

Fall 2012

Closing International Loopholes: Changing the Corporate Tax Base to Effectively Combat Tax Avoidance

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Recommended Citation

John T. VanDenburgh, *Closing International Loopholes: Changing the Corporate Tax Base to Effectively Combat Tax Avoidance*, 47 Val. U. L. Rev. 313 (2012).

Available at: <https://scholar.valpo.edu/vulr/vol47/iss1/8>

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CLOSING INTERNATIONAL LOOPHOLES: CHANGING THE CORPORATE TAX BASE TO EFFECTIVELY COMBAT TAX AVOIDANCE

I. INTRODUCTION

NoTax is a publicly traded technology corporation that deals primarily with internet-based services and products. NoTax is headquartered in California, incorporated in Delaware, and does the majority of its business within the United States. In 2010, NoTax reported three hundred and fifty million dollars in worldwide revenue to its shareholders and reported a net income of one hundred million dollars to the IRS. NoTax paid the standard 35% federal tax rate, or thirty-five million dollars, to the IRS. Subsequently, NoTax's president and board of directors decided to hire a group of tax consultants and attorneys to see if there was a way to reduce their corporate tax. In 2011, NoTax reported approximately the same level of revenue and business to its shareholders but reported a much lower net income and only paid around two million dollars to the IRS. NoTax did not physically move its headquarters, change its products, or cut any employees. How was it able to cut its corporate taxes by nearly thirty-three million dollars? NoTax employed a complex scheme of tax planning strategies to manipulate its financial records, take advantage of international tax loopholes, and avoid paying U.S. taxes. Even more remarkable, NoTax was able to do this primarily with paper transactions that are completely legal.¹

Many U.S. corporations have started using similar tax avoidance strategies to reduce their corporate tax.² These strategies have become a problem in the last few decades because of the globalization of the world economy, improvements in technology, and increased tax competition.³

¹ NoTax is a fictional company. The author of this Note created this hypothetical to explain the concept of international tax avoidance.

² "Tax avoidance" refers to the legal strategies corporations employ to get around paying taxes, as opposed to "tax evasion," which refers to the avoidance of tax obligations through illegal means. See JANE G. GRAVELLE, MAJOR TAX ISSUES IN THE 111TH CONGRESS, CONG. RESEARCH SERV. 13 (May 6, 2009), http://royce.house.gov/uploadedfiles/major_tax_issues_in_the_111th_congress.pdf (explaining the major differences between tax evasion and tax avoidance techniques); see also Michelle Hirsch, *Tax Havens: Offshore Operations Cost U.S. Billions*, FISCAL TIMES, Sept. 7, 2010, http://hsgac.senate.gov/public/_files/071708PSIReport.pdf (noting that eighty-three out of the largest one hundred publicly traded U.S. companies have subsidiaries in countries with lower corporate tax rates than the United States).

³ See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575-76 (2000) (discussing the increased mobility of capital from technology advances, which has led to international tax competition because

314 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

Most of these methods involve setting up a shell corporation—a corporation with no operations or assets—as a subsidiary in a lower tax jurisdiction and then manipulating the parent corporation’s financial records to show that the income was earned by the shell subsidiary outside of the United States.⁴ What these corporations are doing is technically legal, but only because of the difficulty of applying U.S. tax law to other sovereign countries.⁵ There have been many attempts to try to fix this current tax avoidance problem while keeping the same tax base, but these have all proved to be ineffective, which is evident from the alarming number of corporations that are employing tax avoidance schemes.⁶ Tax avoidance strategies are causing the United States to lose

companies can easily shift capital to low-tax jurisdictions). Tax competition in this context refers to countries lowering their tax rates to make it more desirable for corporations to do business in their country. *Id.* See also Jason Bordoff & Jason Furman, General Essay, *Progressive Tax Reform in the Era of Globalization: Building Consensus for More Broadly Shared Prosperity*, 2 HARV. L. & POL’Y REV. 327, 328 (2008) (explaining that tax reform might be necessary with recent changes in the economy); Timothy V. Addison, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOBAL LEGAL STUD. 703, 711 (2009) (discussing several reasons for why tax havens exist); Diane Ring, *Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World*, 33 FORDHAM INT’L L.J. 649, 702 (2010) (explaining why some countries lower their tax rates).

⁴ See Press Release, The White House, Executive Office of the President, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas*, May 4, 2009, available at http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS/ [hereinafter Press Release] (providing examples of several problems that exist under current U.S. law and describing proposals to fix each problem).

⁵ See Ilan Benshalom, *The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase*, 28 VA. TAX REV. 165, 166 (2008) (noting how the corporate structure has changed because of changes in the global economy); Diane M. Ring, *What’s at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT’L L. 155, 156–57 (2008) (explaining the link between sovereignty and international tax laws). Countries are not able to enforce their tax laws in other sovereign states because those sovereign states represent the supreme source of the law on internal matters, such as corporate taxation. *Id.* at 160. See also David R. Tillinghast, *Issues of International Tax Enforcement*, in THE CRISIS IN TAX ADMINISTRATION 38, 38–42 (Henry J. Aaron & Joel Slemrod eds., 2004) (discussing a number of challenges facing the IRS in enforcing U.S. tax laws in foreign jurisdictions, as well as the complexity of the Tax Code and the difficulty in obtaining financial information). See generally Nancy Birdsall, *Asymmetric Globalization: Global Markets Require Good Global Politics*, (Ctr. for Global Dev., Working Paper No. 12, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106282 (explaining how the global economy has made it more difficult to enforce tax laws).

⁶ See Ilan Benshalom, *Sourcing the “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 642–44 (2007) (explaining the Arm’s Length Standard as one attempt to prevent corporate tax avoidance through the use of subsidiaries); see also Tracy A. Kaye, *The Regulation of Corporate Tax Shelters in the United States*, 58 AM. J. COMP. L. 585, 588–92 (2010) (describing the judiciary’s development of different common law doctrines to combat tax avoidance, such as

billions of annual tax dollars that could be used to pay off the current budget deficit.⁷ Allowing corporations to escape paying U.S. taxes when they actively derive benefits from the U.S. market is unacceptable.⁸ The attempts and proposals to fix this problem through legislation have focused on creating laws to force corporations to stop manipulating their net income; however, the more effective method to combat this issue might be changing the tax base altogether.⁹ This Note proposes that the United States needs to change the current tax base so that corporations no longer have the incentive to manipulate their financial information.¹⁰

First, Part II of this Note briefly provides a historical context of the U.S. corporate tax, presenting relevant background information, theories for and against taxation, and popular techniques used by corporations to avoid tax.¹¹ Next, Part III offers an analysis of the current tax base and

“substance over form,” “step-transaction,” “business purpose,” and “economic substance”); Abraham W. Smith, *Tax Dodgers Beware: New Foreign Account Tax Compliance Legislation*, 84 FLA. B.J., July–Aug. 2010, at 52–53 (explaining legislative attempts by the Obama Administration to correct the tax avoidance problem); Anthony D. Todero, Note, *The Stop Haven Abuse Act: A Unilateral Solution to a Multilateral Problem*, 19 MINN. J. INTL. L. 241, 258–60 (2010) (examining the Stop Tax Haven Abuse Act (STHAA), which was another attempt to prevent corporations from establishing tax havens).

⁷ See Frederick J. Tansill, *Asset Protection Trusts (APTS): Non-Tax Issues*, ST012 A.L.L.-A.B.A., in INT’L TRUST & EST. PLAN. 293, 309 (2011) (noting how President Obama’s administration had clear plans to crack down on tax avoidance to pay for the U.S. deficit); see also Lilian V. Faulhaber, *Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance*, 48 COLUM. J. TRANSNAT’L L. 177, 179 (2010) (explaining that tax avoidance is a problem, not only in the United States, but also in the European Union); Hirsch, *supra* note 2 (explaining that U.S. multinational corporations are collectively avoiding anywhere between \$10 billion and \$60 billion a year in taxes by shifting their earnings on paper to overseas subsidiaries); Anup Shah, *Tax Havens; Undermining Democracy*, GLOBAL ISSUES, <http://www.globalissues.org/article/54/tax-havens-undermining-democracy> (last updated July 12, 2009) (explaining some effects that tax havens are having on the U.S. economy).

⁸ See *infra* Part II (discussing the benefits theory of taxation). The U.S. companies that are using these tax avoidance strategies are taking advantage of the benefits that the U.S. market provides. *Id.* See also Jennifer Barton, Comment, *Running from the United States Treasury: The Need to Reform the Taxation of Multinational Corporations*, 43 J. MARSHALL L. REV. 1041, 1051 (2010) (noting the need for reform in the corporate tax structure because of tax avoidance issues).

⁹ See I.R.C. § 11 (2006) (containing the current tax base for corporations—net income); Rachele Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 2 (2010) (noting that most proposed solutions to the tax problem are structural, including statutory changes to stop companies from using loopholes); see also *infra* Part IV (proposing a change in the tax base, thus altering the way that companies are taxed altogether, rather than adding new laws to the already complicated Tax Code).

¹⁰ See *infra* Part IV (explaining how changing the tax base to corporate revenue will decrease the incentive to shift income abroad and avoid paying U.S. taxes).

¹¹ See *infra* Part II (providing relevant background information on U.S. corporate taxation, as well as describing popular tax avoidance methods and previous legislation).

316 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47

its weaknesses.¹² Further, Part III illustrates the potential effects of failing to change the tax base in the near future.¹³ Finally, Part IV proposes a change of the tax base that will take away corporations' incentives to manipulate their financial records and that will fairly tax corporations based on the benefits they derive from the U.S. market, which will lead to a much more efficient and profitable U.S. economy.¹⁴

II. BACKGROUND

Despite recent legislative changes aimed at stopping U.S. corporate tax avoidance and President Obama's full commitment to reforming the corporate tax system, many corporations continue to use aggressive tax planning to circumvent much of their corporate tax obligations.¹⁵ There is difficulty in making effective legislative changes, because there are many problems with the U.S. corporate tax base—or general pool of wealth to which tax liability is imposed.¹⁶ Currently, the U.S. corporate tax base consists of net income, which is calculated by taking revenues and adjusting for (subtracting) expenses, interest, depreciation, taxes, and amortization. Corporations are presently able to manipulate their

¹² See *infra* Part III (analyzing why the current tax base has led to corporate tax avoidance).

¹³ See *infra* Part III (presenting the possible effects on the U.S. economy of continuing to allow corporations to legally avoid paying taxes).

¹⁴ See *infra* Part IV (proposing a change to the current tax base that will eliminate the corporate incentive to transfer income abroad in order to avoid paying U.S. taxes); see also *The World's Largest Economies*, ECONOMYWATCH.COM (June 30, 2010), <http://www.economywatch.com/economies-in-top/> (noting the profitability of top economies in the world).

¹⁵ See Holmes, *supra* note 9, at 2 n.3 (explaining some recent prevalent recommendations for changing the U.S. tax system); Kaye, *supra* note 6, at 594 (explaining the emergence of the American Jobs Creation Act of 2004, which enacted new penalties, strengthened disclosure requirements, and changed substantive law against tax shelters); David J. Lynch, *Does Tax Code Send U.S. Jobs Offshore?*, USA TODAY, Mar. 21, 2008, http://www.usatoday.com/money/perfi/taxes/2008-03-20-corporate-tax-offshoring_N.htm (“Big businesses will always look for ways to skirt the tax code. An Obama administration will close loopholes and will tighten (IRS) enforcement so companies cannot go around tax regulations,” says Bill Burton, a spokesman for the Obama campaign.”).

¹⁶ See BLACK'S LAW DICTIONARY 1599 (9th ed. 2009) (defining the tax base as the “total property, income, or wealth subject to taxation in a given jurisdiction; the aggregate value of the property being taxed by a particular tax”); Melissa J. Morrow, Comment, *Twenty-Five Years of Debate: Is Acquisition-Value Property Taxation Constitutional? Is It Fair? Is It Good Policy?*, 53 EMORY L.J. 587, 591 (2004) (“The tax base is the ‘assessed value’ of the taxable property.”).

net income, because it is separately reported to the IRS, and there is no incentive for them to keep this figure high.¹⁷

Before analyzing the benefits associated with changing the corporate tax base, Part II.A of this Note provides the key history of the corporate tax, highlighting the major theories supporting why corporations should be taxed.¹⁸ Next, Part II.B lays out the basic framework of how corporations are taxed in the United States.¹⁹ Part II.C then examines the major tax avoidance techniques that corporations use, providing a more in-depth context of these techniques by looking at what Google does to reduce its taxes.²⁰ Then, Part II.D briefly mentions four of the most popular proposals to fix tax avoidance in the United States.²¹

A. *The History of the Corporate Tax*

The corporate tax was first enacted in 1909 on corporate income to provide support for a general individual income tax on citizens.²² The goals of this tax were: (1) to provide the government with knowledge about profits in order to prevent the abuse of power; (2) to raise additional revenue; (3) to supervise corporations; and (4) to discourage excessive borrowing.²³ Many corporations challenged the tax in court,

¹⁷ See *infra* Part III (analyzing the problems with the current tax base); see also MICHAEL MAZEROV, STATE CORPORATE TAX SHELTERS AND THE NEED FOR “COMBINED REPORTING” 1 (CTR. ON BUDGET & POL’Y PRIORITIES 2007), available at <http://www.cbpp.org/files/10-26-07sfp.pdf> (advocating for combined reporting); Michael J. McIntyre, Paul Mines & Richard D. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 LA. L. REV. 699, 702–05 (2001) (examining the benefits of a combined reporting regime for corporations at the state level).

¹⁸ See *infra* Part II.A (providing the key history of the corporate tax and highlighting the major theories supporting why corporations should be taxed).

¹⁹ See *infra* Part II.B (laying out the basic framework of how corporations are taxed in the United States).

²⁰ See *infra* Part II.C (providing a more in-depth context of the major tax avoidance techniques by specifically looking at what Google does to reduce its taxes).

²¹ See *infra* Part II.D (defining four of the most popular proposals to fix the U.S. tax avoidance problem).

²² See Corporate Tax Act of 1909, Pub. L. No. 61-4, § 38, 36 Stat. 11, 112 (establishing the corporate tax by creating an excise tax for corporations measured by corporate income); see also Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 464 (2001) (noting that there were several motivations for the first corporate income tax); Jane G. Gravelle, *The Corporate Income Tax: A Persistent Policy Challenge*, 11 FLA. TAX REV. 75, 78 (2011) (explaining that there was support for the income tax because it taxed the wealthy, reduced the concentration of power, and provided for a flexible revenue source).

²³ See W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY 50–52 (1996) (highlighting how corporations originally fit into the U.S. tax policy); SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 280–83 (1980) (providing a detailed account of the congressional deliberations that lead up to the Corporate Tax Act of 1909).

