VOLUME 11 2011 NUMBER 9

FLORIDA TAX REVIEW

ARTICLE

STATELESS INCOME

Edward D. Kleinbard

FLORIDA TAX REVIEW

Volume 11 *2011* *Number 9*

FLORIDA TAX REVIEW

Volume 11 *2011* *Number 9*

STATELESS INCOME

by

Edward D. Kleinbard[*]

∗ Professor of Law, University of Southern California Gould School of Law. I thank William Kessler, Yungsheng Wang and Douglas Wicks for their research assistance in the preparation of earlier versions of this article. Helpful comments on this article were received from Rosanne Altshuler, Joseph Bankman, Tim Edgar, Edward McCaffery, Martin J. McMahon, Jr., Michael Knoll, Patrick Oglesby and Daniel Shaviro, as well as participants in presentations at the University of Florida Levin College of Law, the University of Southern California Gould School of Law, Stanford Law School, and the University of Pennsylvania Law School. The author is solely responsible for all errors of fact, law or economic theory.

ABSTRACT

This paper and its companion, *The Lessons of Stateless Income*, together comprehensively analyze the tax consequences and policy implications of the phenomenon of "stateless income." Stateless income comprises income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company. Google Inc.'s "Double Irish Dutch Sandwich" structure is one example of stateless income tax planning in operation.

This paper focuses on the consequences to current tax policies of stateless income tax planning. The companion paper extends the analysis along two margins, by considering the implications of stateless income tax planning for the reliability of standard efficiency benchmarks relating to foreign direct investment, and by considering in detail the phenomenon's implications for the design of future U.S. tax policy in this area, whether couched as the adoption of a territorial tax regime or a genuine worldwide tax consolidation system.

This paper first demonstrates that the current U.S. tax rules governing income from foreign direct investments often are misapprehended: in practice the U.S. tax rules do not operate as a "worldwide" system of taxation, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes. This claim holds whether one analyzes these rules as a cash tax matter, or through the lens of financial accounting standards. This paper rejects as inconsistent with the data any suggestion that current law disadvantages U.S. multinational firms in respect of the effective foreign tax rates they suffer, when compared with their territorial-based competitors.

This paper's fundamental thesis is that the pervasive presence of stateless income tax planning changes everything. Stateless income

privileges multinational firms over domestic ones by offering the former the prospect of capturing "tax rents" — low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important implications of stateless income include the dissolution of any coherence to the concept of geographic source, the systematic bias towards offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the erosion of the U.S. domestic tax base through debt-financed tax arbitrage, many instances of deadweight loss, and — essentially uniquely to the United States — the exacerbation of the lock-out phenomenon, under which the price that U.S. firms pay to enjoy the benefits of dramatically low foreign tax rates is the accumulation of extraordinary amounts of earnings (about $1.4 trillion, by the most recent estimates) and cash outside the United States.

Stateless income tax planning as applied in practice to current U.S. law's ersatz territorial tax system means that the lock-out effect now operates in fact as a kind of lock-in effect: firms retain more overseas earnings than they profitably can redeploy, to the great frustration of their shareholders, who would prefer that the cash be distributed to them. This tension between shareholders and management likely lies at the heart of current demands by U.S.-based multinational firms that the United States adopt a territorial tax system. The firms themselves are not greatly disadvantaged by the current U.S. tax system, but shareholders are. The ultimate reward of successful stateless income tax planning from this perspective should be massive stock repurchases, but instead shareholders are tantalized by glimpses of enormous cash hoards just out of their reach.

I. INTRODUCTION

A. Stateless Income

Like happy families, all multinational business enterprises are alike, in at least one critical respect: they all possess a special tax attribute, which is the ability to generate stateless income. By "stateless income," I mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company.[1]

1. I first used this term in Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 114 TAX NOTES 547, 559 (Feb. 5, 2007) [hereinafter Kleinbard, *Territorial Taxation*].

Stateless income thus can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries *without* shifting the location of externally-supplied capital or activities involving third parties. Stateless persons wander a hostile globe, looking for asylum; by contrast, stateless income takes a bearing for any of a number of zero or low-tax jurisdictions, where it finds a ready welcome.

