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Inversions, Related Party Expenditures, and Source Taxation: Changing the Paradigm for the Taxation of Foreign and Foreign-Owned Businesses

*Julie A. Roin**

The disconnect between the rules for the taxation of domestic businesses and foreign and foreign-owned businesses operating in the United States both diminishes the federal treasury and distorts taxpayer and business behavior. Yet bringing the sets of rules into closer coordination is no simple task. This Article examines many of the solutions proffered in the academic literature and details the difficulties and trade-offs that each entails.

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INTRODUCTION

Much to the dismay of President Obama,¹ some members of Congress,² and Treasury,³ 2015 was another banner year for inversion transactions.⁴ Indeed, sixty-six percent of the outbound deals involving U.S. companies proposed in 2015 were inversions.⁵ Even Treasury's issuance of an inversion-unfriendly notice in November of 2015 failed to slow the pace of these transactions; shortly thereafter, Pfizer, a U.S. drug company, and Allergan, an Irish drug company, announced plans for a record-breaking, \$160 billion merger.⁶ There

1. President Obama lambasted inversion transactions as “unpatriotic” in a speech given in July 2014. See Dunstan Prial, *Obama Takes Aim at ‘Unpatriotic’ Corporate Inversions*, FOX BUS.: POL. (July 24, 2014), <http://www.foxbusiness.com/economy-policy/2014/07/24/obama-takes-aim-at-unpatriotic-corporate-inversions/>.

2. Several anti-inversion bills have been introduced over the last several years, but “[t]he congressional Republican majority has been unwilling to clamp down further without an agreement for broader tax reform.” Richard Summerfield, *The continuing appeal of inversions*, FINANCIER WORLDWIDE (Nov. 2015), <http://www.financierworldwide.com/the-continuing-appeal-of-inversions/#.VpF21fkrJpg>.

3. The term “Treasury,” as used in this Article, refers to the United States Department of the Treasury. Treasury issued two notices, Notice 2014-52 on September 22, 2014, and Notice 2015-79 on November 19, 2015, aimed at making inversion transactions less attractive by increasing their costs and decreasing their benefits. See Timothy R. Larson, *2016: Another Year of the Inversion: Playing Whack-a-Mole with Corporate Taxes until Congress Acts*, METRO. CORP. COUNS., Jan. 2016, at 8 (describing contents of Treasury notices).

4. An inversion transaction is a transaction in which a U.S. corporation redomiciles for tax purposes in a foreign country, typically a lower-tax or even-tax haven country. Such transactions typically involve mergers with larger foreign corporations. See Larson, *supra* note 3, at 8 (“Simply put, inversion is the process whereby a U.S. multinational group essentially redomiciles outside the United States.”); Summerfield, *supra* note 2 (“A tax inversion allows firms—typically US companies—to agree and complete an M&A transaction which sees the firm acquire an overseas target in a jurisdiction with a lower corporate tax rate. Once the deal has completed, the acquiring company merges with the target and then redomiciles in the target company’s homeland, or a third country with a lower level of corporate tax.”). Inversions provide a mechanism for redomiciling existing U.S. corporations; those setting up new businesses in corporate form may avoid the anti-inversion rules by setting up their business initially as a foreign corporation.

5. See Summerfield, *supra* note 2 (“In 2015 to date, 66 percent of proposed US outbound deals were inversions.”).

6. See Larson, *supra* note 3 (“Will inversions continue? Yes, just ask Pfizer . . .”); Jim Puzanghera & Samantha Masunaga, *Pfizer and Allergan’s \$160-billion pharmaceutical merger puts new twist on tax-avoiding inversions*, L.A. TIMES, (Nov. 23, 2015, 9:35 AM), <http://www.latimes.com/business/la-fi-pfizer-allergan-merger-20151123-story.html> (“New Treasury Department regulations, including ones issued just last week, have made the tactic somewhat more difficult. But the Pfizer-Allergan deal is structured as a foreign acquisition to avoid those rules.”); Press Release, Kirkland & Ellis, U.S. Treasury and Internal Revenue Service Issue New Anti-Inversion Guidance (Nov. 2015), <http://www.kirkland.com/siteFiles/>

was no reason to think that 2016 would be any different⁷ until Treasury released two sets of proposed and temporary regulations on April 4, 2016.⁸ One set of regulations further broadened the definition of “inversion transactions” subject to the unfriendly strictures of section 7874 of the Internal Revenue Code,⁹ while the other greatly restricted the circumstances under which related party debt would be recognized as “debt” for tax purposes.¹⁰ Although the tax bar and their corporate clients were stunned by the sweep of these regulations,¹¹ the future of inversion transactions remains uncertain.

Publications/112315.pdf (“Indeed, on November 23, 2015, Pfizer Inc. announced its combination with Allergan PLC in the largest inversion transaction ever announced. On November 19, 2015, the Treasury and the IRS launched their latest attack on inversion transactions by issuing Notice 2015-79 . . .”).

7. TYCO and Johnson Controls announced their intention to merge, with the survivor a foreign corporation, on January 25, 2016. See Andrew Ross Sorkin, *A Tidal Wave of Corporate Migrants Seeking (Tax) Shelter*, N.Y. TIMES, Jan. 26, 2016, at B1 (“By my count, based on a series of conversations with investment bankers, there are probably at least another dozen deals of meaningful size being negotiated in the pipeline.”).

8. See Press Release, U.S. Dep’t of the Treas., Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations (Apr. 4, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx> [hereinafter Treasury Fact Sheet I] (describing proposed and temporary regulations). A final version of the earnings stripping portion of the regulations was issued on October 13, 2016. Press Release, U.S. Dep’t of the Treas., Fact Sheet: Treasury Issues Final Earnings Stripping Regulations (Oct. 13, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0579.aspx> [hereinafter Treasury Fact Sheet II].

9. Prop. Treas. Reg. §§ 1.304-7, 1.367(a)-3, 1.367(b)-4, 1.956-2, 1.7701(d)-4, 1.7874-1, 1.7874-2, 1.7874-3, 1.7874-4, 1.7874-6, 1.7874-7, 1.7874-8, 1.7874-9, 1.7874-10, 1.7874-11, 1.7874-12 Fed. Reg. 20588, 20589–91 (Apr. 8, 2016) (as amended by T.D. 9761, 2016-20 I.R.B. 743), <https://www.federalregister.gov/articles/2016/04/08/2016-07299/inversions-and-related-transactions>.

10. Prop. Treas. Reg. §§ 1.385-1, 1.385-2, 1.385-3, 1.385-4 Fed. Reg. 20912, 20930–43 (Apr. 8, 2016), <https://www.federalregister.gov/documents/2016/04/08/2016-07425/treatment-of-certain-interests-in-corporations-as-stock-or-indebtedness> [hereinafter Notice of Proposed Rulemaking Under Section 385]. The final and temporary version of these regulations were promulgated on October 13, 2016. See Treas. Reg. §§ 1.385-1, 1.385-2, 1.385-3, 1.385-4, 81 Fed. Reg. 72,858, 72,950–84 (Oct. 21, 2016) (to be codified at 26 C.F.R. pt. 1), <https://www.federalregister.gov/documents/2016/10/21/2016-25105/treatment-of-certain-interests-in-corporations-as-stock-or-indebtedness> [hereinafter Final Section 385 Regulations].

11. See Michael J. de la Merced & Leslie Picker, *Pfizer and Allergan Said to End Merger as Tax Rules Tighten*, N.Y. TIMES, Apr. 6, 2016, at B1 (“We are surprised, to say the least, that Treasury took the drastic step of proposing such a punitive rule, apparently without the authority to do so,” Robert Willens, an independent tax consultant, wrote in a note to clients on Tuesday.”); *id.* (“These rules are going to apply much more broadly than people had expected,” said Stephen L. Gordon, the head of the tax department at the law firm Cravath, Swaine & Moore.”); Victor Fleischer, *Treasury Department Takes Off the Gloves on Corporate Inversions*,

Pfizer and Allergan called off their pending deal,¹² but many experts believed not only that the other inversion transactions already in the pipeline would be consummated, but that additional inversion deals would take place.¹³

After all, most of the financial benefits of inversion transactions remain available despite the latest (proposed and actual) regulatory changes. With the right inversion partner, a (formerly) U.S. company can substitute a territorial system of taxation of the sort adopted by most developed countries for the U.S. system of world-wide taxation.¹⁴ Given that U.S. corporate tax rates may be among the highest in the world,¹⁵ that substitution of taxing regimes could

N.Y. TIMES, Apr. 6, 2016, at B4 (“The proposed regulations are more aggressive and expansive than the Treasury’s earlier volleys, venturing into at least two areas where its legal authority seems likely to be challenged.”); Press Release, Morrison Forester, *Proposed IRS Debt-Equity Regulations: Aimed at Post-Inversion “Earnings Stripping,” But May Also Impact Ordinary Related-Party Debt* (April 12, 2016), <https://media2.mofo.com/documents/160412irsdebtequityregulations.pdf> (“The Proposed Regulations were unexpected and have been immediately controversial.”).

12. See de la Merced & Picker, *supra* note 11 (“Pfizer plans to abandon its \$152 billion merger with Allergan . . . just days after the Obama administration introduced new tax rules, a person briefed on the matter said late Tuesday.”).

13. See Andrew Velarde, *Johnson Controls Goes ‘Full Steam Ahead’ with Tyco Inversion*, 151 TAX NOTES 413 (2016) (Johnson Controls CEO Molinaroli stated “that the new regs would affect the company’s tax planning, but that global tax benefits were not limited exclusively to the United States and would still be achievable” as a result of the inversion transaction); de la Merced & Picker, *supra* note 11 (“There is perhaps less of a probability that Treasury’s new rules will derail any of the other six inversion deals that are still pending, according to analysts . . .”); Tom Murphy, *Experts expect corporate tax inversions to survive new rules*, PHYS.ORG (Apr. 6, 2016), <http://phys.org/news/2016-04-experts-corporate-tax-inversions-survive.html> (“[S]ome narrowly tailored deals that have the right balance of U.S. and foreign ownership should survive . . . [such as] the pending \$14.6 billion combination of Milwaukee-based Johnson Controls Inc. and Ireland’s Tyco International . . .”).

14. See Sorkin, *supra* note 7 (“Ultimately, the only way inversions will stop is when the corporate tax code changes so it becomes more attractive for American companies to be American companies.”); Martin Sullivan, *Don’t Count On Tax Reform to Stop Inversions*, FORBES (Aug. 5, 2014, 11:20 AM), <http://www.forbes.com/sites/taxanalysts/2014/08/05/dont-count-on-tax-reform-to-stop-inversions/#656942af2df3> (“In the press and on Capitol Hill, the conventional wisdom is that inversions occur because Congress has failed to enact tax reform. The United States has a high corporate tax rate and a worldwide system.”).

15. Statutory U.S. corporate tax rates are relatively high. See Summerfield, *supra* note 2 (“In the US, the federal and state level of corporate tax combined reached 39 percent, well above the OECD average of 25 percent.”). There is considerable dispute, however, as to whether its effective tax rates—let alone the rates payable on foreign sourced income—are higher or lower than average. See also Edward D. Kleinbard, *‘Competitiveness’ Has Nothing to Do with It*, 144 TAX NOTES 1055, 1057 (2014) (“As a result, whether one measures effective marginal or overall

provide a significant financial advantage. Indeed, many regard inversions as no more than the home-made territoriality necessary to ensure that U.S. owned corporations can operate on a “level playing field” with foreign-owned corporations operating under territorial regimes.¹⁶

But the advantages of inversions—and foreign ownership of U.S. companies in general—go beyond reducing tax rates on foreign sourced income to the (say) European average because the United States (like some other countries) currently fails to exercise meaningful territorial taxing jurisdiction.¹⁷ Rather than reducing multijurisdictional tax claims to a single, source-based tax, inversion transactions often can be used to generate “stateless income” which is not taxed anywhere.¹⁸ To make inversions unattractive, then, the United States must first deal with the more general problem of the undertaxation of foreign-owned U.S. corporations, whether or not “inverted.” It must actually tax the U.S. source income earned by all foreign-owned multinationals.¹⁹

tax rates, sophisticated U.S. multinational firms are burdened by tax rates that are the envy of their international peers.”).

16. See Editorial, *How to stop the inversion perversion*, ECONOMIST (July 26, 2014), <http://www.economist.com/news/leaders/21608751-restricting-companies-moving-abroad-no-substitute-corporate-tax-reform-how-stop> (“America’s corporate tax has two horrible flaws. The first is the tax rate . . . The second flaw is that America levies tax on a company’s income no matter where in the world it is earned.”); Scott A. Hodge, *The Simple Solution to the Pfizer Deal: Cut the Rate and Move to a Territorial Tax System*, TAX FOUND. (Nov. 24, 2015), <http://taxfoundation.org/blog/simple-solution-pfizer-deal-cut-rate-and-move-territorial-tax-system>.

17. See Sullivan, *supra* note 14.

18. Edward Kleinbard has done an excellent job of explaining the phenomenon of—and the mechanics of creating— “stateless income,” and there is no need to repeat it in this article. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011).

19. I am among those who have argued for the necessity of increasing taxes on foreigners earning income in the United States, though not specifically for the purpose of discouraging inversion transactions. See Julie A. Roin, *Can Income from Capital Be Taxed? An International Perspective*, in TAXING CAPITAL INCOME 211, 235 (Henry J. Aaron et al. eds., 2007) (“To combat such tax evasion, the United States will have to increase its taxation of foreigners’ U.S.-sourced capital income”); Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 170 (2008) (“It is hard to see how the corporate, and perhaps even the individual, income tax can survive as an effective revenue-raising device unless countries devise an effective method of taxing the domestic income of foreign corporations.”). Those who argue for increased taxation at source particularly to stem inversion transactions include: Kleinbard, *supra* note 15, at 1068; Steven E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473 (2014); Willard B. Taylor, Letter to the Editor, *A Comment on Eric Solomon’s Article on Corporate Inversions*, 137 TAX NOTES 105 (2012); Bret Wells, *Cant and the Inconvenient Truth About Corporate*

This Article looks at the steps the United States could take to increase its taxation of U.S. source income, and whether those steps would in fact dissipate the incentive for U.S. multinational enterprises, or “MNEs,” to engage in inversion transactions—or for foreign corporations to acquire U.S. MNEs. Its conclusions are at least somewhat dispiriting for fans of the corporate (and perhaps) income tax. Not only would devising rules that effectively tax income at source be technically demanding and in some cases impossible, but doing so would at best only partially eliminate the incentives for inversion transactions. In addition, the changes may drive some businesses operations currently carried out in the United States to other, lower tax countries. These risks would be reduced, of course, if other developed countries made similar changes in their tax laws and treaty practices. But there is no guarantee that this will occur. For all the apparent recent advances in the OECD’s BEPS project,²⁰ when it comes to actual legal change, countries seem to be moving in the opposite direction with, for example, the adoption of patent box regimes.²¹

This does not mean that the United States should not take steps to increase taxation at source. Residence-based taxation is becoming increasingly untenable as globalized securities markets eliminate the

Inversions, 136 TAX NOTES 429 (2012); Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy*, 143 TAX NOTES 1429 (2014).

20. The Organization for Economic Cooperation and Development, or “OECD”, and the G20 launched the Base Erosion and Profit Shifting (BEPS) project in 2013 in an effort to develop a coordinated response to tax avoidance activities and opportunities. See *About BEPS and the inclusive framework*, OECD.ORG, <http://www.oecd.org/ctp/beps-about.htm> (last visited Oct. 22, 2016). A “BEPS package” of 15 “actions” was presented to the G20 Leaders at their November 2015 summit in hopes that they would be able to convince their governments to enact legislation to implement them. See *id.*

21. Patent box regimes provide special tax benefits for profits derived from intellectual property rights. Typically, they provide for the taxation of such income at preferential rates provided that some of the associated research and development activities occur in-country. See Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 363–69 (2013) (describing tax regimes). The EC recently determined that these regimes would not be considered to constitute either “state aid” or “harmful tax competition” as long as they require “substantial” economic activity in the jurisdiction. See DLA PIPER, *EU PATENT BOX REGIMES—THE WAY AHEAD* (Feb. 15, 2015), http://information.dla.com/information/published/EU_Patent_Box_Regimes.pdf (countries in Europe with such regimes include the UK, The Netherlands, Belgium, Luxembourg, Spain, France, and Hungary). For a criticism of such regimes, see Graetz & Doud, *supra*, at 375 (“Given the mobility of IP income, one cannot help but conclude that firms are more likely to shift income eligible for patent box treatment to low-tax jurisdictions than to increase local R&D in response to patent box tax breaks.”).

barriers that used to prevent taxpayers from becoming residents of countries levying little or no income tax. If countries abandon source taxation as well, the end game is clear: there will be no corporate income tax.²² By contrast, if countries such as the United States tax more of the income that is generated within their borders—that is, they actually exercise territorial jurisdiction—corporate tax revenue may increase and the incentive to engage in inversion transactions and other tax motivated ownership changes will decrease.²³ Unfortunately, the deleterious incentives will not disappear. Ultimately, the benefits (and costs) of such tax changes will be determined by the strength of the “frictions” or nontax impediments to tax avoidance behavior. And it is very hard to measure that in advance.

This Article consists of four parts. Part I explains the dangers of relying on residence for the taxation of business entities. Part II explains the current undertaxation of foreign investors. Part III explains the steps that can be taken to correct this undertaxation and their likely effects. Part IV concludes.

