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A PAYOFF TO SECOND BEST PRAGMATISM: RETHINKING ENTITY CLASSIFICATION FOR FOREIGN COMPANIES

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Whether it is an attempt by the Obama administration to curb corporate inversions or a strategy by the Trump administration to make U.S. businesses more competitive abroad, the world of international taxation seems primed to occupy policy conversations for the foreseeable future.

Yet few areas of law are as contentious while remaining so abstruse. Indeed, international taxation—while enormously important for global commerce and domestic companies alike—is extraordinarily complex. Consequently, companies with the resources to dream up sophisticated tax shelters are better positioned to take advantage of U.S. tax laws when operating transnationally.

The following example of this is illustrative. Suppose two companies (one domiciled in the United States and one domiciled overseas) sold the exact same products in both the United States and overseas. The U.S. company would be treated differently under U.S. tax law—and would have to pay higher taxes by consequence—solely because of its status as a U.S. domiciliary. While the foreign company would be exempt from U.S. taxation on all of its foreign revenue, the U.S. company would merely get a tax credit against its U.S. taxes on any income earned overseas. This reality has led companies to come up with tax strategies (including inversions) that enable them to avoid this competitive disadvantage in the global marketplace.

The status quo is untenable, but it remains frustratingly difficult to reach a consensus on how to solve the problem. Many countries—including the United Kingdom and Japan—have followed a global trend towards a territorial system, or taxing companies only on revenue earned in that particular country. With the current state of political affairs, bipartisan comprehensive tax overhaul legislation remains elusive, even if the Republican-

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backed Tax Cuts and Jobs Act of 2017 becomes law. This paper argues for an elegant "second best" solution that could help crack down on corporate tax games while providing a road map towards a territorial system, bringing the United States into alignment with global trends.

Namely, this proposal suggests that in the same vein as the corporate check-the-box regulations promulgated during the Clinton administration, companies could simply elect whether they wish to be treated as a foreign or a domestic entity. While this would leave the vast majority of the tax code largely intact, it would have wide-reaching implications for tax law and corporate structuring (without upsetting the legal form of current structures), provide a pathway towards a true territorial system, and potentially help uncover abusive tax shelters in the process.

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INTRODUCTION

On April 4, 2016, the Treasury Department, under the leadership of President Obama and his Secretary of the Treasury, Jacob Lew, announced new regulations tightening the rules regarding corporate inversions.[1] This move led Pfizer (domiciled in the United States[2]) and Allergan (domiciled in Ireland[3]) to call off their planned merger, as the companies viewed the new regulations as an "adverse tax law change."[4] While the new rules set the battle lines in the Obama administration's attempts to prevent companies from moving their place of incorporation offshore, they help illuminate an enormous problem in tax policy today. The U.S. taxes domestic companies on all of their worldwide income, but it taxes foreign companies on only their U.S.-source income. This disparate treatment, coupled with one of the highest corporate tax rates in the world, has created a strong incentive for companies to figure out ways to move their place of incorporation overseas.

Perhaps the most straightforward way to address this problem would be to treat U.S. and foreign companies the same. This would mean, in effect, a transition to a territorial system. However, despite wide acknowledgement of the need to overhaul the tax code, particularly with respect to international taxation,[5] there seems to be little appetite for moving to a true

1. Press Release, U.S. Dep't of Treasury, Treasury Announces Additional Action to Curb Inversions, Address Earnings Stripping, JL-405 (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx.

2. Pfizer, Inc., Current Report (Form 8-K) (Apr. 6, 2016) [hereinafter Pfizer 8-K], http://www.sec.gov/Archives/edgar/data/78003/0001193125 16531559/d175229d8k.htm.

3. Allergan plc, Current Report (Form 8-K) (Apr. 6, 2016), http://www.sec.gov/Archives/edgar/data/1578845/000119312516531600/d177691d8k.htm.

4. Pfizer 8-K, *supra* note 2; *accord* Jonathan D. Rockoff, Liz Hoffman, & Richard Rubin, *Pfizer Walks Away from Allergan Deal*, WALL ST. J. (Apr. 6, 2016), http://www.wsj.com/articles/pfizer-walks-away-from-allergan-deal-1459939739.