As an example, a U.S. firm that sells software in Germany earns stateless income when (through mechanisms described below) the added value from the sales to German consumers is taxed in Ireland rather than Germany. The same analysis would apply to a German firm whose income from sales to U.S. or French customers comes to rest for tax purposes in Luxembourg.

The ability to generate stateless income is an attribute generally shared by most multinational enterprises, regardless of their parent companies' domiciles. It is a quality shared in practice by multinational firms domiciled in the United States (the last redoubt of putative worldwide taxation of income from foreign direct investments) and those domiciled in jurisdictions with "territorial" tax regimes. It is an attribute not available to wholly domestic firms.

The phenomenon of stateless income is not the same as the phenomenon of capital mobility. As traditionally understood, capital mobility involves a person's ability to locate real investments or third-party activity with a view to minimizing the tax burden imposed thereon; it is "the elasticity of supply of a location-denominated factor with respect to its net [after-tax] reward in that location."[2] The phenomenon of stateless income, by contrast, comprises the movement of taxable income within a multinational group without shifting any location-dependent factor supplied by third parties.

The straightforward application of optimal tax theory to the phenomenon of actual capital mobility leads, for example, to the policy recommendation that a small open economy should not impose any tax on returns to imported capital; this recommendation reflects a coherent theory in which efficient global markets lead to identical after-tax returns on business

---

The domicile of a multinational enterprise's ultimate parent company is referred to in the literature as the "residence" country. A country other than the residence country in which a multinational group derives business or investment income is referred to as the "source" country.

2. Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility's Place in Optimal Taxation*, 63 NAT'L TAX J. 843, 844 (2010). Slemrod points in the direction of stateless income with his concept of "tax mobility;" this Article argues that stateless income is an even more pervasive phenomenon than Slemrod's paper might suggest.

income, wherever situated.[3] Stateless income tax planning, by contrast, is divorced from actual market transactions; it undercuts the functions of markets in setting market–clearing after-tax returns on capital investments, by offering advantageously–situated multinational enterprises the opportunity to earn what this Article calls "tax rents."

Stateless income is an inevitable by-product of fundamental international income tax norms, like the recognition of the separate tax personas of different juridical persons, even when they are commonly owned, or the general practice of treating interest on indebtedness as deductible to the payor.[4] Those particular norms enable "earnings stripping" — the extraction of pretax earnings from a source country through tax-deductible payments to offshore affiliates. One example of earnings stripping is capitalizing one group subsidiary located in a low-tax country with equity, and then causing that subsidiary to lend its capital to an affiliate in a high-tax country.

The widely-shared tax norms on which stateless income relies also encompass, for example, a multinational enterprise's relative freedom under consensus "transfer pricing" rules[5] to deal with a subsidiary as if it were an independent actor, or to treat the subsidiary's capital (furnished by the parent) as if that capital were separate from the parent's assets for purposes of measuring the business risks undertaken by the subsidiary (and therefore the share of group income properly attributable to the subsidiary).[6] Similarly,

---

3. George R. Zodrow, *Capital Mobility and Capital Tax Competition*, 63 NAT'L TAX J. 865, 881 (2010).

4. *See*, *e.g*., Richard J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 WORLD TAX J. 291, 322–23 (2010) [hereinafter Vann, *Hard-Boiled Wonderland*] (noting that the principle of "freedom of contract" among affiliated companies in a multinational group is inherently inconsistent with the theory of the firm explanation for the prevalence of multinational enterprises). These norms are summarized through the prism of the Organization for Economic Cooperation and Development ("OECD") Model Convention in Markus Leibrecht and Thomas Rixen, *Double Tax Avoidance and Tax Competition for Mobile Capital, in* INTERNATIONAL TAX COORDINATION: AN INTERDISCIPLINARY PERSPECTIVE ON VIRTUES AND PITFALLS, 61, 63–71 (Martin Zagler ed., 2010).

5. "Transfer pricing" rules refer to the terms under which the affiliated members of a multinational group should be viewed as dealing with each other for purposes of determining the income of each member of the group.