I. THE DEATH OF RESIDENCE COUNTRY TAXATION

There are two²⁴ distinct bases for asserting jurisdiction to tax income derived from transnational transactions: source and

22. Whether one believes that to be a serious problem depends on one’s belief in the likely effectiveness and political acceptability of an integrated tax system which attempts to collect the tax on corporate income at the shareholder level. Some have proposed taxing regimes that would bring the treatment of income derived by corporate entities closer to that accorded to income derived by partnerships and other flow-through entities. See, e.g., Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 70–74 (1993) (describing the operation of a pass-through system for the taxation of income derived by corporate entities in the international context); Bret Wells, *International Tax Reform by Means of Corporate Integration*, FLA. TAX REV. (forthcoming Fall 2016) (manuscript at 5 n.15) (on file with author) (listing integration proposals and studies).

23. The importance of “capital ownership neutrality” and “national ownership neutrality” to economic efficiency was laid out in a seminal article by Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT’L TAX J. 487 (2003). Their particular tax policy recommendations remain open to dispute. See Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53, 55–56 (2006) (“This paper claims that the analysis of Desai and Hines, though valuable as a first step in modeling tax distortions to ownership, must be expanded to take account of many real world complications before drawing any concrete conclusions regarding policy prescriptions.”).

24. The United States insists on a third basis for taxing jurisdiction with respect to natural persons—citizenship. See I.R.C. § 7701(a)(30)(A) (2012) (including “a citizen” within the definition of a U.S. person for tax purposes). However, that view is not shared by the overwhelming majority of other countries. See Michael S. Kirsch, *Taxing Citizens in a Global*

residence.²⁵ For much of the history of the income tax, the question was how to split the tax revenue derived from such transactions between the two claimants, as both source and residence countries plausibly maintained that they provided some of the services and conditions necessary for such income to have been earned.²⁶ However, countries soon learned that they could profit from providing residency status to corporate and other legal entities in the absence of substantial business or ownership ties. Such countries encourage firms to become “residents” by promising to levy few or no taxes²⁷ and by imposing minimal fees, a strategy made economically plausible by the fact that the governmental services rendered to these new “residents” may be equally minimal or absent.²⁸ In the absence of nontax reasons to

Economy, 82 N.Y.U. L. REV. 443, 445 (2007) (“On this issue, the United States has long been an outlier in the international community.”).

25. See MICHAEL J. MCINTYRE, *THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 1–3 to 1–4* (1992) (discussing “competing claims for tax revenue based on residence and source”); AM. LAW INST., *FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 6* (1987) (“Jurisdiction to tax the income of a person or an entity may be based on . . . domicile or residence Jurisdiction to tax may also be based on the source of the income subject to tax”).

26. See, e.g., Ilan Benshalom, *The Quest to Tax Interest Income in a Global Economy: Stages in the Development of International Income Taxation*, 27 VA. TAX REV. 631, 644 (2008) (“[T]he bone of contention between sovereigns during the Revenue Phase [from the end of WWI until the end of WWII] related to the allocation of the revenue base.”); Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. J. TAX L. 1, 6 (2013) [hereinafter Wells & Lowell, *Income Tax Treaty Policy*] (“The primacy of residence in treaty policy has persisted through the global economic evolution of the post-World War II and Cold War eras As the economies of the BRICS and other Source Countries matured in the late twentieth century, resistance to the subordination of source to residence as the means of allocating residual income has been reflected in the evolution of their domestic tax policies.”). For a complete exegesis of the development of tax treaty policy and the apparent acceptance, at least since 1951, of its potential to create “stateless income”, see Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin*, 65 TAX L. REV. 535 (2012) [hereinafter Wells & Lowell, *Tax Base Erosion*].

27. Many view the adoption of territorial taxation as an attempt to lure MNE residents. See Wells & Lowell, *Income Tax Treaty Policy*, *supra* note 26, at 35 (“[T]he trend toward territorial taxation . . . which results from countries competing with one another for MNE headquarters locations, amounts to an international race to the tax bottom.”).

28. See Adam Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 955–56 (2010) (explaining how tax havens derive financial benefits from “selling income tax benefits to foreign investors”). One recent commentator suggests that these financial benefits may not be as beneficial as their proponents imagine. See Kleinbard, *supra* note 15, at 1067 (“The reason Ireland is not picking up significant tax revenues from these deals,[is] because in fact nothing changes But the larger revenues of the expanded Irish parent company are treated as Irish for gross national product purposes, which has the consequence of increasing Ireland’s share of EU budget costs.”). Ireland may have been an exceptional situation and one,

maintain their residency in higher tax jurisdictions, enterprises are open to such invitations. Sometimes with and sometimes without the explicit connivance of source countries,²⁹ such “tax haven” countries enable increasing numbers of taxpayers to avoid paying tax on that portion of their income allocated, by statutory law or by treaty, to residence countries.³⁰ Hence the rise in inversion transactions and the attraction of “greenfield” foreign incorporations, even for enterprises with (or planning on) substantial U.S. operations. And unfortunately, as described below, it will be very difficult, if not impossible, to put this genie back into its bottle. Corporations may too easily become residents of low-tax countries, while too few nontax benefits accrue from U.S. residence.

A. The Definition of Corporate Residency

Corporations are legal fictions; their existence and characteristics are determined by the laws under which they are created. Most countries, and certainly all even semi-developed countries, have laws providing for the formation and regulation of corporate (or corporate-like) legal entities. They also have laws establishing how legal entities can establish residence for tax purposes. In the United States, the rule is that residence depends on the country of incorporation. If a corporation is incorporated in the United States, or in a state of the United States, the corporation is considered a U.S. resident for tax purposes;³¹ all other corporations are considered “foreign

moreover, that has been retroactively reversed by an EU decision to treat these favorable tax rules as prohibited “state aid.” See European Commission Press Release 16/2926, Statement by Commissioner Vestager on state aid decision that Ireland’s tax benefits for Apple were illegal (Aug. 30, 2016), http://europa.eu/rapid/press-release_STATEMENT-16-2926_en.htm. The recent growth in patent box regimes, see Graetz & Doud, *supra* note 21, at 363–69, suggests that the list of countries willing to act as tax havens may be expanding rather than contracting.

29. As is detailed in the next section, the success of many (but not all) tax reduction schemes relies on the existence of a tax treaty between the country of residence and the country of source. High-tax countries could revoke or renegotiate their treaties with low-tax countries to avoid such outcomes; instead, many continue their treaty arrangements but enact complex side-regimes, such as the United States’ subpart F regime, contained at I.R.C. §§ 951–965, which only partially undercut some of their deleterious effects. Or, as in the case of patent boxes, they simply accede to such behavior. See *infra* text accompanying notes 186–87 (describing the 2016 U.S. Model Treaty’s treatment of patent boxes).

30. This is the phenomenon so aptly described by Ed Kleinbard as the creation of “stateless income.” See Kleinbard, *supra* note 18, at 700.

31. I.R.C. § 7701(a)(4) (2012).

corporations.”³² Once a corporation has established itself as a U.S. resident, the “anti-inversion” rules³³ make it somewhat difficult for corporations to switch from U.S. residency to foreign residency,³⁴ but there are no formal impediments to the initial incorporation of a business venture owned by U.S. citizens and carried out in the United States as a foreign corporation. And as is explained next, there is very little that compels those thinking about undertaking new business ventures to do so through a U.S., as opposed to a foreign, corporation. Indeed, if the United States increases its restrictions on inversion transactions, there is every reason to think that one reaction will be an increase in the number of businesses that begin as foreign enterprises.³⁵ Once that happens, residence country tax will become little more than a “transition tax” on “trapped” capital.³⁶

B. The Non-Tax Market for Corporate Residency

Although it has always been easy, as a formal matter, for businesses—even those wholly owned by U.S. persons and those operated exclusively in the United States—to incorporate abroad, most U.S. business enterprises never thought of doing so. There were

32. *Id.* § 7701(a)(5).

33. *Id.* §§ 4985, 7874.

34. Congress attempted to stop inversion transactions in 2004 by enacting I.R.C. § 7874. However, that provision has been, at best, only partially effective. *See* J. Clifton Fleming, Jr. et al., *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytic Framework*, 93 N.C. L. REV. 673, 678–79 (2015) (recognizing that “there has been considerable discussion regarding the appropriate response” to the provision’s flaws); Gary M. Friedman, *The Discreet Charm of the Inversion Rules*, 144 TAX NOTES 1147 (2014) (describing rules and their flaws); Kleinbard, *supra* note 15, at 1068 (describing measures necessary to make anti-inversion rules effective). It remains to be seen whether the more recently proposed anti-inversion regulations, *see supra* note 8, are more successful.

35. *See* Mihir A. Desai & Dhammika Dharmapala, *Do Strong Fences Make Strong Neighbors?*, 63 NAT’L TAX J. 723, 724 (2010) (“This paper takes a first step towards providing . . . evidence” of the effect of incentives for foreign incorporation.); Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 378 (2011) (“I have heard U.S. tax lawyers joke that recommending (or even not objecting to) U.S. incorporation of an intended global business verges on being malpractice per se.”). Although one study indicates that most of the tax haven entities conducting recent U.S. IPOs were Chinese-headquartered, not U.S. headquartered firms, *see* Eric J. Allen & Susan C. Morse, *Tax-Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet*, 66 NAT’L TAX J. 395, 396 (2013) (firms headquartered in China and Hong Kong largely responsible for the increase in tax haven firms conducting U.S. IPOs), the study period ended in 2010, before the latest rounds of Treasury’s anti-inversion notices.

36. Shaviro, *supra* note 35, at 379–80.

compelling non-tax business reasons for using a U.S. corporate or other legal vehicle—chiefly unfettered access to the U.S. securities markets and the country’s distinguished history of corporate governance. Unfortunately, those non-tax business reasons have largely disappeared, making the adoption of foreign status for tax purposes more attractive.

1. The globalization of the securities markets

Foreign firms have long had the ability to seek U.S. investors through the U.S. securities markets. J.P. Morgan devised the “American Depositary Receipt,” or ADR, to allow U.S. investors effectively to purchase shares of foreign companies through U.S. exchanges in 1927.³⁷ Foreign firms were also allowed to cross-list their shares on U.S. exchanges if they met the same disclosure requirements as U.S. firms. However, relatively few firms bothered to do so because the significant costs of complying with the U.S. securities laws³⁸ outweighed the probable benefits, given U.S. investors’ reluctance to invest in foreign equities, wherever those equities were listed.³⁹

37. *American Depositary Receipt*, WIKIPEDIA, https://en.wikipedia.org/wiki/American_depository_receipt (last visited Oct. 20, 2016). An ADR is a negotiable instrument issued by a U.S. bank and represents an ownership interest in foreign securities (usually equities) deposited in a foreign financial institution. See Mark A. Saunders, *American Depositary Receipts: An Introduction to U.S. Capital Markets for Foreign Companies*, 17 *FORDHAM INT’L L. J.* 48, 49 (1993) (describing ADRs). ADRs come in two varieties, “sponsored” and “unsponsored.” Unsponsored ADRs are created by brokers. Sponsored ADRs are created jointly by a foreign private issuer and a depository. That issuer signs the registration forms required by the SEC before the ADRs can be traded and enters into a contract with the depository setting forth not only the rights and responsibilities of the respective parties, but also the depository’s fee structure for its interaction with investors. Sponsorship provides the foreign issuer with more control over the depository; it also often reduces the costs of the arrangement borne by U.S. investors. For example, under many sponsorship agreements, the depository may not deduct a fee for paying out dividends. See *id.* at 55–57 (describing the difference between sponsored and unsponsored ADRs). The American and New York Stock Exchange do not list unsponsored ADRs. *Id.* at 57. There are, in turn, several classes of sponsored ADRs, depending on the level of scrutiny they subject themselves to under U.S. securities laws. To be traded on anything other than the OTC market, an ADR must be a Sponsored Level II or III. See *American Depositary Receipt, supra*.

38. See Steven M. Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 *U. CIN. L. REV.* 619, 621–23 (2010) (describing securities law impediments to listing).

39. U.S. investors were not alone in being remarkably unwilling to invest in anything other than domestic firms. See Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 *AM. ECON. REV.* 222, 222 (1991) (“The domestic ownership shares of the world’s five largest stock markets are: United States, 92.2 percent; Japan, 95.7 percent; United Kingdom, 92 percent; Germany, 79 percent; and France, 89.4 percent.”).

Both the costs and benefits of cross-listing shifted in the 1990s. The SEC, largely at the behest of the NYSE, reduced its disclosure requirements for foreign issuers,⁴⁰ making it easier and cheaper for such firms to be listed there. At the same time, home bias began to decrease,⁴¹ a trend that has continued, making it easier for foreign firms to attract U.S. investors.⁴² Significant numbers of foreign firms began listing in the U.S. exchanges⁴³ and the amount U.S. investors invested in foreign firms through these exchanges grew.⁴⁴ In short, U.S. residency became much less important for those eager to access the rich capital markets in the United States made available through its exchanges.

Over the same period, the importance of those exchanges declined. Although most U.S. investors in foreign equities continue to favor firms cross-listed (or available in ADR form) on U.S.

At the end of 1989, foreign stocks comprised 6.2 percent of U.S. investors' equity investments. *Id.*

40. See Davidoff, *supra* note 38, at 623–25 (describing the development of a “new architecture” of “mutual recognition” attributable to “shifting market forces”). However, the costs of listing on a U.S. stock exchange remain significant. See Richard Dobbs & Marc H. Goedhart, *Why cross-listing shares doesn't create value*, MCKINSEY & CO. (Nov. 2008), http://www.mckinsey.com/insights/corporate-finance/why_cross-listing_shares_doesnt_create_value (describing costs).

41. See MATHIAS M. SIEMS, CONVERGENCE IN SHAREHOLDER LAW 312 (2008) (noting “the ‘home bias’ of investment is therefore declining”); Amir A. Amadi, *Equity Home Bias: A Disappearing Phenomenon?*, 2 (May 5, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=540662 (“[F]rom 1986 to 2001, international diversification has increased in almost every country.”).

42. See Rick Kahler, *U.S. Investors' Home Bias*, NASDAQ (July 23, 2015, 9:25 AM), <http://www.nasdaq.com/article/us-investors-home-bias-cm499769> (“[I]n 2014, a quarter of new cash put into American mutual funds went to overseas-oriented mutual funds. That’s up from 15% in 2004”); INT’L MONETARY FUND, *Long-Term Investors and Their Asset Allocation: Where Are They Now?*, in GLOBAL FINANCIAL STABILITY REPORT: GRAPPLING WITH CRISIS LEGACIES 55 (2011), <http://www.imf.org/external/pubs/ft/gfsr/2011/02/pdf/text.pdf> (“[T]he longer-term developments in global asset allocation show . . . slowly declining home bias”).

43. See Davidoff, *supra* note 38, at 625–26.

44. The market value of U.S. holdings of foreign securities more than doubled between December 2001 and December 2009. See DEP’T OF THE TREASURY, REPORT ON U.S. PORTFOLIO HOLDINGS OF FOREIGN SECURITIES AS OF DECEMBER 31, 2009 3 (2010), https://www.treasury.gov/press-center/press-releases/Documents/claimsreport_10_27_2010_withappendixtables.pdf (Table 1: 2317 billion to 5977 billion). Foreign investment also grew as a proportion of total equity wealth held by U.S. investors. See Matthew M. Wynter, *Why Has the U.S. Foreign Portfolio Share Increased?*, 2 (Aug. 2015), <http://ssrn.com/abstract=2679196> (“In 1994 the U.S. foreign portfolio share was 16.794%; by 2010, it rose to 28.150%.”).

exchanges,⁴⁵ changes in technology and regulation are leading more large investors to trade on foreign exchanges⁴⁶ while others have moved to invest through private placements, which avoid exchanges entirely.⁴⁷ Small investors, meanwhile, have increasingly channeled their investments in equity, including foreign stock, through mutual funds,⁴⁸ which have the capacity to buy shares on foreign exchanges.⁴⁹

The result of these changes in the securities markets means that businesses no longer fear adverse market repercussions from inverting—or from failing to establish a U.S. residence to begin with. They can access U.S. capital as foreign firms almost as easily as domestic firms.⁵⁰ The market access advantages enjoyed by U.S.

45. See Bd. of Governors of the Fed. Reserve Sys., Int'l Fin. Discussion Papers No. 1044, John Ammer et al., *U.S. International Equity Investment* 2, 4–5 (2012), www.federalreserve.gov/pubs/ifdp/2012/1044/ifdp1044.htm [hereinafter *U.S. International Equity Investment*] (“Median U.S. investment in cross-listed firms is 13.6 percent of the firm’s market capitalization, dwarfing the 0.3 percent median holdings in non-cross-listed firms.” The authors note, however, that “the majority of U.S. investors do not even use the U.S. market to acquire foreign shares of cross-listed firms; rather they acquire the shares in the firms’ home market.”); Bd. of Governors of the Fed. Reserve Sys., Int'l Fin. Discussion Papers No. 815, *Look at Me Now: The Role of Cross-Listing in Attracting U.S. Investors* 33 (2004), www.federalreserve.gov/pubs/ifdp/2004/815/ifdp815.htm (“[F]irms can increase their U.S. holdings by 8 to 11 percent of their market capitalization by cross-listing in the United States, doubling or more the amount prior to cross-listing.”).

46. See Dobbs & Goedhart, *supra* note 40 (“[A]s capital markets become increasingly global, institutional investors typically invest in stocks they find attractive, no matter where those stocks are listed. One large US investor—CalPERS—has an international equity portfolio of around 2,400 companies, for example, but less than 10 percent of them have a US cross-listing.”). *But see U.S. International Equity Investment, supra* note 45, at 5 (“U.S. investors seem most attracted to cross-listed firms that become more informationally transparent following the cross-listing, particularly those firms with poor accounting practices prior to listing in the United States.”).