318 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

because they thought the government was overstepping its boundaries, discouraging the corporate form, and killing the profit motive.²⁴ The Supreme Court upheld the tax, reasoning that it was an appropriate tax on the privilege of doing business in the corporate capacity.²⁵

Then, in 1918, the taxation of international income began with the Revenue Act of 1918, which allowed a credit against U.S. income for taxes paid by a U.S. corporation to any foreign government on income earned outside the United States.²⁶ In 1928, the League of Nations created the first model bilateral treaty agreement, giving a corporation relief from being taxed twice on income earned abroad.²⁷ Subsequently, in 1934, the Supreme Court decided, in *Helvering v. Gregory*, that a corporation could not simply “reorganize” for tax purposes and that

²⁴ See Gravelle, *supra* note 22, at 78–79 (noting some general reasons why many people opposed the 1909 corporate income tax); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 125 (1990) (illustrating some of the objections to the corporate income tax in 1909).

²⁵ See *Flint v. Stone Tracy Co.*, 220 U.S. 107, 176 (1911) (upholding the corporate excise tax in its entirety); see also Kornhauser, *supra* note 24, at 118 (explaining that the Corporate Tax Act of 1909 was challenged immediately after it was enacted, but a decision by the Supreme Court was not rendered until 1911).

²⁶ See Revenue Act of 1918, ch. 18 §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080–82 (1919) (providing a foreign tax credit for individuals and a similar credit for domestic corporations and describing creditable taxes). The Revenue Act of 1921 limited this foreign tax credit so that it could not exceed the amount of the U.S. tax liability on the taxpayer’s foreign source income. Revenue Act of 1921, ch. 136 §§ 222(a)(5), 238(a), 42 Stat. 227, 249, 258 (1923). This limitation was intended to ensure that U.S. companies and individuals could not use foreign taxes to reduce or eliminate U.S. taxes on U.S. source income. *Id.*

²⁷ See Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1023 (1997) (explaining the importance of the League of Nations’ 1928 model bilateral income tax treaties); C. John Taylor, *Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?*, 34 MELB. U. L. REV. 268, 270–71 (2010) (providing a brief history of bilateral tax treaties as a model to relieve corporations from double taxation). Double taxation refers to instances where income is taxed by one jurisdiction and then taxed again by another jurisdiction. *Id.* For example, if country A taxes a corporation at a rate of 35% on income because the income was earned in its county, and then country B taxes the same income by that corporation at a rate of 30% because that corporation is a resident of country B, then the corporation is forced to pay an astronomically high total effective tax rate of 65% on that net income. See *infra* part II.B (explaining in more depth source income and residence income). One way that countries eliminate double taxation is by cooperating with each other through bilateral tax treaties. See also Sunita Jogarajan, *Prelude to the International Tax Treaty Network: 1815–1914 Early Tax Treaties and the Conditions for Action*, 31 OXFORD J. LEGAL STUD. 679, 680 (2011) (noting that there are over three thousand bilateral tax treaties in the world currently). The common bilateral tax treaties account for double taxation by making it so that one country agrees unilaterally not to impose tax on income earned in another country, reducing the amount of tax payable in their country for any tax paid in another country on the same income, or by allocating taxation rights from different types of incomes between the different countries. *Id.* at 683.

there must be a business purpose for the corporate reorganization outside of saving on corporate taxes.²⁸ This decision was particularly important because it was the first decision addressing corporate techniques to avoid paying taxes.²⁹ The international income tax regime has remained reasonably intact, despite the growth of the economy, increases in technology, and the globalization of business.³⁰

Throughout history, the U.S corporate income tax has been based on the benefit theory of taxation, which indicates that corporations should be taxed because they take advantage of the benefits that the state provides.³¹ The United States taxes corporations under this theory in

²⁸ *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (holding that the transfer of the original corporation's assets to the shareholder did not qualify as reorganization because it was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character"). The Court further held that there had to be a business purpose for the reorganization and not just the benefit of saving on taxes. *Id.*

²⁹ *Id.* Though it was not a decision regarding corporations using international law to avoid taxes, the decision represented the Court's stance that business decisions should not be made for the sole reason of avoiding taxes. *Id.* These types of decisions affect the business market and make it less efficient. See Donald C. Lubick, *Remarks to the Tax Executives Institute*, reprinted in FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 19–21 (Michael J. Graetz ed., 2003) (explaining different policy goals in the area of international taxation). The goals of having an efficient market, market neutrality, and a competitive market sometimes conflict, and the goal is to find to what extent taxation can be reduced to stay competitive internationally while not distorting business decisions based on this reduced taxation. *Id.* The author then explains the two major types of efficiency norms that exist in the market: (1) capital import neutrality (CIN) and (2) capital export neutrality (CEN). *Id.* at 21. See also William B. Barker, *International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax*, 30 NW. J. INT'L L. & BUS. 647, 654 (2010) (explaining that an efficient tax is a neutral tax, which does not change the relative price of goods or services).

³⁰ See Avi-Yonah, *supra* note 3, at 1575–76 (explaining how technological advances have led to a much more global economy); see also MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 4 (2003) (noting that the basic framework of the international structure remains the same as it did in the early 1920s). The author explains that the basic international tax structure has not changed, because it has never proved to be a barrier to the international flow of goods, services, or capital. *Id.* See generally Holmes, *supra* note 9, at 3 (noting that the only two major changes in international tax law came in the form of the Revenue Act of 1962 and the Tax Reform Act of 1986).

³¹ See Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 521 (1997) (explaining the Benefits Principle, which gives the right to tax active business income primarily to the source jurisdiction, while the right to tax passive investment income is assigned primarily to the residence jurisdiction); Jeffrey M. Colón, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy*, 34 SAN DIEGO L. REV. 1, 11 (1997) ("The theoretical basis for source and trade or business taxation is that the United States has provided the benefits that generated the income."); Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 144 n.79 (2009) (explaining that source income, or income earned in one country, is based on the notion that the government has the right to collect tax revenues by providing the services that make the creation of that underlying

320 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

two different ways: (1) on the benefits resulting from being incorporated in the United States, or residence based tax; and (2) on the benefits that corporations receive from using the U.S. market to derive their income, or source based tax.³² Examples of some of the benefits that U.S. corporations receive include the: transportation facilities, infrastructure, education system, labor force, financial institutions, customer base, and stock markets.³³ The basic framework of the U.S. tax system follows this theory and taxes corporations based on their residence and whether their income is derived within the United States.³⁴

income possible); Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289, 1293-94 (2011) (maintaining that source based taxation reflects the notion that a certain tax jurisdiction provides benefits that protect income and assets maintained in that jurisdiction); *see also* Peggy B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union* (2000), reprinted in FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 6 (Michael J. Graetz ed., 2003) (explaining that a jurisdiction should be able to charge a tax to pay for the services that it renders).

³² *See* Deborah A. Geier, Letter to the Editor, *Time to Bring Back the "Benefit" Norm?*, 102 TAX NOTES 1155, 1157 (2004) (advocating the benefits theory of taxation because of the exploitation of the U.S. economic system); Majorie E. Kornhauser, *Choosing a Tax Rate Structure in the Face of Disagreement*, 52 UCLA L. REV. 1697, 1708 (2005) ("[B]enefit taxation underlies international tax principles that allow both the country of residence and the source country to tax income."); Herwig J. Schlunk, *Double Taxation: The Unappreciated Ideal*, 102 TAX NOTES 893, 895 (2004) (explaining the two types of taxation and analyzing them under the benefits theory); *see also infra* Part II.B (explaining the framework of U.S. tax policy, specifically residence and source based taxation).

³³ *See* Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1553-54 (2009) (explaining some of the benefits conferred on corporations associated with source based taxation, including human resources, natural resources, infrastructure, and markets); *see also* Musgrave, *supra* note 31, at 6 (explaining the more complicated benefits that come from source and residence based income). A company may also benefit by having a lower intermediate goods cost, which in turn lowers the total cost of production. *Id.* Benefits also arise when the government contributes capital to the capital of the corporation in order to generate a profit. *Id.* *But see* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 184-85 (1998) (comparing principles of source based taxation to those of benefit theory taxation).

³⁴ *See* GRAETZ, *supra* note 30, at 5 (2003) (distinguishing between residence and source taxation). There is much difficulty in defining residence and source, which creates problems in international taxation. *Id.* *See also* Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, "What's Source Got to do With It?" *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 90-92 (2002) (explaining that source based taxation represents the price paid for access to state markets, while residence based taxation represents the benefits associated with being a citizen of that state).

B. Basic Corporate Taxation Framework

There are two major types of taxation systems for international corporations: (1) the territorial system and (2) the worldwide system.³⁵ The territorial system, also known as the source system, taxes income that is derived within a particular country.³⁶ This means that a corporation is taxed by a country if the corporation earns its income within the country's borders, irrespective of the corporation's residency.³⁷

In a worldwide system, a corporation is taxed on its worldwide income based on its "residence," regardless of where the income is actually earned.³⁸ Accordingly, a corporation is taxed only if it is a "resident" of a particular country.³⁹ Some countries deem a corporation a resident based on where its headquarters are located; however, most

³⁵ See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 411 (1987) [hereinafter RESTATEMENT (THIRD)] (explaining the main ways that people and corporations are subject to tax in the United States); *id.* § 412(1)(a) (stating that no matter the source of the income, the United States has authority to tax based on residence); GRAETZ, *supra* note 30, at 12-13 (outlining the basics of a pure territorial tax system and a pure worldwide tax system).

³⁶ See HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 347-49 (2d ed. 2004) (discussing the positives and negatives of both the source and residence tax systems); GRAETZ, *supra* note 30, at 12-17 (discussing different rationales for worldwide and territorial tax systems); Barker, *supra* note 29, at 664-65 (highlighting some factors that connect a nation's tax base to the taxing jurisdiction).

³⁷ See GRAETZ, *supra* note 30, at 12-13 (explaining the importance of the source income concept in international taxation). The principal right to tax usually lies with the source country, and the burden of preventing the corporation from being taxed twice on the income—from the source country and the residence country—is on the resident country. *Id.* at 13. See also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 303 (2001) (illustrating that source based taxation does not take into account the residence of the corporation); Timothy Hisao Shapiro, *Tax First, Ask Questions Later: Problems Predicting the Effect of President Obama's International Tax Reforms*, 16 STAN. J.L. BUS. & FIN. 141, 149-50 (2010) (explaining the basics of both worldwide and territorial taxation).

³⁸ See Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65, 66 (2011) (maintaining that in a worldwide system, the United States taxes the income of residents no matter where it arose); see also Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1311-14 (1996) (providing several reasons for preferring residency-based taxation over source based taxation).

³⁹ See I.R.C. § 7701(a)(30)(C) (2006) (defining the term "United States Person" as "a domestic corporation"); Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 383 (2011) ("A corporation is a U.S. resident if and only if it is 'created or organized in the United States or under the law of the United States or of any State.'").

322 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47

countries, including the United States, use place of incorporation as the test for corporate residence.⁴⁰

Like most other industrialized countries, the United States employs a system of taxation that combines both the territorial and the worldwide tax systems.⁴¹ The United States taxes corporations if they are incorporated in the United States and also taxes foreign corporations if the income is earned within the United States.⁴² Thus, the only way that a corporation will not incur any U.S. tax is if the company is a foreign

⁴⁰ See Shaviro, *supra* note 39, at 413 (“A number of countries base corporate residence on some version of an inquiry into the location of a given company’s headquarters, or its place of central management and control.”).

⁴¹ See GRAETZ, *supra* note 30, at 13 (explaining that the United States tax system is referred to by most as a worldwide system, because the United States taxes foreign source income even though it is not quite a pure system). The author explains:

Sometimes analysts distinguish systems that tax foreign-source income from those that do not. They often call the former “worldwide systems” and the latter “territorial systems.” No country, however employs a pure “worldwide system” or a pure “territorial system.” International tax regimes throughout the world are hybrid or “mixed” systems.

Id.

⁴² See I.R.C. §§ 881(a), 882(a) (2010) (imposing tax on foreign corporations that generate or derive their income within the United States); *id.* § 63 (2010) (imposing tax on U.S. corporations); see also Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 499–500 (2009) (examining some specifics in the U.S. tax system). An example is provided:

The U.S. government taxes U.S. multinational firms on a residence basis, and thus U.S. resident firms incur taxation on income earned abroad as well as income earned in the United States. U.S. taxation is imposed only when income is repatriated by a foreign subsidiary to the U.S. parent via a dividend. Thus, a subsidiary’s income can grow free of U.S. tax prior to repatriation, a process known as deferral. Deferral provides strong incentives to earn income in low-tax countries.

As an example, consider a U.S. based multinational firm that operates a subsidiary in Ireland. Assume that the U.S. corporate income tax rate is 35% while the Irish corporate income tax rate is 12.5%. The Irish subsidiary earns 800 and decides to repatriate 70 of the profits to the United States. (Assume, for ease of computation only, a 1:1 exchange rate.) First, the Irish affiliate pays 100 to the Irish government on profits of 800. It then repatriates \$70 to the United States, using the remaining profit (630) to reinvest in its Irish operations. The firm must pay U.S. tax on the repatriated income, but it is generally eligible for a tax credit of \$100 (taxes paid) times 70/700 (the ratio of dividends to after-tax profits), or \$10. Owing to deferral, the remaining profits (630) can grow abroad tax-free prior to repatriation.

Id. (footnotes omitted).

corporation and has not earned any income in the United States.⁴³ If the parent corporation is based in the United States and has foreign subsidiaries, then the income earned by these subsidiaries is not taxed until it is repatriated to the U.S. parent via dividends or some other financial alternative.⁴⁴ Therefore, the current tax base for U.S. corporations is net income, and the tax base for foreign corporations is income earned within the United States—both of which are separately reported to the IRS, which means that the only reason to report is to determine tax liability.⁴⁵ These current tax bases represent the general pools of wealth that are subject to taxation—those numbers are then subject to thousands of pages of complex tax code and Treasury Regulations, which attempt to resolve a seemingly never-ending amount of issues, including: regulating certain actors, monitoring specific transactions, and reconciling U.S. law with other international taxing jurisdictions by issuing credits.⁴⁶

⁴³ See GRAETZ, *supra* note 30, at 40 (explaining how the United States generally does not have taxing authority over foreign based residents with foreign source income).