6. The OECD, a supranational organization comprised of 33 member states, including the United States and many other developed economies, publishes extensive guidance on the taxation of multinational businesses representing the consensus views of its members. It has recently published comprehensive guidance on transfer pricing issues in international tax administration. OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010) [hereinafter OECD Guidelines].

those norms contemplate that a multinational enterprise can situate economic rents attributable to unique business opportunities in low-tax countries, because pure business opportunities generally are not regarded as subjects of transfer pricing analysis in the first instance.[7]

The OECD Guidelines emphatically reject the idea of approaching the taxation of a multinational group of companies by ignoring the separate juridical existence of subsidiaries and apportioning group income to worldwide activities on a "formulary apportionment" basis:

[T]he the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.

Id. at 33. The OECD Guidelines continue:

OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected.

Id. at 41.

For a comprehensive critique of the arm's-length principle as applied to intangible assets (the most important class of assets in modern transfer pricing disputes), *see* Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 96–104 (2008) [hereinafter Brauner, *Value in the Eye of the Beholder*].

7. Hospital Corp. of Am. v. Commissioner, 81 T.C. 520 (1983). The case involved, inter alia, the application of section 367, which imposes a "toll charge" on the outbound transfer from the United States of certain appreciated property, including intangible assets (for which a special regime exists under section 367(d)). In *Hospital Corp*., the U.S. taxpayer presented a newly-formed foreign affiliate with an opportunity to enter into a lucrative contract to manage an overseas medical facility owned by an unaffiliated group. *Id.* at 532. The court in *Hospital Corp.* found that section 367 was not implicated by the arrangement, because the "opportunity to contract" did not constitute "property" to which section 367 might apply. *Id.* at 589–90. The court did conclude, however, that seventy-five percent of the net income of the foreign affiliate was attributable to the U.S. taxpayer under the principles of section 482. *Id.* at 301–02.

The Internal Revenue Service non-acquiesced as to the decision, but noted that "the Tax Court's finding that 'opportunity to contract' was not property is not clearly erroneous." *See* Action on Decision 1987-2 C.B. 1, 1, 2 n.22 (Oct. 26, 1987).

In the same vein, the OECD Guidelines appear to take the position that a business opportunity is not a tax-cognizable intangible asset to which transfer pricing rules might apply. OECD Guidelines, *supra* note 6, at 191–93 (defining commercial intangible assets subject to transfer pricing scrutiny as comprising trade and marketing intangibles, neither of which in turn is defined as including the simple right to pursue a lucrative opportunity), 256–67 ("The arm's length principle does

Stateless income also flourishes because of nations' collective failure to agree on other critical international tax norms that would determine the "source" of income — that is, the mechanical rules by which income is attributed to one jurisdiction or another, based on the perceived economic contribution in that jurisdiction to the generation of that income. This failure reflects the fundamental commercial and economic ambiguity surrounding the locus of the value added through the exploitation of intangible assets. The consequences of this failure in turn are exacerbated by aggressive transfer pricing strategies. As the earlier examples of income stripping demonstrate, however, stateless income tax planning encompasses more than the exploitation of the collective failure to develop binding normative source rules for income derived from intangible assets. And as this Article demonstrates, whatever first-order coherence in the definition of the source of income might exist in turn is vitiated when stateless income tax planning is layered on top of basic sourcing principles, because that planning can take income originally "booked" in an economically-rational jurisdiction and in a second, separate step move that income to another, lower-taxed jurisdiction.

Multinational firms thus get at least two bites at the stateless income generation apple. First, they can rely on the norms of freedom of contract within the group, the purportedly arm's-length nature of arrangements reached by a parent company and its wholly-owned subsidiary (freshly capitalized by the parent), and ambiguities in the international consensus rules surrounding the source of returns to intangible assets to situate in a low-tax jurisdiction returns from factors most plausibly situated in high-tax countries (e.g., sales to local customers).[8] Second, multinational firms can use "earnings stripping" strategies to move income tentatively situated in a jurisdiction with the most plausible claim to be the source of that income to another (low-tax) jurisdiction, typically through the creation of an item of intragroup deduction/income inclusion (e.g., intercompany interest, rents, or royalties). That second stage earnings stripping strategy need not have any nexus to the generation of the income.

---

not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation of existing arrangements . . . ."), 266–67 (distinguishing the case of an indirect transfer of long-term customer contracts). *See also* Lee A. Sheppard, *Tax Officials Contemplate Bleak Future for Corporate Tax Base,* 129 TAX NOTES 169, 170 (Oct. 11, 2010) [hereinafter Sheppard, *Tax Officials*] ("Significantly, the OECD[] . . . says that a transfer of a business opportunity or profit potential is not a transfer of a cognizable asset requiring compensation."); Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 326 (OECD Guidelines appear to countenance that risk may be assigned within a group at will).

