 12, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2245128](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245128).

<sup>4</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 739 (2011) (Microsoft effective foreign tax rate of 4 percent, and Google effective foreign tax rate of 2.4 percent).

<sup>5</sup> Wall St. J., CFO Journal, *Indefinitely Reinvested Foreign Earnings on the Rise*, May 7, 2013.

companies).

The Senate's Permanent Subcommittee on Investigations (PSI) recently released a case study of Apple's stateless income generation strategies, which it used as background information for its hearing on May 21<sup>st</sup> on this topic.<sup>6</sup> It is useful to reflect on the lessons of that hearing for a minute.

What struck me as most remarkable about the PSI report and the hearing itself was the baldness of Apple's tax planning. It did not involve "Double Irish Dutch Sandwich" structures, exotic forms of Lichtenstein trusts or reliance on obscure tax treaties. Instead, the entirety of the business arrangements that explain why Apple paid virtually no tax anywhere in the world on \$38 billion of income in the period 2009-11 alone from research and development work conducted in California boils down to this: in 1980 Apple created a shell company subsidiary in Ireland, capitalized it, and entered into a special kind of contract with this shell company (a "cost sharing agreement"), in which the shell company returned to Apple some of the capital seeded to it by Apple, thereby first purportedly acquiring ownership in all of Apple's intangible assets outside the Americas. This description is a bit simplified, but in essence, that is the entirety of the story.

I refer to Apple's Irish subsidiaries that purportedly own and exploit some of the world's most valuable assets as "shell companies" because they are. Until 2012, the key Irish subsidiary (Apple Sales International) had no employees and no independent ability to act according to its own perceived interests. What little activity the shell companies performed ("negotiating" a cost sharing agreement with the parent company, where the shell companies act through the mouthpiece of senior Apple Inc. employees who were 'dual hatted' to the Irish companies as well, and "negotiating" contracts with third party manufacturers of Apple products, like Foxconn, when the record showed that those contracts again were in fact negotiated by Apple Inc. employees, and just mirror the contracts used by Apple Inc.) were not in any way performed by actors independent of Apple Inc. Nor have the subsidiaries done anything with their crown jewel intangible

<sup>6</sup> *Memorandum to the Members of the Permanent Subcommittee on Investigations Re: Offshore Profit Shifting and the U.S Tax Code – Part 2 (Apple Inc.)*, May 21, 2013, available at [http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code\\_-part-2](http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2).

assets that is separate from what Apple Inc. does. These truly are shell companies.

One issue that the Apple case study therefore presents is not where the "minds and management" of the Irish shell companies might be, but whether they have any minds at all? Do they really have the corporate mental capacity to enter into cost sharing agreements of such importance? If closely examined, would the cost sharing agreement hold up as a bona fide agreement entered into by two companies with their own resources, risk appetites and executives? Of course at some ultimate level this question is circular, in that subsidiaries ultimately are controlled by parent companies, but in other cases with which I am familiar, extensive and expensive efforts were made to give substance and at least the flavor of independence to the subsidiary.

In watching the PSI hearing, I understood Apple's Chief Financial Officer to argue that, because the original cost sharing agreement was executed at the very beginning of Apple Time (1980), it therefore cannot now be challenged as ineffective in producing the tax magic ascribed to it. I respectfully suggest that in this he confused the enduring authority of his cost sharing agreement with the tablets brought down from the mountain by Moses.

Also during the hearing, Apple's Chief Executive Officer, Tim Cook, several times made what I thought was an admission against tax interest, when he said that 95 percent of Apple's collective creative genius was located in a single zip code in Cupertino CA. To the same effect, the PSI report found that less than one percent of Apple's worldwide research and development was conducted by its Irish subsidiaries, and that in 2011, 95 percent of Apple's worldwide research and development was conducted in California.<sup>7</sup> As policymakers, it is appropriate for this Committee to ask whether cost sharing agreements as coarsely constructed as this one seems to be really are efficacious in shifting \$74 billion in income over the four year period 2009-12 from this Cupertino-centric creative genius to a stateless company.