⁴⁴ See I.R.C. § 881 (2010) (providing for taxation of foreign corporations that repatriate their income to a U.S. parent corporation); Avi-Yonah et al., *supra* note 42, at 499 (examining some specifics in the U.S. tax system). The process of companies keeping funds in their overseas subsidiaries and not repatriating until they need capital is known as deferral. *Id.* The reasoning behind this is that the money earned by the subsidiary is attributed to a foreign corporation until it is repatriated to the U.S. parent. *Id.* See also William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing, and Development: It is All About Source!*, 29 U. PA. J. INT'L L. 349, 353-54 (2007) (“Under a residence-based system like the one used in the United States, as long as home country [corporations] use the form of foreign corporations to carry out their activities, income is deferred until repatriated and, upon repatriation of the profits, the enterprise is still entitled to a credit for foreign taxes previously paid.”); Shapiro, *supra* note 37, at 150 (noting that U.S. corporations are able to defer recognition of their foreign-source income, lowering their effective tax rate); *supra* note 42 (giving an example of repatriation and the foreign tax credit).

⁴⁵ See Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 17-18 (1996) (explaining the difference between having an income or consumption tax base); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 717 (2011) (describing the current U.S. corporate tax base of net income as worldwide, except for income earned by U.S. subsidiaries and not repatriated); Edward J. McCaffery & James R. Hines Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031, 1041 (2010) (explaining that having a certain tax base affects the particular tax rate a jurisdiction sets); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 976 (1997) (supporting the U.S. tax base of net income for the foreseeable future); Holmes, *supra* note 9, at 4 (explaining that the shifting of income out of the United States has eroded the corporate tax base because it has removed a large part of potential tax revenue to other countries with lower tax rates); see also Barker, *supra* note 29, at 651-52 (explaining the three different aspects of the tax base and how they are all inter-related).

⁴⁶ See Reuven S. Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* 5 (Brookings Inst., Discussion

324 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

To prevent double taxation, the United States gives a foreign tax credit to U.S. corporations if they earn income abroad.⁴⁷ For example, if a U.S. corporation earns income in a foreign country and that country imposes a territorial tax (as most countries do), then that corporation will receive a credit for the taxes paid.⁴⁸ The U.S. corporation would only owe the United States the difference between the U.S. rate and the foreign territorial taxes paid, unless the foreign rate was higher, at which point the corporation would not be subject to any U.S. tax.⁴⁹ The main

Paper, 2007), available at http://www.brookings.edu/~media/Research/Files/Papers/2007/6/corporatetaxes%20clausing/200706clausing_aviyonah.PDF ("The U.S. system is also notoriously complex: observers are nearly unanimous in lamenting the heavy compliance burdens and the impracticality of coherent enforcement."); Holmes, *supra* note 9, at 6-7 (describing the complexity of the U.S. Tax Code as many bright line rules aimed at various goals that lack uniformity); see also David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 871 (1999) (explaining that the more tax laws there are, the more transactional costs there are to ensure that those laws work together and that they do not allow for any loopholes).

⁴⁷ See I.R.C. §§ 901-08 (2010) (providing the rules governing the foreign tax credit for U.S. corporations); see also Zelinsky, *supra* note 31, at 1297 (providing a simplified example of the foreign tax credit system). That example is provided below:

To see the operation of the foreign income tax credit, suppose a highly simplified example in which A, a U.S. citizen, is in a 30% federal income tax bracket and earns \$100 from renting his condominium in Country X. If X has no income tax, A, on her federal return, reports this rental income as part of her worldwide income and pays \$30 of such income to the federal fisc. If, on the other hand, X also imposes income taxes on A at a 30% bracket, A pays a \$30 income tax to X, the source jurisdiction, and then credits that \$30 paid against the tax A would otherwise owe to the United States. The result is no net payment by A to the U.S. Treasury. If, in contrast, X imposes income taxes on A at a 20% bracket, A pays a \$20 tax to X, takes a credit on her federal tax return for that \$20 income tax payment, and thereby pays a net tax to the United States of \$10 on her rental income from her condominium located in X. The conventional view is that the credit for foreign income taxes prevents double taxation by giving the source jurisdiction the priority to tax.

Id. (footnote omitted).

⁴⁸ See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 81 (2009) (explaining the fundamentals of the foreign tax credit system).

Under the foreign tax credit system, the residence country subtracts the source-country tax on a resident's foreign income from the residence-country tax on the resident's foreign income and collects a so-called residual tax to the extent that the residence-country tax exceeds the source-country tax. Where a resident's source-country tax exceeds the residence-country tax, however, the residence country does not refund the excess to the resident.

Id.

⁴⁹ *Id.*; see Jane G. Gravelle, *International Corporate Income Tax Reform: Issues and Proposals*, 9 FLA. TAX REV. 469, 473 (2009) ("[I]f foreign taxes exceed the U.S. tax that would be due, the excess foreign taxes cannot be credited.").

policy reasons behind creating the foreign tax credit were to encourage corporations to continue to form and operate in the United States and to attract foreign investment in these corporations by eliminating the negative effect of double taxation.⁵⁰ However, corporations have found ways to manipulate their tax credits, shielding their income and paying a lower overall effective tax rate.⁵¹ The foreign tax credit system also depends, in large part, on accurately identifying the source of the income—which has proved to be difficult with the globalization of the economy.⁵²

As the global economy has evolved, most tax rules have become more complicated and harder to implement.⁵³ The residence rules have become much easier to manipulate because of how simple it is to incorporate in another country.⁵⁴ Even if a corporation decides not to

⁵⁰ See Raquel Alexander, Stephen W. Mazza & Susan Scholz, *Measuring Rates of Return on Lobbying Expenditures: An Empirical Case Study of Tax Breaks for Multinational Corporations*, 25 J.L. & POL'Y 401, 411 (2009) (describing how corporations are able to defer U.S. tax on income derived by a foreign subsidiary until the parent corporation repatriates the income). See generally Michael S. Kirsch, *The Role of Physical Presence in the Taxation of Cross-Border Personal Services*, 51 B.C. L. REV. 993, 1025 (2010) (providing a very broad description of the foreign tax credit system).

⁵¹ See Steven A. Dean, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 HASTINGS L.J. 911, 924–25 (2007) (explaining the process of using foreign tax credits to shield income). The shielding process involves racking up a high amount of foreign tax credits in a low-tax jurisdiction to shield that income from being taxed at a higher rate in another jurisdiction. *Id.*

⁵² See I.R.C. §§ 861, 862, 863, 865 (2006) (providing the statutory rules governing how the United States determines the source of income); INT'L BUREAU FISCAL DOCUMENTATION, INTERNATIONAL TAX GLOSSARY 277 (3d ed. 1996) (providing that a source of income is the “country or countries from which the company derived its profits”); Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 490 (2004) (“The special problem of territoriality in the tax area is that the source of income is very difficult to define.”).

⁵³ See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559–60 (1992) (examining the differences between tax standards and tax laws). The problem with tax laws is that their ideal content is not immediately apparent, and they are promulgated after the fact. *Id.* at 569. See also Kenneth W. Gideon, Cutler & Pickering Wilmer, *Tax Law Works Best when the Rules are Clear*, 81 TAX NOTES 999, 1001 (1998) (arguing that tax law problems need to be confronted and solved before they occur so the laws do not continue to get more complex).

⁵⁴ See I.R.C. §§ 7701(a)(4)–(5) (2006) (explaining that the term “domestic,” when applied to a corporation, means created or organized under the laws of the United States and the term “foreign,” when applied to corporations, means one that is not domestic); William M. Funk, *On and over the Horizon: Emerging Issues in U.S. Taxation of Investments*, 10 Hous. BUS. & TAX L.J. 1, 30–31 (2010) (noting that the United States corporate residence test is unusual because it is based on form rather than substance, which encourages tax avoidance); David R. Tillinaghast, *A Matter of Definition: “Foreign” and “Domestic” Taxpayers*, 2 INT'L TAX & BUS. LAW. 239, 259–60 (1984) (explaining the positives and negatives of the United States using the place of incorporation to determine a corporation's residence). The one advantage of the place of incorporation test is that it is very easy to apply. *Id.* It is applied by referring

326 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

change its country of incorporation, it could set up a foreign subsidiary, incorporate in that foreign jurisdiction, and transfer its income through financial record manipulation.⁵⁵

The source rules have been criticized for containing inherent problems in their application.⁵⁶ In order to determine the source of the income, the IRS has developed bright line rules that apply to different types of income, different parties depending on their residence, and exemptions. However, these rules are easily manipulated.⁵⁷ Also, issues

to the jurisdiction in which the charter is filed and by the laws governing the shareholders. *Id.* at 260. The major drawback of the place of incorporation test is that it is by nature androgynous and creates progeny. *Id.* Once a decision to incorporate in the United States is made, tax restraints discourage a company from incorporating abroad, but there are not restraints hindering the subsidiary of a U.S. corporation from incorporating abroad. *Id.*

⁵⁵ See Edward Kofi Osei, *Transfer Pricing in Comparative Perspective and the Need for Reforms in Ghana*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 599, 603 (2010) (identifying a few major U.S. corporations that set up subsidiaries in lower tax jurisdictions); Jon M. Truby, *Towards Overcoming the Conflict Between Environmental Tax Leakage and Border Tax Adjustment Concessions for Developing Countries*, 12 VT. J. ENVTL. L. 149, 165-67 (2010) (providing four examples of different ways that corporations set up subsidiaries in lower tax jurisdictions); Jesse Drucker, *Forest Laboratories' Globe-Trotting Profits*, BLOOMBERG BUSINESSWEEK (May 13, 2010), http://www.businessweek/magazine/content/10_21/b4179062992003.htm (explaining that thousands of U.S. companies are using subsidiaries in other countries and describing some of the techniques that they are using).

⁵⁶ See I.R.C. §§ 861-63, 865 (2006) (providing the U.S. source rules); GRAETZ, *supra* note 30, at 41 (explaining problems associated with the U.S. source rules). An example is provided:

Suppose a company manufactures and sells bicycles. Its owners live in Japan; its factory is in Mexico; its main offices are in Canada; its principle sales office is in the U.S., where most of its bicycles are sold; and it is incorporated in Bermuda. The geographical source of income from its bicycle sales is far from clear. On one hand, the Japanese owners supplied the capital to create the company, and the U.S. provides its principal market. But Mexico provides the bulk of its labor, Canada is the locus of its management, and Bermuda provides the legal arrangements enabling the company to exist.

Id. See also Fred B. Brown, *An Equity-Based, Multilateral Approach for Sourcing Income Among Nations*, 11 FLA. TAX REV. 565, 579-83 (2011) (pointing out that the two major problems with the current U.S. source rules are that they lack coherence to achieve a consistent tax policy, and there is such a variation between the U.S. rules and the rules of other developed countries).

⁵⁷ See GRAETZ, *supra* note 30, at 55-56 (explaining source rule manipulation). "Two prevalent types of source rule manipulation are the shifting of source within a particular category of income and the recharacterization of income into a different source category altogether." *Id.* An example of the former is shifting income between passive and active because they are taxed differently. *Id.* An example of the latter is shifting income to capital gains. *Id.* See also Avi-Yonah, *supra* note 38, at 1331 ("[T]he current [source] rules place an immense premium on [how] payments are characterized . . . [T]hese distinctions require constant policing, and much of the complexity of the inbound rules of the Code stems from this problem."); Charles I. Kingson, *Taxing the Future*, 51 TAX L. REV. 641, 642 (1996) (explaining how income is sometimes characterized as royalties, service, sales, or interest).

with determining the source have grown even more with technology, e-commerce, and intellectual property.⁵⁸ Difficulties arise when attributing the source of an Internet transaction and when determining the source of income produced by an algorithm or some other type of intellectual property.⁵⁹ The U.S. corporate tax structure has opened up loopholes for a few popular tax avoidance methods that corporations like to exploit.⁶⁰ This Note explains the fundamentals of each popular strategy by using Google as a structural example.⁶¹ Although there are many corporations that utilize these tax avoidance techniques, each has its own specific version.⁶² Google's tax avoidance process illuminates the basics of several different methods employed to take advantage of multiple international tax loopholes simultaneously.⁶³

⁵⁸ See Avi-Yonah, *supra* note 31, at 527 (explaining how easy it is for corporations to establish their business and income in tax havens); Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 312 (2003) (explaining that the source and resident rules are "fairly easy to exploit in the e-commerce context"); Thomas C. Pearson, *Proposed International Legal Reforms for Reducing Transfer Pricing Manipulation of Intellectual Property*, 40 N.Y.U. J. INT'L L. & POL. 541, 562-63 (2008) (describing the problem with intellectual property and abusing tax avoidance); Kyrie E. Thorpe, Comment, *International Taxation of Electronic Commerce: Is the Internet Age Rendering the Concept of Permanent Establishment Obsolete?*, 11 EMORY INT'L L. REV. 633, 639-40 (1997) (describing how corporations earning money through e-commerce transactions can avoid source taxes by locating their servers in countries with a lower tax rate); see also 26 C.F.R. § 1.482-4(b)(1) (as amended in 2006) (providing the regulations governing the transfer of intellectual property, such as inventions, formula, processes, designs, and patterns).

⁵⁹ See Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 599 (2010) ("Common transfer pricing strategies include the location of valuable intellectual property in low-tax offshore corporations . . ."). The I.R.S. has tried to fix this problem by changing regulations to require the sharing of a larger pool of costs and to attribute a higher value to intellectual property originating with the parent company. *Id.* at 627. There have also been proposals to tax U.S. corporations on excess returns from intangibles placed in low-tax jurisdictions. *Id.* The problem with this proposal is that it is very hard to put a value on intellectual property to properly determine what is in excess. *Id.*

⁶⁰ See Colin P. Marks, *Jiminy Cricket for the Corporation: Understanding the Corporate "Conscience"*, 42 VAL. U. L. REV. 1129, 1154-55 (2008) (stating that the use of loopholes allows corporations to comply with the letter, but not necessarily the spirit, of a law, which in turn gives them the ability to manipulate and exploit the legal system); see also *infra* Part II.C (explaining four major tax avoidance techniques used by corporations); Gary Clyde Hufbauer & Jisun Kim, *U.S. Taxation of Multinational Corporations: What Makes Sense, What Doesn't* 4 (Peterson Inst. Int'l Econ., Policy Brief No. PB09-7, 2009), available at <http://www.iie.com/publications/interstitial.cfm?ResearchID=1152> (noting the loopholes in the U.S. tax system).

⁶¹ See *infra* Part II.C (using Google as the example in each section to provide an example of the type of tax avoidance structures that corporations employ).

⁶² See, e.g., Kleinbard, *supra* note 45, at 763 (explaining Cisco's strategies for tax avoidance).

⁶³ See Gravelle, *supra* note 22, at 76 (discussing why Google uses so many different types of loopholes in its tax avoidance scheme).