8. *See*, *e.g.*, Vann, *Hard-Boiled Wonderland*, *supra* note 4, at 313–43.

Because the generation of stateless income relies on norms woven deep into the warp and woof of virtually every tax system, it is not possible to understand the consequences of a country's system for taxing income from foreign direct investments without appreciating the first-order importance of stateless income tax planning. When unchecked, stateless income strips source countries (including the United States as the location of subsidiaries of foreign-controlled groups) of the tax revenues attributable to income generated in those jurisdictions. Its availability also distorts the investment decisions of multinational firms, and under current U.S. rules distorts a U.S. multinational firm's decision whether to repatriate that stateless income back to the United States.

The phenomenon of stateless income is closely allied with the problem of residence country base erosion, principally through aggressive transfer pricing strategies.[9] As used in this Article, however, the term is reserved for strategies to reduce high-tax source country income. Nonetheless, the policy recommendations made by this Article respond to both issues, for two reasons. First, the technologies employed in source and residence country base erosion overlap. Second, the Article's ultimate goal of outlining a coherent approach to cross-border taxation in light of the stateless income phenomenon implicates the familiar question of whether that proposed approach distorts investment decisions as between source and residence countries.

B. An Illustrative Example: The Double Irish Dutch Sandwich

The phenomenon of stateless income risks appearing vague, and its analysis tedious. Recent news stories on the internal tax planning of U.S. firms like Microsoft, Forest Laboratories and Google, however, have injected needed drama to the narrative, by providing useful insights into how firms generate stateless income in practice.[10] This section uses Google Inc.'s

---

9. Examples of recent papers emphasizing how current arm's-length transfer pricing rules invite the erosion of residence country tax revenues include Yariv Brauner, *Cost Sharing and the Acrobatics of Arm's Length Taxation*, 38 Intertax 554 (2010) [hereinafter Brauner, *Cost Sharing*], and Harry Grubert, *Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren't Being Globalized, Only Profits* (Dec. 7, 2009), http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert_March16.pdf *[hereinafter, Grubert,* Foreign Taxes and Domestic Income*].*

10. Richard Waters, *Tax Drives US Tech Groups to Tap Debt*, FINANCIAL TIMES, Feb. 6, 2011, p. 15 Col. 6 (Microsoft); Jesse Drucker, *U.S. Companies Dodge $60 Billion in Taxes With Global Odyssey*, BLOOMBERG, May 13, 2010, http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html (Forest Laboratories); Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct.

"Double Irish Dutch Sandwich" structure to illustrate how stateless income tax planning relies on deeply embedded global tax norms, and how it operates to disassociate taxable income from any connection with any location in which the value-adding activities that generated that income could plausibly be said to lie.[11] The same story (in a number of cases, literally so, because the Double Irish Dutch Sandwich is an easily-replicable staple of current stateless income tax planning) could be told of many other U.S. multinational firms.[12]

In 2003, a few months before its initial public offering, Google Inc. entered into a cost sharing agreement with a newly-organized wholly-owned Irish subsidiary, Google Ireland Holdings ("Ireland Holdings"), under which Ireland Holdings acquired the rights to Google Inc.'s search and advertising technologies and other intangible property for the territory comprising Europe, the Middle East, and Africa ("EMEA"). Google commenced its Irish operations in 2003 with five employees.[13]

21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html (Google). In the same vein, Microsoft's very recent announcement of plans to acquire Skype Software S.a.r.l. (a Luxembourg-based company) has been explained as a tax-efficient use of the firm's vast hoard of offshore cash. *See* Zaid Jilani, *Microsoft Structured Acquisition Of Skype To Avoid U.S. Taxes*, http://thinkprogress.org/ 2011/05/13/microsoft-skype-tax-havens/ [hereinafter Jilani, *Microsoft Structured Acquisition*].