47. See Davidoff, *supra* note 38, at 628 (“[T]he rise of private and more complete equity markets . . . provided an alternative capital raising outlet. In the private realm, the market for foreign equity . . . in the U.S. exploded. . . . It was clear that a viable market alternative now existed in the United States to raise capital outside the public listing markets.”).

48. See Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PENN. L. REV. 605, 610 (2014) (“Mutual funds are the dominant investment vehicle for retail investors.”); INV. CO. INST., 2015 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 8, 27–28 (55th ed. 2015), https://www.ici.org/pdf/2015_factbook.pdf (showing 56% of U.S. mutual fund and exchange-traded fund assets at year-end 2014 were equities; 42% of total assets were comprised of shares of domestic corporations while shares in non-U.S. corporations accounted for 14% of total assets, or 25% of equity mutual fund assets).

49. See sources cited *supra* note 46.

50. See Martin Phelan et al., *Pharma and Irish inversions: Increasing your share price*, INT’L TAX REV. (June 1, 2014), <http://www.internationaltaxreview.com/Article/3348569/Pharma->

firms—and increasingly the U.S. exchanges⁵¹—are swiftly disappearing.

But it was not just access to U.S. investors that domestic firms prized; it was also their access to high quality (and familiar) corporate governance standards. In short, Delaware.⁵² Yet that advantage, too, has been dissipating.

2. *The globalization of corporate governance*

The internal affairs of corporations are largely governed by the laws of the state (or nation) of which they are residents. For many years, it was taken as a given (at least in the United States) that U.S. corporate governance standards were the highest in the world. That may well have been one source of U.S. investors' "home bias"; U.S. shareholders were certain that their interests would be respected in the course of corporate affairs as long as they invested in U.S. corporations.⁵³ In addition, the SEC was touted for forcing greater

and-Irish-inversions-Increasing-your-share-price.html ("In general, companies which have undertaken corporate inversions have noted an increase in share prices . . .").

51. As trading on U.S. exchanges becomes a less important prerequisite for gaining access to U.S. investors, the dangers of relying on U.S. listing status as a marker of tax residence, a move suggested by some, see J. Clifton Fleming, Jr. et al., *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1, 23–24 (2014) (advocating use as "rebuttable presumption" for determining U.S. residence), become more apparent. It may do little to increase tax revenue while subverting what is (for better or worse) a major component of the U.S. economy, the financial sector.

52. More than sixty percent of domestic corporations are incorporated in Delaware. The reasons for this phenomenon are disputed. For the last forty years, U.S. legal academics have argued over whether Delaware won out over other states in a "race-to-the-bottom" by unjustly catering to managerial interests, see, e.g., Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1783 (2002) (not a race; Delaware has a monopoly); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 663–65 (1974) (race to the bottom), or in a "race-to-the-top" by successfully balancing shareholder interests and business needs, see generally Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 281 (1985) (Delaware's prominence in corporate charter market "a matter of efficiency"); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289–92 (1977) (race-to-the-top). Others have argued that its successes have been due less to the contents of its laws (which have been copied wholesale by some other states) than to network externalities or the quality of the state's corporate bar and judiciary. See, e.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 738–39 (2002); William Savitt, *The Genius of the Modern Chancery System*, 2012 COLUM. BUS. L. REV. 570, 571.

53. See Stefan Eichler, *Equity home bias and corporate disclosure*, 31 J. INT'L MONEY & FIN. 1008, 1008 (2012) (showing that information asymmetries caused by inadequate corporate disclosure can result in "home bias" investing). Of course, if the critics of Delaware's legal

financial transparency, among other shareholder protections, as a condition of trading on U.S. exchanges.⁵⁴ Companies incorporated in Delaware⁵⁵ and listed on U.S. stock exchanges⁵⁶ to convince prospective shareholders that they were “good actors” and thus, good investment opportunities. The assumption was that any costs associated with such actions (both regulatory and tax) would be more than offset by the additional value shareholders were willing to ascribe to the shares of such entities. Recently, however, some have argued that the corporate governance rationale for maintaining U.S. residence status has dissipated. There are several grounds for believing that this may be true.

The first is the increasing “federalization” of corporate governance as a result of the enactment of Sarbanes-Oxley⁵⁷ and Dodd-Frank.⁵⁸ These federal laws incorporate many of the corporate governance rules formerly imposed under state level incorporation statutes and require their application to all corporations listed on U.S. exchanges.⁵⁹ Corporations can demonstrate good corporate governance by listing on a U.S. exchange rather than incorporating in Delaware. And as explained in the previous section, corporations do not have to be U.S. residents to be listed on a U.S. exchange. Thus, there is no need to go the further step of maintaining a Delaware (or other U.S.) residency

regime—those arguing that it is slanted in the direction of protecting managerial rather than shareholder interests—are correct, *see supra* note 52, these investors could well have been misguided.

54. *See* Eric L. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649, 1691–92 (2015) (explaining that “the bonding hypothesis continues to have significant support in the academic community” as a driver of cross-listings).

55. *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533 (2001) (explaining that Delaware law enhances shareholder value by five percent); Talley, *supra* note 54, at 1690–91 (“Empirically, the proposition that Delaware law creates value (at least historically) enjoys some support.”); Steven Lipin, *Firms Incorporated in Delaware Are Valued More by Investors*, WALL ST. J., (Feb. 28, 2000), <http://www.wsj.com/articles/SB951694281741477590> (referring to Daines study).

56. *See* Talley, *supra* note 54 (“[S]ubstantial empirical evidence suggests that listing in U.S. securities markets is associated with positive and persistent economic value creation. . . . Some of this literature suggests that a key driver of this market premium comes through ‘bonding’ of foreign firms to the more demanding standards (including those related to corporate governance) in the United States.”).

57. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of U.S.C.).

58. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S.C.).

59. *See* Talley, *supra* note 54, at 1694–97 (listing federal mandates).

because foreign companies can “bond” themselves to good corporate governance standards merely by listing themselves on U.S. exchanges.⁶⁰ They can prove their willingness to abide by good governance standards to potential investors while maintaining the favorable tax status of a foreign corporation.

The second (and more troubling) reason to discount the lure of good governance standards as a path to residency is that the standards of corporate governance in other countries have improved sufficiently to challenge U.S. (and Delaware’s) dominance.⁶¹ This argument is particularly attractive to those who believe that some of the recent changes to federal law under Sarbanes-Oxley and Dodd-Frank amount to “overregulation”;⁶² in their view, U.S. corporate governance standards have gone down just as other countries’ standards have gone up.

Whether one believes that Sarbanes-Oxley and Dodd-Frank were positive or negative developments, the bottom line is much the same. The corporate governance benefits accruing to U.S. corporate residents (and their investors) are no longer unique enough to overcome the substantial tax detriments of U.S. residency.⁶³ As much as one might wish otherwise, there is no easy way of going back to the world in which taxpayers have the opposite calculus. Unfortunately, it is not possible to change the U.S. residency rules to do so.

C. Changing the Definition of Corporate Residence

As noted above, the U.S. definition of corporate residence is purely formal in nature; residence depends on the country in which the entity is incorporated. The choice of residence thus lies wholly within the control of the incorporators, and can be exercised to maximize whatever benefits those incorporators choose to maximize.

60. See, e.g., *id.* at 1699 (“To the extent that federal law has appropriated from Delaware (and other states) large sectors of corporate governance jurisprudence, most of the benefits from domestic incorporation can be retained simply by remaining listed in U.S. securities markets (governed by federal securities laws).”).

61. See Dobbs & Goedhart, *supra* note 40 (“However, other developed economies . . . have radically improved their own corporate-governance requirements.”).

62. See Davidoff, *supra* note 38, at 629 (“In the wake of Sarbanes-Oxley, a skein of academic literature, supported by industry commentary expressed an opinion that provisions of the Act were ham-handed, over-broad, and too costly.”).

63. See Talley, *supra* note 54, at 1652 (“[T]he recent pace of inversion activity plausibly suggests that America’s traditional market power in regulatory competition has begun to slip.”).

Some have contended that the proper response to the impending (if not actual) death of residency taxation is for the United States to adopt a more substantive residency rule, one which would make it much harder for entities with substantial U.S. contacts to avoid U.S. tax residence and thus tax obligations.⁶⁴

Some other countries have more substantive rules. For example, some determine residence based on the location of the corporate management—a term defined variously as the country in which the board of directors meetings are held⁶⁵ or the country in which the home office is located.⁶⁶ Unfortunately, experience has shown that

64. See, e.g., Fleming et al., *supra* note 51, at 22 (“We believe this demonstrates that the United States should seriously consider broadening its definition of a resident corporation to provide that foreign corporations are U.S. tax residents if they satisfy either a shareholder residency test or the presently controlling place of incorporation test.”); Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 583 (2005) (“[I]f the place-of-incorporation rule fails accurately to reflect legislators’ and the public’s understanding of what makes a corporation American, that definition should be revisited across-the-board Possible alternatives include a focus on the residence of the corporation’s shareholders . . . or a focus on the place of the corporation’s management and control.”); Reuven Avi-Yonah, *For Haven’s Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1797 (2002) (advocating replacement of place-of-incorporation with “managed and controlled” test for corporate residency).

65. See HUGH J. AULT ET AL., *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 371–73 (1997) (noting that in 1997 the United Kingdom, Canada, and the Netherlands applied effective management and control tests that focused on the meeting location of the board of directors). This test seems to be falling out of international favor. See Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1629 & n.63 (2013) (describing the OECD’s move away from the place of board meeting test).

66. The commentary on the July 14, 2015, version of the OECD Model Tax Convention on Income and on Capital describes the preferred test for corporate residence as “the ‘place of effective management’ . . . the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.” OECD, *MODEL TAX CONVENTION ON INCOME AND ON CAP.: CONDENSED VERSION 2014*, Commentary on Article 4, ¶ 24, at 90–91, <http://dx.doi.org/10.1787/9789264239081-en> [hereinafter 2014 OECD Model Income Tax Treaty]. The commentary continues that “[a]ll relevant facts and circumstances must be examined to determine the place of effective management.” *Id.* at 91. The “Observations on the Commentary” and the “Reservations on the Article” that follow this section of the Commentary make clear that different countries have different interpretations of the term “place of effective management.” See, e.g., *id.* at ¶ 26.3, at 92 (France “considers . . . [that the term] will generally correspond to the place where the person or group of persons who exercises the most senior functions (for example a board of directors or management board) makes its decisions”); *id.* at ¶ 26.4, at 92 (Hungary will take into account “the place where the chief executive officer and other senior executives usually carry on their activities . . .”); *id.* at ¶ 28, at 92 (Japan and Korea “wish to use in their conventions the term ‘head or main office’” rather than place of effective management). See Reuven S. Avi-Yonah, *Beyond Territoriality and Deferral: The Promise of “Managed and Controlled,”* 63 TAX NOTES

these rules are just about as porous as the formal place of incorporation rule. Few officers or directors are upset at the prospect of holding the relatively infrequent board meetings in out-of-the-way locales to generate better tax results, particularly if those locations are warm and sunny. Given the ease of telecommuting and the like, not to mention the indeterminate definition of “company headquarters,” there is little indication that headquarters tests for residency are very effective at restricting residency choice.⁶⁷

Another recent suggestion is to determine residency by the nationality of the shareholders of the corporation.⁶⁸ This is likely to be far harder than its proponents project, given the ease of creating and the difficulty of penetrating intermediary entities as holders of shares.⁶⁹

INT’L 667, 667 (2011) (explaining that the “place of effective management” determines residence under tax treaties based on the OECD model).

67. See Kimberly A. Clausing, *Should Tax Policy Target Multinational Firm Headquarters?*, 63 NAT’L TAX J. 741, 743 (2010) (“[E]ven beyond traditional divisions of activities among countries, the location of the headquarters themselves has become increasingly scattered in recent years. . . . Indeed, it may be profitable for a firm to split headquarters functions across countries.”); Fleming et al., *supra* note 51, at 25 (noting that “the site of a corporation’s place of management can be indeterminate”; also noting that this test would “create an incentive for corporations to refrain from maintaining their headquarters in the United States”); Aldo Forgiome, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE U. L. REV. 719, 726 (2003) (discussing the complications today’s “digital environment” cause in determining “the place of central management”); David R. Tillinghast, *A Matter of Definition: “Foreign” and “Domestic” Taxpayers*, 2 INT’L TAX & BUS. LAW. 239, 261–62 (2006) (discussing the malleability of, and uncertainty caused by, a place-of-central-management test); Johannes Voget, *Relocation of Headquarters and International Taxation*, 95 J. PUB. ECON. 1067, 1069 (2011) (noting that about six percent of multinationals moved their headquarters between countries between 1997 and 2007; linking movement to increases in residence taxation); Leslie Picker, *Tyco Merger Will Shift Tax Liability Overseas*, N.Y. TIMES, Jan. 26, 2016, at B1, B5 (describing how Tyco changed its headquarters several times to gain tax advantages). *But see* Avi-Yonah, *supra* note 66, at 667–68 (arguing for headquarters test for residency); Marian, *supra* note 65, at 1618 (same).

68. See Fleming et al., *supra* note 51, at 22–23 (describing operation of such a system).

69. FATCA (Foreign Account Tax Compliance Act, Pub. Law 111–147, 124 Stat. 71, 97–117, codified at I.R.C. §§ 1471–1474, 6038D and scattered sections) requires foreign financial corporations to identify their U.S. account holders. The information gathered for FATCA purposes would not easily be translated into what is necessary to implement an ownership rule for non-financial corporations. Such corporations would have to obtain the FATCA U.S. ownership information from all of its institutional shareholders, in addition to information about the owners of shares held outside such institutions. Further, because of the effect of U.S. status on foreign shareholders of these foreign corporations, foreign corporations (and possibly foreign stock exchanges) would no doubt devise mechanisms for preventing the accumulation of “undesirable” levels of U.S. ownership—mechanisms which could make it difficult for U.S. investors to diversify their investments from an international standpoint. The

Further, it is likely to increase the number of situations of overlapping or dual residency, imposing costs on both taxpayers and tax authorities.

Others have suggested tying residency to listing on securities exchanges; if a corporation is listed on a U.S. exchange, it ought to be taxed as a U.S. resident.⁷⁰ This suggestion, too, could create a number of dual residence corporations, but it brings with it a more serious risk: given the tax dollars involved and the increasing globalization of the securities markets, the primary effect of such a rule may be to decrease the attractiveness of utilizing U.S. exchanges.⁷¹ At the very least, the possibility of such an outcome would, as a practical matter, make such a change in U.S. law politically impossible.

The bottom line is clear. As the non-tax benefits of U.S. residency have declined, any tax disadvantages of maintaining such a residency become more salient and more pressing. These tax disadvantages abound. One of the most serious of those disadvantages relates not to the taxation (or not) of income earned abroad, but rather of income earned in the United States. As the next section lays out, much of the income earned by foreign taxpayers from U.S. sources is not taxed in the United States. The right to tax this income is all too often assigned by treaty to a taxpayer's country of residence—and since a taxpayer can choose to be resident in a country that will not tax such income, such income is not taxed anywhere.

II. THE UNDERTAXATION OF FOREIGN INVESTORS AND FOREIGN-OWNED BUSINESSES

The United States claims the right to tax all income earned by foreigners from sources within the United States. Like most countries, though, the United States does not tax all income legally sourced within its borders. Instead, it divides U.S. sourced income into two categories: business income and investment income. Once the requisite minimum of business activity occurs within the United

effects on the securities markets may well be profound, and there is no guarantee that the changes will be salubrious.

70. See Fleming et al., *supra* note 51, at 23 (suggesting listing on U.S. exchange as rebuttable presumption of residency).

71. See Davidoff, *supra* note 38, at 628 (stating recent declines in cross-listing may reflect “a viable market alternative . . . in the United States to raise capital outside the public listing markets” and “a decline in U.S. equity premiums”).

States,⁷² foreigners' U.S. sourced business income becomes subject to U.S. tax under the rules applicable to U.S. residents and corporations.⁷³ U.S. sourced investment income, by contrast, may be subject to tax at a flat rate on the gross amount by statute,⁷⁴ but often escapes tax altogether as a result of tax treaty concessions. Tax planning for foreign investors involves ensuring that as much U.S. sourced income as possible falls within the category either of untaxed investment income or of business income earned by a taxpayer who fails the applicable business nexus test. And at present, many such planning opportunities are available, although the new section 385 regulations⁷⁵ are aimed at shutting some of them down.⁷⁶

For example, "earnings stripping transactions" are used to transmute taxable business income into untaxed investment income. An entity operating a U.S. business and generating U.S. source business income⁷⁷ can siphon off much of that income to a related foreign entity which is not itself engaged in a U.S. business in the form of deductible interest⁷⁸ or royalty payments.⁷⁹ These deductions reduce the operating entity's taxable income and thus its U.S. tax

72. Under statutory law, before income becomes taxable under the preceding sections, the foreigner's U.S. activities have to rise to the level of a "trade or business." See I.R.C. § 882(b) (2012). When the foreigner is a resident of a country with which the United States has a tax treaty, the nexus requirement is higher; the taxpayer must have a "permanent establishment" in the United States before its business income can be taxed. See United States Model Income Tax Convention of February 17, 2016, art. 7.1, <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf> [hereinafter 2016 U.S. Model Treaty]. This provision of the U.S. Model Treaty is identical to its counterpart in the OECD Model Treaty, see 2014 OECD Model Income Tax Treaty, *supra* note 66, art. 7.1, as well as the prior U.S. model treaty, see United States Model Income Tax Convention of November 15, 2006, art. 7.1, <https://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf> [hereinafter 2006 U.S. Model Treaty].