The Apple hearing generated a great deal of interest around the world. In many cases the lesson drawn from the hearing has taken the form of a general belief that the problem lies with multinational high-tech and pharmaceutical firms. But it simply is not

---

<sup>7</sup> PSI Report p. 28.

the case that stateless income generation is their unique bailiwick. That is the point of my new paper, *Through a Latte, Darkly: Starbucks' Stateless Income Planning*. Starbucks follows a classic bricks and mortar retail business model, with direct customer interactions in thousands of “high street” locations in high-tax countries around the world. Moreover, Starbucks is not a firm driven by hugely valuable identifiable intangibles that are separate from its business model, which it employs whenever it deals with those retail customers. Nonetheless, it appears that Starbucks enjoys a much lower effective tax rate on its non-U.S. income than would be predicted by looking at a weighted average of the tax rates in the countries in which it does business. To put matters bluntly, if Starbucks can organize itself as a successful stateless income generator, any multinational firm can.

### III. MYTHS AND MISUNDERSTANDINGS.

No one stands in defense of the current U.S. international tax system applicable to foreign direct investment. The Apple hearing, press articles and comments filed with this Committee in response to its Discussion Draft all represent a healthy and widely-shared interest in improving the current system, even if proposed solutions vary. But current debates often are marred by the injection into the arguments of some recurring myths and misunderstandings. In the remainder of this section I address some of these.

#### A. Myth I: We Should Cheer When Our Companies Avoid Foreign Taxes.

It is intuitively appealing to argue that when “our” multinationals employ stateless income technologies to minimize their foreign tax liabilities, the outcome is something we should cheer rather than criticize. After all, lower foreign taxes means more net income for “our” companies, and at least under current law, the highly theoretical prospect of higher U.S. tax revenues when the money is fully repatriated (because there will be smaller foreign tax credits to shelter the income).

The argument is interesting for its implicit assumption that companies really do have nationalities, and that we sometimes mentally equate “our” companies with, say, U.S. Olympic athletes in international competition. But the intuition that we should cheer

when our corporate athletes minimize their foreign tax liabilities is false, for a number of reasons.

The first reason was one driven home by the Apple PSI hearing: what appears facially to be “foreign” income in fact often more properly should be classified as U.S. income in the first place. In cases like this, apparent foreign tax avoidance is in fact an extension of U.S. tax avoidance, and all Americans are the poorer for the missing tax revenues.

The second reason we should care about foreign tax avoidance in the service of stateless income generation is that under current law streams of very low-taxed stateless income enable U.S. firms to engage in tax arbitrage that erodes the U.S. domestic corporate tax base. A U.S. firm has an incentive to capitalize its foreign subsidiaries with equity supplied by the parent company, to maximize the group’s stateless income, and to overleverage the U.S. parent company with third-party debt. By doing so firms can deduct their *global* interest expense against their *U.S.* domestic tax base.<sup>8</sup> The end result is that it is not simply foreign tax revenues that have disappeared, but also U.S. tax revenues on U.S. domestic income. In turn, the one rule that today purports to limit this overleveraging of the U.S. parent (by limiting foreign tax credits available to the U.S. parent) simply has no bite when foreign tax rates are driven to absurdly low levels.

The third reason we should care about stateless income, even when it appears that foreign countries, and not the United States, suffer the immediate tax revenue losses, is a bit subtler. We live today in a globalized world of deep and liquid capital markets, and few constraints on the cross-border movement of capital. Most economists begin their analyses of international tax policy from the premise that these conditions should mean that risk-adjusted *after-tax* returns are roughly the same everywhere in the world. If this were not true, investors would flock to the jurisdiction offering better returns for the same risk, until the influx of new capital drove down those returns.

In turn, this means that acceptable pretax returns must be higher in high-tax countries, so that their after-tax returns reach the global level. This is the real cost of

---

<sup>8</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 724-25, 757-58 (2011).

higher corporate taxes, for example: it is not that investors obtain lower after-tax returns, but rather that the pool of capital invested in such businesses is smaller, because some projects that would be feasible in a lower tax rate environment do not achieve the required global after-tax rate of return. Investors simply decline to make these investments, rather than suffer lower returns.