11. The facts that follow are drawn principally from Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html [hereinafter Drucker, *Google 2.4% Rate*] as supplemented by inferences drawn from Joseph B. Darby III and Kelsey Lemaster, *Double Irish More than Doubles the Tax Saving: Hybrid Structure Reduces Irish, US and Worldwide Taxation*, 11 PRACTICAL U.S./INT'L TAX STRATEGIES 2 (2007) [hereinafter Darby & Lemaster, *Double Irish*]. Since Google's tax planning is not transparent to outside observers, it is possible that there are some slight mischaracterizations of details in the text, but these would not change the thrust of the points made therein.

12. As one example roughly contemporaneous with Google's Double Irish Dutch Sandwich, *see* Jeffrey L. Rubinger & William B. Sherman, *Holding Intangibles Offshore May Produce Tangible Tax Benefits*, 106 TAX NOTES 938 (Feb, 21, 2005), proposing a complex structure involving Norwegian companies to achieve comparable results.

13. Angus Kelsall, D*ublin Go Bragh*, GOOGLE BLOG (Oct. 6, 2004), http://googleblog.blogspot.com/2004/10/dublin-go-bragh.html ("A year ago, Dublin became the first location for Google's regional operations outside the U.S. We designed it to serve Google customers across multiple time zones and languages spanning Europe, the Middle East and Africa. There were just five of us in 2003. Today we've built a team of 150. . . .").

Ireland Holdings made an undisclosed "buy-in" payment for rights to the Google technologies as they then existed, and further appears to have agreed pursuant to a "cost sharing agreement" to bear future development costs in proportion to the size that the EMEA market bore to the worldwide market for those technologies.[14] As a practical matter, that buy-in payment likely reflected in part the then-market capitalization of Google (which in turn would have been a good proxy for the value of its intangible assets); that value in turn presumably was much smaller than the value that might have been inferred post-IPO.[15] Regardless, in 2006 Google eventually negotiated an Advance Pricing Agreement with the Internal Revenue Service that accepted the bona fides of the 2003 buy-in payments for the then-existing intangibles; the terms of the Advance Pricing Agreement (like all such agreements) are not public.

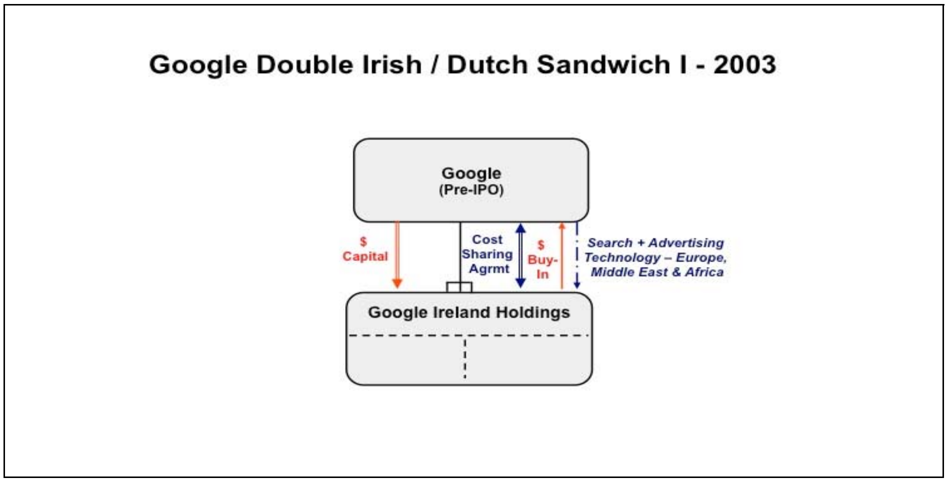
The Google structure immediately after entering into the cost sharing agreement can be represented schematically as follows:

---

14. For a brief summary of cost sharing agreements, *see* Staff of the Joint Comm. on Tax'n, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10) 25–29, 111–14 (2010) [hereinafter JCT, INCOME SHIFTING AND TRANSFER PRICING].