73. See I.R.C. §§ 871(b), 882 (2012).

74. See I.R.C. §§ 871(a), 881.

75. See Final Section 385 Regulations, *supra* note 10.

76. See Treasury Fact Sheet II, *supra* note 8 ("[T]oday's final regulations narrowly target problematic earnings stripping transactions . . ."); Treasury Fact Sheet I, *supra* note 8 (same).

77. The operating entity could be domestic or foreign, and may be a partnership or a corporation.

78. Section 163(j)(4)(B)(ii)–(5)(B) of the Internal Revenue Code disallows a deduction for "excess" interest payments made to foreign related entities protected from the withholding tax by treaty. However, its definition of "excess" is quite circumscribed (and generous to taxpayers). See *infra* notes 117–18 and accompanying text.

79. See Wells & Lowell, *Tax Base Erosion*, *supra* note 26, at 542–43 (analyzing opportunities for foreign companies to strip income out of U.S. affiliates through royalty and other supply chain transactions); see also Fleming et al., *supra* note 34, at 680–82 (same).

liability. Meanwhile, the foreign recipients of these payments generally escape U.S. withholding tax because, although interest and royalties are types of investment income that by statute are subject to a substantial withholding tax,⁸⁰ that tax is reduced or eliminated in most U.S. tax treaties.⁸¹

Interest and royalty arrangements traditionally have been the easiest of the earnings stripping mechanisms to implement, but they are far from the only ones that are employed by taxpayers.⁸² Any transactions effected between the operating entity and a foreign related entity can be used to similar effect.⁸³ The operating entity can purchase products (or services) from related foreign entities for resale in the United States at prices which incorporate the value of

80. Interest paid to unrelated foreign recipients is excluded from withholding tax by statute. See I.R.C. § 871(h) (2012) (portfolio interest exemption for foreign individual recipients); I.R.C. § 881(c)(1) (portfolio interest exemption for foreign corporate recipients). However, interest paid to related foreign companies falls outside those statutory exemptions and thus, in the absence of treaty protection, would be subjected to a withholding tax equal to thirty percent of the amount transferred. I.R.C. §§ 871(a)(1)(A), 881(a)(1).

81. See *Tax Rates on Income Other than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties*, INTERNAL REVENUE SERV. https://www.irs.gov/PUP/individuals/international/Tax_Treaty_Table_1.pdf (last visited Oct. 26, 2016) (listing treaty withholding rates) [hereinafter *I.R.S. Table 1*]. In 2012, almost ninety percent of all U.S. source income paid to foreign persons was exempt from withholding tax. Scott Luttrell, *Foreign Recipients of U.S. Income, 2012*, INTERNAL REVENUE SERV. (Winter 2016), <https://www.irs.gov/pub/irs-soi/soi-a-init-id1602.pdf>.

82. See Fleming et al., *supra* note 34, at 681 (example 1); Wells, *supra* note 22, at 6–9 (describing income stripping transactions utilizing interest, royalty, lease, and supply chain transactions); Wells & Lowell, *Tax Base Erosion*, *supra* note 26, at 540–45 (same).

83. Moreover, the foreign entity need not be related to the U.S. entity for these payments to have an untoward effect on the U.S. fisc. See *infra* notes 126–28 and accompanying text (discussing effects of credit transactions involving unrelated parties). However, taxpayers tend to prefer transactions with related parties because no portion of the overall (tax or economic) gains have to be split with outsiders; in addition, related party transactions provide opportunities to exploit pricing uncertainties. Although section 482 allows the Internal Revenue Service to readjust the prices at which related parties transact to conform to “arm’s length standards,” its implementation is, to say the least, imperfect. See, e.g., JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, *TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 21–22* (2015), <https://www.fas.org/sgp/crs/misc/R40623.pdf> (“A more recent study by Clausing indicated that the revenue loss from profit shifting may have been as high as \$90 billion in 2008, although an alternative data set indicates profit shifting of \$57 billion. . . . If rising proportional to revenue, the 2014 level would be \$66 billion to \$104 billion.” “Grubert has estimated that about half of income shifting was due to transfer pricing of intangibles and most of the remainder to shifting of debt.”); STAFF OF JOINT COMM. ON TAX’N, 111TH CONG., *PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 110* (2010) (describing difficulties in applying rules to “unique intangible property”); Kleinbard, *supra* note 18, at 733–37 (detailing flaws in application of arm’s length standards).

trademarks, patents, or other forms of intangible property for which a royalty could have been separately stated and charged. As long as the foreign provider avoids U.S. business status, its profits escape U.S. source taxation—and of course, the operating entity pays U.S. tax only on the difference between its resale price and its cost of acquiring the resold products. Alternatively, a foreign provider's price can include a substantial payment for the "business risks" assumed by the foreign entity. As long as the related foreign entity receiving such payments falls short of satisfying the applicable business nexus test, such income falls outside the U.S. tax net.⁸⁴

These earnings stripping techniques are beneficial, of course, only if and to the extent the income diverted from the U.S. tax base does not end up included in the tax base of another high-tax jurisdiction. It is absolutely of no benefit to avoid a \$350 U.S. tax obligation at the cost of paying \$350 in taxes to France. Fortunately for taxpayers (and unfortunately for the U.S. fisc), foreign tax laws⁸⁵—and the intersection between foreign and U.S. tax laws⁸⁶—provide myriad opportunities for foreign MNEs—and often only foreign MNEs⁸⁷—to

84. If the related foreign entity is directly or indirectly owned by a U.S. corporation, this income remains subject to U.S. taxation and indeed may become immediately taxable in the hands of its U.S. owner under the subpart F taxing regime. See I.R.C. §§ 951–52, 954, 957–58. The desire to escape the subpart F regime is a motivating factor for many inversion transactions. See Fleming et al., *supra* note 34, at 682 (“Avoiding the Subpart F rules in order to engage in U.S. earnings stripping is an important reason for corporate expatriations/inversions.”).

85. Though one might think that a treaty partner would want to collect the taxes awarded to it under a treaty arrangement, foreign countries have as little power to attract or retain “residents” as does the United States. Thus, they often compete for residents by foregoing residence-based taxing rights. The recent proliferation of “patent boxes”—which set exceptionally low rates of tax for royalty income generated by entities engaging in “substantial” research and development activities in the country—is an example of such competition. See Peter R. Merrill et al., *Is It Time for the United States to Consider the Patent Box?*, 134 TAX NOTES 1665, 1665 (2012) (describing patent boxes and their prevalence).

86. For example, taxpayers may utilize elections made available under the “check-the-box” regulations to create entities which are respected for U.S. tax purposes (and capable of being recipients of deducted and treaty-exempted payments of interest or royalty income) while being ignored for foreign tax purposes (so that the foreign jurisdiction fails to “see” the income such entities have received). There are a number of variations on this basic theme. See Talley, *supra* note 54, at 1668–71 (detailing the double Irish sandwich); Edward D. Kleinbard, *Through a Latte, Darkly: Starbucks's Stateless Income Planning*, 139 TAX NOTES 1515, 1521–24 (2013) (detailing the tax effects of Starbucks's internal structure).

87. The income of foreign entities directly or indirectly owned by U.S. shareholders may be included in the income of those shareholders under the subpart F regime in the year earned, see I.R.C. §§ 951–58, thus preventing the MNE from obtaining a tax advantage from the arrangement. Then again, the subpart F regime has enough holes in it that such an outcome is

escape that alternative tax. Entities have to be careful when choosing their residence country, but many countries have positioned themselves as attractive residence choices.⁸⁸ Indeed, inversion transactions are all about making such a careful residence country choice.

Is it any wonder that U.S. multinationals are rushing for the exits? Inversion transactions not only provide a way of escaping the reach of the subpart F regime and other U.S. rules for the taxation of foreign income, they also provide a way of escaping U.S. taxation of U.S. business income. Indeed, virtually all U.S. business income can be transmuted into “stateless” or “untaxed” income through earnings stripping transactions.⁸⁹ Though one can argue whether it matters, from a non-tax perspective, whether the multinationals operating in the United States are foreign or domestic,⁹⁰ the threat inversions pose to the corporate income tax system—and perhaps the individual income tax as well—is nothing short of existential. The question is what to do about it.

The next part details the changes that have to be made, and the changes that could be made, to rectify the disparity in tax treatment

not assured. See Kleinbard, *supra* note 86, at 1524–25 (examining Starbucks’s avoidance of that regime).

88. Although some countries maintain controlled foreign corporation regimes that are analogous to subpart F, other countries do not. See Brian J. Arnold, *A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules*, 65 TAX L. REV. 473, 496 (2012) (“Since 1972, however, twenty-seven countries have adopted CFC rules.”). Like the subpart F regime, however, foreign-controlled corporation regimes are far from perfect at ensuring that the residence country picks up the tax foregone at source—though some may be more effective than subpart F. See *id.* at 497 (“The CFC rules of most European countries are considerably less effective than subpart F (Germany is an exception in this regard).”). But see Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS*, 6 HARV. BUS. L. REV. (forthcoming 2016) (manuscript at 55) (<http://ssrn.com/abstract=2716125>) (last visited Oct. 26, 2016) (“It should be remembered that the other G20 have more effective CFC rules than we do, and those CFC rules already act as a de facto worldwide system with a minimum tax . . .”).

89. See Kleinbard, *supra* note 86, at 1515 (“[I]f Starbucks can organize itself as a successful stateless income generator, any multinational company can.”). The regulations promulgated under section 385 are aimed at making such maneuvers more difficult. See Treasury Fact Sheet II, *supra* note 8 (“The new regulations restrict the ability of corporations to engage in earnings stripping . . .”). For a more extended discussion of the effect of these regulations, see *infra* notes 121–31 and accompanying text.

90. Often nothing other than taxes are at stake; the inverting corporation may change neither the location of its business operations nor its headquarters. Indeed, it is possible that toughening tax rules would be counterproductive. The United States would not benefit, for example, from adopting a headquarters rule for corporate residence if doing so led a number of multinationals to move their headquarters from New York to Dublin.

between U.S. and foreign multinationals, at least as regards their U.S. source income. Whether such changes would be enough to prevent corporations from fleeing U.S. status is an open question; even were the tax on U.S. source income equalized, some corporations might still avoid U.S. status to reduce the worldwide tax liability imposed on their foreign income.⁹¹ Changing the rules for the taxation of U.S. income in the first instance would affect the amount of tax collected by the U.S. government from all taxpayers—inverted or not—more than it would affect corporate decisions about tax residence. And as the discussion makes clear, it is not even certain that the first end can be achieved.

III. HOW TO INCREASE TAXATION AT SOURCE

Although countries have the right to tax the worldwide income of their residents, they may only tax nonresidents on the portion of their income that is derived from sources within their borders. Thus the United States may tax the U.S. source income of a French corporation, but not the U.K. source income of that corporation, even if the French corporation also operates in the United States. At present, though, much of the U.S. sourced income of foreign and foreign-owned entities escapes the U.S. tax net.⁹² The question faced in this Part is what would be required to change that outcome and thereby bring the tax treatment of wholly domestic, foreign, and domestic but foreign-owned business operations in the United States into closer tax conformity with respect to their U.S. source income. One easy solution, which would engender perfect conformity, would be to eliminate the corporate income tax in its entirety. However, for

91. Because of the availability of tax credits, the U.S. tax on foreign earnings becomes a non-issue if such income has been taxed at source at a rate similar to the U.S. tax rate. At present, not only are U.S. statutory tax rates higher than that of most other countries, but U.S. MNEs have become masters at avoiding other countries' source-based taxes. Inversions would be less popular if other countries also did a better job of taxing income at source. The BEPS project, *see* OECD, *supra* note 20, ostensibly is aimed at helping countries do just that, but it is too early to see whether it will fulfill that mission.

92. Almost all of the acknowledged U.S. source income paid to foreigners escapes the withholding tax. *See* Luttrell, *supra* note 81 (in 2012, almost 90% of all U.S. source income paid to foreign persons was exempt from withholding tax). In addition, as discussed *infra* Sections III.B & C, foreign multinationals may understate their U.S. source income by manipulating the prices they charge their U.S. entities for goods, services or intellectual property rights. The "foreign sourced income" of foreign companies is not (at least as a general rule) subject to tax in the United States.

purposes of this Article, I assume that the goal is to levy a positive rate of tax on the income of both entities.

As the discussion in this Part explains, bringing U.S. sourced income earned by foreign entities within the U.S. tax net will not be easy. It will often require the United States to develop legally acceptable evasions of tax treaty provisions which cede taxing jurisdiction over such income to recipients' residence countries. Many if not most of the current tax avoidance techniques are made possible by provisions in U.S. tax treaties reallocating taxing rights from source countries to residence countries. Though these treaty practices may once have made sense,⁹³ they do great damage in a world in which taxpayers are free to establish residence in no- or low-tax countries, at least if one's goal is to collect a corporate income tax.⁹⁴

The most direct route to achieving realistic reform in many cases would be to amend U.S. tax treaty policy and its existing treaties. However, that is easier said than done, both mechanically, politically, and practically. Treaties are bilateral instruments; the United States lacks the power of unilateral amendment. Bilateral renegotiation is a long and fraught process, with no guarantee of success. Political factors other than tax policy may further impede the process. The time horizon for such changes is quite long.⁹⁵ Hence, although in some cases treaty changes provide the only option for effective change, this Article rarely considers them as the first option.

A. Interest Deductions and Payments

Although the distinction between “debt” and “equity” is one of the foundations of most (and certainly the U.S.) income tax systems,

93. Or not. These treaty policies grew out of the mercantilist economic model adopted by the victors of World War I, a model that presumed that “the country of residence should have the primary and residual right to collect tax on international business activity” because “the imperial countries were viewed as providing the capital and technology with which to produce income in the colonies.” Wells & Lowell, *Tax Base Erosion*, *supra* note 26, at 537. Even its framers, though, recognized that they “provided the implements to erode the tax base of [residence] countries” *See id.*

94. *See* Wells & Lowell, *Income Tax Treaty Policy*, *supra* note 26, at 34 (“To a significant extent, the governments that now pillory MNEs for creating homeless income were the framers of the mercantilist approach to international taxation that created the opportunity in the first place.”).

95. *See* Benshalom, *supra* note 26, at 704 (discussing treaty networks as “extremely difficult to negotiate and amend”); David R. Tillinghast, *Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 455–57 (1996) (describing clumsiness of treaty mechanisms).

it has always been problematic.⁹⁶ Tax authorities themselves have had enormous difficulty distinguishing between debt and equity.⁹⁷ Given the extremely low rates of return on “riskless” debt,⁹⁸ it seems quite obvious that the overwhelming majority of the return on debt, like the return on equity, ultimately stems from the success of the business enterprise in which the funds have been invested, and thus should be treated for tax purposes in a manner similar to equity, which is subject to tax at both the corporate and shareholder level in the United States. While the rules for sourcing interest income are similar to those for sourcing business income,⁹⁹ for the most part, the United States does not tax U.S. source interest income received by a foreign taxpayer unless that taxpayer derives such interest income in the context of that taxpayer’s U.S. business operations. If a U.S. business (be it foreign or domestic) pays interest to a foreign entity that is not itself engaged in a U.S. business activity, the interest generally escapes U.S. tax altogether.¹⁰⁰

96. See U.S. DEP’T OF THE TREAS., REP. ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 39–60 (1992) (detailing inefficiencies created by differential taxation of corporate income and debt and alternate taxing mechanisms); ALVIN C. WARREN, JR., AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES 42 (1993).

97. Section 385, granting Treasury the power to issue regulations differentiating between debt and equity, was enacted in 1969. Treasury enacted a first set of regulations in 1980, but these were so heavily criticized that their effective date was repeatedly postponed. A similar fate befell the 1981 amendments to those regulations. Eventually, all versions of the regulation were “withdrawn . . . and the project abandoned.” David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1638 n.49 (1999) (describing the saga of these regulations as “lamentable”). The regulations adopted on October 14, 2016, see Final Section 385 Regulations, *supra* note 10, are the first attempt since then to utilize this statutorily granted power.

98. “Riskless debt” is the closest approximation to a pure “time value of money” return on capital investment. At present, investors are willing to accept negative returns on Swiss, German, and Dutch government bonds. See Buttonwood, *The crazy world of credit: Where negative yields and worries about default coincide*, ECONOMIST, Jan. 30, 2016, at 62.

99. Interest income is sourced under statutory law at the residence of the debtor, I.R.C. § 861(a)(1)(A) (2012), or in the United States if deducted as an expense of a U.S. business, I.R.C. § 884(f)(1).

100. If the foreign entity is a subsidiary of a U.S. MNE, however, the interest income may be included in the income of its U.S. shareholder(s) under the subpart F regime. Fleming et al., *supra* note 34, at 687 n.44.

Although, by statute, much U.S. sourced interest income paid to related foreigners not engaged in U.S. trades or businesses¹⁰¹ is subject to a flat rate withholding tax,¹⁰² the practice of using tax treaties to eliminate source country taxation of interest income was established quite early on.¹⁰³ Its elimination remains a feature of the most recent U.S. Model Income Tax Convention.¹⁰⁴ Treaties' removal of the withholding tax obligation is subject to a "limitation of benefits" provision, which ensures that the entity receiving the benefit is not a mere conduit for another, non-treaty protected entity.¹⁰⁵ But limitation of benefits provisions do not guarantee that the foreign recipient of the interest will pay residence country tax comparable to the foregone U.S. source tax. Not only has the United States entered into a number of treaties with low-tax countries, but the treaty limits themselves have proven to be relatively ineffective due to "high negotiation costs, complexity, and enormous information-finding and litigation costs not available to tax authorities."¹⁰⁶ As a result, the

101. Sections 871(h) and 881(c) of the Internal Revenue Code call off this tax for certain "portfolio" interest income, that is, interest income received by foreign persons or entities unrelated to the U.S. payor.