5. *See* House Republican Members of the Ways and Means Comm., *A Better Way: Our Vision for a Confident America – Tax* 27 (June 24, 2016) [hereinafter House Republican Members], http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf ("Taken together, a 20 percent corporate rate, a switch to a territorial system, and border adjustments will cause the recent wave of inversions to come to a halt."); REUVEN AVI-YONAH, THE CENTURY FOUND. PROPOSALS FOR INTERNATIONAL TAX REFORM: IS THERE A MIDDLE ROAD? (Nov. 17, 2016), https://s3-us-west-2.amazonaws.com/production.tcf.org/app/uploads/2016/11/17084930/proposals-for-international-tax-reform-is-there-a-middle-road.pdf.

territorial system by Congress.[6] While the Tax Cuts and Jobs Act of 2017 ostensibly moves to a territorial system by virtue of granting a deduction to U.S. shareholders for dividends received from controlled foreign corporations with respect to such a subsidiary's foreign earnings, it does so while retaining complicated provisions intended on preventing base erosion. It might be a laudable effort in the abstract, but does not address the issue of a U.S. corporation being taxed on its overseas earnings; it merely tries to allow earnings from foreign subsidiaries to be repatriated without any tax cost. In light of that reality, perhaps a different strategy would be worthwhile. Building on the success of the Treasury's check-the-box regulations in the mid-1990s, which allowed companies to elect to be treated as either a corporation or as a partnership for tax purposes, this Article suggests a "second best" strategy for accomplishing a similar end in the realm of international tax. Rather than fixing a company's status under the tax code by place of incorporation, this Article suggests allowing business entities the ability to elect treatment as either a domestic or foreign entity. This small change would leave the rest of the Internal Revenue Code ("Code") intact (including transfer pricing rules and Subpart F, which governs foreign entities controlled by U.S. persons) while giving companies the flexibility to both retain their place of incorporation here in the United States and avoid U.S. taxation of their foreign income.

I.
The Taxation of International Transactions by the United States

The current tax regime employed by the United States with respect to international transactions is commonly referred to as a worldwide tax system, meaning that U.S. persons are taxed on all of their worldwide income.[7] By contrast, non-U.S. corporations are taxed only on certain types of invest-

6. Richard Rubin, *U.S. Crackdown on Inversions Renews Calls for Tax Code Overhaul*, WALL ST. J. (Apr. 6, 2016) ("[T]here are few signs that the parade of companies attempting to flee the U.S. tax net or the administration's increasingly ambitious regulatory attempts to stop them will prompt Congress to act."), http://www.wsj.com/articles/u-s-crackdown-on-inversions-renews-calls-for-tax-code-overhaul-1459982348.

7. I.R.C. § 61 (2012).

ment income from U.S. sources[8] or income effectively connected with the conduct of a U.S. trade or business.[9] Because foreign corporations are not subject to U.S. corporate tax on their non-U.S. income, there is a discrepancy in how foreign persons are treated compared with how U.S. persons are treated.

In the context of corporate law, this system of worldwide taxation ultimately incentivizes multinational corporations to minimize their overall tax liability through the use of offshore corporations, including the use of shell entities. These tax games are not illegal, and though often hidden by layers of offshore holding companies and tax strategies, they are used regularly by many multinational companies. According to the Citizens for Tax Justice, 73 percent of Fortune 500 companies use subsidiaries in tax haven jurisdictions.[10] Multinationals do not limit themselves to incorporating in tax havens, either. Repeated waves of "corporate inversions" have dominated tax planning for decades, meaning that dozens of companies formerly domiciled in the United States are now considered to be located in a foreign country for tax purposes.[11]

While a boon to lawyers and investment bankers, this reincorporating, inverting, and creating offshore subsidiaries serves little purpose for corporations other than aiding in tax planning. In short, they are taking advantage of a system that penalizes American companies for being American, because it is only American companies that are required to pay taxes on their worldwide income.

For the purposes of U.S. taxation, foreign companies are liable to be taxed on two different types of income. The first, Effectively Connected Income (ECI), refers to income that is effectively connected with a U.S. trade or business.[12] Thus, when a foreign company operates its business within the United States, that income will be subject to taxation under

8. I.R.C. § 881 (2012).
9. I.R.C. § 882 (West 2014).
10. ROBERT S. MCINTYRE ET AL., CITIZENS FOR TAX JUSTICE & U.S. PIRG ED. FUND, OFFSHORE SHELL GAMES 1 (2015), http://ctj.org/pdf/offshoreshell2015.pdf.
11. Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 821–833 (2015) (providing a survey of four generations of tax-driven corporate inversions).
12. I.R.C. § 864(c) (2012).

the normal tax regime.[13] In order to prevent companies from manipulating the source of income to avoid U.S. taxation, certain types of income (such as royalties or interest payments to a financial institution) are considered ECI if the company "has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable."[14]

The second type of income is known as Fixed or Determinable Annual or Periodical income (FDAP income), which refers to income from U.S. sources that is not ECI.[15] Such income is subject to a withholding tax of 30 percent (often reduced if the offshore company's home country has a relevant treaty with the United States[16]) and reflects the interest in preventing certain types of highly mobile income (e.g., interest, dividends, rents, royalties, etc.) from going untaxed.[17] What remains clear, however, is that the sourcing rules are designed to ensure that companies treated as foreign corporations by the tax code are still taxed on income earned within the United States.

This system tends to benefit companies with the resources to either reincorporate offshore or set up offshore subsidiaries. For those companies with the resources to map out even more complex and ingenious tax strategies, the benefits of gaming the international tax system are even larger.[18] For example, lawyers for technology companies notoriously developed the "Double Irish with a Dutch Sandwich," which ulti-

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13. *See* I.R.C. § 882 (West 2014).