C. Major Tax Avoidance Techniques

Recent technological innovations, as well as a movement towards a global economy, have enabled corporations to take advantage of the U.S. tax system, avoiding taxation.⁶⁴ Part II.C.1 explains the use of shell companies; Part II.C.2 examines the earnings stripping technique; Part II.C.3 provides details about transfer pricing; and Part II.C.4 combines the three strategies to show how Google is manipulating the U.S. tax system.⁶⁵

1. Shell Companies

One major technique being used by U.S. corporations occurs when a company sets up shell companies, companies with little or no assets, as subsidiaries in tax shelters or countries with low tax rates.⁶⁶ This usually involves establishing an office or even just a mailbox in a low-tax country and then either incorporating in that country or claiming that its office in that country is its central place of management.⁶⁷ Corporations

⁶⁴ See *supra* note 3 (describing how technology has made it easier for corporations to get around tax laws); see also Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 467 (2002) (explaining how technological improvements made it easier for corporations to get around financial services requirements).

⁶⁵ See *infra* Part II.C.1 (discussing the use of shell companies); *infra* Part II.C.2 (explaining the use of earnings stripping); *infra* Part II.C.3 (examining the practice of transfer pricing); *infra* Part II.C.4 (defining and explaining the “Double Dutch Irish Sandwich”).

⁶⁶ See 17 C.F.R. § 240.12b-2(3)(iv) (2010) (providing a definition of a shell company); Simone M. Haug, *The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis*, 29 VAND. J. TRANSNAT’L L. 191, 250 (1996) (maintaining that shell corporations follow the sham doctrine in which no real business or activity is going on in them); Pirooska Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 160 (1990) (explaining the basic strategy of filtering money through a shell company); Press Release, *supra* note 4 (noting that shell companies are created for the sole reason of saving money on taxes); see also John Hasnas, *Between Scylla and Charybdis: Ethical Dilemmas of Corporate Counsel in the World of the Holder Memorandum*, 44 VAL. U. L. REV. 1199, 1211–12 (2010) (explaining that tax shelters are designed to allow wealthy investors to avoid paying taxes); David E. Spencer & Jason C. Sharman, *OECD Proposals on Harmful Tax Practices*, 13 N.Z. J. TAX’N L. & POL’Y 129, 148 (2007) (giving details on how criminals use shell companies to house funds derived from criminal activity).

⁶⁷ See *60 minutes Special Report: A Look at the World’s New Corporate Tax Havens*, CBSNEWS.COM (Mar. 25, 2011), <http://www.cbsnews.com/stories/2011/03/25/60minutes/main20046867.shtml?tag=contentMain;contentBody> (describing certain companies that employ these techniques in Switzerland). Central place of management is another test that countries use for establishing whether a corporation is a resident for tax purposes. See Aldo Forgiione, *Weaving the Continental Web: Exploring Free trade, Taxation, and the Internet*, 9 L. & BUS. REV. AM. 513, 534 (2003) (exploring the different ways countries define a corporation). Forgiione provides a brief summary:

do this because they can take advantage of the lower tax rates, repatriating just enough money in order to keep their U.S. parent companies running.⁶⁸ For example, Google, Inc., a U.S. based corporation, created a subsidiary in the Netherlands, Google Netherlands Holdings, which has no employees or assets but filters through 99.8% of Google's income for tax reasons.⁶⁹

One preventive measure that the IRS employed to stop this type of behavior was the subpart F rules, or the Controlled Foreign Corporations ("CFC") regulations, as part of the 1962 Tax Revenue Act.⁷⁰ These regulations identified corporate forms that were more prone to tax avoidance and specified several categories of income that would be subject to U.S. income tax, because certain types of income could easily

While many nations define a resident corporation, for tax purposes, as a company incorporated in the state, a significant number of countries have also enacted laws that purport to deem a corporation to be a resident of the country if the company's place of central management is located domestically or, more rarely, if the corporation's principal economic activities are conducted locally.

Id. The central place of management test looks more to the substance rather than the form of the corporation. See Avi-Yonah, *supra* note 52, at 486 (explaining the advantages and disadvantages of the central place of management test used in the United Kingdom).

⁶⁸ See Andrew Brady Spalding, *The Irony of International Business Law: U.S. Progressivism and China's New Laissez-Faire*, 59 UCLA L. REV. 354, 386 (2011) ("When a foreign-chartered corporation is owned by a U.S. corporation, the result is that profits attributable to U.S. shareholders escape U.S. tax as long as they are reinvested in foreign tax jurisdictions; hence the frequent establishment of subsidiaries in low-tax foreign jurisdictions."); Avi-Yonah et al., *supra* note 42, at 499-500 (examining some specifics in the U.S. tax system and noting how the U.S. system creates an incentive for corporations to earn profits in countries with lower tax rates). The process of companies keeping funds in their overseas subsidiaries and not repatriating them until they need capital is known as deferral. *Id.* Companies employ this tactic because the money earned by the subsidiary is deemed to be of a foreign corporation until it is attributed to the U.S. parent. *Id.*

⁶⁹ See Gravelle, *supra* note 22, at 76 (describing the scheme that Google uses, which is commonly referred to as the "Double Irish" with a "Dutch Sandwich"); Jesse Drucker, *The Tax Haven That's Saving Google Billions*, BLOOMBERG BUSINESSWEEK (Oct. 21, 2010), http://www.businessweek.com/magazine/content/10_44/b4201043146825.htm (explaining the entire process that Google goes through in order to cut their effective corporate tax rate from 35% to 2.4%).

⁷⁰ Revenue Act of 1962, Pub. L. No. 87-834, § 956(d), 76 Stat. 960 (codified as amended in scattered sections of 26 I.R.C.); see I.R.C. § 957 (2006) (defining a controlled foreign corporation in the Tax Code); GRAETZ, *supra* note 30, at 218 (defining a "controlled foreign corporation" or "CFC" as a "foreign corporation that is majority owned by U.S. individuals or corporations, counting only those U.S. shareholders who hold 10% or more of the stock"); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525, 1538-40 (2001) (explaining the history of subpart F and how President Kennedy's administration worked to enact it); Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 974-76 (2010) (examining the history of the subpart F regulations and why they were enacted).

330 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

be shifted to low-tax jurisdictions.⁷¹ Under these rules, specific U.S. corporations are taxed to the extent that their foreign subsidiaries received disfavored forms of income, which were most likely aimed at shifting income.⁷² Corporations, such as Google, are still finding ways to manipulate their form, circumventing the controlled foreign corporation label.⁷³ These rules are objective, mechanical, and designed to isolate income typically associated with tax avoidance.⁷⁴ This has led to layers upon layers of technical rules aimed at retroactively fixing a specific problem; however, these rules simultaneously create another loophole.⁷⁵

2. Earnings Stripping

Earnings Stripping is a tax avoidance technique in which a U.S. corporation sets up a subsidiary in a low-tax country, and then the U.S. corporation uses its U.S. earnings and makes deductible payments to the

⁷¹ See Charles E. McLure Jr., *Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the U.S. and the E.U.*, 14 COLUM. J. EUR. L. 377, 389 (2008) (explaining how CFC regulations target certain corporations that are prone to shift their income); GRAETZ, *supra* note 30, at 218 (noting that most controlled foreign corporations were formed for the sole reason of moving their passive income); see also I.R.C. § 954(c)(1)-(2) (2006) (codifying the different types of income that the subpart F regulations apply to); Engel, *supra* note 70, at 1542-48 (examining the major categories of income targeted under Subpart F including: passive income, diversionary sales income, diversionary services income, and miscellaneous provisions). The biggest category that companies abuse is passive income, which includes dividends, interest, rents, royalties, stocks, and securities. *Id.* at 1542.

⁷² See GRAETZ, *supra* note 30, at 220 (maintaining that the disfavored forms of business income include income involving structures that shift income outside a foreign subsidiary's place of incorporation with little or no economic cost); see also *supra* note 71 (naming types of income to which controlled foreign corporation regulations are aimed).

⁷³ See I.R.C. § 957 (2006) (providing that a corporation is considered a "controlled foreign corporation" when a certain percentage of stock is owned by U.S. shareholders). If subsidiaries are owned by means other than stock, then these controlled foreign corporation regulations can be avoided. *Id.* See also GRAETZ, *supra* note 30, at 236 (explaining a few other ways that controlled foreign corporation regulations can be avoided). Corporations avoid these regulations by becoming a hybrid entity and transferring income inter-branch. *Id.* Another way to avoid these regulations is contracting out the actual processing or manufacturing into a low-tax jurisdiction. *Id.* at 236-37.

⁷⁴ See sources cited *supra* note 50 (explaining why tax laws in the United States appear to be so complicated); see also Ilya A. Lipin, *Uncertain Tax Positions and the New Tax Policy of Disclosure Through the Schedule UTP*, 30 VA. TAX REV. 663, 665-67 (2011) (explaining that U.S. tax laws contain ambiguities, obscurities, and perplexities, which make their interaction and application to specific situations incoherent and complex).

⁷⁵ See Lipin, *supra* note 74, at 665-67 (explaining that there are over seventy thousand pages of tax code that have been changed over fifteen thousand times, with each new change creating an opportunity for exploitation); see also sources cited *supra* note 50 (providing an explanation for why the U.S. Tax Code is so difficult to apply).

subsidiary in the form of interest, royalties, or fees.⁷⁶ This “strips” the earnings from the U.S. corporation and transfers the majority of the income to the country with the low tax rate.⁷⁷ For example, the foreign subsidiary could make a loan to the U.S. parent, and in return the parent would make extremely high interest payments back to the subsidiary.⁷⁸ In 2006, Google, Inc. (U.S.) implemented a form of earnings stripping when it licensed the rights of its intellectual property to its subsidiary in Bermuda for “undisclosed” fees.⁷⁹ These fees are ongoing and are set very low in order to capture as much profit as possible in Bermuda, which does not have a corporate income tax.⁸⁰

⁷⁶ See Press Release, *supra* note 4 (describing the process that corporations go through in order to shift their income to subsidiaries in countries with lower tax rates). Traditionally, if a U.S. company sets up a foreign subsidiary in a tax haven and one in another country, income shifted between the two subsidiaries—for example, through interest on loans—would be considered “passive income” for the U.S. company and subject to U.S. tax. *Id.* Over the last decade, it has become easier for U.S. firms to make these subsidiaries disappear for U.S. tax purposes. *Id.* With the separate subsidiaries disregarded, the firm can shift income among them without reporting any passive income or paying any U.S. tax. *Id.* As a result, U.S. firms that invest overseas are able to shift their income to tax havens. *Id.* “It is clear that this loophole, while legal, has become a reason to shift billions of dollars in investments from the United States to other countries.” *Id.* See also Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm’s Length Allocation Method*, 28 VA. TAX REV. 619, 641–42 (2009) (acknowledging that the traditional earnings stripping technique involved debt, but also maintaining that it could be replicated using other types of related transactions); Robert E. Culbertson & Jaime E. King, *U.S. Rules on Earnings Stripping: Background, Structure, and Treaty Interaction*, 29 TAX NOTES INT’L 1161, 1161–62, 1166–68 (2003) (explaining the background of earnings stripping); Kleinbard, *supra* note 45, at 703 (defining earnings stripping as “the extraction of pretax earnings from a source country through tax-deductible payments to offshore affiliates”).

⁷⁷ See Culbertson & King, *supra* note 76, at 1161–68 (explaining that foreign investors can take advantage of debt structuring to strip their earnings to a low-tax jurisdiction); Kleinbard, *supra* note 45, at 706 (noting that earnings stripping is a type of leveraging technique that strips countries of attributable tax revenue).

⁷⁸ See Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1218 (2010) (“Remarkably, the current rules are ineffective even in preventing tax revenue loss because they fail to recognize the weakest link in terms of tax erosion—interest payments made to foreign investors.”); Kleinbard, *supra* note 45, at 705 (explaining that earnings stripping usually occurs through the creation of an item of income inclusion, such as intercompany interest, rents, or royalties).

⁷⁹ See Drucker, *supra* note 69 (explaining Google’s entire tax avoidance strategy); see Gravelle, *supra* note 22, at 76 (giving a brief summary of Google’s tax avoidance process); Kleinbard, *supra* note 45, at 711–12 (explaining that the earnings stripping step in Google’s tax avoidance process is the last step after which most of its income comes to rest in Bermuda).

⁸⁰ Drucker, *supra* note 69. Drucker goes on to explain:

The subsidiary is supposed to pay an “arm’s length” price for the rights, or the same amount an unrelated company would. Yet because

332 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

One way that Congress tried to stop this type of behavior was by passing the Revenue Reconciliation Act of 1989, which codified the earnings stripping rule as section 163(j) of the Tax Code.⁸¹ Under this regulation, certain rules applied to corporations with debt/equity ratios greater than 1.5 to 1.⁸² In other words, if the company was structured so that it paid out more than half of its cash flow as interest expenses, then the interest payments would be treated as excess interest and not interest income for taxing purposes.⁸³ Corporations are still able to manipulate and restructure to make their ratios appear lower than they actually are.⁸⁴ This rule is also aimed specifically at earnings stripping involving debt and does not consider earnings stripping involving other forms of intercompany payments, such as Google's use of fees.⁸⁵

3. Transfer Pricing

Transfer pricing is probably the most used tax avoidance strategy, which involves the setting of prices in transactions between related entities.⁸⁶ A common example occurs when a U.S. parent corporation

licensing fees from the Irish subsidiary generate income that is taxed at 35 percent, one of the highest corporate rates in the world, Google has an incentive to set the licensing price as low as possible.

Id.

⁸¹ Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(a), 103 Stat. 2106, 2339; I.R.C. § 163(j)(2)(A)-(C) (2006) (describing the earnings stripping rules for corporations); Julie A. Roin, *Adding Insult to Injury: The "Enhancement" of S 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 TAX L. REV. 269, 270 (1994) (commenting that section 163(j) is known as the "earnings stripping rule" because it prevents shareholders from using interest payments to strip corporations of their earnings).

⁸² See I.R.C. § 163(j)(2)(A)-(C) (2006) (providing the statutory rules designed to prevent corporations from abusing the debt to equity form in order to avoid paying taxes).

⁸³ See Culbertson & King, *supra* note 76, at 1167-68 (explaining section 163(j) represents the principle that a corporation should not be able to filter its income through interest or any other kind of intra-company payments to reduce its tax liability).

⁸⁴ See Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 168-70 (1997) (explaining that companies use debt/equity swaps and other transactions to manipulate their ratio for a purely cosmetic effect). Not only will the company be able to bypass the earnings stripping rules, but it also will look more attractive to future investors. *Id.*

⁸⁵ See I.R.C. § 163(j)(2)(A)-(C) (giving the rules associated with stopping earnings stripping). These rules do not contain any regulations for fees, rents, or royalties and only relate to earnings stripping by debt. *Id.* See also Benshalom, *supra* note 76, at 641 (mentioning how earnings stripping could also be accomplished by manipulating a variety of different financial transactions).