Veritas Software Corp. v. Commissioner (Symantec), 133 T.C. 297 (2009), offers an important window into how cost sharing agreements actually were constructed at times proximate to the formation of Ireland Holdings. In *Veritas*, the Tax Court accepted as correct the $118 million dollar cost-sharing "buy-in" payments made by an Irish subsidiary of a U.S. parent company beginning in 1999 against a challenge by the Internal Revenue Service that the correct number for the buy-in payment was $1.675 billion. *See id*. at 315–16. For brief summaries, *see, e.g.*, Kerwin Chung, Cindy Hustad, & Alan Shapiro, *Tax Court Rejects IRS's Cost-Sharing Buy-In Analysis*, 125 TAX NOTES 1343 (Dec. 21, 2009); Stephen Blough, Charles Cope, & Thomas Zollo, *Veritas Vincit,* 126 TAX NOTES 839 (Feb. 15, 2010). More recently the Internal Revenue Service announced that it would not appeal the *Veritas* decision. Cindy Hustad and Alan Shapiro, *IRS Decides Not to Appeal Veritas; Action on Decision Issued,* 129 TAX NOTES 1342 (Dec. 20, 2010). The relevant Treasury regulations covering cost sharing arrangements were revised in 2009; the new regulations arguably give the Internal Revenue Service more scope to insist that buy-in payments like those at issue in Veritas must take notice of the value of transferred "platform" intangibles as a long-lived continuing foundation that gives incremental value to subsequent research and development work.

15. There is no publicly-available information on the size or calculation of the buy-in payment or on the operations of Ireland Holdings before the cost sharing agreement was entered into; the text's description relies on the author's general experience and conversations with market professionals, and therefore may not strictly comport with Google's actual case. The author believes, however, that the presentation is a fair summary of practice in this area in general.



In a sense, the most remarkable aspect of the entire structure is contained in this schematic. It is the ready acceptance by countries of the fantastic notions that (i) a wholly-owned subsidiary has a mind of its own with which to negotiate "arm's-length" contractual terms with its parent, (ii) capital provided to the subsidiary by the parent somehow becomes the property of an independent actor (the subsidiary) with which it can take business risks that for tax purposes are not simply assimilated into those borne by the parent (as both provider of the capital and ultimate economic owner of the assets acquired therewith), and (iii) a multinational enterprise that exists as a global platform to exploit a core set of intangible assets best is analogized to wholly independent actors taking on limited and straightforward roles in a vertical chain of production or a horizontal array of distribution of a product. The second and third of these notions in particular transcend the question of transfer pricing — in the second case, because of the international tax norm that equity owners are not required to include in income any minimum current return on their investment, and in the third case, because the global assets and synergies that a multinational group exploits are attributes of the group as whole, not any one member. Within a few years, the structure had morphed. First, Ireland Holdings had become a dual resident company: that is, for U.S. tax purposes it remained an Irish corporation (because that is its place of incorporation), but for Irish tax purposes Ireland Holdings became a resident of Bermuda (because that is where its "mind and management" are centered). Second, Ireland Holdings had put the EMEA rights to the core technologies to work by licensing them to a subsidiary organized as a Dutch company ("Google BV"), which in turn had licensed the rights to a lower-tier subsidiary, Google Ireland Limited ("Ireland Limited"). Ireland Limited licenses the technologies throughout the EMEA territories, and collects billions of dollars of advertising revenues from the use of those technologies.

Presumably, each of Google BV and Ireland Limited has "checked the box"[16] — that is, has made a special election relevant only for purposes of U.S. tax law not to be characterized as a corporation. Because each has a single owner and has elected not to be regarded as a corporation for U.S. tax purposes, each is treated as a disregarded entity — a "tax nothing" — for U.S. purposes, but continues as a juridical person for all non-U.S. tax purposes. Here one can see another fantastic element of international tax planning. By virtue of a simple tax return election a company can disappear from view for purposes of U.S. tax law, while remaining relevant for purposes of all other fiscal systems, thereby facilitating a host of tax system arbitrage opportunities.

Ireland Limited today employs about 2,000 employees; it is not clear how many of them are engaged in the sale and marketing of Google products in the EMEA territory, and how many are working as engineers in the development of extensions of those technologies.[17] Technically, it is possible for a foreign subsidiary to perform its obligations under a cost sharing agreement by hiring affiliates to do the actual work, using capital provided by the parent to pay those affiliates until it generates its own revenues.

---

16. Treas. Reg. § 301.7701-3(b)(2). That is the structure proposed in Darby and Lemaster, *Double Irish*, *supra* note 11. Like all federal income tax return materials, "check-the-box" filings are not publicly available.