14. I.R.C. § 864(c)(4)(B) (2012).

15. I.R.C. § 881(a) (2012).

16. *See, e.g.*, Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.K.–U.S., art. XI(1), July 24, 2001, T.I.A.S. No. 13161 (reducing withholding tax on interest income to 0 percent), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/uktreaty.pdf.

17. *See* Howell H. Zee, *Taxation of Financial Capital in a Globalized Environment: The Role of Withholding Taxes*, 51 NAT'L TAX J. 587, 587 (1998).

18. *See* Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX L. REV. 375, 383 (2012) (showing that the largest U.S. multinationals pay an effective tax rate far lower than their statutory rate).

mately enables companies using the structure to legally pay a near-zero tax rate on much of its foreign income.[19]

This system is also problematic because it creates a system ripe for *illegal* tax abuse and tax evasion. By shielding their balance sheets in foreign jurisdictions, foreign subsidiaries are able to operate in a world with little oversight from the governments of the countries in which they do most of their business.[20] Of particular concern to many is the fact that money held in offshore jurisdictions is far in excess of those countries' GDPs. For example, Bermuda's GDP was $6 billion in 2010, but U.S.-controlled subsidiaries reported $94 billion in

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19. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 712–13 (2011). The "Double Irish with a Dutch Sandwich" is a technique by which a company incorporated in Ireland (IrishCoOne) wholly owns a company wholly owned in the Netherlands (DutchCo), which in turn wholly owns a company that is incorporated in Ireland but has its principal place of business in an offshore tax haven such as the Cayman Islands (IrishCoTwo). IrishCoOne, wholly owned by the U.S. parent, elects to be treated as a corporation for U.S. tax purposes, and DutchCo and IrishCoTwo elect to be treated as disregarded entities such that from the perspective of U.S. tax law, the U.S. parent only has an Irish subsidiary, thereby avoiding potential issues with regards to Subpart F income. The U.S. parent incorporates the companies by successively contributing its non-U.S. intellectual property (IP) assets (such as certain European IP assets) and setting up license agreements between the companies. IrishCoOne receives profits generated pursuant to the use of the IP, but pursuant to the license agreement with DutchCo, gets a deduction for royalties paid such that it can nearly eliminated any Irish tax liability. Because both the Netherlands and Ireland are not subject to certain withholding taxes by virtue of both being in the European Union (EU), there is no tax leakage on the transfer of royalty payments to DutchCo. DutchCo then sends the revenue received from IrishCoOne (and thereby receiving a deduction roughly equal to its profit, thereby negating any Dutch tax) to IrishCoTwo pursuant to its own license agreement, again with no tax leakage on withholding taxes by virtue of the fact that from the perspective of the Netherlands, IrishCoTwo is an Irish (and therefore, EU) company. However, under Irish tax law, IrishCoTwo is actually a *foreign* company because its principal place of business is located offshore. Therefore, because all of IrishCoTwo's revenue is from the Netherlands and is therefore foreign earnings to a foreign company, no Irish tax is levied on the company. The bottom line is that because of the offsetting revenues and deductions on royalties paid, none of the entities end up paying a significant level of tax, thereby reducing each entity's tax to near zero such that the entire European operation of the company is essentially done tax-free.

20. *See* ALAIN DENEAULT, OFFSHORE: TAX HAVENS AND THE RULE OF GLOBAL CRIME 51 (George Holoch trans., The New Press) (2011).

profits there; for the Cayman Islands, those figures were $3 billion and $51 billion, respectively.[21]

From an economic perspective, scholars have debated the effect that international tax laws have had on the allocation of capital. This debate is often framed as a tension between favoring either neutrality of capital exports or capital imports. Capital export neutrality (CEN) is the position that an individual or company should be agnostic as to where it places its assets.[22] To put it another way, if a person is choosing between Country A and Country B as to where to invest her capital, according to CEN, tax considerations should not play a role in that choice. Consequently, the tax rate on the company will be the same irrespective of the choice of where to invest. In terms of tax policy, pure CEN is applied as a tax by the country of residency only.[23] Capital import neutrality (CIN), by contrast, states that the effective tax rate should be agnostic as to where capital is derived.[24] In other words, all capital investment within a particular jurisdiction would be taxed at the same rate. Pure CIN is applied as a tax by the country of the income's source only.[25]

The tension between CEN and CIN comes from the fact that without a global government or tax rates that are uniformly applied worldwide, it is impossible to have both.[26] Therefore, companies seeking to minimize their tax burden will seek to arbitrage their tax liability based on the type of neutrality sought. Under CEN, companies will seek the country which imposes the lowest tax rate on its residents. Under CIN, companies will place their investments in countries with the lowest tax rates.