102. I.R.C. §§ 871(a)(1), 881(a)(1).

103. See Benshalom, *supra* note 26, at 660 (pointing to the 1945 tax convention with the U.K. as the "constitutive moment[]" in the history of this treaty policy).

104. See 2016 U.S. Model Treaty, *supra* note 72, at art. 11.1 ("Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other Contracting State."). This model treaty cuts back on expatriated entities' use of the exemption. Article 11.2(d) calls off the exemption for "interest paid by an expatriated entity" and received by a related party for ten years following that expatriation. It also treats the interest paid by a permanent establishment of a corporation resident in the treaty partner to its home office as taxable business profits. See *id.* at art. 11.5. However, it does not treat interest paid to a related corporate entity as business profits. And, of course, these new limiting terms apply only to entities resident in countries which have entered into treaties containing them; the former model (issued in 2006) did not have an analogous rule. See 2006 U.S. Model Treaty, *supra* note 72, at art. 11.

105. See 2016 U.S. Model Treaty, *supra* note 72, at art. 22; 2006 U.S. Model Treaty, *supra* note 72, at art. 22.

106. Benshalom, *supra* note 26, at 683. Moreover, the limitation-of-benefits provisions found in existing tax treaties are far from uniform, with some more effective than others. See Marie Sapirie, *Model Treaty Highlights Treasury's New International Policies*, 151 TAX NOTES 148, 149 (2016) ("[E]ach model treaty since 1996 has changed LOB rules significantly The result is that no two LOB provisions in actual treaties look alike"). The relative ineffectiveness of these provisions is one reason why "treaty abuse, and in particular treaty shopping" was identified as "one of the most important sources of BEPS concerns." OECD, PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6: 2015 FINAL REPORT, at 9 (OECD Publishing Paris) (2015), <http://www.oecd->

current U.S. tax treaty network affords foreign MNEs substantial opportunities and incentives to use interest deductions to strip out the earnings of business operations conducted in the United States.¹⁰⁷

For example, suppose U.S. Acme, a company owned by Irish Acme, earns \$10 million before interest expenses are taken into account by manufacturing and selling widgets. Irish Acme, however, had loaned U.S. Acme \$150 million to build its widget factory, and the interest payments on that loan are \$8 million per year. Those interest payments reduce U.S. Acme's taxable income from \$10 million to \$2 million, and its corporate tax obligation from \$3.5 million to \$700,000. Under the terms of the U.S.-Ireland Tax Treaty,

library.org/docserver/download/2315331e.pdf?expires=1475619379&cid=id&accname=gues
&checksum=0F889782A71EF9323972F99640717811.

107. Interest payments have been one of the largest components of current earnings stripping transactions by inverted U.S. companies. See Gravelle, *supra* note 83, at 22 (“Grubert has estimated that about half of income shifting was due to transfer pricing of intangibles and most of the remainder to shifting of debt”). It is unclear how often “true” foreign MNEs use interest-based earnings stripping techniques. In 2007, Treasury, at the explicit behest of Congress, carried out a study on the use of earnings stripping transactions by foreign-controlled domestic corporations, and “did not find conclusive evidence of earnings stripping from foreign-controlled domestic corporations that had not inverted.” DEP’T OF THE TREASURY, EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 4 (2007), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Earnings-Stripping-Transfer-Pricing-2007.pdf>. This finding was echoed in a more recent discussion of the issue by the staff of the Joint Committee on Taxation. See JOINT COMM. ON TAX’N, BACKGROUND, SUMMARY, AND IMPLICATIONS OF OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT 35 (2015) (“Figure 2 does not offer conclusive evidence that FCDCs are, or are not, engaged in earnings stripping . . .”). However, the OECD’s BEPS studies revealed strong evidence of global BEPS behavior. OECD, MEASURING AND MONITORING: BEPS ACTION 11, at 15–16 (2015) (listing “[s]ix indicators of BEPS activity” including “[t]he profit rates of MNE affiliates located in lower-tax countries are higher than their group’s average worldwide profit rate” and “[t]he effective tax rates paid by large MNE entities are estimated to be 4 to 8 ½ percentage points lower than similar enterprises with domestic-only operations”). As one commentator noted, “the U.S. nonfinding of earnings stripping [by foreign multinationals] . . . defies intuition, [and] runs against the general results from almost everywhere . . .” Patrick Driessen, *Do Foreign Corporations Really Not Strip the U.S. Tax Base?*, 150 TAX NOTES 927, 929 (2016); see also Fleming et al., *supra* note 34, at 691 (“Moreover, the aggressive behavior of corporations in using other tactics to shift profits out of the U.S. tax base ipso facto suggests that earnings stripping is surely being employed for the same purpose in scenarios other than corporate inversions even if the confirming data has not yet been collected.”). Driessen suggests that the Treasury study may have missed the base erosion problems created by foreign corporations because they tend to strip income out of the United States through transfer pricing schemes rather than interest deductions. See Driessen, *supra*, at 929 n.18. Others have suggested that Treasury and Congress have looked the other way for fear of scaring away foreign investors. See Martin A. Sullivan, *Is Earnings Stripping Our Inbound Investment Incentive?*, 151 TAX NOTES 259, 259 (“In contrast to the easy politics of attacking inversions, the politics of raising taxes on U.S. subsidiaries of foreign multinationals is a minefield.”).

no U.S. tax is imposed on the interest payment made to Irish Acme.¹⁰⁸ Though Irish Acme has to pay tax on its interest income in Ireland, Irish corporate tax rates are only 12.5%,¹⁰⁹ so its Irish tax obligation amounts to a mere \$1 million. The loan arrangement thus reduces the Acmes' combined tax obligation from around \$3.5 million¹¹⁰ to \$1.7 million, or even less if the taxpayer finds a way to reduce the Irish residence tax.¹¹¹

Several countries, including the United States, attempt to ameliorate the adverse effects of these treaty provisions by imposing restrictions on the deductibility of interest payments.¹¹² When effective, such deduction limitations increase the income of—and the taxes paid by—entities making interest payments. Those entities end up paying a source tax at the entity level on interest that, in the absence

108. See CONVENTION BETWEEN THE GOV'T OF THE U.S. AND THE GOV'T OF IRELAND FOR THE AVOIDANCE OF DOUBLE TAX'N AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAP. GAINS, at art. 11.1 (1998), <https://www.irs.gov/pub/irs-trty/ireland.pdf> (“Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.”). The only exception to this rule provided in the treaty is for interest paid “by reason of a special relationship between the payer and the beneficial owner . . . [which] exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such a relationship.” *Id.* at art. 11.5.

109. See DELOITTE, CORPORATE TAX RATES 2016 (updated Mar. 2016), <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates.pdf> (“Standard corporation tax rate on trading income is 12.5%.”).

110. The tax obligation would actually be a bit higher because most U.S. tax treaties impose a small withholding tax on dividend payments, even those made to controlling shareholders. See *I.R.S. Table 1*, *supra* note 81.

111. Historically, most taxpayers did find ways to reduce the Irish tax obligation from 12.5% to around 2%. See Kleinbard, *supra* note 18, at 706–13 (describing the “Double Irish Dutch Sandwich”). Although Ireland claims to have eliminated this particular tax device, many are skeptical. See Kelly Phillips Erb, *Ireland Declares ‘Double Irish’ Tax Scheme Dead*, FORBES (Oct. 15, 2014, 08:50 AM), <http://www.forbes.com/sites/kellyphillipserb/2014/10/15/ireland-declares-double-irish-tax-scheme-dead/#3a6931ee1527> (“Under the new rules, companies not already operating in the country may not pursue the ‘Double Irish’ scheme as of January 2015; those already engaging in the scheme have a five year window to wind down”; “the 2% tax rate paid by Apple may become a thing of the past”). Indeed, now that the EU Commission has determined that this taxing regime constituted “state aid” impermissible under the terms of the EU governing treaty, Apple and other users may be forced to repay some of their tax savings to the Irish government. See Press Release, European Commission, Statement by Commissioner Vestager on state aid decision that Ireland’s tax benefits for Apple were illegal (Aug. 30, 2016), http://europa.eu/rapid/press-release_STATEMENT-16-2926_en.htm.

112. The United States’ first limitation, contained in § 163(j) of the Internal Revenue Code, was enacted in 1989. The newly adopted section 385 regulations, see *supra* note 10, are vastly more inclusive and stringent. See *infra* text accompanying notes 122–35 (describing reach of section 385 regulations).

of the deduction disallowance, would have been received by a treaty country resident free of source tax under the terms of the applicable tax treaty.¹¹³ For example, in the U.S. Acme-Irish Acme example above, if the United States limited U.S. Acme's interest deduction to \$4 million (rather than the claimed \$8 million), U.S. Acme's taxable income would be \$6 million (rather than \$2 million) and its U.S. tax obligation would increase from \$700,000 to \$2,100,000. What remained of the \$4 million in disallowed interest (after payment of the U.S. tax) could still be distributed to Irish Acme; whether this distribution would be free of additional U.S. source tax imposed on the recipient (but collected in the form of a withholding tax from U.S. Acme, the payor) would depend on whether this payment retains its characterization as an "interest" payment for treaty purposes (so that no additional source tax is imposed) or whether it is treated as a dividend, a distribution of U.S. Acme's after-tax profits. Although tax treaties substantially reduce the source taxation of dividend payments, they often leave a small residual source tax in place, even when the dividend payment is being made to a related foreign corporation.¹¹⁴ As a technical matter, however, countries with these limitations¹¹⁵ have successfully maintained the fiction that they do not constitute treaty overrides by arguing that they target only non-arm's-length debt or interest amounts. This is certainly how the United States has rationalized its own limitations on related party debt and interest

113. See Julie A. Roin, *Adding Insult to Injury: The "Enhancement" of § 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 TAX L. REV. 269, 289 (1994) (describing § 163(j) as a treaty override).

114. Interestingly, most tax treaties retain some vestige of the withholding tax for dividends paid to residents of the treaty partner, despite the fact that dividends typically (although not always) are paid out of funds that have already been subjected to one level of source country tax. See *I.R.S. Table 1*, *supra* note 81 (listing treaty withholding rates). This withholding tax may be eliminated, however, if the treaty country recipient is a tax-exempt entity such as a charity.

115. Many countries already have such limitations. See HM REVENUE & CUSTOMS, TAX DEDUCTIBILITY OF CORPORATE INTEREST EXPENSE § 2 (2016), <https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense/tax-deductibility-of-corporate-interest-expense-consultation> (Australia, Germany, Italy, Japan, and Spain "already have rules that provide a structural restriction on tax relief for interest expense"; the UK has a "worldwide debt cap"). More will follow if countries adopt the recommendations promulgated by the BEPS project. See OECD, LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS, ACTION 4: 2015 FINAL REPORT 11 (2015) ("The recommended approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). As a minimum this should apply to entities in multinational groups.").

deductions.¹¹⁶ Section 163(j), for example, disallows deductions only for interest payments defined in the statute as “excess interest expense.”¹¹⁷

Section 163(j), however, has been widely regarded as under-inclusive.¹¹⁸ For instance, although it could reduce the allowable interest deduction in the U.S. Acme-Irish Acme example above from \$8 million to \$5 million, it would only do so if U.S. Acme had a debt-to-equity ratio in excess of 1.5 to 1. Numerous amendments and alternative approaches have been proposed to broaden and rationalize its reach.¹¹⁹

116. See Notice of Proposed Rulemaking Under Section 385, *supra* note 10, at 20914 (describing the focus of the regulations as “excessive indebtedness between . . . related parties”); Benshalom, *supra* note 26, at 699 (differentiating “limiting abusive affiliated transactions and the overriding of treaty obligations”); Fleming et al., *supra* note 34, at 706–07 (describing § 163(j)’s conformity with treaty obligations). Further, Treasury has pointed out that while treaties may exempt interest payments from source country taxation, the source country’s domestic law determines whether a particular payment constitutes interest. See Final Section 385 Regulations, *supra* note 10, at 72,888 (“[T]he arm’s length . . . principle would not apply to the classification in the first instance of whether an instrument is debt or equity, which is a determination made under the relevant domestic law of the jurisdiction that is applying the treaty.”). Of course, given the near ubiquity of “non-discrimination” clauses in its tax treaties, U.S. rules for distinguishing between debt and equity cannot impose greater burdens on foreign taxpayers than are imposed on its own citizens or residents “in the same circumstances.” See Fleming et al., *supra* note 34, at 703 (describing treaty nondiscrimination rule). However, just as Congress extended section 163(j) to certain tax exempt U.S. payors to satisfy this rule, Treasury extended the reach of the section 385 regulations to instruments and payments made between related domestic corporations that do not file on a consolidated basis. See Final Section 385 Regulations, *supra* note 10, at 72,889 (arguing that the regulations do not “raise discrimination concerns” because “the recharacterization does not depend on whether the lender is a U.S. or foreign person, but on whether the lender files (or is required to file) a consolidated return with the issuer”). Given that most related domestic corporations must file consolidated returns, and most of the remainder find it beneficial to do so, while related domestic and foreign corporations cannot file consolidated returns, this is a distinction without any real difference.

117. See I.R.C. § 163(j)(1)(A) (2012) (disallowing deduction for “disqualified interest” up to the amount of the corporation’s “excess interest expense”). “Disqualified interest” is interest paid to a related party that is not subject to U.S. tax. I.R.C. § 163(j)(3). Only corporations with a debt to equity ratio in excess of 1.5 to 1 can have an “excess interest expense,” I.R.C. § 163(j)(2)(A); an interest expense becomes “excess” when it exceeds fifty percent of the corporation’s “adjusted taxable income . . . plus any excess limitation carryforward.” I.R.C. § 163(j)(2)(B)(i)(II).

118. See, e.g., Benshalom, *supra* note 26, at 691–93 (earnings-stripping provision’s “limited scope”); Jasper L. Cummings, Jr., *Income Stripping by Interest Deductions*, 141 TAX NOTES 971, 978 (2013) (same); Fleming et al., *supra* note 34, at 727 (“Section 163(j) is under-inclusive in several respects . . .”).

119. See, e.g., Fleming et al., *supra* note 34, at 729–33 (suggesting “strengthening” at the “margins” but admitting that even if amended “it is difficult to see how § 163(j) . . . will have

One oft-made suggestion is simply to disallow all deductions for interest paid with respect to related party debt, regardless of amount.¹²⁰ There is good reason to be suspicious of such related party loan transactions. The congruence of interest between debtor and creditor entities leaves open the possibility that both the price and amount of debt provided may reflect tax considerations rather than any underlying economic reality.¹²¹ And certainly it is more attractive to load up a subsidiary with debt and its accompanying obligations to make interest payments if those payments remain in the corporate group. However, to comply with the nondiscrimination rules found in many of our existing tax treaties, such a disallowance would have to apply across the board, to interest payments made to related foreign and domestic entities.¹²² Few thought that Congress or Treasury would go that far.

Yet that is close to what Treasury has done in its newly adopted section 385 regulations. In addition to imposing stringent documentation requirements on related party debt,¹²³ the regulations will treat “purported debt” as equity when issued to a member of the debtor’s “expanded group”¹²⁴ in the context of a distribution—

any significant role to play in developing a comprehensive and coherent approach to dealing with earnings stripping”); Kleinbard, *supra* note 15, at 1068 (advocating lowering ceiling on deductions applicable to all foreign corporations, not just inverted ones); Martin A. Sullivan, *The Many Ways to Limit Earnings Stripping*, 144 TAX NOTES 377 (2014) (describing the ten proposals offered to Congress since 2002 for strengthening § 163(j)).

120. See, e.g., Avi-Yonah & Xu, *supra* note 88, at 35 (“We strongly urge that the bottom line of international tax law reform is that interest deductions may not be greater in aggregate than each corporate group’s consolidated interest costs to third parties.”); Fleming et al., *supra* note 34, at 700–01 (advocating disallowance of deductions for payments to related parties except to the extent they can be traced to third party expenditures made on its behalf by the related party); Lee A. Sheppard, *BEPS Action 4: Interest Deduction Restrictions*, 149 TAX NOTES 190, 190 (2015).

121. See Benshalom, *supra* note 26, at 706 (“MNEs are able to skew, contractually, the risks from the income and deductions associated with the holdings of their financial assets between their various subsidiaries.”); Roin, *supra* note 113, at 291 (same).

122. See Fleming et al., *supra* note 34, at 707 (“Fortunately, these [treaty] difficulties can be overcome by adopting a U.S. rule that prohibits deductions for payments . . . to all related parties, both domestic and foreign.”).

123. See Final Section 385 Regulations, *supra* note 10, § 1.385-2 (documentation requirements). The final documentation rules are somewhat less stringent than those contained in the proposed regulations. See *id.* at 72,872–73 (describing changes in documentation standards in final regulations in response to comments).