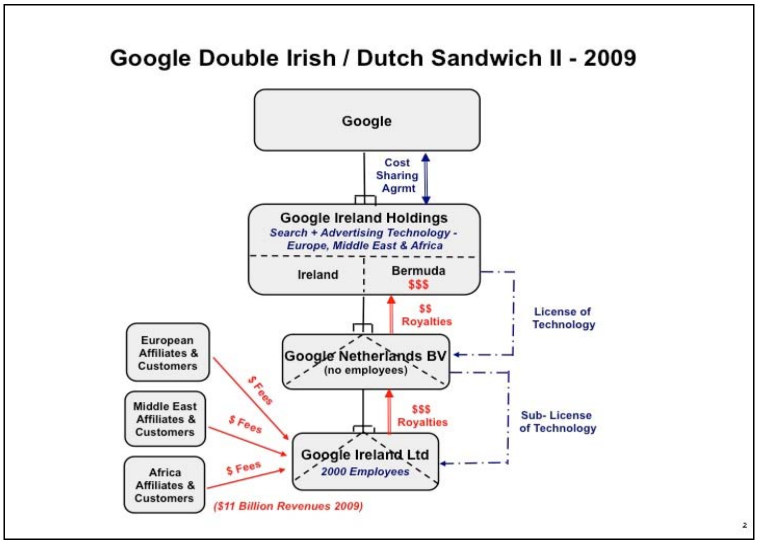
17. In a 2008 video interview, John Herlihy, the manager of Google Ireland, described Google's Irish operations as the second largest Google office in the world. At the time, Google Ireland employed 1350 employees, of whom 900 worked in the "online [sales] team," 250 "on the technology side," and 200 apparently in corporate support type functions for the EMEA operations. Interview with John Herlihy, V.P. Online Sales, E,EA, Google, http://www.youtube.com/watch?v=pYZsLLMQZxM&NR=1&feature=fvwp (last visited May 19, 2011). Google describes its Irish operations this way:

> What we do in Dublin is help millions of Google users and customers right across Europe, the Middle East, and Africa (EMEA) to get the most from our products. Google's Dublin office is the EMEA Operations Headquarters. That means we support everyone who uses our products: the search engine that we are most known for, plus consumer products like Gmail and Calendar, advertising products like AdWords and AdSense, right through to business solutions for major corporations. In Dublin we also build on our existing products and create new ones, employing some of the finest engineering talent in the world. Many of the Dublin-based teams are engaged in supporting other Google offices across the EMEA region, working in areas like finance, payroll, legal, and HR.

Google Dublin, http://www.google.ie/intl/en/jobs/dublin/ (last visited May 20, 2011).

Again, one sees at work the fantastic idea that a subsidiary has both capital and an appetite for risk that can be separated from those of its parent.[18]

The structure now can be summarized in this illustration:



Now the full stateless income generation machine can be seen. Income earned from the use of the Google intangibles by customers (or, to the extent relevant, affiliates) in high-tax countries streams directly to Ireland Limited as a component of Ireland Limited's advertising fees, without bearing source-country tax, because the fees paid are deductible in the source

18. Treasury regulations governing cost sharing agreements were revised in 2008 to adopt the "investor model" of arm's length pricing. Treas. Reg. § 1.482-7T (as amended by T.D. 9441, 2009-7 I.R.B. 460). This model emphasizes the idea that an affiliate that contributes only cash to a cost sharing agreement built around existing high-value intangible assets should make buy-in payments that leave the affiliate with only a normal return on its operations. JCT, INCOME SHIFTING AND TRANSFER PRICING, *supra* note 14, at 25–29, 111–14. But the regulations do not reject the idea of a "cash box" subsidiary participating in a cost sharing agreement in the first instance, and might be expected only to lead to transfers of intangible assets at a somewhat earlier stage of development. Moreover, "cash box" subsidiaries can contract with and license intangible assets from their U.S. parent; those transactions are not ignored for U.S. tax purposes. *Id.* at 115–16.

country.[19] While much of Ireland Limited's income presumably comes directly from third-party customers in the EMEA region, the same sort of structure can be used to strip out income from local affiliates that in turn serve local customers and then to move that income to Ireland. The net effect in either case is that income from the exploitation of the Google intangibles throughout the EMEA region is taxed only in Ireland.