The decision between CIN and CEN is complicated by several factors. For example, while the theoretical goal of CEN is for countries to forgo taxation on any non-residents, in practice CEN is interpreted as residence countries using a foreign tax credit to account for taxes paid to source countries.[27] Be-

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21. MCINTYRE ET AL, *supra* note 10, at 14.
22. Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 270 (2001).
23. *Id.* at 270–71.
24. *Id.* at 270.
25. *Id.* at 270–71.
26. *Id.* at 272.
27. *Id.* at 271.

yond that, however, the question comes down to how policymakers want to orient their goals. From the perspective of promoting worldwide tax efficiency and minimizing the ability of companies to arbitrage their way to artificially lowered tax burdens, the question becomes whether it is easier to move corporate residency or to move capital.

There is significant debate over which of these two norms provides the ideal system for moving forward. Among economists and academics, CEN earns the most support, in part due to the fact that "distortions in the location of investments are thought to be more costly than distortions in the allocations of savings."[28] However, that conclusion is not universally shared, as some argue that taxing foreign income would have a detrimental effect on business competitiveness.[29]

While the academic debate between CIN and CEN will undoubtedly continue, countries around the world have shifted their tax policy toward CIN. Japan and the United Kingdom both switched to territorial systems in 2009.[30] In fact, "[e]very country that is the residence of major multinational enterprises, other than the United States, has adopted some form of territorial tax system."[31] Corporations seem to favor territorial systems, and while bowing to corporate interests need hardly be the sole motivation for a tax system, it is not hard to imagine companies "speaking with their feet" and setting up operations offshore.[32] By contrast, the current system employed by the United States is one that tends towards CEN (the United States currently taxes all worldwide income of *its*

28. *Id.* at 272. *See also* 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, 1010 (1997).

29. Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 843–44 (2000).

30. JOINT COMM. ON TAX'N, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 28, 42 (2011).

31. Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 135 (2011).

32. The use of corporate inversions, where companies are simply moving their corporate residency, and subsequent attempts by Congress and the executive to curb such corporate expatriation provides ample evidence of this. *See* Joshua Simpson, *Analyzing Corporate Inversions and Proposed Changes to the Repatriation Rule*, 68 N.Y.U. ANN. SURVEY OF AM. L. 673, 695–99 (2013) (providing an overview of corporate inversion transactions).

residents), but involves elements of CIN as well (the United States generally taxes *foreign* persons on their U.S.-sourced income only). Because U.S. law respects the corporate form, a company can keep its offshore active income in a foreign subsidiary indefinitely; but once it brings it home in the form of dividends, it is subject to taxation. In popular news articles, this is often described as a situation in which earnings are "trapped offshore."[33]

One of the particular problems associated with the tax planning strategies is the two-pronged issue of base erosion and profit shifting. OECD countries are concerned that the tax systems currently in place create incentives for companies to shift their profits to untaxed jurisdictions, thereby avoiding any significant taxes on them. This has led to the phenomenon of "stateless income," which Edward Kleinbard describes as follows:

> Stateless income comprises income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company.[34]

This allows certain companies to find jurisdictions with very low tax rates to park their income, preventing it from being subject to U.S. taxation.[35] The OECD has responded with its Base Erosion and Profit Shifting (BEPS) Project, aimed at combatting "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."[36]

Most of all, however, the problem with this mixture of tax planning strategies is that they are almost entirely tax-driven. It is generally recognized that a well-designed tax system should

33. *See* Victor Fleischer, *How Obama's Tax Plan May Not Work as Intended*, N.Y. TIMES: DEALBOOK (Feb. 6, 2015 10:22 AM), http://dealbook.nytimes.com/2015/02/06/obama-proposal-to-tax-offshore-earnings-may-have-unintended-effects/.

34. Kleinbard, *supra* note 19, at 700.

35. Kleinbard, *supra* note 31, at 135.

36. *About the Inclusive Framework on BEPS*, OECD, http://www.oecd.org/ctp/beps-about.htm (last visited May 6, 2016).

minimize the distortions and inefficiencies caused by the system itself.[37] Yet companies spend billions of dollars every year to devise tax strategies to ensure that they minimize their tax burden, and one of the chief ways in which companies do this is by reincorporating overseas to avoid the liability caused by the worldwide system of taxation.

Despite all of the problems that result from the worldwide system of taxation employed by the United States, what is often overlooked are the beneficial ways in which companies utilize foreign subsidiaries to compete in the global marketplace. In short, the existence of offshore jurisdictions that levy no corporate income tax provides an invaluable service to the U.S. economy that is often overlooked. Because the United States remains somewhat of an outlier in terms of its tax policy regarding worldwide income, tax shelters in low tax jurisdictions help bring the United States into alignment with international norms of taxation. The fact is, therefore, that the United States relies on low tax jurisdictions to accomplish what the rest of the world has already accomplished through substantive change to their tax codes. This is an exceedingly bizarre result, for the only benefit the U.S. system provides over the international system is to tax advisors and tax planners—a "benefit" usually described as deadweight loss.[38] To modify the words of Michael Graetz, we have a system set up by very smart people that, but for the tax considerations, would otherwise be very stupid.[39]

Tax shelters—among them the use of offshore subsidiaries—are strategies used by people to lower their tax burden. While tax shelters generally take advantage of loopholes in the tax code, this Article will avoid making a normative claim about them. Tax *havens*, in contrast, are jurisdictions (generally offshore) that provide a tax benefit to companies that incorporate there—usually by virtue of favorable rates or gener-

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37. Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006).