But stateless income planning undermines this neat story. If a U.S. firm can invest in a *high-tax* foreign country, with its high pretax returns, and then avoid paying the tax that is associated with returns in that country, the U.S. firm can generate supersized returns on its money – what I call “tax rents.”<sup>9</sup> For technical reasons, and the Apple Inc. story notwithstanding, it often is easier as a U.S. tax matter to shift profits from a high-tax foreign country to a low-tax one than it is to shift profits from the United States to a tax haven. What this means is that, when the United States turns a blind eye to stateless income planning, it inadvertently encourages U.S. firms to prefer foreign investment over U.S. investment – not investment directly in real businesses in low-tax jurisdictions (how many Irish pubs are there to acquire?), but rather real businesses in *high-tax* foreign jurisdictions, to serve as the raw feedstock for the ultimate end product: super low-taxed income, or in other words, tax rents.

The final reason to object to U.S. firms’ avid pursuit of stateless income is international comity. The United States is not just a capital exporter through foreign direct investment; it also is a host country to inbound direct investment from foreign multinational firms. It would be foolish to think that foreign multinationals do not play the stateless income game, with the United States as host country as the tax revenue loser. Similarly, it is a fool’s game to imagine that we can encourage “our” multinationals to game the tax systems of other countries, while successfully defending our borders from the same sort of strategies. This is trade war by another name, in which the United States effectively is subsidizing exports (in this case, of capital) and penalizing imports. Like all trade wars, it will end badly, in a beggar-thy-neighbor race to the bottom, where multinational firms collectively will be the winners, and taxing jurisdictions the losers.

---

<sup>9</sup> *Stateless Income*, 11 Florida Tax Rev. 699, 752-57 (2011). *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011) considers in detail how stateless income undermines the global equilibrium story that is the cornerstone of the policy case for a territorial tax system.

The lesson is that international recognition of the importance of the stateless income problem, and international consensus on solutions, are urgently required. This is why the OECD's report on base erosion and profit shifting was so important, and why the United States should vigorously push its peer countries in forums like the OECD and the G-8 to address the issue to recognize this for the global problem that it is. U.S. firms may be the world leaders in tax avoidance technologies, but every multinational has learned the tricks of this business. The work of the OECD and other international institutions should not be allowed to degenerate into an unproductive bashing of U.S. firms as the unique locus of the problem.

The OECD and other international forums also need to be mindful of the bad habits of policymakers worldwide to try to steal a march on other countries by arguing that others should be bound to more rigorous standards, while they continue to subsidize the international exploits of their national champions. Some countries (e.g. the United Kingdom) appear to me, as an outsider, to be of two minds on these issues: outraged that as host countries they are the victims of stateless income revenue deprecations, and at the same time committed to offering multinational firms a particularly convenient flag of residence from which to base their international tax avoidance activities. As I suggested earlier, this is just a sort of subsurface trade war by another name, and if not reversed leads to a beggar-thy-neighbor race to the bottom that impedes meaningful substantive progress.

B. Myth II: Firms' Money is Trapped Abroad, to Our Great Detriment.

As noted earlier, U.S. firms today have nearly \$2 trillion in offshore so-called "permanently reinvested earnings." Some of that \$2 trillion is invested in real businesses around the world, but a large fraction is held in cash (in the broadest sense, including bank deposits, short-term government securities, commercial paper and money market fund shares).<sup>10</sup> It is intuitively appealing to argue that all of this "trapped" cash is lying fallow, as if it were buried in a backyard in Zug, and that if only a repatriation holiday or

---

<sup>10</sup> One recent empirical study of this question is Jennifer Blouin, Linda Krull and Leslie Robinson, *Where in the World Are "Permanently Reinvested" Foreign Earnings?*, Sept. 2012, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2154662](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154662).

the like were bolted onto a tax reform package, the U.S. economy could be set to humming again.

There are a great many answers to this argument. One is that nothing is trapped at all: firms choose to leave their cash offshore because the costs to them of doing so are lower – much lower – than paying the U.S. tax that is part of the basic deal to which they signed up when they set their foreign structures in place. Another is the evidence from the 2004 tax repatriation – a rare natural experiment in alternative tax policies – that showed that the large cash repatriations that followed from that tax holiday in net terms funded shareholder dividends and stock buy-backs, not structural investments in the U.S. real economy.<sup>11</sup>

I want to make some different points. The extraordinary sums of cash held offshore by some U.S. firms – \$102 billion, in the case of Apple Inc. – is the telltale mark of successful stateless income strategies in operation. But that cash is not lying fallow. No Chief Financial Officer of a U.S. firm invests the firm’s surplus offshore cash (that is, cash not comprising working capital of foreign operations) in anything other than U.S. dollar investments, because nonfinancial firms are not in business to gamble on currency movements. In turn, every U.S. dollar fixed-income asset – a U.S. Treasury note, a bank account, an interest in a money market fund – held “offshore” is on the other side a dollar *liability* of some U.S. person.<sup>12</sup> This simply means that the money is at work in the U.S. economy. It might not have found its absolute optimal home (but see the next paragraph), but it is financing the U.S. debt, or bank loans to U.S. businesses, or the like.