124. *Id.* § 1.385-1(c)(4) (defining “expanded group”). Of course, as explained *supra* note 116, very few if any domestic-to-domestic transactions will be affected because of the exclusion of transactions occurring between taxpayers filing consolidated returns.

including a redemption—, in exchange for affiliate stock, pursuant to an internal reorganization, or for the purpose of funding a distribution or an acquisition.¹²⁵

Of course, even a complete elimination of deductions for related party interest may fail to significantly increase U.S. tax revenues. U.S. subsidiaries of foreign MNEs (including “legitimately”¹²⁶ inverted MNEs) may substitute unrelated party debt for related party debt, just as they did to avoid the reach of section 163(j);¹²⁷ fully domestic companies can do the same. Interest payments made to unrelated foreign entities and individuals would remain tax-favored, that is, deductible against U.S. source business income and exempt from taxation at source. Although this would prevent companies from “juicing up” the debt obligations of their U.S. operations with related party loans, the U.S. treasury may collect far less revenue than they expect from this change in rules, as it is unclear how much of the related party debt is “overstated.”¹²⁸

But would U.S. businesses replace related party debt with debt provided by unrelated foreign creditors? Ultimately, it will depend on whether the favorable tax treatment of interest payable to unrelated foreign lenders is passed through to U.S. customers in the form of lower interest rates. If so, there is no reason to believe that taxpayers will pass up such cost savings. Thirty years ago, Congress believed that the favorable tax treatment of foreign lenders was passed through to their customers. That belief provided the rationale for Congress’s removal of the statutory withholding tax on “portfolio” interest.

125. *Id.* § 1.385-3(b); *id.* at 72,889 (describing minimal changes from proposed regulations).

126. In other words, those former U.S. MNEs that manage to avoid the reach of section 7874 and become foreign MNEs.

127. Alternatively, the foreign multinational may “check-the-box” for the U.S. and other entities, leading to a formulaic allocation to the U.S. operations of the interest expenses of the larger operation.

128. Debt may be overstated either in terms of principal amount (the total amount of loans borne by the entity in excess of its economic carrying capacity) or its interest rate (the debtor would have been able to obtain funds on better terms from an outside lender). To the extent the interest disallowance merely disallowed overstated interest, the disallowance would be in perfect accord with United States’ rights and responsibilities under its treaty arrangements; all treaties allow a state to recalculate the income of an entity which has been distorted by “conditions [which] are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises” 2016 U.S. Model Treaty, *supra* note 72, at art. 9.1.

Congress wanted the cost savings for its own debt.¹²⁹ It also wanted to ensure that U.S. businesses did not pay higher costs of capital than their foreign competitors.¹³⁰ Congress may have been deluded then; it may be that facts on the ground have changed.¹³¹ But if Congress was even partially right in its analysis, the revenue implications of the proposed section 385 regulations may be disappointing.

Both the revenue and the policy impact of those regulations may be particularly disappointing because the exceptions¹³² to the treatment of related party debt as equity include money advanced to allow the debtor to make “new” investments in U.S. assets.¹³³ This exception may leave section 163(j) as the only impediment to tax planning in the U.S. Acme-Irish Acme scenario detailed in this subsection, and any other transaction in which a foreign corporation

129. As I wrote many years ago, this rationale was “questionable” given that the government’s interest savings would be counterbalanced by revenue losses; it would only make financial sense in the very unlikely event that lenders reduced their interest rates by an amount greater than the reduction in their U.S. tax liabilities. See Roin, *supra* note 113, at 279 n.40.

130. See STAFF OF THE JOINT COMM. ON TAX’N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 391–92 (1984) (explaining the importance of “direct,” “tax-free access to the Eurobond market”).

131. Exemption from source taxation is not advantageous if it is offset by a higher residence country tax. See *supra* text accompanying notes 86–89. It was never clear how much of the tax-favored treatment of investors in the Eurobond market—and thus their ability to offer lower pre-tax interest rates—stemmed from the self-help behavior of those investors in failing to report such income to their home jurisdictions. See Roin, *supra* note 113, at 284 n.61 (discussing the ubiquity of anonymity on the Eurobond market). To the extent FATCA and the OECD’s implementation of its common reporting standard (“CRS”) are successful at removing this anonymity and enforcing residence country taxation, some of this behavior—and the associated benefits to debtors—may simply disappear. See William Hoke, *Reporting Rule Might Deflect Some Criticism of U.S. as Tax Haven*, 150 TAX NOTES 528, 528 (2016) (describing the interplay between the two regimes). However, there is no assurance of their success. See *Financial transparency: The biggest loophole of all*, ECONOMIST, Feb. 20, 2016, at 51, 52 (“[The CRS] was drafted in a rush, and one expert thinks it would fail to catch 80% of tax-dodging.”).

132. The proposed regulations contain de minimis rules; they also exempt domestic consolidated groups that file a single consolidated tax return since intercompany debt has no tax significance for such groups. See Notice of Proposed Rulemaking Under Section 385, *supra* note 10, at 72,929 (“[C]oncerns addressed in the proposed regulations generally are not present when the issuer’s deduction for interest expense and the holder’s corresponding interest income offset on the group’s consolidated federal income tax return.”).

133. See Treasury Fact Sheet I, *supra* note 8 (“The proposed regulations generally do not apply to related-party debt that is incurred to fund actual business investment, such as building or equipping a factory.”); Final Section 385 Regulations, *supra* note 10, at 72,882 (“The final and temporary regulations are intended to address debt instruments that do not finance new investment in operations of the borrower.”). This exception has led some to wonder “to what extent these highly complex regulations would hurt multinationals that haven’t inverted.” Sullivan, *supra* note 107, at 259.

advances money to a related U.S. corporation to purchase U.S. assets from an unrelated company. Foreign multinationals thus may continue to have both the financial incentive and the legal means to strip from the U.S. tax base earnings gleaned from new investments. As a result, U.S. entities planning on increasing their U.S. operations continue to have an incentive to invert (as long as they can do so in a way that avoids triggering section 7874) and founders of new businesses have an incentive to establish them as foreign, rather than domestic, entities. In short, this exemption from the coverage of the proposed regulations leaves earnings stripping as a tax incentive for new investment, a decision that may come back to haunt Treasury.¹³⁴ Although the new regulations require that purported debt instruments be treated as debt for tax purposes only if the purported debtor has the capacity to repay the debt,¹³⁵ there is no requirement that such debt actually be repaid. Indeed, the regulations seem to foresee interest-only debt that is payable on demand—demand which may never be made.¹³⁶

An alternative (and simpler) approach would involve applying an across-the-board limitation on interest deductions for related party debt, regardless of the use of the funds. The Germans already have such a rule, and such a limitation is “one of the most important recommendations in the OECD’s BEPS report.”¹³⁷ The amount of revenue raised would depend on the percentage of income cap as well as the extent to which a taxpayer substitutes unrelated party debt for

134. See Sullivan, *supra* note 107, at 262 (“Even if a case could be made that inbound investment deserves its own targeted tax benefit, earnings stripping is clearly an outlandish delivery mechanism.”).

135. See Final Section 385 Regulations, *supra* note 10, at 72,943 (“[T]axpayers must be able to provide such things as: Evidence of an unconditional and binding obligation to make interest and principal payments on certain fixed dates; that the holder of the loan has the rights of a creditor . . . ; a reasonable expectation of the borrower’s ability to repay the loan; and evidence of conduct consistent with a debtor-creditor relationship.”); Notice of Proposed Rulemaking Under Section 385, *supra* note 10, at 20932 (“There must be written documentation prepared containing information establishing that . . . the issuer’s financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument.”).

136. See Notice of Proposed Rulemaking Under Section 385, *supra* note 10, at 20932 (“There must be written documentation . . . establishing that the issuer has entered into an unconditional and legally binding obligation to pay a sum certain *on demand* or at one or more fixed dates.”) (emphasis added). However, it may be difficult under the regulations for the debtor to pay dividends prior to repaying outstanding debt principal.

137. Ryan Finley, *Expect BEPS to Affect Private Equity Deals*, Panel Says, 150 TAX NOTES 185, 185 (describing “the action 4 report’s fixed-ratio rule”).

related party debt. The BEPS Action Plan suggests a cap of between ten and thirty percent¹³⁸ of earnings before interest, taxes, depreciation and amortization (“EBITDA”). It suggests “supplementing” this fixed cap with a “worldwide group ratio rule which allows an entity to exceed this limit”¹³⁹ to deal with special cases such as financial intermediaries. Many regard the particulars of the BEPS proposal as unduly taxpayer friendly, criticizing in particular the allowance of a thirty percent cap and its failure to limit total intragroup debt by the amount of outside debt.¹⁴⁰

The BEPS proposal, of course, is just that. Its drafters hope that participating governments will enact laws and negotiate treaties consistent with its recommendations of best practices.¹⁴¹ But standing on its own, it has no legal effect.¹⁴² Although a deduction cap applicable only to multinational entities would appear to violate the nondiscrimination rules found in many current U.S. tax treaties,¹⁴³ the United States could argue that the need to conform to BEPS overrides any conflicting treaty obligation. Whether that argument will succeed in placating its treaty partners, however, is uncertain. Alternatively, given that both treaty partners may be under some pressure to adhere to the BEPS recommendations, they may be willing to agree on a treaty protocol specifically authorizing such legislation. Such protocols, however, would have to comply with the procedures applicable to treaty ratification, hindering speedy adoption.¹⁴⁴

138. OECD, *supra* note 115, at 11 (“[T]he recommended approach includes a corridor of possible ratios of between 10% and 30%,” which “[a]s a minimum . . . should apply to entities in multinational groups.”). Current U.S. law, embodied in section 163(j), contains a 50% cap. See I.R.C. § 163(j) (2012).

139. OECD, *supra* note 115, at 11.

140. See, e.g., Avi-Yonah & Xu, *supra* note 88, at 34 (“Such a recommendation is not as powerful and strong as the audience anticipated.”); Sheppard, *supra* note 120, at 191 (“There is a broad view that the German level of 30 percent is too high . . . so that intragroup debt does not reflect, and often exceeds, outside debt.”).

141. See OECD, *supra* note 115, at 3 (“OECD and G20 countries have also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations.”).

142. See *id.* (“The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions . . .”).

143. To conform to such U.S. treaty obligations, the cap would have to apply to interest payments made to foreign and domestic residents. See *supra* text accompanying note 122.

144. See STAFFS OF THE JOINT COMM. ON TAX’N AND SENATE COMM. ON FOREIGN REL., TAX TREATIES: STEPS IN THE NEGOT. AND RATIFICATION OF TAX TREATIES AND STATUS OF PROPOSED TAX TREATIES 1 (1979) (outlining the steps and procedures for the negotiation and ratification of “[t]ax treaties (and protocols to existing tax treaties)”).

Adopting a cap on related party interest deductions would decrease, but not eliminate, the financial incentive for U.S. corporations to engage in inversion transactions. Both U.S. and foreign multinationals would have to live with the same cap. However, only foreign multinationals would be able to derive the tax benefits associated with making those payments that survived the cap to related, low-tax foreign entities.¹⁴⁵

It is unclear how much revenue would be raised by enacting such a cap. Revenue would depend on the height and definition of the cap, as well as the extent to which related party debt was replaced with unrelated party, foreign debt, as discussed in this subsection. Moreover, if the United States adopts a cap that is significantly less generous than that of its competitor nations, it might find business operations locating abroad to qualify for what is, effectively, a lower tax rate. Such a result would be altogether worse than a “pure” inversion transaction, since the end result would be a loss of economic base as well as tax revenues.

Alternatively, the United States could impose restrictions on taxpayers’ ability to fund the U.S. portions of their MNEs with higher levels of debt than the foreign portions of those MNEs.¹⁴⁶ The United States currently applies such a rule to the U.S. portions of U.S. MNEs,¹⁴⁷ and President Obama’s 2015,¹⁴⁸ 2016,¹⁴⁹ and 2017¹⁵⁰

145. If it remained part of a U.S. MNE, the benefit of the low rates likely would be lost due to the application of subpart F. See I.R.C. §§ 951–62 (2012). Thus, the financial incentives to engage in an inversion transaction would be reduced but not eliminated.

146. This amounts to adopting the “supplemental” BEPS rule without the percentage cap.

147. I.R.C. § 864(f).

148. See Sullivan, *supra* note 107, at 260 (“In its fiscal 2015 budget, released in March 2014, the administration dropped the proposal to expand section 163(j) . . . that had been part of every presidential budget since 2008. In its place was an entirely new proposal to limit interest deductions for all foreign-parented multinationals.”).

149. U.S. DEP’T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2016 REVENUE PROPOSALS 10–12 (2015) (discussing how the proposal would limit the interest deduction of any member of a group of companies filing a consolidated financial statement to the sum of the member’s interest income and the proportion of the group’s worldwide net interest expense equal to the member’s proportion of the group’s worldwide earnings). This is not quite the same as the rule for U.S. MNEs, which looks to the proportion of U.S. assets to worldwide assets, rather than assets to earnings. The rule for U.S. MNEs accords better with the underlying fungibility of money theory, but it is much more difficult to determine asset value than EBITDA.

150. U.S. DEP’T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2017 REVENUE PROPOSALS 2–4 (2016) (discussing how the proposal would limit the interest deduction of any member of a group of companies filing a consolidated financial

Budget Proposals include recommendations for the extension of this rule to foreign owned entities.

As has been amply demonstrated by another scholar,¹⁵¹ most proportionality rules can be gamed by taxpayers. Although some of the opportunities for taxpayer avoidance may be correctable,¹⁵² even the best proportionality rule would not remove the tax advantages accorded foreign creditors for debt that continues to be respected as debt. As a result, restrictions on disproportionate debt would not necessarily increase U.S. tax revenues, even assuming no change in the amount of business activity carried out in the United States. U.S. tax revenues will only increase if the total amount of interest deducted and paid to exempt foreign creditors declines—and that will depend not just on the current extent of disproportionate debt levels, but on the ease of development of alternative avoidance techniques.

In sum, none of these proposals completely eliminate the tax preference for U.S. businesses to take on foreign debt, nor do they eliminate the economic incentives for expatriating U.S. multinationals. At best, each of the proposals reduces the demand for debt from low-taxed, related foreign entities; none remove the tax advantages of foreign status (elimination of the withholding tax at source coupled with reduced tax in the country of residence) that accrue to foreign creditors for debt that remains deductible. Inversion transactions would remain desirable as a method of protecting the tax advantaged status of any remaining related party interest income because subpart F, which might tax such income in the hands of related U.S. shareholders, applies only when the creditor entity is owned, directly or indirectly, by large U.S. shareholders.¹⁵³ Of course, any U.S. company that managed to “thread the needle” and escape the clutches of section 7874(b) would have to beware of falling within the ambit of a foreign analogue to subpart F; the choice of residence country may be dictated by the need to avoid becoming subject to such a taxing regime. However, if both the foreign parent company

statement to the sum of the member’s interest income and the proportion of the group’s worldwide net interest expense equal to the member’s proportion of the group’s worldwide earnings).

151. See Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 TAX L. REV. 353, 357 (2001) (explaining how taxpayers can avoid the impact of proportionality limitations on interest deductions with debt-financed portfolio income and lease/own decisions).

152. See *id.* at 385 (explaining difficulty of coping with portfolio income).

153. Subpart F operates by constructively distributing income to U.S. shareholders. I.R.C. § 951(a)(1) (2012).

and the creditor entity are residents of a low-tax country such as Ireland, such arrangements would remain tax-advantaged. And as long as earnings stripping transactions remain tax-advantaged, inversion transactions remain attractive. Finally, none of these proposals reduce the incentive for U.S. companies to rely on debt provided by unrelated foreign providers.

Indeed, the only reform that would eliminate the tax advantages of strategic incorporation and borrowing would be the reinstatement of a significant withholding tax on interest, both as a matter of treaty and statutory law. But doing so would be complex. Not only would our treaty partners have to consent to such a change, but doing it “right” would be technically difficult. Taxes on gross income can easily become confiscatory. Consider the effects of such a tax on a foreign creditor who obtained the funds underlying the loan from another, or incurred other related expenses. To avoid imposing multiple levels of tax on the same income, treaties would have to include provisions mandating the flow-through of tax credits for taxes paid at source to those upstream lenders.¹⁵⁴ If pass-through credits are provided, this change in treaty policy may be more palatable to taxpayers than it would have been even a few years ago due to the advent of FATCA and the CRS,¹⁵⁵ both of which are aimed at ensuring the ultimate beneficiaries of investment income report such income to their countries of residence. Indeed, to the extent individual taxpayers are forced to report such income to their home tax authorities, the taxes paid by foreign corporations (as well as foreign individuals) at source may end up costing the treasury of the treaty partner rather than the foreign investor.¹⁵⁶

No taxing regime is perfect, and even a perfectly creditable source tax carries with it a danger arising from the disparities in national tax

154. The same problem is encountered with dividend income. As the intermediary entities in that context tend to be part of the same corporate family, though, it seems natural to either credit foreign taxes to, or exempt the dividend income received from the income of, subsequent recipients. Indeed, unrelated recipients of dividends often are subject to a second level of income tax. Many loan transactions are the result of a string of loan transactions involving unrelated parties (for example, a depositor to a bank to a hedge fund to an operating business); if credits (or exemptions) do not flow from one unrelated creditor to the next, any given amount of interest may be subject to multiple levels of tax.