⁸⁶ See GRAETZ, *supra* note 30, at 400 (explaining that the common transfer pricing strategy involves income that is earned by a high tax rate entity being somehow realized by a subsidiary that pays tax at a lower rate). Corporations that own subsidiaries in low-tax jurisdictions usually engage in transfer pricing to shift income through the manufacturing process without lowering the overall economic profit per transaction. *Id.* at 401. See *About*

interacts with a foreign subsidiary, and that subsidiary sells either goods or services abroad.⁸⁷ The U.S. corporation can then “sell,” on paper, the product to its foreign subsidiary for a minimum price so that most of the profit is captured in the foreign country with the lower tax rate.⁸⁸ Transfer pricing is a problem because there is not one globally recognized tax code, and corporations are always searching for ways to maximize profit.⁸⁹ Google, Inc. (U.S.) also employs a form of transfer pricing, in which it licenses its search and advertising technology to Google Ireland in return for licensing payments.⁹⁰ The licensing

Transfer Pricing, OECD CTR. TAX POL’Y & ADMIN. (last updated July 2010), <http://www.oecd.org/ctp/transferpricing/abouttransferpricing.htm> (explaining the process of transfer pricing generally); see also Eduardo Baistrocchi, *The Transfer Pricing Problem: A Global Proposal for Simplification*, 59 TAX LAW. 941, 949 (2006) (defining transfer price as “the unit price assigned to goods and services between the parent company and subsidiaries or between divisions within the same firm”).

⁸⁷ See John Sokatch, *Transfer-Pricing with Software Allows for Effective Circumvention of Sub-Part F Income: Google’s “Sandwich” Costs Taxpayers Millions*, 45 INT’L LAW. 725, 739 (2011) (“Transfer-pricing is the practice of making payments from one business entity to another affiliated business entity for the receipt of goods or services.”).

⁸⁸ See GRAETZ, *supra* note 30, at 400 (explaining transfer pricing and the allocation of income among related parties). An example is provided:

Suppose that Company A, a U.S. corporation, manufactures contact lenses. Most of Company A’s product is sold abroad through a wholly owned subsidiary, Company B. Each lens costs \$5 to manufacture and is sold to the public abroad for \$9 by Company B. Suppose that Company B is a wholly-owned subsidiary of Company A, then Company A may, by controlling the sales price of the lenses, be able to choose in which jurisdiction its taxable income is realized. Company A may attempt to realize the bulk of its income in the foreign jurisdiction by selling contact lenses to Company B for say, \$5.25, resulting in a token profit of \$0.25 per lens in the U.S. Company B will realize profit of \$3.75 per lens (\$9.00 minus the \$5.25 it paid for each lens from Company A). Absent a challenge by the IRS, for the purpose of allocating income from the sales of each lens for determining income tax owed, the profit will be split between Companies A and B, with only 25 cents of profit realized in the U.S. and \$3.75 in Company B’s low-tax jurisdiction for each lens produced and sold.

Id.

⁸⁹ See Miguel González Marcos, *Seclusion in (Fiscal) Paradise is Not an Option: The OECD Harmful Tax Practices Initiative and Offshore Financial Centers*, 24 N.Y. INT’L L. REV. 1, 22–23 (2011) (explaining that tax policies are efficient if they minimize tax considerations in corporations’ decision making); Sokatch, *supra* note 87, at 739 (noting that corporations and consumers always search for ways to “re-capture” profits that would normally be attributed to taxes); see also Ian B. Lee, *Corporate Law, Profit Maximization, and the “Responsible” Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 31–32 (2005) (explaining the main goals of a corporation).

⁹⁰ See Kleinbard, *supra* note 45, at 707 (noting that Google Ireland Holdings operated with five total employees in 2003); Sokatch, *supra* note 87, at 740 (explaining that Google

334 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

agreement allows Google to attribute its overseas profits to its Irish operations, instead of the United States where most of the technology was developed.⁹¹

One way that the IRS tried to combat transfer pricing was through the Arm's Length Standard.⁹² This standard states that "in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."⁹³ This standard is met if uncontrolled taxpayers would have engaged in the same transactions under the same circumstances.⁹⁴ However, this standard creates uncertainty because neither the taxpayer nor the market can predict in advance what a reasonable outcome should be in a transfer pricing case, especially for unique goods.⁹⁵

4. Putting It All Together—Google's "Double Irish Dutch Sandwich"

These three techniques all involve methods of manipulating financial statements to lower income, but Google has combined these three methods, creating what has become known as the "Double Irish Dutch

Ireland Holdings is in control of Google's "search engine software, advertising banners, and the Android platform").

⁹¹ See Drucker, *supra* note 69 (explaining that although Google's money filters through its Irish subsidiary, the money still has another step in Google's tax avoidance scheme); see *supra* note 55 (explaining the problem that arises with attributing the source of e-commerce, intellectual property, formulas, and designs).

⁹² See I.R.C. § 482 (2006) (codifying the Arm's Length Standard); see also *supra* note 80 (explaining the meaning of the Arm's Length Standard).

⁹³ Treas. Reg. § 1.482(b)(1) (1994); see REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 6-7* (2007) (maintaining that one is only engaged in the Arm's Length Standard as long as he or she is looking for comparable prices); see also GRAETZ, *supra* note 30, at 407 (explaining that the Arm's Length Standard requires that parties to a transaction not only calculate their respective profits separately, but also that related parties treat transactions as if unrelated parties had entered into them).

⁹⁴ See Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Ruling*, 29 VA. TAX REV. 137, 170 n.113 (2009) (explaining that the applicable standard in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer).

⁹⁵ See Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 137 (1995) (explaining that the Arm's Length Standard leads to uncertainty because "neither the taxpayer nor the IRS can know in advance the likely revenue outcome in a transfer pricing case"); Wayne M. Gazur, *An Arm's Length Solution to the Shareholder Loan Tax Puzzle*, 40 SETON HALL L. REV. 407, 428-29 (2010) (establishing that an Arm's Length Standard might be hard to prove in the majority of markets); see also Benshalom, *supra* note 76, at 621 (noting that another flaw in the Arm's Length Standard is that it requires unrealistic levels of government monitoring and can be easily abused).

Sandwich.”⁹⁶ Google has created four separate subsidiaries and has used conflicting tax codes, as well as bilateral tax agreements to avoid paying almost any U.S. taxes.⁹⁷ Google licenses to Google Ireland Holdings, a shell company with only two thousand employees, the offshore rights to its intellectual property for undisclosed fees so that the United States has an incentive to set a very low price.⁹⁸ Next, while Google Ireland Holdings is an Irish company, it reports that its place of management (Irish residence rule) is centered in Bermuda, exempting it from Irish taxes.⁹⁹ Google Ireland Holdings gets credit for about 88% of the company’s overseas sales, yet reported a pre-tax profit of less than 1% of sales in 2008, in large part because of the \$5.4 billion in royalties it paid, indirectly, to the Bermuda managed company.¹⁰⁰ Finally, the royalty payments from Google Ireland Holdings in Dublin take a quick detour to the Netherlands to avoid triggering an Irish withholding tax.¹⁰¹ In Amsterdam, Google Netherlands Holdings BV paid out 99.8% of the \$5.4 billion it received from Dublin to the unit managed in Bermuda.¹⁰² The Dutch company has no employees, meeting the definition of a shell corporation.¹⁰³ Other corporations have now engaged in similar practices, which costs the United States billions of dollars in tax revenue annually.¹⁰⁴ Now that this Note has described the tax avoidance problem, it will define a few popular proposals to fix this problem.¹⁰⁵

D. Popular Proposals

The four most popular proposals to fix the corporate tax avoidance problem in the United States include: (1) lowering the corporate tax rate,

⁹⁶ See Sokatch, *supra* note 87, at 741 (explaining how this scheme received its name).

⁹⁷ See *id.* at 740 (explaining how Google developed its tax avoidance scheme).

⁹⁸ See *id.* at 740–42 (describing the first step of Google’s process); Drucker, *supra* note 69 (explaining how Google uses the strategy of earnings stripping in the Netherlands).

⁹⁹ See Drucker, *supra* note 69 (explaining how Google manipulates the residence rules and filters their income through a complicated system of shell companies); see also *supra* Part II.B (providing a background for the U.S. corporate residence rules).

¹⁰⁰ See Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, BLOOMBERG BUSINESSWEEK (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> (explaining how Google uses the transfer pricing method of tax avoidance).

¹⁰¹ *Id.* (explaining the final step in Google’s tax avoidance scheme).

¹⁰² *Id.* (describing Google’s use of Bermuda’s tax haven).

¹⁰³ See Sokatch, *supra* note 87, at 742 (evaluating the final numbers after Google has utilized several tax avoidance techniques.)

¹⁰⁴ See *id.* (explaining how other corporations are using the same type of techniques); see also *supra* note 7 (describing the widespread use of tax avoidance techniques by corporations all over the world).

¹⁰⁵ See *infra* Part II.D (defining a few popular proposals to fix the tax avoidance problem in the United States); *infra* Part IV (proposing a change to the tax base).

336 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

(2) shifting the U.S. tax system to a pure territorial tax, (3) continuing to add provisions to the Tax Code to address specific problems, and (4) using a formulary apportionment to tax corporations.¹⁰⁶ Lowering the corporate rate refers to lowering the 35% corporate rate to a rate comparable to tax havens and other low-tax jurisdictions.¹⁰⁷ This has become especially popular since President Obama made a proposal to lower the standard corporate tax rate from 35% to 28%.¹⁰⁸ This plan focuses on attracting investment to the United States while reducing one of the highest tax rates in the world.¹⁰⁹ Shifting to a pure territorial tax implies that the United States would no longer tax U.S. corporations on the basis of residency, taxing corporations based only on their U.S. source income.¹¹⁰ This is the way that most industrialized countries currently tax corporations.¹¹¹ There has been much support for this

¹⁰⁶ See *infra* text accompanying notes 106-18 (explaining generally these four proposals).

¹⁰⁷ See Kathryn J. Kennedy, *The IRS's Recent Uncertain Tax Positions Initiative: A Tangle of Accounting, Tax and Privilege Issues*, 9 DEPAUL BUS. & COM. L.J. 401, 406 (2011) (acknowledging that lower tax rates could cause businesses to stay in the United States); Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will it Last? Will it Work?*, 9 STAN. J.L. BUS. & FIN. 37, 41 (2003) (mentioning that firms invest in countries with low tax rates to give them a tax advantage); Richard T. Page, *The International and Comparative Tax War: A Strategic Tax Cut Recommendation for the Obama Administration*, 18 TUL. J. INT'L & COMP. L. 287, 289-90 (2009) (listing other countries that have recently lowered their corporate tax); Meg Shreve, *Sessions Open to Paying for Corporate Tax Cut*, 130 TAX NOTES 632, 632 (2011) (arguing for lowering the corporate tax rate in the United States); Martin Feldstein, *Want to Boost the Economy? Lower Corporate Tax Rates*, WALL ST. J., Feb. 15, 2011, <http://online.wsj.com/article/SB10001424052748703584804576144131539072472.html> (explaining how lowering a country's tax rate can attract investors). *But see* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 21 (1993) (asserting that a corporate tax rate war would threaten the U.S. economy).

¹⁰⁸ See Zachary A. Goldfarb, *Obama Proposes Lowering Corporate Tax Rate to 28 Percent*, WASH. POST, Feb. 22, 2012, http://www.washingtonpost.com/business/economy/obama-to-propose-lowering-corporate-tax-rate-to-28-percent/2012/02/22/gIQA1sjdSR_story.html (explaining Obama's proposal to cut the corporate tax to 28% in order to be competitive with other countries).

¹⁰⁹ *Id.*

¹¹⁰ See David L. Cameron & Phillip F. Postlewaite, *Incremental International Tax Reform: A Review of Selected Proposals*, 30 NW. J. INT'L L. & BUS. 565, 566-79 (2010) (describing a few proposals to fix the international tax avoidance problem in the United States); Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771, 772 (2010) (evaluating the advantages and disadvantages of the United States moving to a territorial tax); Gravelle, *supra* note 49, at 491-92 (analyzing the territorial and worldwide tax systems). *But see* Alex Khachatryan, *Reforming the United States Export Tax Policy: An Alternative to the American Trade War with the European Union*, 14 U.C. DAVIS J. INT'L L. & POL'Y 185, 195-97 (2008) (supporting the idea of a territorial tax in the United States).

¹¹¹ See GRAETZ, *supra* note 30, at 12-13 (explaining how most European nations have territorial systems and do not have a residence tax).

proposal because of its relative success in European countries.¹¹² The third proposal—adding specific provisions to the Tax Code—is how the United States currently handles tax issues.¹¹³ When a problem arises, a provision is added to the Tax Code to retroactively address it.¹¹⁴ Keeping the corporate tax system this way is the least popular of the current proposals because of its well documented failures in the past.¹¹⁵ Formulary apportionment is a rather new proposal that suggests using a formula and basing a corporation's income on a variety of factors.¹¹⁶ This proposal is more modern in that it recognizes the abuse that results from corporations reporting their own income to the IRS.¹¹⁷ These proposals have advantages and disadvantages that can be best understood by first analyzing why these tax avoidance problems are occurring in the United States.¹¹⁸

III. ANALYSIS

The IRS has struggled in its attempts to create regulations that prevent U.S. corporations from using tax avoidance techniques.¹¹⁹ Part III of this Note discusses the various reasons why the IRS has struggled to combat tax avoidance techniques and the continued effects that corporate tax avoidance is having on the U.S. economy as a whole.¹²⁰ More specifically, Part III.A explains the inherent problems contained within the current U.S. tax base, which make it difficult for the IRS to

¹¹² *Id.*

¹¹³ *See, e.g.,* Stop Tax Haven Abuse Act, § 681, 111th Cong. § 7492, Subchapter F (as introduced by Senator Levin, Mar. 2, 2009) (providing an example of retroactive rules proposed to the Tax Code); *see also* Gravelle, *supra* note 49, at 488–89 (explaining some specific provisions that could be added to the Tax Code); *supra* note 52 (discussing the complexity of tax code rules).

¹¹⁴ *See* Holmes, *supra* note 9, at 23–26 (highlighting the complexities of the Tax Code, which explains why making tax laws after the fact do not work).

¹¹⁵ *See* Bordoff & Furman, *supra* note 3, at 353–54 (illustrating the brokenness of the U.S. corporate tax system).

¹¹⁶ *See* Avi-Yonah et al., *supra* note 42, at 498 (advocating for the United States to switch its tax system to formulary apportionment); Morse, *supra* note 59, at 599–600 (examining the benefits of formulary apportionment). *But see* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 149 (2011) (explaining formulary apportionment of income methodology as “the mechanism for allocating a multinational enterprise’s global income to source countries”).