Moreover, as a practical matter “offshore” funds are easily repatriated tax-free today. Apple Inc. just reminded us all how to do so. It recently borrowed \$17 billion in the capital markets to fund stock buy-backs and dividends – exactly how the 2004 experience suggests a repatriation holiday would be used today. Conceptually, one can imagine that interest earned on \$17 billion of its offshore cash hoard is currently repatriated to pay the interest costs on that borrowing, resulting in a wash for tax purposes (the interest income from the investment of the cash hoard is reported in the

<sup>11</sup> The history of the 2004 experiment and some of the research results from studying it are summarized in Edward Kleinbard and Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 Tax Notes 1191 (Sept. 22, 2008).

<sup>12</sup> Obviously there can be intermediary institutions along the way.

United States, but is offset by the third party interest expense). Indeed, given Apple's superior credit rating, it might conceptually make a spread on the transaction. In turn, Apple can roll over both its U.S. domestic indebtedness and its offshore dollar investments from time to time, thereby leaving it indefinitely in exactly the same net economic position as if it repatriated \$17 billion tax free today to fund stock repurchases. So in practical effect Apple did just repatriate \$17 billion tax-free to buy back stock – it is just that no one noticed.

Finally, when economists have happy dreams, they dream of efficient taxes. In ordinary situations all taxes incur “deadweight loss” – the cost to the economy of the transaction not undertaken because its returns after-tax are too low, even though its pretax returns would have cleared the hurdle. But the \$2 trillion in offshore permanently reinvested earnings occupies a different place, because taxing those earnings as part of the transition to an entirely new international tax system will have no effect on future behavior, since the earnings hoard relates entirely to the past. Thus demands for a very low transition tax rate on the repatriation of existing foreign earnings in the context of tax reform are precisely backwards as an economic matter. We should tax those earnings at whatever rate we need to help fund business tax reform, and economists nonetheless will sleep easy, because this for once will be an efficient tax.

### C. Myth III: Everything That U.S. Firms Do is “Legal.”

When reporters and commentators grapple with events like the Apple PSI hearing, they invariably begin by framing the issue as whether the firm in question did anything “illegal.” This framing makes anyone who has worked in this field wince. Not reporting cash income is illegal; fabricating the existence of inventory is illegal. No one to my knowledge has ever suggested that in their international tax planning U.S. multinational firms have done anything remotely illegal.

The problem is that observers then jump to the opposite label, and declare that everything that U.S. firms do by way of stateless income planning must therefore be “legal.” But this is a meaningless phrase in this context.

The fact is that every large U.S. firm is audited by the Internal Revenue Service

on a continuous basis. It is a bit too cynical to describe a firm's tax return as filed as just an opening bid, but firms do take positions that they expect to be challenged, they do establish accounting reserves for uncertain tax positions, and they often do settle tax disputes (most commonly at the administrative level) by paying additional tax. To a current or former practitioner, the question is not whether a particular firm's stateless income planning is "legal," but rather whether that planning can be characterized as inappropriately aggressive.

Very aggressive tax planning sometimes leads to the assertion by the Internal Revenue Service of penalties in addition to back tax, but realistically it must be remembered that no one knows a firm's business as well as does that firm itself, and further that firms typically have available to them far greater resources to defend their tax return positions than the Internal Revenue Service can devote to attacking them. So it is a depressing truth, particularly in fields as complex and fact-intensive as transfer pricing, that smart aggressive tax behavior is rewarded, at least in this world.