Ireland imposes a 12.5 percent corporate income tax on Irish resident companies; Ireland Limited therefore is subject to that tax rate on its net income, but Ireland Limited makes very large deductible royalty payments to Google BV for the use of the core Google intangibles originally transferred in 2003 (and since extended by investments made under the internal cost sharing agreement). Google BV in turn makes royalty payments almost exactly as large to Ireland Holdings. The latter is a Bermuda company from an Irish perspective, and Bermuda has no corporate income tax.

Google BV exists because royalties paid directly from an Irish company to a Bermuda company (that is, from Ireland Limited to Ireland Holdings) would be subject to an Irish withholding tax.[20] That tax does not apply to royalties paid to a company resident in an EU member state, even one that is an affiliate and that apparently serves no purpose but the elimination of Irish withholding tax. The Netherlands does not impose withholding tax on the outbound royalties paid to Ireland Holdings, and contents itself with collecting a small tax (essentially a fee for the use of its tax system) on the modest "spread" between the royalties Google BV receives and those it pays on to Ireland Holdings. It is normal in Dutch tax practice to negotiate this sort of spread in advance with the Dutch tax authorities.

Meanwhile, from a U.S. tax point of view, neither Ireland Limited nor Google BV exists at all. The United States sees only an Irish (not Bermuda) company (Irish Holdings) with a Bermuda branch, where most of its net income comes to rest. The end result is a near-zero rate of tax on income derived from customers in Europe, the Middle East, and Africa that

19. Whether the fees are characterized as paid in respect of the provision of advertising services or as licensing fees for the use of the Google platform is a technical issue whose resolution is irrelevant to this simple narrative. Within the European Union in particular Member States cannot impose source-country withholding tax on royalties paid to a company resident in another State. Moreover, Ireland has a good tax treaty network whose treaties often reduce the tax rate on royalties paid between firms in the two treaty countries to zero.

20. Darby and Lemaster do not discuss the role of the Dutch firm, either because the authors viewed it as a proprietary twist on the basic "Double Irish" idea or because it had not yet come into vogue. Darby & Lemaster, *Double Irish*, *supra* note 11. The article by Drucker does discuss it. Drucker, *Google 2.4% Rate*, *supra* note 11.

is attributable to the high-value intangibles that encompass the bulk of Google's economic factors of production, and a very low rate of tax on returns attributable to the services of Google's Irish-based sales force.

This stateless income generation machine is referred to as a "Double Irish" structure because of the use of the two Irish firms; the "Dutch Sandwich" sobriquet follows from the insertion of Google BV as a sort of tax filler between the two Irish firms. Importantly, the structure is easily replicable by others (and in fact has been reported to be in widespread use among U.S. technology firms);[21] there is nothing in the structure that relies on any unique business model or asset of Google's. From the point of view of sophisticated U.S. multinational firms, this arrangement is simply one tool among many in the stateless income planning toolkit.

C. Overview and Conclusions of Article

This Article accepts as an arbitrary postulate the existence of a corporate income tax that in fact is meant to burden corporate income in some coherent fashion. The Article asks the question, how does the pervasive phenomenon of stateless income affect the operation of that tax today?

The Article's answer is that the pervasive presence of stateless income tax planning changes everything. As the example of Google's Double Irish Dutch Sandwich structure implies, it destroys any possible coherence to the concept of the geographic source of income, on which all territorial tax systems rely. It erodes the tax base of high-tax countries in which multinational firms are domiciled through debt-financed tax arbitrage. It privileges multinational firms over domestic ones by offering the former the prospect of capturing what the Article terms "tax rents" — low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. And since the costs required to accomplish it create noting of economic value, it leads to deadweight loss.

The Article presents a comprehensive picture of the role of stateless income in international tax planning, in contrast to existing literature's tendency to focus on a series of discrete problems. The Article demonstrates why the eradication of stateless income in the field is a highly implausible scenario. Finally, the Article considers the policy implications of stateless income tax planning for the design of tax systems.

Section II of this Article briefly reviews the current U.S. tax system for taxing the returns to corporate foreign direct investment. Beyond a recitation of these rules and principles, Section II argues that the current U.S. tax rules governing income from foreign direct investments often are

21. Drucker, *Google 2.4% Rate*, supra note 11.