¹¹⁷ *See* Avi-Yonah et al., *supra* note 42, at 498–99 (explaining some benefits of formulary apportionment).

¹¹⁸ *See infra* Part III.A (analyzing why these loopholes in the U.S. Tax Code exist).

¹¹⁹ *See supra* note 7 (noting how much revenue the United States is losing because of tax avoidance).

¹²⁰ *See infra* Part III (discussing various reasons why tax avoidance is a problem in U.S. tax law).

338 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

create regulations that effectively combat tax avoidance strategies.¹²¹ Part III.B examines the continued negative effects that corporate tax avoidance has on the U.S. economy and some public policy reasons that support changing the Tax Code to better eliminate these tax loopholes.¹²² Part III.C evaluates the shortcomings of some popular proposals that have been offered as solutions to the corporate tax avoidance problem.¹²³ Ultimately, Part III concludes that the existing regulations designed to address tax avoidance strategies fail to resolve this problem adequately because of the current structure of the U.S. tax base and that the best solution to this problem is to change the tax base altogether.¹²⁴

A. *Inherent Problems with Current U.S. Tax Base*

“More effective taxation internationally is primarily a question of the tax base.”¹²⁵ One inherent problem with the current tax base for corporations is that it promotes manipulation.¹²⁶ One way it does this is exemplified in the fact that corporations separately report their income to the IRS.¹²⁷ This means that corporations have the added incentive to report their income as low as possible, pay as little taxes as possible, and

¹²¹ See *infra* Part III.A (explaining the problems that the United States faces from using net income as the corporate tax base).

¹²² See *infra* Part III.B (examining the negative effects that tax avoidance is having on the U.S. economy).

¹²³ See *infra* Part III.C (evaluating the advantages and disadvantages of some popular proposals to fix the tax avoidance problem).

¹²⁴ See *infra* Part IV (proposing to fix the corporate tax avoidance problem by changing the tax base).

¹²⁵ See Barker, *supra* note 29, at 651 (explaining generally the importance of having a good tax base); McCaffery & Hines, *supra* note 45, at 1041 (stating that the tax structure and rate depend on the tax base).

¹²⁶ See Holmes, *supra* note 9, at 10 (examining some of the shortcomings of the United States’ prescriptive corporate tax regime). Holmes explains:

[T]he U.S. corporate tax system represents the worst of both worlds: (i) a high statutory tax rate with relatively low, declining effective rates (and thus corporate tax revenue); and (ii) complex rules that fail to protect the corporate tax base, but can be manipulated, with significant social costs, by sophisticated MNCs to lower their effective rates.

Id.

¹²⁷ See McIntyre et al., *supra* note 17, at 706-07 (explaining that separate reporting opens up the opportunity for corporations to employ tax minimization strategies). The article explains transfer pricing and asserts that combined reporting “directly blocks these techniques and other similar tax-minimization strategies.” *Id.* See Mazerov, *supra* note 17, at 4 (“In combined-reporting states, however, corporate manipulation of transfer prices does not affect state corporate tax revenues. Since the profits of a corporation’s components are added together to determine the corporation’s taxable base, the allocation of those profits within the corporation is irrelevant.”).

thus maximize their after tax profits.¹²⁸ Because there is a lack of cooperation between countries on how high or low to set the tax rate for corporations, countries tend to undercut one another with lower tax rates so they can attract foreign investment.¹²⁹ If corporations can manipulate their income so that it looks as though it was earned in a low-tax jurisdiction, then they can lower their tax liability.¹³⁰ Former IRS Commissioner Mark Everson noted that large multinational corporations will “utilize every available resource to explore opportunities to reduce their tax liability by using the most intricate and complicated Code provisions”¹³¹ Corporations do not have an incentive to keep the income figure that they report to the IRS high, and the IRS cannot make laws forcing them to pay because of state sovereignty.¹³²

Since these rules were enacted, the U.S. economy has changed dramatically.¹³³ Increases in technology have led to globalization, which has made it easier for capital and resources to be shifted internationally.¹³⁴ The current tax base was created without this new

¹²⁸ See McIntyre et al., *supra* note 17, at 708 (explaining that when income is separately reported, there is a higher likelihood of tax avoidance); see also Holmes, *supra* note 9, at 8 (asserting that taxes tend to be a very critical part in a large corporation’s decision making processes because it is focused on maximizing its after-tax profits); Marcos, *supra* note 89, at 22–23 (explaining the goals of efficient tax policies).

¹²⁹ See Rosenzweig, *supra* note 70, at 955 (explaining that tax havens exist because countries that cannot compete in a competitive market can attract investors by offering a minimal tax rate); Ring, *supra* note 5, at 184 (explaining that countries lower their tax rates to attract business); Addison, *supra* note 3, at 711 (“A state becomes a tax haven for one undeniable reason: to attract capital to help promote growth in its financial industry.”).

¹³⁰ See, e.g., GRAETZ, *supra* note 30, at 400 (providing one method whereby corporations can shift the origin of their earned income); Kleinbard, *supra* note 45, at 735 (identifying cost sharing agreements as another popular way that corporations like to shift their profits).

¹³¹ Senate Committee on Homeland Security and Governmental Affairs’ Permanent Subcommittee on Investigations Hearing on Offshore Abuses: *The Enablers, the Tools and Offshore Secrecy*, 109th Cong. 2 (2006) (statement of Mark Everson, Comm’r, Internal Revenue), available at www.hsgac.senate.gov/download/stmt-8-1-06-everson-mark-irs. See Weisbach, *supra* note 46, at 867 (explaining that nations assert tax sovereignty because they want to control revenue and fiscal policy); Kaplow, *supra* note 53, at 571–72 (explaining the complexity of tax rules compared to that of tax standards).

¹³² See Ring, *supra* note 5, at 160, 170 (explaining that countries are the supreme source of control over their respective tax laws); *supra* note 44 and accompanying text (explaining that the United States cannot enforce a tax regulation on a foreign corporation that derived its income outside of the United States).

¹³³ See Bordoff & Furman, *supra* note 3, at 341 (“The U.S. economy has become increasingly integrated with the rest of the world over the past twenty years, due to advances in technology and transportation. The result has been greater flows across borders of goods, services, capital, people, and ideas.”).

¹³⁴ See Benshalom, *supra* note 5, at 166 (noting the change in the corporate structure due to globalization); Holmes, *supra* note 9, at 7 (“Globalization has both magnified the competitive pressures that MNCs feel from their foreign competitors and increased the

340 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

technology in mind, and the United States cannot easily account for this change because the problem extends internationally.¹³⁵ The IRS is not able to hold these corporations liable for their tax avoidance, because their behavior is completely legal in the United States.¹³⁶

Another problem with the current tax base is that it was enacted, for the most part, in 1962 and 1986.¹³⁷ As technology and the U.S. economy changed, the IRS addressed the changing needs of the corporate tax system by adding patchwork rules to the framework, instead of reviewing and reformulating the tax base as a whole.¹³⁸ This created a very complex set of rules to compensate for the outdated tax base.¹³⁹ Corporations have found ways around most of these rules, because the rules lack coherence and uniformity, often working to counteract each other.¹⁴⁰

ability of jurisdictions around the world to effectively compete for their resources.”). *See generally* Birdsall, *supra* note 5 (describing the globalization of the last few decades).

¹³⁵ *See* Avi-Yonah, *supra* note 3, at 1575-76 (discussing how the increased mobility of capital due to technological advances has led to international tax competition, because companies can easily shift capital to low-tax jurisdictions).

¹³⁶ *See* Tillinghast, *supra* note 5, at 38-39 (explaining how the IRS has certain powers in enforcing tax laws within the United States that it lacks in other jurisdictions). The IRS does not have a practical way to enforce U.S. tax liabilities on foreign corporations. *Id.* *See also supra* note 5 (explaining the limits on the U.S. taxing authority).

¹³⁷ Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 1009 (codified as amended at 26 U.S.C. § 954 (2006)). The most significant changes to the international tax system since the 1960s occurred in the Tax Reform Act of 1986, which adopted changes to the income source, expense allocation, and foreign tax credit rules; however, these changes did not alter the fundamental system. *See generally* Peter H. Blessing et al., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649 (2006).

¹³⁸ *See* Holmes, *supra* note 9, at 11-12 (summarizing the American Bar Association’s findings regarding the U.S. tax system). Holmes provides the following conclusions:

As a result, the United States has gone “from a complex to a super-complex regime . . .” Indeed, the American Bar Association, in its recent report evaluating various tax reform proposals, recognized that the “accretion of tax rules without periodic thorough reviews of the needs of the system” is a key source of complexity in the corporate tax regime.

Id. (footnotes omitted). The enormous complexity of the tax system creates efficiency, administrative, and equity problems. *Id.* This includes the increased compliance costs to taxpayers, challenging administrative enforcement, and proliferation of high cost tax planning. *Id.* *See also* note 46 (noting the complexity of the U.S. Tax Code).

¹³⁹ *See* Barker, *supra* note 29, at 649-50 (noting that Congress adds patches to the existing system to close loopholes and raise additional revenue); *see also* Holmes, *supra* note 9, at 11 (recommending a fundamental review of the outdated tax system); Weisbach, *supra* note 46, at 882 (explaining the downfalls of putting rules on top of rules); *supra* note 46 (explaining the intricacies and complexities of U.S. tax laws).

¹⁴⁰ *See* Barton, *supra* note 8, at 1050 (“The IRS attempts to close the loopholes that allow MNCs to avoid paying taxes on money that the U.S. Treasury should be entitled to tax. Yet these practices have essentially created a game of cat and mouse, and companies always

B. *Negative Effects*

These tax avoidance strategies are continuing to have negative effects on the U.S. economy by unfairly draining significant tax revenue away from the U.S. government.¹⁴¹ This is harmful because the U.S. government then has to raise revenue in other ways (like raising taxes on individuals) to make up for the large U.S. deficit, instead of using these corporate funds.¹⁴² The first function of taxation is to raise revenue to pay for the benefits associated with being a U.S. citizen or business.¹⁴³ If the larger corporations are not paying their corporate income tax, then they are, in effect, passing these costs onto someone else while still utilizing the same U.S. economy, infrastructure, and other benefits that the United States provides.¹⁴⁴

Another negative effect that these tax avoidance strategies have on the United States is the long-term loss of jobs and capital to other countries.¹⁴⁵ U.S. corporations that employ these tax avoidance strategies end up attributing most of their money to these low-tax jurisdictions in order to pay less.¹⁴⁶ The money is not taxed until it is brought back, or repatriated, to the United States.¹⁴⁷ This creates the fear that the United States will permanently lose jobs, assets, and production

seem one step ahead of the government.”); *see also* Lynch, *supra* note 15 (explaining that big corporations will always try to find ways to save money on taxes).

¹⁴¹ *See* Hirsch, *supra* note 2 (explaining that U.S. multinational corporations are collectively avoiding anywhere between \$10 billion and \$60 billion a year in taxes by shifting their earnings on paper to overseas subsidiaries); Bill McGuire, *U.S. Debt Tops \$15 Trillion Mark Today*, ABC NEWS (Nov. 16, 2011), <http://abcnews.go.com/blogs/business/2011/11/u-s-debt-will-top-15-trillion-mark-today/> (noting the record breaking debt in the United States); *see also* Tansill, *supra* note 7, at 294 (describing how President Obama’s administration planned to make laws stopping tax avoidance techniques so that money could be put towards the U.S. deficit).

¹⁴² *See* Sokatch, *supra* note 87, at 747 (explaining that the United States will try to find ways to stop tax avoidance so it can pay for its historically high national deficit); Shah, *supra* note 7 (explaining that most governments tax the population to compensate for the lost revenue from corporate tax avoidance).

¹⁴³ *See* sources cited *supra* note 32 (providing a variety of sources that explain the benefits theory of taxation).

¹⁴⁴ *See* Hirsch, *supra* note 2 (providing a study of the largest U.S. corporations); *see also* Shah, *supra* note 7 (explaining that individual taxes are raised as a result of corporate tax avoidance).

¹⁴⁵ *See* Press Release, *supra* note 4 (explaining how the United States has lost jobs to foreign countries because these countries offer tax incentives, encouraging corporations to move their operations overseas); Rosenzweig, *supra* note 70, at 956 (describing how low-tax jurisdictions attract investment).

¹⁴⁶ *See supra* Part II.C (stating that the goal of avoidance techniques is to make the IRS attribute earnings to a country with lower taxes).

¹⁴⁷ *See supra* notes 42, 44–45, 50 (analyzing tax deferral and explaining that corporations are not taxed until they repatriate the money back into the United States).

342 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

to foreign jurisdictions, because it is much cheaper for corporations to operate abroad.¹⁴⁸ On the other hand, the United States arguably has the most attractive market when it comes to investment and, no matter how cheap investment is in other jurisdictions, corporations will still invest in the United States because of the how much it imports.¹⁴⁹

The policy arguments heavily favor the need to change the corporate tax system to account for these tax avoidance strategies.¹⁵⁰ The United States never intended for these corporations to avoid paying corporate income tax.¹⁵¹ According to the benefit theory of taxation and other equity theories, these corporations should be required to pay their corporate taxes even if they have the resources to find loopholes in the system.¹⁵² The question is not whether it should be done, but rather what is the most effective way to remedy the problem.¹⁵³ Next, this Note analyzes some common proposals to fix this problem before ultimately concluding that, instead of adding another regulation to the current complex Tax Code, the United States should change its tax base altogether.¹⁵⁴

C. Popular Proposals

As the tax avoidance problem has persisted, the public has opposed the corporate use of tax avoidance techniques and supported corporate

¹⁴⁸ See Hufbauer & Kim, *supra* note 60, at 2 n.6 (discussing the United States' downward trend in the world economy and how the United States is losing its competitive advantage against the emerging economies of Brazil, Russia, India, China, and Korea).

¹⁴⁹ See *The World's Largest Economies*, *supra* note 14 (identifying the top economies in the world). The U.S. is the largest economy in the world, thus the largest consumer of goods and services in the world. *Id.*

¹⁵⁰ See Gravelle, *supra* note 22, at 89-90 (explaining some policy arguments for the need for corporate tax reform in the United States). See generally JOINT REP. WHITE HOUSE & DEP'T TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM (Feb. 2012), <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf> (explaining the push towards closing loopholes, broadening the tax base, and cutting corporate tax rates).

¹⁵¹ See GRAVELLE, *supra* note 2, at 13 (explaining the definition of tax avoidance). There are a variety of factors that give corporations the ability to avoid taxes, none of which are because the United States wanted it. See generally Part II (explaining the background of the U.S. tax structure and how tax avoidance came to be).

¹⁵² See *supra* note 32 (describing the benefit theory of taxation); see also Holmes, *supra* note 9, at 13 (explaining that when corporations spend dollars on tax planning it creates an extraordinary amount of social waste and can result in lower profits, higher prices for goods and services for customers, and decreased capital available for domestic and foreign investment).