Large multinational firms thus achieve tax results that they would not obtain if the energies available to the two sides of the argument were more evenly matched. This in turn has important repercussions for tax system design. It means that a complex and highly fact-driven international corporate tax system invariably will lead to lower tax revenues than might be expected under more neutral terms of engagement, and it means that the corporate tax system in turn will have a negative spillover into personal tax collections, through a degradation of individuals' confidence in the fairness of the tax system.

#### IV. WHAT THEN SHOULD WE DO?

Again, I appreciate the seriousness of purpose behind this Committee's international tax reform Discussion Draft. But for reasons implicit in the earlier discussion, I think that its anti-abuse rules are too complex and too narrowly constructed, and that the key parameters of its thin capitalization rule must be robustly specified if it is to accomplish its purpose. (I also believe that a thin capitalization rule is needed in the wholly-domestic context as well.) The situation is quite desperate, as evidenced by the

ease with which a quintessentially retail firm like Starbucks has been able to generate stateless income, and we must ensure that the future U.S. international tax system is not only “competitive” but also appropriate in the outcomes it engenders.

I recognize that there is something of a consensus around the idea of a territorial system with anti-abuse constraints (or a “hybrid” system, as some prefer), but I respectfully submit that there is a far simpler alternative that is more resistant to tax gaming, that is “competitive,” and that is economically defensible. I have in mind genuine worldwide tax consolidation, combined with a corporate tax rate squarely in the middle of the pack of peer countries’ rates. Worldwide consolidation is not the same as “ending deferral,” because true worldwide tax consolidation means that foreign losses are currently deductible against domestic income. Symmetry in treatment between income and loss is an important economic desideratum.

I developed this proposal at length in *The Lessons of Stateless Income*,<sup>13</sup> but, very briefly, imagine a U.S. tax system that taxes U.S. resident companies on their worldwide net income at a 25 percent tax rate, that preserves a foreign tax credit, and that introduces a thin capitalization rule. If it helps, one can visualize my proposal as a territorial tax system with a 25 percent worldwide (not per country) minimum tax – the economic effects are the same.

Financial accounting norms of course require worldwide consolidation in presenting the results of a multinational firm’s activities. Tax laws might do well to follow the same fundamental approach to presenting the financial results of multinational enterprises, because only a consolidated perspective reflects the reality that these are tightly integrated global enterprises with internal synergies that cannot be assigned to particular jurisdictions.

The resulting system is simple and, more important, highly resistant to tax gaming, because there are no positive returns to base erosion or profit shifting. What is more, my proposed system is “competitive,” once we reclaim the word “competitive” to mean competitive with the tax environment that foreign domestic firms actually face in the country in which they operate, rather than a system that, like current law, or like

---

<sup>13</sup> *The Lessons of Stateless Income*, 65 Tax Law Rev. 99, 152-68 (2011)

unprotected territoriality, heavily subsidizes foreign investment, at the expense of our own domestic economy.

The system I propose is competitive by virtue of the worldwide tax rate that we choose comporting closely with the consensus rates adopted by peer countries. It is true that other multinationals might face lower effective rates if they are allowed to reap the rewards of rampant unprotected territoriality, but that is why the United States needs to assert leadership in urging all the major economies of the world to recognize that they have a shared interest in abandoning their under the table tax trade wars. By moving past these beggar-thy-neighbor policies, jurisdictions can eliminate the revenue costs and economic dislocations of stateless income.

Finally, there are some countries that have materially lower corporate tax rates than 25 percent. But these jurisdictions have relatively small real economies. The Republic of Ireland has a population of 4.6 million, and Singapore just over 5 million. Added together the populations of these two low-tax countries are smaller than the population of Los Angeles County. And of course the tax rate averaging implicit in the foreign tax credit mechanism can alleviate a great deal of pain even in respect of real investments in low-tax locales.

In my academic work I tried to respond to all the standard criticisms of my preferred approach, but I want to highlight just two here. First, it usually is observed that everybody else has moved to a territorial tax system – but so what? European countries have little choice in what they call their systems, by virtue of the constraints imposed on them by European Court of Justice. And as I observed above, once one concedes that there are no “pure” territorial tax systems, but rather only hybrids, then my proposal can be recast as just another hybrid – in this case, a territorial tax with a 25 percent global minimum tax on foreign income. What matters are outcomes, not labels.