38. Kleinbard, *supra* note 19, at 713.

39. Graetz was referring to tax shelters, which he describes as "a deal done by very smart people that, absent tax considerations, would be very stupid." Lynnley Browning, *How to Know When a Tax Deal Isn't a Good Deal*, N.Y. TIMES (Sept. 10, 2008), http://www.nytimes.com/2008/09/10/business/businessspecial3/10TAX.html.

ous corporate laws.[40] The offshore tax economy refers to the use of tax havens and tax shelters—particularly by multinational corporations—as a method by which entities and individuals navigate complex international tax laws in an effort to minimize their overall tax burden.

II.
THE ROLE OF THE OFFSHORE TAX ECONOMY IN U.S. AND GLOBAL MARKETS

It seems a common sport among commentators and politicians to rail against the use of tax havens in our economy. Alain Deneault describes how the powerful have "set up custom-made political jurisdictions—tax havens—that enable them to exercise decisive influence on the historical course of events without having to comply with any democratic principle."[41] Tax shelters became a campaign issue in 2012 when President Obama criticized Mitt Romney's investments in Bermuda and the Cayman Islands.[42] They remain a point of criticism for Cabinet-level nominees during Senate confirmation hearings.[43] Certainly not all uses of tax havens are legitimate, yet these criticisms fail to recognize the positive role that offshore tax havens and shelters may play.

A. *Facilitation of Inbound Foreign Investment*

For many companies that are seeking to do business in the United States or to gain access to American capital markets, U.S. tax law presents a formidable obstacle. While many politicians have recognized this as a problem and have sought to unravel the challenges to better allow inbound capital to come into the United States,[44] companies still use the offshore tax economy to facilitate their investment.

40. *See* Calvin H. Johnson, *Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters*, 71 TAX NOTES 377, 380 (Apr. 15, 1996).

41. DENEAULT, *supra* note 20, at viii.

42. Michael D. Shear, *Obama Ad Continues Effort to Tie Romney to Outsourcing*, N.Y. TIMES: THE CAUCUS (July 14, 2012), http://thecaucus.blogs.nytimes.com/2012/07/14/obama-ad-features-a-singing-romney.

43. *See, e.g.*, Alan Rappeport, *Issues of Riches Trip Up Steven Mnuchin and Other Nominees*, N.Y. TIMES (Jan. 19, 2017), https://www.nytimes.com/2017/01/19/us/politics/steven-mnuchin-treasury-confirmation-hearing.html.

44. *See* Invest in Transportation Act, S. 981, 114th Cong. (2015) (providing for a repatriation holiday of overseas profits).

Effective tax planning involves trying to use the tax law to accomplish several ends: (1) achieving temporary tax savings by accelerating deductions and deferring income, (2) permanently reclassifying income to achieve a lower tax rate, and (3) avoiding the complexity of U.S. tax law altogether.[45] Tax minimization strategies—including those that use the offshore tax economy—are not in themselves any less legal than an individual taking the standard deduction on her annual tax return. In the words of Judge Learned Hand, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[46] Of course, that does not imply that the policies that make tax minimization strategies legal are good policies,[47] but it is important to take a closer look at how the offshore tax economy facilitates inbound investment.

In recent years, Chinese companies have sought access to American capital markets by listing on a U.S. stock exchange.[48] The advantage to Chinese companies is that American capital markets give access to deep reservoirs of capital that would otherwise be unavailable in China. It also gives American investors the chance to take advantage of a growing Chinese economy. Until recently, American investors were unable to even access Chinese stock markets—and it remains cumbersome to purchase those shares.[49]

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45. Mark J. Cowan, *A GAAP Critic's Guide to Corporate Income Taxes*, 66 TAX LAW. 209, 232 (2012).

46. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

47. In an open letter published on May 9, 2016, a group of notable economists declared that "[t]here is no economic justification for allowing the continuation of tax havens." This paper is not an attempt to refute this view, but an attempt to reshape the legal architecture such that tax havens are obsolete and the problems these economists identified can be dealt with directly. Letter from Economists to World Leaders (May 9, 2016), https://www.oxfam.org/en/pressroom/pressreleases/2016-05-09/tax-havens-serve-no-useful-economic-purpose-300-economists-tell.