155. See *supra* note 131.

156. Even a perfect pass-through credit will not compensate investors for the loss of their ability to defer taxation while the income is retained at the corporate level. It will merely reduce the sting of the individual-level tax which all too many taxpayers evaded prior to enactment of those new regimes. Under present economic conditions, this time value of money loss may not be very significant.

rates. No country, at least not purposely, grants credit for taxes paid to a foreign country in an amount greater than the taxes that would have been payable on such income had it been earned domestically. Thus, if the U.S. source tax rate exceeds the tax rate in the ultimate creditor's state of residence, the burden of this excess will fall on the foreign creditor rather than its residence country's treasury. This would likely cause such creditors to increase the required amount of pretax return—the interest rate—demanded of U.S. debtors to levels above that demanded of debtors from countries levying source tax at a lower rate. Such an increase in the cost of capital might be enough to convince some businesses to relocate abroad, or to avoid making new investments in the United States. It was fear of precisely this effect that led many to argue that the United States should not tax such interest income in the 1980s.¹⁵⁷ Source countries, as well as residence countries, engage in tax competition in an effort to attract investors. Even if not worried about this under present economic conditions, terms embodied in tax treaties are hard to change.¹⁵⁸

Interest payments are not the only device used by MNEs to strip income out of high-tax jurisdictions such as the United States. Royalties and license fees are another. Presumably, as the opportunities for interest-based earnings stripping transactions are reduced, more foreign—and domestic—MNEs will turn to royalties or license-based schemes.¹⁵⁹ As Starbucks has shown,¹⁶⁰ virtually any business can use such schemes to covert ordinary business income into stateless income. However, as discussed in the next Section, closing down such opportunities may be even harder than closing down the opportunities for interest-based earnings stripping transactions.

157. See *supra* note 129.

158. But see Sullivan, *supra* note 107, at 260 (arguing that allowing earnings stripping is an irrational way to attract foreign investment).

159. At present, these schemes seem to be used mostly by U.S. MNEs to strip income from high-tax European countries into tax-haven countries. Fleming et al., *supra* note 34, at 714. Subpart F generally does not pick up this income because of its exception for royalty income paid by unrelated parties in the course of the active conduct of a trade or business or by operation of section 954(c)(6) “which characterizes intragroup royalties and other deductible payments . . . as active income as long as the amounts are not paid out of the payer’s own subpart F income.” See Kleinbard, *supra* note 86, at 1524 (describing Starbucks’s tax planning).

160. See Kleinbard, *supra* note 86, at 1516 (“[I]f Starbucks can organize itself as a successful stateless income generator, any multinational company can.”).

B. Taxation of Royalties and Other Payments for Intellectual Property

Transactions for stripping income out of a jurisdiction through the payment of royalties or other analogous transfers are often¹⁶¹ mechanically similar to those of interest stripping transactions. Instead of cash, the foreign tax-haven entity leases its rights to use some form of intellectual property rights to the operating U.S. business. The U.S. business deducts the royalties paid for the use of that property as an expense of its U.S. operations. Although by statute such royalty payments are considered U.S. source income¹⁶² subject to a withholding tax,¹⁶³ in practice, most treaties waive most or all of this source tax.¹⁶⁴ Thus, the judicious choice of a residence country enables taxpayers receiving such payments to avoid or reduce both source and residence country tax paid on such income. Finding such an amenable country has become easier, as an increasing number of countries have adopted “patent box” regimes, which provide low tax rates for income derived from intellectual property rights developed within their borders.¹⁶⁵

Devising a regime for taxing intellectual property income at source, however, presents an even greater challenge than devising a regime for the taxation of interest income. Optics is the first problem. The distinction between “business profits” and “passive royalties” simply has not been challenged to the same degree as the distinction between debt and equity. The intellectual confusion between debt and

161. The mechanics vary, and are distinctly more complex, when they involve “cost-sharing arrangements.” See Bret Wells, *Revisiting Section 367(d): How Treasury Took the Bite Out of Section 367(d) and What Should Be Done About It*, 16 FLA. TAX REV. 519, 555–64 (2014) (discussing mechanics of such arrangements).

162. I.R.C. § 861(a)(4) (2012) (U.S. source income includes “[r]entals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.”).

163. I.R.C. §§ 871(a)(1), 881(a)(1); Internal Revenue, 26 C.F.R. § 1.871-7(b)(1).

164. See *I.R.S. Table 1*, *supra* note 81 (columns 10 & 11, listing withholding rates under treaties). The same treaty provisions provide concessionary rates for lease payments made with respect to the use in the United States of tangible personal property owned by a resident of the treaty partner. See *id.*; Wells, *supra* note 22, at 8 (describing “Lease Stripping Transactions”).

165. The EC recently determined that these regimes would not be considered to constitute either “state aid” or “harmful tax competition” as long as they require “substantial” economic activity in the jurisdiction. See DLA PIPER, *supra* note 21 (noting countries in Europe with such regimes include the United Kingdom, The Netherlands, Belgium, Luxembourg, Spain, France, and Hungary).

equity¹⁶⁶ makes it easy to contend that the economic returns from each ought to be treated identically.¹⁶⁷ Because “business income” is taxed at source, so too should be the returns from “debt”—and because income from “equity” is currently subjected to two levels of taxation, so too should be income from “debt.”¹⁶⁸ The same could be said of income derived from the use of intellectual property. Ultimately most of this income, too, is derived from active business operations, with the remainder the monopoly profits generated by legal protections conferred on the property in the market state. Yet returns labeled “royalties” have not been conceptualized as merely another distribution of business income equivalent to dividends.

This may be because intellectual property income so clearly has more than one source—the country of development and the country of use—each of which deserves the right to levy the primary tax on a portion of the total taxable return.¹⁶⁹ This makes the prospect of assigning not single but double taxing rights to just one of those countries a very unattractive proposition. Indeed, determining the proper (economically accurate) allocation of income for even the first level of taxation between these sources is not simple,¹⁷⁰ and may differ

166. See *supra* note 97.

167. Scholars differ on whether such income should be taxed once (at the business level) or twice (at the business level and again at the shareholder level). See Wells, *supra* note 22, at text accompanying notes 5–9 (describing integration proposals).

168. Note that this position does not require subscribing to the view, as some have argued, see Fleming et al., *supra* note 34, at 695–96, that related party financing is “costless” to a business enterprise. That proposition seems implausible on its face. The entity providing cash or credit to another entity in the very least incurs an opportunity cost (i.e., it gives up the opportunity to use the money in other income-producing activities) and may be incurring actual, actual out-of-pocket costs to obtain use of that money. The question is where the return from that investment ought to be taxed—and under tax treaties, that question is usually determined by whether the recipient is itself engaged in a U.S. trade or business rather than by whether the income was derived from U.S. business activities.

169. As discussed in more detail *infra* Section III.C, the problem is similar to that faced when dealing with income arising from the sale of goods manufactured by a taxpayer in one country and sold in another, or services performed in one country and sold to customers in another. See REUVEN AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 44–45 (2007); Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 233, 241–42 (1981). Note that one could make the same argument with respect to debt and equity, in that the accumulations of capital used to provide such funds take place in one country, and are used in another, with each country deserving the right to tax part of the return, but the analogy has not found much purchase in that context.

170. Although some advocate the use of the “profit split” method for making this allocation, see Internal Revenue, 26 C.F.R. § 1.482-6 (detailing profit split method); Wells &

not only from taxpayer to taxpayer but also from project to project. Some have concluded that the problem is too difficult to manage, and thus that all the income should be assigned to one state.¹⁷¹

In addition, the expenses associated with the derivation of royalties—research and development expenses, most obviously—make it an unattractive subject for a gross income-based withholding tax or its economic analogue, a statutory disallowance of a deduction for royalties. However, the failure to impose any sort of tax on such income in the market state, the treatment accorded by most treaties,¹⁷² has led to systematic undertaxation of such income as the ownership of intellectual property—and the associated taxing rights—has become concentrated in low-tax countries.¹⁷³

Lowell, *Tax Base Erosion*, *supra* note 26, at 595 (OECD accepts profit split methodology), the method actually highlights rather than solves the problem of determining how much of the overall profit should be allocated between countries. There is no reason to believe that the appropriate profit split should be the same for all taxpayers or even all products; thus, the application of this method needs to be either highly contextual and fact dependent or to rely on arbitrary formulas. *See* JULIE ROIN, *TRANSFER PRICING IN THE COURTS: A CROSS-COUNTRY COMPARISON*, *in* *FUNDAMENTALS OF INTERNATIONAL TRANSFER PRICING IN LAW AND ECONOMICS* 185, 191 (Wolfgang Schon and Kai A. Konrad eds., 2012) (“Under the profit split method each affiliated entity is assigned the proper return for its ‘routine’ contributions first, with the remaining (‘residual’) profit allocated to the entity performing a [sic] nonroutine functions or contributing nonroutine property Like the transactional profit split method, the US profit split method . . . is less successful when more than one entity makes such [nonroutine] contributions because, by definition, no market comparable exists to help the fact-finder allocate the residual profit between such entities.”).

171. *See* Lokken, *supra* note 169, at 242 (“[A] typical royalty cannot feasibly be split between the place of the licensee’s use of the licensed property and the place of the activities by which the licensor created the property.”). Professor Lokken argued for the taxation of such income in the market state, regarding that state as having the strongest claim. *See id.* at 243. Interestingly, current treaty practice—combined with the development of patent box regimes—would do the opposite by assigning all income to a development country, which often levies a tax at a risible rate.

172. *See I.R.S. Table 1*, *supra* note 81 (listing withholding rates).

173. *See* OECD, *supra* note 107, at 15–16 (“*The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly.* For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.”); Matthias Dischinger & Nadine Riedel, *Corporate Taxes and the Location of Intangible Assets Within Multinational Firms* 3 (Munich Economics Discussion Paper No. 2008-15), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.606.2157&rep=rep1&type=pdf> (finding “evidence for a statistically significant and quantitatively relevant bias of intangible property holdings towards affiliates with a low corporate tax rate relative to other group locations”). As patent boxes become more widespread, taxpayers will have a wider choice of low-tax locations in which to park their intangible assets. *See supra* note 21 (describing patent boxes).

And again, even more extreme undertaxation is possible when the owner and the user of the intellectual property are related entities. A related party is happy to overstate the value of intellectual property (thus overstating its own income for tax purposes) if the overstatement results in an understatement of the income derived by a (higher-taxed) related entity. The question is what to do about this in a world in which it is very difficult, or even impossible, to determine the appropriate price for transferring intellectual property.¹⁷⁴ Having succeeded in characterizing the disallowance of deductions for “excessive” interest deductions as a legitimate response to transfer pricing violations, a statute disallowing royalty deductions for payments to related parties in excess of a stated percentage of EBITDA might well pass treaty muster.

But what would be the appropriate percentage or formula for imposing such a disallowance? Indeed, is EBITDA even the right baseline? If the concern is that taxpayers are understating the amount of income due to U.S. sales activities, it might be better to require that those U.S. activities generate an appropriate return—say, impute a return equal to a stated percentage of the U.S. operating unit’s expenditures—and work backwards from there. In short, instead of looking like section 163(j), which limits the percentage of the overall profit that can be reduced by the related party payment, perhaps the statutory rule should disallow royalty deductions that reduce the U.S. sales entity’s income to below an expected return on investment or return on expenditure. Such a statute would be equivalent to mandating a uniform, one-sided transfer pricing adjustment on royalty transactions, with all the administrative difficulties and uncertainties such analyses entail.¹⁷⁵ Further, and this is a big further, such a one-sided analysis would not allocate any portion of the returns from the legal protections provided by the United States to the United States for tax purposes. The only one-sided analysis that would make such an allocation would be one that disallowed royalties in excess of the amount necessary to generate a stated return on the foreign payee’s

174. The difficulty is both substantive (such property is extremely difficult to value) and administrative (tax authorities do not have the resources to closely examine each such transaction).

175. Of course, if both entities contributed intellectual property or other extraordinary factors to the income producing process, a two-sided transfer pricing analysis would be required. This exercise would replicate the profit-split method of pricing transactions.

research and development and other related business expenses.¹⁷⁶ The problem, of course, is that the taxing authorities in the United States generally do not have access to such information about a foreign taxpayer.

They may be able to obtain that information, though, if the foreign taxpayer is related to the U.S. payor. The United States could, conceivably, limit the U.S. payor's deduction for royalties to an amount equal to a related foreign payee's related research and development expenses (or those expenses plus a stated return). This would leave the U.S. tax authorities in the position of having to audit expenditures that were largely taken abroad, which may be difficult, and obvious avoidance possibilities would have to be foreclosed. For example, the impact of the deduction limitation would be blunted, if not eliminated, if that foreign payee were allowed to claim as an expense the costs of purchasing royalty rights from another foreign related party, as the price charged by that related party could include the value of the monopoly conferred by U.S. legal authorities. One possibility would be to limit the expenses taken into account to amounts paid to unrelated parties, although one might want to supplement such a limitation with a rule allowing related entities to effectively combine for purposes of determining the total amount of third party royalty-related expenditures. If Treasury is willing to consolidate related foreign entities for purposes of computing the allowable amount of interest deductions, there would seem to be no impediment to doing the same for research and development expenses.

But what if the foreign payee is unrelated to the U.S. payor? Consolidation imposed through a limitation of deductions would be unavailable. Although the problem of "excessive" royalty deductions does not arise between unrelated payees and payors, failing to levy a U.S. tax on the returns generated by the intellectual property protections provided by U.S. law would encourage U.S. intellectual property rights to be held by unrelated foreign entities just as the non-taxation of interest payments to unrelated foreign creditors encourages domestic entities to borrow from unrelated foreign creditors. The underlying problem—that treaty provisions grant the right to tax U.S. source income to residence countries that may not exercise that right—would remain, and with it the incentives for

176. This technique could be flipped, of course, if the U.S. entity engaged in research and development or production activities and marketed its products abroad.

taxpayers to take actions that will substantially reduce U.S. tax revenues. There is, after all, very little prospect that such treaty concessions would result in anything close to an equal exchange of revenues between the United States and a low-tax treaty partner. No Irish taxpayer is going to structure its business transactions to generate a large royalty payable to a U.S. entity. It makes financial sense for intangible assets to reside in low-tax countries, and the United States is not a low-tax country.

The only legal change that would remove the incentive to park ownership of intellectual (or indeed other types of personal property) used in the United States in unrelated entities resident in low-tax jurisdictions would be to reinstate the right to tax royalty and other property income at source. And, as in the interest context, the only way to accomplish that is through the explicit imposition of a withholding tax. In short, reformation of treaties would be necessary. However, even if the treaty partners were amendable to such a change, devising an acceptable withholding tax regime would be far from simple.¹⁷⁷ The imposition of a gross basis withholding tax at the thirty percent statutory rate would run into the same problems—and the same objections—as a flat disallowance of royalty deductions. As a practical matter, there is no way to impose the “right” amount of tax using such a gross income-based taxing mechanism. However, those very imperfections may provide a mechanism for enticing (or forcing) taxpayers to opt into a net income-based source tax regime.

A withholding tax regime would need to allow for the division of taxing rights between the country in which the research and development activities took place and the country whose legal system provided the income-boosting monopoly powers. One might want to analogize this situation to the one encountered by taxpayers that both produce and sell inventory property. Regulations allow taxpayers to divide income generated by such “mixed” activities between their sales and manufacturing components on a fifty-fifty basis;¹⁷⁸ a similarly arbitrary division might be imposed in this context and effectuated by imposing a withholding tax equal to a fraction of the statutory tax rate.

However, such a division, in addition to being arbitrary, runs the risk of being confiscatory if levied on the taxpayer’s gross rather than

177. See Wells & Lowell, *Tax Base Erosion*, *supra* note 26, at 569–70 (describing efforts of a UN Ad Hoc Group of Experts in 1969 to devise an appropriate taxing regime).

178. See Treas. Reg. § 1.863-3 (as amended in 2006) (rules for the allocation and apportionment of mixed source sales income).

net income. After all, royalty income is often, if not always, associated with substantial expenses (including research and development expenses). If one of the parties to the transaction incurs the lion's share of the joint expenses, even a pro-rated (i.e., arbitrarily reduced) withholding tax rate may leave that party paying withholding tax at an extraordinarily high effective rate. The excessive tax is unlikely to be ameliorated through even a well-designed pass-through credit provided by the payee's country of residence because (unlike in the interest context), many of the expenses would not be royalties, nor even U.S. sourced, in the hands of the recipients, making a full pass-through extraordinarily difficult.

The very unattractiveness of such a tax regime, though, might be its salvation, in that it could make an alternate approach attractive to both taxpayers and source countries. This alternate approach is already in use in another context, rental real estate. Both the Internal Revenue Code¹⁷⁹ and treaties¹⁸⁰ allow nonbusiness foreign taxpayers receiving income from the rental of real estate to "elect" into business status for purposes of determining the tax liability of this income. This allows them the option of being taxed on their net rental income at regular statutory rates, rather than gross rental income at treaty rates. Similar provision could be made for foreign taxpayers receiving U.S. source royalty income that is taxed at source. This would allow such taxpayers to deduct their costs of developing such intellectual property prior to computing their source tax liability.¹⁸¹ Such a rule could incorporate a division of taxing authority between the market country and the development countries by grossing up the allowable deductions by an appropriate profit percentage before applying the U.S. tax to the remainder, thus dealing with the first complication as well.¹⁸²

Unfortunately, current tax treaty policy seems to be moving in the direction of less, rather than more, taxation of royalty income earned

179. See I.R.C. §§ 871(d) (individuals); 882(d) (corporations).

180. See 2016 U.S. Model Treaty, *supra* note 72, at art. 6.5.

181. This would unfortunately leave the United States' tax authorities in the position of having to audit expenditures which were largely undertaken abroad. And it would be a complicated audit, as it would involve allocating the overall research and development costs between U.S. and foreign components (as the same research and development may lead to the creation of intellectual property rights in multiple jurisdictions).