Second, it sometimes is asserted that my suggested system would encourage start-ups to incorporate outside the United States, to avoid the consequences of U.S. residence. One answer to that is that the definition of corporate residence needs to be updated to reflect “mind and management” principles.<sup>14</sup> As the Apple PSI hearing implied, this

---

<sup>14</sup> Mr. Doggett has introduced legislation that, among other matters, would do just this.

should be done regardless of the larger tax reform debate; were it the law, Apple's Irish subsidiaries would have been viewed, in accordance with their economic substance, as U.S. businesses. But another, even more remarkable point follows from recent empirical research by Professor Susan Morse at the University of Texas Law School. There are important tax incentives *today* to organizing a new enterprise for which international operations are a rational hope as an offshore entity, yet Professor Morse and her colleague found that new businesses overwhelmingly were structured as U.S firms, even when the new firm has "global ambitions."<sup>15</sup>

I therefore believe that a true worldwide tax consolidation system combined with a tax rate approximating 25 percent should be the base case for this Committee's decision making. If other tax systems can be designed that are more economically efficient, net of the administrative issues that I believe to loom large in the entire area of international taxation, or that have other advantages, that is fine, but as an overall compromise among competing goals I doubt that you will find a better solution.

If the Committee continues with an approach closer to that of the Discussion Draft, then I think it desirable to embrace a per-country minimum tax, along the general lines suggested by Grubert and Altshuler in the paper I cited earlier. A minimum tax is much easier to specify and to administer than is a tax on intangible income, for example. As a practical matter, however, this Committee should appreciate that the floor you pick (the minimum tax) will become a foreign tax ceiling as well. Every U.S.-based multinational firm will continue to employ the same stateless income strategies that it does today, except that it will stop when it has managed its foreign effective tax rates down to where the minimum tax would bite.

Finally, without regard to the fate of tax reform legislation, I urge the Committee to work with other Committees of the House to put onto a fast track legislation requiring every U.S. firm to publish a worldwide disclosure matrix of its actual tax burdens by

---

<sup>15</sup> Susan Morse, *Startup Ltd.*, Fla. Tax Rev., forthcoming (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2275072](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2275072)) ; Eric Allen and Susan Morse, *Tax Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet*, Nat'l Tax J., forthcoming (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1950760](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760)).

jurisdiction.<sup>16</sup> Tax transparency rules are not a substitute for substantive international tax reform, but they would enable tax authorities to identify possible patterns of inappropriate income shifting, thereby making better use of limited audit resources. A transparency principle further would awaken the public to the massive amounts of international tax avoidance today known only to specialists.

To anticipate the argument that a worldwide tax disclosure matrix would reveal proprietary information about a firm's real business operations, the matrix could contemplate some aggregation of data. For example, it might divide firms' tax burdens into buckets by effective tax rates, in 5 percentage point increments, and then lump all income taxed at effective rates above 25 percent into one bucket. Income attributable to a particular country that was less than two percent of the firm's worldwide income could be lumped into a category of "other." Income would be presented by reference to the accounting principles followed in preparing the firm's consolidated worldwide financial statements.

The idea of worldwide disclosure of per-jurisdiction income and actual tax paid has very recently gained momentum around the world. The OECD's current *Base Erosion and Profit Shifting* report, for example, stresses that it is now time to emphasize transparency with regard to the effective tax rates of multinational enterprises.<sup>17</sup> And in early May 2013 the European Union took important first steps in this direction, when it announced that it would press forward with legislation this summer that would require:

[D]isclosure of information such as the nature of the company's activities and its geographical location, turn-over, number of employees on a full-time equivalent basis, profit or loss before tax, tax on profit or loss, and public subsidies received on a country-by-country basis on the trading of a group as a whole – in order to monitor respect for proper transfer pricing rules.<sup>18</sup>

---

<sup>16</sup> I develop this suggestion in a bit more detail in *Through a Latte, Darkly: Starbucks' Stateless Income Planning*, (draft of May 28, 2013 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2264384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264384)), forthcoming, Tax Notes.

<sup>17</sup> OECD, *Base Erosion and Profit Shifting*, at 6 and 47 (OECD 2013).

<sup>18</sup> European Union Committee on Economic and Monetary Affairs, Report on Fight Against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI)), Par. 48 (May 2, 2013).

The United States should join these initiatives, and do so on an accelerated timetable.