48. *See* Sophie Song, *Chinese Companies Consider Listing in US Stock Exchanges Again Following Accounting Woes of 2011*, INT'L BUS. TIMES (Aug. 6, 2013), http://www.ibtimes.com/chinese-companies-consider-listing-us-stock-exchanges-again-following-accounting-woes-1373269.

49. Gregor Stuart Hunter, *China Opens Door Wider to Foreign Investors*, WALL ST. J. (Nov. 10, 2014), http://www.wsj.com/articles/china-opens-doors-to-foreign-investment-in-stocks-1415604267.

Today, well over a hundred Chinese companies have gone public in the United States—nearly all of which were first listed in the last decade.[50] However, listing on a U.S. exchange can prove challenging for a Chinese company for several reasons. First, these companies are often highly regulated, which frequently means a requirement that their shares are owned by Chinese nationals.[51] Second, the rules of U.S. stock exchanges regarding corporate governance often contain exemptions for foreign issuers, giving greater flexibility to companies domiciled offshore.[52]

To help facilitate this trade, many Chinese companies have employed a variable interest entity (VIE) structure, which generally involves three different entities. The first is the company operating in China, the second is a wholly foreign-owned entity (WFOE), also domiciled in China, and the third is the company being listed on the U.S. exchange (the VIE) and usually domiciled in the Cayman Islands or another offshore jurisdiction (presumably to avoid an entity-level tax). The VIE owns 100 percent of the WFOE, and the WFOE enters into contractual agreements that allow foreign investors effective control over the Chinese company without having a direct stake in the company itself.[53]

The Chinese government has typically turned a blind eye to these structures, which have proven to be enormously successful for the companies that have made use of them.[54] Because there is no direct ownership between the Chinese com-

50. The website www.TopForeignStocks.com keeps a list of Chinese companies listed on U.S. exchanges; as of March 2016, it listed 111 companies. *The Full List of Chinese ADRs*, TOPFOREIGNSTOCKS.COM, http://topforeignstocks.com/foreign-adrs-list/the-full-list-of-chinese-adrs (last visited May 7, 2016).

51. Gregory J. Millman, *Foreign Companies at Risk from Proposed Chinese Law*, WALL ST. J. (Apr. 19, 2015), http://www.wsj.com/articles/foreign-companies-at-risk-from-proposed-chinese-law-1429474352. Certain U.S. industries maintain similar regulations; commercial aviation, for example, has limits on the ownership of airlines by non-U.S. persons. *See* 49 U.S.C. § 40102 (2012).

52. ROBERT ELLISON ET AL., SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE FOR FOREIGN PRIVATE ISSUERS: OVERVIEW 1 (2009), http://uscorporate.practicallaw.com/2-386-6205.

53. Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1277 (2014).

54. Millman, *supra* note 51.

pany and the WFOE, they cannot be consolidated for tax purposes.[55] Thus, if the VIE were to be domiciled in the United States without an intervening offshore entity, it would be liable to pay a tax on any income—including income earned from China. Thus, setting up the VIE offshore allows this structure to function in a way that largely limits its tax burden to the country in which it earns most of its income—i.e., China.

Another way in which the offshore tax economy helps catalyze the movement of capital in the U.S. economy is through investment funds. Investment funds (which include everything from mutual funds to hedge funds to private equity funds) represent an increasingly large sector of American capital markets and are well known for their use of extensive tax planning.[56] While some investment fund tax planning is centered around domestic tax issues (e.g., treating income as long term capital gains via the carried interest provision[57]), other planning strategies help protect investors from unwanted tax liabilities, particularly for foreign and tax-exempt investors. Tax-exempt investors, which include university endowments and pension funds, play an important role in capital markets.[58] Yet for such tax-exempts, unrelated business taxable income (UBTI) can often prove very costly, since it becomes taxable at the corporate rate.[59] UBTI is defined as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it."[60] Normally, income earned by a tax-exempt entity—such as dividends and interest—is not taxable, but UBTI is an exception to the rule.[61] Sometimes investment funds will purchase controlling shares in a partnership or other pass-through entity, which does not qualify as such a UBTI exclusion under Section 512. In order to transform this "bad" UBTI income into "good" dividend income, fund man-

55. *See* I.R.C. § 1504 (West 2014).

56. *See generally* Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 VA. TAX REV. 695 (2010).

57. Note, *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773 (2011).

58. Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1, 6 (2010).