¹⁵³ See THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM, *supra* note 150, at 1 (noting that America's system of business taxation is in need of reform).

¹⁵⁴ See *infra* Part III.C (examining the disadvantages of some popular proposals to fix the tax avoidance problem).

tax reform.¹⁵⁵ Part III.C.1 evaluates what would happen if the United States tried lowering its tax rate; Part III.C.2 examines the possibility of shifting to a territorial tax; Part III.C.3 looks at the option of continuing with the same strategy; and Part III.C.4 assesses the option of formulary apportionment.¹⁵⁶

1. Lowering the Corporate Tax Rate

One common proposal is for the United States to lower its corporate tax rate to be more competitive with other countries.¹⁵⁷ In theory, this would solve the tax avoidance problem because if the United States lowers the rate, there will no longer be an incentive for corporations to shift their income abroad.¹⁵⁸ Some positives of this approach are that it would attract more foreign investment and keep domestic corporations from shifting their earnings abroad.¹⁵⁹ The major reason why this would not work is that corporations are greedy and even if the United States lowers its corporate rate, there will always be lower tax jurisdictions to which corporations will try to shift their earnings.¹⁶⁰ For example, if President Obama's proposal to cut corporate tax rates to 28% passes, corporations, such as Google, that use tax avoidance strategies to cut their effective tax rate to around 3% will still be saving a substantial amount of money by using these strategies.¹⁶¹ The fact that the rate is lower will not matter because another country will probably have a lower rate.¹⁶²

2. Shifting to a Pure Territorial Tax

Another common proposal is to stop taxing corporations based on incorporation and only tax them based on where income is earned, like

¹⁵⁵ See Faulhaber, *supra* note 7, at 178–79 (explaining that public opposition grew on a global scale as the issue of tax avoidance became more well-known).

¹⁵⁶ See *infra* Part III.C.1 (discussing the possibility of lowering the tax rate); *infra* Part III.C.2 (describing the territorial tax); *infra* Part III.C.3 (listing specific provisions of the current Tax Code); *infra* Part III.C.4 (evaluating formulary apportionment).

¹⁵⁷ See Kennedy, *supra* note 107, at 406 (discussing lowering the corporate tax rate as a means of competing with low-tax jurisdictions).

¹⁵⁸ *Id.*; see also *supra* Part II.C (explaining four popular tax avoidance techniques and noting that the goal is for corporations to filter their money into a country with a lower tax rate).

¹⁵⁹ See *supra* note 107 (describing how countries with lower tax rates attract investment because it costs less to do business there).

¹⁶⁰ See Lynch, *supra* note 15 (explaining that no matter how low the tax rate is, corporations will try to find new ways around them).

¹⁶¹ *Id.*

¹⁶² *Id.*

most other developed countries.¹⁶³ There would no longer be a foreign tax credit, which would lead to a more efficient and a more simplified system.¹⁶⁴ This approach would also ensure that the United States remains an attractive location for multinational corporation headquarters.¹⁶⁵ This proposal is likely to fail, because it would still incentivize corporations to manipulate their income.¹⁶⁶ Corporations could continue to transfer income into jurisdictions with a lower source tax rate; thus, unless the United States had the lowest tax rate in the world, there would still be the incentive to shift income.¹⁶⁷ Although this approach would simplify the tax system, the same worries about income manipulation would exist as they do now.¹⁶⁸

3. Specific Provisions to Address Tax Avoidance

Another popular proposal is to keep the U.S. tax system as is and continue adding provisions to the Tax Code when specific problems

¹⁶³ See Rosenzweig, *supra* note 70, at 964–66 (explaining how a country would go about imposing a territorial tax); see also Barker, *supra* note 29, at 715 (advocating a territorial approach to corporate taxation); Gravelle, *supra* note 49, at 491 (offering analyses of these proposals and indicating that switching to a territorial tax would raise tax revenues in the United States by \$10 billion); Kleinbard, *supra* note 45, at 701 (noting that there is pressure on the United States to change to a territorial tax system); Shaviro, *supra* note 39, at 378 (explaining that all of the other world industrial powers use a territorial tax system). See generally *supra* Part II (explaining the territorial tax system).

¹⁶⁴ See Brown, *supra* note 56, at 589–90 (explaining that countries using a foreign tax credit give primary taxing authority to the source country); see also Fleming, Jr. et al., *supra* note 48, at 82 (discussing the complexity and heavy administrative costs of the foreign tax credit system); *supra* Part II (laying out the basics of the territorial tax system).

¹⁶⁵ See Knoll, *supra* note 110, at 782–83 (noting that if the United States adopted a territorial tax, it would remove the undue tax burden of being a U.S. corporation and attract more investors); Rosenzweig, *supra* note 70, at 965 (explaining that a territorial tax leads to tax competition among countries); Shaviro, *supra* note 39, at 378 (asserting that as long as the territorial tax rate is comparable to other industrialized countries, corporations will not shy away from investing in the United States).

¹⁶⁶ See Rosenzweig, *supra* note 70, at 965 (noting that manipulation can still occur under a pure territorial tax system).

¹⁶⁷ Gravelle, *supra* note 49, at 492. Outlining several criticisms with the territorial tax, the author explains:

The main reservation with an explicit territorial approach is that it increases the pressure to shift profits into active business enterprises in low-tax jurisdictions. The increased pressures on transfer pricing, including shifting of intangibles and the income from those intangibles into low-tax jurisdictions, were cited by the Joint Committee on Taxation and others as a problem with a territorial approach.

Id.

¹⁶⁸ *Id.*

arise.¹⁶⁹ These new provisions would be narrow and technical, addressing very specific problems and attempting to cut down tax avoidance strategies.¹⁷⁰ An example of this might be an alteration that changes the Arms Length Standard or cracks down on specific tax havens.¹⁷¹ Provisions like this are beneficial because they are goal oriented and are not as difficult to implement, as they are only minor changes.¹⁷² The reason why these types of regulations have failed is that they add more complexity to the Tax Code and do not act with uniformity. Regulations like this are also known to address certain problems with the effect of creating new problems.¹⁷³ Since the main formulation of the Tax Code, all the changes have been small regulations that build on one another.¹⁷⁴

4. Formulary Apportionment

Under formulary apportionment, a corporation's worldwide income is calculated using a mathematical formula that reflects the distribution of economic activity and divides the income of the business among the jurisdictions in which it operates.¹⁷⁵ The formula treats a parent and a subsidiary as the same unit and uses factors such as sales, assets, or payroll to determine the tax rate in a certain jurisdiction.¹⁷⁶ Essentially, a

¹⁶⁹ See *id.* at 487–88 (providing some examples of provisions that could be added to the Tax Code).

¹⁷⁰ See Holmes, *supra* note 9, at 20–21 (describing the current prescriptive rules that the United States has in its Tax Code); Kaplow, *supra* note 53, at 588–89 (assessing the complexity of U.S. Tax Code while analyzing the alternatives to tax standards).

¹⁷¹ See, e.g., I.R.C. § 482 (2006) (defining and codifying the Arm's Length Standard); see also Lipin, *supra* note 74, at 665–67 (explaining that there are thousands of pages in the Tax Code that have been changed numerous times).

¹⁷² See Barker, *supra* note 29, at 649–50 (explaining how the government sometimes adds patchwork rules).

¹⁷³ See Holmes, *supra* note 9, at 12–13 (explaining that the enormous complexity of the tax system creates inefficiency, as well as administrative and equity problems). This includes the increased compliance costs to taxpayers, challenges to administrative enforcement, and proliferation of high cost tax planning. *Id.*

¹⁷⁴ See Lipin, *supra* note 74, at 666–67 (explaining how each rule adds to the depth and makes matters worse instead of better).

¹⁷⁵ See Morse, *supra* note 59, at 601–02 (providing a general explanation of formulary apportionment).

Under formulary apportionment, the existence of an apportionment factor such as sales into the jurisdiction—rather than residence or source—could constitute taxing nexus. Accordingly, formulary apportionment would have no need for the current rules determining corporate residence or corporate income source. It is a wholly different way of allocating jurisdiction to tax.

Id. (footnotes omitted).

¹⁷⁶ *Id.* at 600.

corporation would only pay U.S. taxes on the share of worldwide income that was apportioned to the United States using the formula.¹⁷⁷ A major strength of formulary apportionment is that it would eliminate most of a corporation's incentive to shift its earnings into a low-tax jurisdiction, because it would base a corporation's tax liability on measures of its real economic activity as established by the formula, rather than its legal residence or form.¹⁷⁸ Another strength of this system is that it simplifies the tax system for corporations into one formula.¹⁷⁹ However, formulary apportionment is likely to fail, because it would require the cooperation of foreign countries in order to properly implement the system.¹⁸⁰ This would be extremely difficult as most countries have existing tax treaties or are trying to attract investment by offering a lower tax rate.¹⁸¹ Although there are some strengths associated with the common proposals, none of them adequately address the corporate tax avoidance problem. Thus, this Note proposes to fix the problem by changing the U.S. corporate tax base to either (1) revenue reported to a U.S. public stock exchange or (2) revenue reported to a U.S. bank to obtain a loan.¹⁸²

IV. CONTRIBUTION

The current tax base allows many corporations to use international loopholes to take advantage of the U.S. tax system, costing the United States billions annually in lost tax revenue.¹⁸³ Society's ever increasing obsession with maximizing profits has encouraged corporations to cheat the United States out of tax revenue, even though the United States has provided these corporations with many resources that contribute to their

¹⁷⁷ See, e.g., Avi-Yonah et al., *supra* note 42, at 498 (proposing a particular formulary apportionment in which the fraction of that corporation's worldwide income would be "the sum of (1) a fixed return on their expenses in the United States and (2) the share of their worldwide sales that occur in the United States").

¹⁷⁸ See *id.* at 510-16 (examining the advantages and disadvantages of formulary apportionment). Formulary apportionment removes the incentive for companies to use accounting devices to shift income on paper because it does not matter where the income is attributed. *Id.* The formula takes a percentage of the corporation's worldwide income. *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ See Kleinbard, *supra* note 116, at 150-51 (explaining that formulary apportionment can bring about its own harm). There would still be an incentive for smaller countries to remain as tax havens and not cooperate. *Id.* Unless cooperation is full among the international community, corporations will just flee to the countries that are not participating and that still have very little or no corporate tax. *Id.*

¹⁸¹ *Id.*

¹⁸² See *infra* Part IV (proposing a change to the tax base as a solution to the corporate tax avoidance problem).

¹⁸³ See *supra* Part II.B (explaining the current U.S. tax structure); *supra* Part II.C (examining some popular tax avoidance techniques that corporations use).

success.¹⁸⁴ The current outdated tax structure has proved that it is impossible to reconcile this tax problem by making new laws that fit into the structure.¹⁸⁵ Every new law opens up another loophole in the system and makes it more complicated.¹⁸⁶ However, tax avoidance creates such great harm to the economy that something must be done to capture this tax revenue.¹⁸⁷ Unlike all other unsuccessful attempts, this proposal attempts to fix the problem by changing the initial tax base, instead of merely adding another law to an already complicated tax structure.¹⁸⁸

First, Part IV.A proposes a new tax base in statutory form and explains why it is a superior method of taxing corporations.¹⁸⁹ More specifically, Part IV.A.1 explains the first part of the new tax base—taxing corporations on revenue reported to a U.S. public stock exchange.¹⁹⁰ Then, Part IV.A.2 examines the second part of the new tax base—taxing corporations on revenue reported to a U.S. bank to obtain a loan.¹⁹¹ Lastly, Part IV.B examines the potential problems associated with such a big change in the tax structure.¹⁹²

A. *Proposed Tax Base*

To address tax avoidance strategies, the tax base for publicly traded corporations and corporations that apply for a bank loan should be changed to revenue. Accordingly, a corporation would be taxed on its revenue if that corporation (1) is traded publicly on a U.S. public stock exchange, or (2) applies for a loan from a U.S. bank. If a corporation does not do either of these things, then its tax base will not change, and it will continue to pay tax on its net income reported to the IRS. The proposed amendment appears as follows:

¹⁸⁴ See *supra* note 32 and accompanying text (explaining the theory that corporations should pay taxes if they take advantage of the benefits a country provides).

¹⁸⁵ See *supra* Part III.A (discussing the problems with the current tax base, which make it difficult for the United States to prevent tax avoidance); see also *supra* notes 3, 7 (discussing the prevalence of corporations using tax avoidance methods).

¹⁸⁶ See *supra* notes 113–18 and accompanying text (explaining how the complexity and lack of uniformity of the Tax Code leads to loopholes, which corporations are able to exploit).

¹⁸⁷ See *supra* Part III.B (discussing the continued negative effects that tax avoidance is having on the U.S. economy).

¹⁸⁸ See *supra* Part II.B (identifying and explaining some of the failed reform measures); see also Part III.C (examining some popular proposals to fix the U.S. tax avoidance problem).

¹⁸⁹ See *infra* IV.A (proposing an amended tax base that decreases incentives for corporations to manipulate financial records).

¹⁹⁰ See *infra* Part IV.A.1 (explaining how a corporation would be taxed on a percentage of its total revenue reported to a U.S. public stock exchange).

¹⁹¹ See *infra* Part IV.A.2 (discussing how a corporation would be taxed on a percentage of its total revenue reported to a U.S. bank).

¹⁹² See *infra* Part IV.B (noting the potential problems in implementing this new tax base).

Proposed Amendment to I.R.C. § 11(a)(1)(2)¹⁹³

- (a) Corporations in General—A tax is hereby imposed for each taxable year on the *total revenue of a corporation—U.S. resident or not—if:*
 - (1) *The corporation is publicly traded on a U.S. public stock exchange;*
or
 - (2) *The corporation applied for a bank loan from a U.S. bank.*
- (b) *If a corporation does not fall into § 11(a)(1) or § 11(a)(2), then a tax is hereby imposed on the taxable income reported by that corporation to the IRS.*
- (c) *If a corporation operates at a loss, then it will not be subject to any tax on its revenue.*
- (d) *Revenue will be determined by:*
 - (1) *The total revenue the corporation reports to the public stock exchange in § 11(a)(1) on its Form 10-k or equivalent reporting procedure; or*
 - (2) *By the total revenue the corporation reports to the U.S. bank in § 11(a)(2).*
 - (3) *If a corporation falls into both § 11(a)(1) and § 11(a)(2), the revenue figure used will be the higher of the two reported.*
- (e) *Definitions*
 - (1) *U.S. public stock exchange—any stock exchange registered as a U.S. public exchange with the Securities and Exchange Commission. This includes but is not limited to: Arizona Stock Exchange (AZX), BATS Exchange, Chicago Board Options Exchange (CBOE), Chicago Board of Trade (CBOT), Chicago Mercantile Exchange (CME), Chicago Stock Exchange (CHX), Direct Edge, International Securities Exchange (ISE), NASDAQ Stock Market, National Stock Exchange (NSE), and the New York Stock Exchange (NYSE).*
 - (2) *U.S. bank—any bank registered under the laws of the United States.*

Commentary

The above provisions change the corporate tax base for publicly traded corporations and corporations that apply for a bank loan from income reported to the IRS to total revenue reported to a U.S. public stock exchange or U.S. bank. If a corporation is not traded on a U.S.