182. For a discussion of the difficulties involved in setting such a percentage, see Fleming et al., *supra* note 34, at 712–13. In addition, such a taxing regime might be undermined through the use of an intermediate entity which purchases the intellectual property from its developer at a price incorporating (at least) the value of the legal protections afforded by the market state.

from foreign sources. In an effort to attract research and development activities, several European countries have enacted “patent boxes” which provide preferential tax treatment of royalty income derived from the exploitation of intellectual property.¹⁸³ The European Commission concluded that these tax regimes would not constitute proscribed “state aid” provided the taxpayers covered by them were required to engage in “substantial” in-country research and development activities.¹⁸⁴ The effect of these regimes, of course, is to attract research and development activities by turning the associated royalty income into a variant of “stateless” income, subject to tax neither at source (because of the treaty reductions in source taxation) nor (very much) in the country of residence. Many have advocated for the United States’ adoption of such a regime to counter this competition for the research and development activities.¹⁸⁵ Doing so would be to participate in a classic race-to-the-bottom framework. If non-adopting countries like the United States adopt patent box regimes, MNEs would benefit by paying lower taxes wherever they operate, all of the affected countries would collect less revenue, and research and development activities would take place in whichever country they would have been in had no patent box regimes existed.

Indeed, even if unwilling to reinstate the source tax on all royalties or impose a deduction limitation on related party royalty payments generally, the United States should do so for taxpayers from countries with patent box regimes. Subjecting royalty income to tax at source would reduce the benefit of the patent box tax regime,¹⁸⁶ and with it the incentive to remove research and development activities to the

183. Merrill et al., *supra* note 85.

184. *See supra* note 21.

185. *See, e.g.*, Bernard Knight & Goud Maragani, *It Is Time for the United States to Implement a Patent Box Tax Regime to Encourage Domestic Manufacturing*, 19 STAN. J.L. BUS. & FIN. 39, 41 (2013) (advocating adoption); Merrill et al., *supra* note 85 (same); Evan M. Migdail & Bruce Thompson, *Patent box concept emerges on the tax reform agenda for US Congress*, DLA PIPER PUBLS. (June 10, 2015), <https://www.dlapiper.com/en/us/insights/publications/2015/05/patent-box-concept-emerges-us-tax-reform/> (detailing legislative efforts); Robert W. Wood, *Patent Boxes come to Ireland & UK, Why not U.S.?*, FORBES (Oct. 16, 2014, 1:57 AM), www.forbes.com/sites/robertwood/2014/10/16/patent-boxes-come-to-ireland-uk-why-not-u-s/2/#475c0646552c (advocating adoption).

186. Imposing a tax at the full statutory rate on the entire royalty payment, even that portion attributable to the return on the research and development activities, would be required to completely eliminate the benefit of a patent box regime. However, that would probably be regarded as overreaching, as countries generally have the right to determine the rate of tax to be levied on income generated within their borders.

sponsoring nation (as well as to engage in an inversion transaction to become eligible to take advantage of the regime). And indeed, in the 2016 U.S. Model Treaty, taxpayers are supposed to be denied benefits for income that will be taxed under “special tax regimes” in the treaty partner.¹⁸⁷ Unfortunately, and to my mind inexplicably, the terms of the Model Treaty specifically exclude from the definition of a “special tax regime” a royalty regime which “condition[s] such benefits on the extent of research and development activities that take place in the Contracting State.”¹⁸⁸ In short, the Treasury Department seems to have decided that it is perfectly appropriate for the U.S. fisc to finance, by foregoing its legitimate tax claims,¹⁸⁹ the United Kingdom’s attempt (for example) to lure research and development activities from the United States to the United Kingdom.

The only excuse for such self-defeating behavior is that, in the end, it may be impossible to effectively impose a source tax on royalties. After all, it is not just related parties who are willing to buy intellectual property rights from a foreign owner at a price incorporating the value of U.S. legal protection. If a foreign entity A, the original owner of such rights, sells them to an unrelated foreign entity B, which then licenses them to a (related or unrelated) U.S. operating entity C, the income subject to any net income-based U.S. source tax (whether imposed on C through a deduction disallowance or on B through a withholding tax) could well be minimal because the taxable income amount would be reduced by the payment to A (if not B, if C and B are unrelated entities). Transferable credits, available in the interest context, do not work well in this one because the associated expenses are of many different types. Moreover, to the extent those expenses relate to research or development activities carried out by A or B outside the United States, the countries in which those activities took place would be well within their rights in refusing to pass through the

187. See 2016 U.S. Model Treaty, *supra* note 72, at art. 12.2(a).

188. See *id.* at art. 3.1.I.ii.

189. It is perfectly appropriate for the United States to give up its claim to tax the return from any research and development activities that have moved abroad. One could describe the analytic basis of our current international tax regime (as well as territorial tax regimes) as following the principle that the tax base follows the economic base: there is no U.S. tax if there are no U.S. economic activities. After all, activities occurring outside the United States generally do not impose significant costs on the U.S. government. In the patent box context, though, the taxpayer removes only part of its U.S. economic activities, leaving behind a part that requires the (sometimes expensive) protection of the U.S. government. There is no reason that protection should be provided for “free.”

credit to offset the tax liability due on income attributable to activities occurring within their jurisdiction.¹⁹⁰

Nor is this the end of the parade of horrors. There is yet another method for avoiding a source tax on royalties, one which poses perhaps an even greater threat to the U.S. economy than the schemes described earlier. Instead of licensing intellectual property for use in the United States, businesses may switch to selling finished products into the U.S. market at prices incorporating the value of the intellectual property inherent in those products. If businesses do this, not only will the United States collect no additional tax revenue, but more of its economic base will disappear—all the U.S. business activities and jobs involved in transforming the intellectual property into the final product. At least it will if the businesses at issue are foreign entities, since in many, if not most, cases, sales by foreign companies can be structured so that they do not give rise to U.S. source income. This last possibility, and the possible countermeasures, are the focus of the next Section.

190. One of the “old chestnuts” of U.S. tax jurisprudence, *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957), involves a similar factual situation. The taxpayer in that case, a Swiss professor, was employed by a Swiss corporation to work on a joint research project. Under the terms of their agreement, the company owned the commercial rights, including patents, resulting from the research while the professor was to be paid a percentage of the net proceeds from the sale of products developed with the use of those patents. The Swiss company licensed its U.S. intellectual property rights to its U.S. affiliate. The U.S. affiliate paid the Swiss parent a royalty for the use of this property. The U.S. affiliate also paid Karrer the sums due him under his contract with the Swiss parent with respect to the U.S. sales. For reasons known only to the Internal Revenue Service, instead of contending that the payments to Karrer constituted additional royalties paid to the Swiss parent (royalties that would have been taxable as apparently no tax treaty applied), it argued that the payments constituted royalties in Karrer’s hands—a difficult case to make given that Karrer did not own the underlying patent. The court held that these payments were recompense for personal services performed by Karrer outside the United States, and thus fell outside U.S. taxing jurisdiction. That may have been the right result in that the U.S. withholding tax ended up being collected only on the Swiss company’s net—rather than gross—royalties, *see supra* text accompanying notes 85–88 (advocating a net income-based tax), but perhaps it was not. It depends on one’s view of the proper characterization of personal services income that is measured by the value of patent rights. In the absence of U.S. enforcement of those patent rights, presumably, the price of the products sold by the U.S. affiliate, and thus Karrer’s checks, would have been lower. Thus Karrer benefited not just from performing services, but also from monopoly rights conferred by the U.S. government—an increment of value that perhaps should have been traced to (and taxed by) its U.S. source. Indeed, one could view Karrer’s non-taxation as exemplifying the difficulties posed by earnings stripping transactions effected between unrelated parties.

C. Sales Income

Perhaps the greatest threat to the U.S. tax base comes from sales of foreign products (both goods and services) into the United States. In today's economy, many of the highest value products take the form of services or digital content. Though some services have to be provided locally, an ever-increasing number can be performed remotely; likewise, sellers of digital content never have to set foot in the United States. Even physical products can be ordered and shipped from remote sellers, over the Internet. Though legal changes could draw some of these sales into the U.S. tax net when they are effected by foreign companies, it is hard to envision how such taxes could be enforceable. How can the U.S. tax authorities reach business entities with no physical connections to the United States? But the enforcement troubles are not limited to remote seller contexts. They exist even when a foreign entity sells products or services to a domestic entity for resale to U.S. customers.

Legislators¹⁹¹ and Treasury¹⁹² have long worried about the use of non-arm's-length pricing in transactions between related parties to

191. Congress first authorized the consolidation of "the accounts of . . . related trades and businesses . . . for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital" in the Revenue Act of 1921. Robert N. Lent, Comment, *New Importance for Section 482 of the Internal Revenue Code*, 7 WM. & MARY L. REV. 345, 346 (1966). By 1928, Congress had authorized the Commissioner of the IRS to "allocate gross income or deductions among businesses controlled by the same interests to prevent the evasion of taxes or to clearly reflect income." *Id.* at 346. The language changed somewhat over the next several tax acts, but by 1939, Congress settled on the language that is currently found in the first sentence of what is now section 482 of the Code. *See id.* ("the law has remained consistent through the 1939 Code to the present Section 482 of the 1954 Code"). Congress added a second sentence to section 482 in 1986, allowing Treasury to adjust the price at which intangible property is transferred among related parties so that it is "commensurate with the income" to "fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each." *See also* STAFF OF J. COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1015 (Comm. Print 1987). And most people regard the enactment of the subpart F regime in 1962 as an attempt to backstop the general inadequacies in the operation of the section 482 transfer pricing rules. *See generally* Federal Tax System—Message from the President of the United States, 107 Cong. Rec. 6456, 6458 (1961) (proposing enactment of subpart F regime to eliminate the "shelter for tax escape . . . aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights").

192. *See* Michael C. Durst & Robert Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 TAX L. REV. 37, 42–76 (2003) (detailing successive attempts to promulgate regulations under section 482 of the Code to forestall transfer pricing abuses).

reduce taxable business income. Although section 482 and parts of the subpart F regime were supposed to ameliorate such abuses, no one believes that they are very effective. Far too few related party sales have third party comparators to make the arm's-length standard very useful. One reason such comparators are missing is that many of the transfers involve items that incorporate hard-to-value intellectual property; the value of the property then, to a very large extent, equates to the value of the intellectual property. When that intellectual property is owned by the foreign seller or another foreign party, under current law there is little reason for the country in which the buyer is located to try to differentiate the (nontaxable) royalty portion from its generic accompaniment. Thus, for example, Starbucks can justify charging much more for coffee beans that have been roasted to its specification than for unroasted beans, even though the roasting process itself is not expensive.¹⁹³

In a world in which royalties are taxed at source, it may be possible to “kill two birds with one stone” by forcing all transfers of branded or otherwise intellectual property-protected property to be bifurcated, into an intellectual property component and a “generic” component, with the sums paid for the first component treated as royalties for tax purposes.¹⁹⁴ Taxpayers have long taken advantage of the opportunities to slice, dice, and consolidate income to achieve the most desirable (from a tax standpoint) characterization; forcing bifurcation in these instances would take away some of this advantage. Although this places a significant burden on the withholding agent, which must figure out how much of the payment constitutes the hidden royalty,¹⁹⁵ when the withholding agent is related to the seller, the burden should be tolerable.¹⁹⁶ Related parties, after all, are already responsible for documenting the derivation of their inter-corporate pricing; it would not be too much to ask that they document the portion of that price that is attributable to the intellectual property component of the items transferred. At worst, one could once again make recourse to a

193. See Kleinbard, *supra* note 86, at 1526–28 (describing Starbucks's internal coffee pricing).

194. This only makes sense, of course, if the tax regime for royalty payments is changed, so that such payments are either subject to a source-based withholding tax or made nondeductible.

195. This can be both a burden and an opportunity, of course; if the national tax authorities have difficulty determining the value of the “generic” component of the transfer, the taxpayer may be able to understate the amount of the royalty.

196. Indeed, the larger problem is likely the administrative one facing tax authorities, who would be in charge of policing the bona fides of such bifurcations.

formulary approach, artificially assigning some portion of the total price (or income) to the intellectual property component, at least as a presumption. Of course, this solution is premised on the adoption of a regime, such as the one described above, that taxes royalties at source.

But what if the U.S. buyer is not related to the foreign seller? Then this approach seems all but unworkable. Perhaps there could be a default rule, similar to the FIRPTA withholding rule, mandating that a certain percentage of the purchase price be withheld and sent to the U.S. government; the foreign seller would then have the right to a refund of part or all of the withheld amount if it can prove to the satisfaction of the IRS that it exceeded the amount appropriate given the incorporated intellectual property rights. Choosing the default withholding rate, though, would be both critical and difficult. Set it too high, and the IRS would be overwhelmed with requests for readjustment; set it too low, and it may not be worth the effort involved in administering it. And what if there are two unrelated entities between the creator and the eventual seller of the products?

CONCLUSION

Continuing to follow a tax treaty policy that seeks removal of withholding tax on U.S. source “investment” income is clearly a mistake; all that removal does (both for businesses operating in the U.S. and abroad) is make it easy for those businesses to transmute active business income into “stateless” investment income that is barely, if at all, taxed. Yet walking back from this policy will be far from simple given the difficulties involved in renegotiating tax treaties. Moreover, walking backwards reveals other problems and tensions in the international tax rules that will be difficult, if not impossible, to solve.

When U.S. business operations are carried out by domestic entities related to the foreign investor, a missing withholding tax can be approximated through the imposition of restrictions on the operating entities’ deductions. Indeed, such restrictions may be preferable to the imposition of a gross income-based withholding tax when they are crafted to take into account expenses incurred by a related “investor.” As detailed above, deduction restrictions can be structured to effectively consolidate the income and expenses of related entities with respect to particular income items, and treat it all as business income. So, too, can withholding taxes, but deduction limitations may have the advantage of not directly running afoul of treaty limitations,

allowing them to be adopted by congressional action and without bilateral negotiations.

Such consolidation necessarily raises difficult issues. What percentage of an intellectual property-based return should be attributed to research and development activities and what percentage should be attributed to the legal protection provided by the country in which the property is used? The answer to that question is critical to determining the amount by which foreign research and development costs should be inflated for purposes of allowing a deduction against the operating entity's income—or the amount by which the tax rate on net royalties should be reduced. How much income should be attributed to sales activities versus manufacturing activities when a multinational group manufactures goods or performs services in one jurisdiction, but sells them in another? To what extent should the rules rely on arbitrary formulas to resolve such issues, and to what extent individualized arms' length determinations? Such issues bleed into perennial questions about source—where is intellectual property used, anyway? And where do sales take place? How should business synergies—or the lack thereof—be allocated among affected jurisdictions? To what extent should tax authorities rely on information provided by a taxpayer about the amount and relevance of costs incurred in other jurisdictions, and what tools are available to them if they choose to not so rely? None of these questions have easy answers, but they are no more difficult to answer—or (eventually) to reach agreement on with competing tax authorities—than they would be under either profit-split or traditional arm's length tax regimes. This should not be surprising given that they are all trying to answer the same question: How much of the income generated by a functionally integrated business enterprise should be allocated to each of the countries within which that enterprise operates?

The implementation problems become significantly more difficult, and perhaps even overwhelming, when the payor and recipient entities are unrelated. Business income can be stripped from U.S. operating entities through transactions with unrelated parties as well as related parties. Yet explicit (and even implicit) consolidation of operating income and expenses is impossible when neither entity has access to the other's income and expense information. Asking taxpayers to "guesstimate" the portion of value attributable to the intellectual property component of inventory items, for example, is a recipe for disaster, not to mention taxpayer resentment. That leaves only gross basis withholding taxes (or standardized deduction disallowances) as

possible tools for combatting earnings stripping effected through transactions with unrelated parties. Those cures may be worse than the disease—unless the disease becomes epidemic.

That is the ultimate question: will taxpayers rearrange their corporate and business structures to avoid the related party transactions targeted by changes in the tax rules? It is not hard to envision structures akin to the contract manufacturing arrangements constructed for purposes of avoiding the impact of the subpart F rules developing in the earnings stripping arena. Starbucks has both wholly owned stores and licensees; it is not obvious which are more profitable. On the other hand, for many taxpayers, implementing such avoidance techniques may entail financial or institutional costs, costs that would outweigh the tax savings to be gleaned from utilizing them. Certainly, the more the vertically integrated activities of MNEs result from business synergies rather than tax efficiencies, the more room countries such as the United States have to combat tax avoidance.¹⁹⁷ At present, we do not know the relative importance of these motives for vertical integration. It may be that the targeting of earnings stripping transactions effected through related party transactions will create sound and fury, but ultimately accomplish very little in terms of increasing domestic tax revenues. To do nothing, however, would guarantee that those revenues continue to decline.

The deficiencies in national rules for the taxation of transnational transactions are not solely due to lack of political will. Taxation—all taxation—distorts economic behavior, and choices made when designing a tax system necessarily reflect a polity's decision as to which of the many possible economic distortions are least harmful to its fisc and its economy. Those choices are particularly fraught when dealing with transnational taxpayers and transactions because of the perceived (and possibly actual) mobility of the taxpayers and their activities. However, it does not make sense to allow transnational taxpayers to avoid taxes paid by fully domestic competitors through the simple expedient of slicing and dicing business income and expenses among functionally integrated but legally separate business entities. As the inversion "crisis" has revealed, that approach merely leads to the replacement of domestic companies with foreign ones, with an

197. See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1396 (2001) ("If a discontinuous friction blocks a transaction, the tax law does not have to block it too."); Weisbach, *supra* note 97, at 1674 ("[W]e should examine how the shift in the line affects the substitution costs and direct costs of a tax.").

accompanying loss of tax revenues. It is time to try a different approach, and hope for the best.