59. I.R.C. § 511 (1988).

60. I.R.C. § 512(a)(1) (2015).

61. I.R.C. § 512(b) (2015).

agers will set up an offshore blocker corporation.[62] While the Code is set up to help prevent abuses of offshore entities, the IRS has explicitly sanctioned investments involving offshore blocker corporations.[63] The reality is that tax-exempt investors are so allergic to the risk of UBTI that they will sometimes accept a *less favorable* result (from a tax perspective) by utilizing the offshore tax economy.[64]

Foreign investors in U.S. investment funds have their own desires when structuring a fund. Like tax-exempt investors, they too will often pool their investment into an offshore corporation, for several reasons. The first reason is a tax minimization strategy. By placing their funds in an offshore entity, any foreign investments made by the fund can be shielded from U.S. income tax liability.[65] Additionally, for onshore investments, having a blocker corporation can help minimize a foreign person's exposure to ECI, which is withheld at the foreign person's highest rate.[66] Finally, while offshore corporations will still have to file U.S. tax returns with respect to U.S. source income, their shareholders (i.e., foreign persons in an investment fund) will not.[67] The desire to avoid the need to file a U.S. tax return should be apparent to any American taxpayer familiar with April 15, and the offshore tax economy provides a vehicle for doing so.

Thus, tax planning allows companies to keep foreign income from being taxed in the United States. Unlike most of the rest of the world, the United States has attempted to tax

62. Taylor, *supra* note 58, at 1.

63. *See* I.R.S. Priv. Ltr. Rul. 2002-51-016 (Dec. 20, 2002); I.R.S. Priv. Ltr. Rul. 2002-51-018 (Dec. 20, 2002); *see also* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 Nw. U. L. REV. 225, 241 (2012); Taylor, *supra* note 58, at 21.

64. JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURES AND OPERATIONS § 5.04[1] (2016) ("The net effect of this structure is that the entire gain of the Tax-Exempt Partners derived from the investment is subject to corporate level tax in the hands of the Alternative Investment Vehicle. This result may be less favorable to a Tax-Exempt Partner than if it decides to make its capital contribution directly to the Fund and suffer the consequences of debt-financed income, particularly if the Tax-Exempt Partner is making a capital contribution to fund part of the investment and, thus, not all the gain from the investment would be UBTI.").

65. *Id.* at § 5.05[2].

66. *Id.* at § 5.05[1].

67. *Id.* at § 5.05[2].

foreign income; as a practical matter, investors have found legal ways to avoid this result—often through the offshore tax economy. The offshore tax economy also provides a safety valve for domestic organizations that would otherwise incur adverse tax consequences (such as tax-exempt organizations receiving UBTI). Yet perhaps contrary to popular belief,[68] the existence of a company headquartered offshore does not mean that the company is avoiding taxes altogether. Indeed, if the offshore company is operating legally, it will still be paying taxes at the normal statutory rate on any ECI and at a withholding rate of 30 percent on any FDAP income.

B. *The Desire to Keep "American" Companies Competitive Abroad*

To illustrate, consider two hypothetical companies, Color Corp. (incorporated in the United States) and Colour Corp. (incorporated in the United Kingdom). If both companies maintain identical businesses such that they earn precisely the same amount of revenue from each country, Color Corp. will still pay more in taxes than Colour Corp.[69] It is no small wonder, then, that Color Corp. will look for ways to level the playing field, such as by creating a British subsidiary or reincorporating to the United Kingdom entirely. Some have questioned the patriotism of companies that have decided to

68. *See* Cauble, *supra* note 56, at 707 (2010) ("Because the types of income earned by hedge funds (predominantly capital gain income and interest income) are generally not the types of income that are subject to U.S. federal income tax when earned by a non-U.S. corporation, the TE Investor Parallel Fund will generally not be subject to corporate-level U.S. federal income tax."). It is true that capital gain and interest income will not be taxed as ECI for a non-U.S. corporation. However, such income—assuming it comes from U.S. sources—*will* be subject to a withholding tax of 30 percent as FDAP income if not reduced by a treaty. The United States does not currently have treaties with common hedge fund domiciles such as the British Virgin Islands, Bermuda, and the Cayman Islands.

69. If the U.S. rate is 35 percent and the British rate is 20 percent, both Color Corp. and Colour Corp. will pay a 35 percent rate on their U.S. source income. However, Color Corp. will pay 15¢ more in taxes on every dollar of U.K.-source income than its British counterpart. Both Color Corp. and Colour Corp. will pay 20 percent of their British-source income to the United Kingdom, but while Color Corp. can credit those taxes paid against its U.S. tax burden, the United States will still impose its 35 percent rate on Color Corp.'s U.K.-source income.

reincorporate overseas.[70] The real question, however—particularly when taking into account a manager's fiduciary duty to maximize shareholder wealth[71]—is why any company would want to be domiciled in the United States in the first place. Clearly, many companies are and will continue to be domiciled in the United States, but this simple example should illustrate how the Code currently places a thumb on the scales in favor of keeping one's domicile outside of the United States.[72]

Setting up an offshore subsidiary allows American business owners to pay local taxes on foreign active income and defer U.S. taxes on most of that income indefinitely, enabling them to remain competitive with competitors who also only pay local taxes.[73] Of course, once foreign income is repatriated, it will immediately be subject to U.S. taxation,[74] so companies prefer to leave that money offshore for as long as possible and defer its tax burden, until either such a time as it needs the money or the U.S. government decides to implement a one-time tax holiday.[75] This practice is widely used, and according to the Citizens for Tax Justice, Fortune 500

70. In the words of President Obama, a corporate inversion is "when big corporations acquire small companies, and then change their address to another country on paper in order to get out of paying their fair share of taxes here at home." President Barack Obama, Remarks by the President on the Economy (Apr. 6, 2016).