¹⁹³ The proposals are the contribution of the author. Specifically, proposed additions are italicized while the unitalicized portions are taken from I.R.C. § 11(a)-(b). See generally I.R.C. § 11(a)-(b) (2006).

public stock exchange and it does not obtain a loan from a U.S. bank, then its tax base does not change, and it is taxed the same way that corporations are currently taxed. This means that the tax base for small, private corporations will not change, and the tax base for corporations who apply for loans through foreign banks will also remain the same. The two main reasons why this proposal does not focus on private corporations are (1) because the majority of the U.S. corporate tax revenue comes from publicly traded corporations, and (2) because most private corporations do not have the resources to shift their income into countries with lower tax rates. This proposal does not change the tax base for corporations that apply for loans through foreign banks because that information would not be easily obtained.

To continue, this proposal treats corporations that operate at a loss as they are currently treated—not making them pay any taxes, because corporations should not have to pay taxes on what they do not have. This proposal also does not deal with any other specific provisions—such as the exact rate that corporations would be taxed—just the initial corporate tax base. Addressing these specific provisions in a tax code that is over 70,000 pages long would be overly complicated and ultimately outside the scope of this Note, especially since it is evident that changing the tax base in this manner would greatly reduce corporate tax avoidance and significantly increase U.S. tax revenue. Most corporate tax rules, like the foreign tax credit system, are focused on fairly taxing corporations while at the same time keeping businesses from moving abroad. However, corporations have found ways to manipulate these rules to their benefit to pay a lesser tax rate. Since this was not the original purpose or design of most U.S. international tax laws, the tax base should be changed to account for the fact that certain laws, like the foreign tax credit, might be subject to manipulation. Making the tax base a higher revenue figure will help ensure that the total tax revenue does not decrease. Part IV.A.1 examines the first part of the proposed statute and Part IV.A.2 analyzes the second part.¹⁹⁴

1. Revenue Reported to a U.S. Stock Exchange

This section of the proposed tax suggests that corporations be taxed if they are publicly traded on a U.S. stock exchange. Corporations are taxed on revenue previously reported to a stock exchange on their Form

¹⁹⁴ See *infra* Part IV.A.1 (explaining why taxing total revenue reported to a public stock exchange is a good alternative tax base); *infra* Part IV.A.2 (discussing why taxing total revenue reported to banks is superior to taxing income).

350 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

10-k.¹⁹⁵ The Form 10-k is an annual report that each publicly traded corporation must file with the SEC giving a comprehensive summary of the corporation's performance. This ensures that the tax base is not a separately reported figure to the IRS and takes away corporations' incentive to report the lowest possible figure so that their taxes are lower.¹⁹⁶ Additionally, there is no longer an incentive for a corporation to manipulate financial records for tax purposes because there is already the motivation to keep the figure as high as possible.¹⁹⁷ When a corporation is traded on a U.S. public stock exchange, like NASDAQ, NYSE, or AMEX, the corporation's main goal is to maximize shareholder value by either increasing the stock price or paying out dividends to shareholders.¹⁹⁸ The best way to maximize shareholder value is by attracting investors so that the stock price of that company will increase.¹⁹⁹ One of the main components of determining shareholder value is the corporation's total revenue.²⁰⁰ Therefore, a corporation will want to report a high revenue figure so that it can increase its shareholder value and thus attract investors.

Although the ultimate goal of a corporation is to maximize income, a corporation's revenue is often a good determinate of its growth. Taxing corporations on their reported revenue is also more effective than taxing corporations on their reported income because net income can be distorted by manipulating expenses, interest, taxes, depreciation, and amortization, all of which are subtracted from revenue. Also, as mentioned above, using a higher tax base figure, such as revenue, takes into account the fact that there are some U.S. tax laws, like the foreign tax credit system, that will always be subject to manipulation. Therefore, by using revenue, the tax base will be larger, a more true representation of a corporation's tax liability, and immune from manipulation. The United States does not need any extra cooperation with other nations to impose this tax base because the reported revenue comes straight from the U.S. stock exchange.²⁰¹ Also, this provision is easily applied to U.S. public

¹⁹⁵ See *supra* Part II.C (noting the dilemma created when companies must report their tax base separately, as illustrated by Google).

¹⁹⁶ See *supra* note 17 and accompanying text (discussing the benefits of combined reporting).

¹⁹⁷ See *supra* Part II.C (describing some popular tax avoidance techniques and noting how corporations have an incentive to manipulate financial records in all of them).

¹⁹⁸ See *supra* note 89 (explaining how the main goal of corporations is to maximize profit).

¹⁹⁹ See Lee, *supra* note 89, at 36-37 (explaining how stock price is a direct reflection of shareholder value).

²⁰⁰ *Id.* at 35.

²⁰¹ See *supra* Part III.C.4 (determining that formulary apportionment would be too difficult to implement because it would call for a great deal of international cooperation between countries).

stock exchanges and does not contain any intricate provisions that could open up loopholes.²⁰²

2. Revenue Reported to a U.S. Bank

In the second section of the proposed tax base, a corporation is taxed when it applies for a loan at a U.S. bank. When a corporation applies for a loan with a bank, it presents financial data to the bank so that it can evaluate the merits of the corporation's ability to pay the loan back.²⁰³ Like in the first section, this takes away the separate reporting aspect because the total revenue number comes from the bank.²⁰⁴ This also eliminates the incentive to manipulate records and lower total revenue, because one of the main components that banks look at when evaluating corporate loans is revenue. The higher the revenue figure, the more likely the corporation will be able to pay back the loan, and thus the higher loan amount that the corporation can obtain. Inherent, then, is the notion that a corporation will not distort this revenue amount but will keep it as high as possible so it is able to secure a larger loan. In addition, there would not be any international cooperation needed—only cooperation with U.S. banks—and the concept is fairly straightforward with a limited set of rules.²⁰⁵

Instead of merely adding another law to an already complicated tax structure that combats tax avoidance and attempts to reconcile an outdated tax base, the proposed solution updates the tax base to eliminate the incentive for corporations to manipulate financial figures.²⁰⁶ Of course, as with any change to the tax structure of this magnitude, there are potential problems that must be analyzed.²⁰⁷

²⁰² See *supra* note 46 (detailing the complexity of the tax and how every new intricacy opens up another loophole); see also *supra* Part III.C.4 (explaining the difficulty in implementing a tax structure like formulary apportionment).

²⁰³ See Wilmarth, *supra* note 64, at 230–31 (listing the requirements for obtaining a loan since 1975).

²⁰⁴ See *supra* note 127 (asserting that manipulation becomes an issue when things are separately reported); *supra* note 17 (describing how combined reporting eliminates the incentive to manipulate).

²⁰⁵ See *supra* Part III.C.4 (noting how international cooperation is not an easy thing in this economy); see also *supra* note 47 (explaining how complexity negatively affects the Tax Code).

²⁰⁶ See *supra* Part III.A (explaining that one of the problems with the tax base is that it does not account for the changes in technology and the global economy).

²⁰⁷ See *infra* Part IV.B (analyzing the possible problems that could occur when implementing this new tax base).

B. *Potential Problems*

Since changing the tax base would be a complete revamp of the current tax structure, there are possible problems that could arise.²⁰⁸ First, because the proposed tax base is calculated from a corporation's total revenue, there are potential issues in determining an applicable rate because not all of the money was earned in the United States.²⁰⁹ Most likely, the rate would have to take into account the fact that not all of the revenue was produced in the United States and would have to be much lower than the current tax rate of 35%. Second, there could be issues with double taxation.²¹⁰ The rate would have to be low enough to account for the fact that corporations might be taxed in other countries on the same revenue.²¹¹

Third, this type of tax could cause corporations to invest in public stock exchanges overseas or obtain loans overseas, causing the United States to lose businesses and jobs permanently.²¹² Considering the size and dominance of the U.S. stock exchanges, this would probably not be a smart option for many of the larger corporations that are currently using tax avoidance strategies. The advantages of being a member of a U.S. stock exchange, being able to obtain loans from U.S. banks, and being in the U.S. market are so great that most corporations would not be willing to pass up the U.S. market permanently.

Fourth, there could be execution problems if the U.S. banks or stock exchanges are not able to report this information efficiently.²¹³ However, the proposed process should be simple enough to avoid significant barriers. Last, because corporations will continue to avoid taxation if they operate at a loss, there could be a potential issue with corporations manipulating their financial statements to show a loss. This problem could easily be solved by additional legislation monitoring whether a corporation reported income on their Form 10-k. Although these potential problems exist, the advantages of having a tax base that

²⁰⁸ See Holmes, *supra* note 9, at 3 (discussing how there have been only two major structural changes in the U.S. Tax Code); see also *supra* Part II.A (explaining how the fundamental tax structure from the 1920's remains today).

²⁰⁹ See *supra* Part II.B (comparing territorial taxation and worldwide taxation); see also *supra* note 113 (asserting that some countries base their rate on competitiveness internationally).

²¹⁰ See *supra* note 27 (exploring the issue of double taxation).

²¹¹ See *supra* Part II.A (noting the benefits theory of taxation). Following this theory, if income is earned in more than one country, then both countries have the right to tax. *Id.*

²¹² See *supra* note 107 (asserting that countries lower their rates so that they can attract investment).

²¹³ See *supra* Part III.C (examining the implementation problems contained within these four popular proposals).

eliminates the incentive for tax avoidance greatly outweighs these potential problems.

V. CONCLUSION

The United States, along with most industrialized nations, follows the benefit theory of taxation.²¹⁴ As a result, the United States enforces a tax because of the benefits that corporations receive from the U.S. market and economy.²¹⁵ Since the establishment of the corporate tax, corporations have been taxed on the basis of the income that they reported separately to the IRS.²¹⁶ The income is then subjected to many rules, regulations, and provisions designed to ensure that companies are paying their share of taxes.²¹⁷ For example, there are laws establishing that a corporation owes tax if it earns the income in the United States, or if it is a U.S. resident corporation.²¹⁸

As the global economy has progressed over time, it has become much easier for corporations to circumvent the rules and manipulate the income they report through financial records.²¹⁹ This allows corporations to escape tax liability by reporting that income was earned in other countries with lower tax rates.²²⁰ It is difficult for the United States to enforce its tax laws because of national sovereignty.²²¹ Today, large corporations, such as Google, employ a wide variety of tax avoidance techniques to avoid billions in taxes annually.²²²

Most proposals to fix the U.S. tax avoidance problem contain new regulations, which are designed to ensure that companies pay a fair amount of taxes.²²³ However, every time a new law is passed to fix a part of the Tax Code, corporations discover new loopholes. This has resulted in a very complicated U.S. Tax Code that does not effectively combat the tax avoidance problem.²²⁴

²¹⁴ See *supra* Part II.A (detailing the history of the U.S. corporate tax).

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ See *supra* Part II.B (explaining the basic U.S. tax structure); *supra* note 47 (noting the complexity of the U.S. Tax Code).

²¹⁸ See *supra* Part II.B (discussing the basic tax framework and establishing when the United States has tax jurisdiction).

²¹⁹ See *supra* Part II.C (exploring a few major tax avoidance techniques that corporations use to bypass tax law).

²²⁰ *Id.*

²²¹ See *supra* note 5 and accompanying text (explaining why sovereignty prevents the United States from enforcing its tax laws in other countries).

²²² See *supra* Part II.C.4 (outlining the entire tax avoidance process that Google uses).

²²³ See *supra* Part III.C (analyzing some of the popular proposals to fix the tax avoidance problem).

²²⁴ See *supra* note 46 (explaining the intricacies of the U.S. Tax Code).

354 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 47]

This Note's proposed solution is to change the U.S. tax base, imposing taxes on a corporation if it (1) is traded publicly on a U.S. public stock exchange or (2) applies for a loan from a U.S. bank.²²⁵ The new tax base would tax a corporation's total income as reported to either the stock exchange or bank. Altering the tax base in this way would eliminate the incentive for corporations to manipulate their financial records.²²⁶ The corporate tax would be based on something that has already been reported and that corporations have an incentive to keep high.²²⁷ Corporations have an incentive to keep their revenue figure high when reporting to the public stock exchange so that they maximize shareholder wealth. Likewise, they have the incentive to keep their revenue figure high when obtaining a bank loan so that they can obtain a larger loan. The proposed tax base is also beneficial because it lacks complexity, requires very minimal international cooperation, and is fairly easy to implement.

However, with any tax structure change of this magnitude, there might be problems in the execution.²²⁸ Nevertheless, the advantages of the new tax base greatly outweigh any potential problems. The change will reduce tax avoidance, increase tax revenue, and eliminate many harmful effects that tax avoidance is having on the United States. Therefore, enacting this proposed solution would not only restore equity back to the corporate tax but also give rise to a much more stable economy.

Using this new tax base would change the situation for NoTax. Instead of owing taxes on its relatively small net income reported to the IRS, NoTax would owe tax on the three hundred and fifty million dollars of worldwide revenue. The fact that NoTax reduced its reported net income to the IRS by thirty-three million dollars is irrelevant because NoTax would pay corporate tax as a percentage of its worldwide income. Since NoTax reported around the same worldwide revenue to

²²⁵ See *supra* Part IV (proposing a change in the tax base to combat the tax avoidance problem in the United States).

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ See *supra* Part IV.B (discussing the possible problems with implementing a new tax base).

2012] *Closing International Loopholes* 355

its shareholders, it would not be able to escape tax liability by manipulating its net income, thus rendering its tax avoidance methods ineffective.

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* J.D. Candidate, Valparaiso University Law School (2013); B.S., Accounting, Management, Purdue University (2009). I would like to thank Professor David Herzig and Executive Editor of Student Writing (2011-2012) Jessica Levitt for their comments and advice on prior drafts of this Note. Also, I sincerely thank my parents for their constant support and guidance. I would also like to thank my siblings, Mark and Lisa, for encouraging me to pursue a legal career and for providing me with the realization that we will need a lawyer in the family. A special thanks to Taryn Baker who believes in me and has been there for me every step of the way throughout our law school career. Lastly, I would like to thank my friends and family who not only encourage me but have made my law school journey bearable.