71. Brian M. McCall, *The Corporation as Imperfect Society*, 36 DEL. J. CORP. L. 509, 511 (2011) ("Conceptualizing corporate law as an area of law facilitating private ordering has led to the entrenchment of the principle of shareholder wealth maximization. Corporations exist to maximize shareholder wealth.").

72. This is particularly true for companies with large cash reserves held overseas, such as pharmaceutical companies. Jonathan D. Rockoff, *Why Pharma Is Flocking to Inversions*, WALL ST. J. (July 14, 2014), http://www.wsj.com/articles/why-pharma-is-flocking-to-inversions-1405360384.

73. In the example of Color Corp. and Colour Corp., Colour Corp. will have an extra 15¢ for every dollar earned in the United Kingdom to distribute to shareholders or reinvest in its business.

74. Graetz, *supra* note 22, at 323.

75. The advantage of tax deferral is, of course, in measuring the net present value of a deferred obligation. In a case that examined a 999-year lease, "The Commissioner asserts, and the taxpayer does not dispute, that the present value of this obligation to pay $23 million at the end of the 950-year period the lease still has to run, using an interest rate of six percent, is two quadrillionths of a cent." *Carolina Clinchfield & Ohio R. Co. v. Comm'r*, 823 F.2d 33, 34 (2d Cir. 1987).

companies alone are holding $2.4 trillion offshore.[76] The righteous anger levied at this practice resulted in the Cayman Islands Financial Services Association issuing the following open letter to President Obama regarding tax deferral:

> Tax deferral arises, as you know, from current provisions of U.S. tax law that were designed to provide a competitive advantage to American companies in global trade. But this is not fraud, evasion or artificial avoidance. Historically, deferral has been used by some U.S. companies to boost the capital they have available for reinvestment, expansion and job creation.[77]

There is, of course, an ugly side to this too. Large multinational companies hire armies of lawyers to minimize their tax burdens, giving an advantage to companies with the resources to generate the most stateless income.[78] One of the more well-known strategies is the "Double Irish with a Dutch Sandwich," employed by technology companies to minimize their tax burdens.[79] Utilizing multiple corporate entities and discrepancies in Irish and Dutch tax laws, a company is able to attribute its income for much of Europe to Bermuda, lowering its effective tax rate to near zero.[80]

Nevertheless, there are at least some reasons why the current global economy benefits from low- or no-tax jurisdictions. In the words of Michael Burns and James McConvill, "[o]ffshore entities (typically companies, but occasionally also limited partnerships) are commonly used as joint venture vehicles when there are investors from different jurisdictions coming together to fund a project."[81] Additionally, they argue, "[o]ffshore entities are also used regularly to raise financing

76. CITIZENS FOR TAX JUSTICE, FORTUNE 500 COMPANIES HOLD A RECORD $2.4 TRILLION OFFSHORE 1 (2016), http://ctj.org/pdf/pre0316.pdf.

77. Letter from Anthony Travers, Chairman, Cayman Is. Fin. Servs. Ass'n to President Barack Obama (May 5, 2009).

78. *See* Kleinbard, *supra* note 19, at 702.

79. This "sandwich" found its way into a cartoon. SCOTT ADAMS, DILBERT (Dec. 28, 2010), http://dilbert.com/strip/2010-12-28.

80. For the details of how this strategy is implemented, *see* Kleinbard, *supra* note 19, at 706–13.

81. Michael J. Burns & James McConvill, *An Unstoppable Force: The Offshore World in A Modern Global Economy*, 7 HASTINGS BUS. L.J. 205, 208 (2011).

through their listing on a major stock exchange."[82] Places like the British Virgin Islands or the Cayman Islands are obviously havens for tax abuse, but before we deride them as cancerous lesions on the global tax system, we should acknowledge their positive role in facilitating the global economy as well.

To put it another way, the problem with the generation of stateless income is not that Bermuda imposes no income tax. Rather, Irish and Dutch tax laws (along with high-tax jurisdictions) exhibit flaws that use Bermuda (and other low-tax jurisdictions) to reduce effective rates far below marginal rates. This problem of tax rent-seeking by multinational companies is one that will likely become increasingly relevant and will require solutions well beyond the scope of this paper.

III. PROPOSING A "SECOND BEST" ALTERNATIVE TO THE CURRENT SYSTEM

It is clear that the current system of taxation of international transactions has enormous structural flaws and is in desperate need of revision. The system of international taxation has the same basic framework as it did in the 1920s.[83] However, political reforms are usually centered around trying to shore up the current system of worldwide taxation, not moving from a worldwide system to a territorial system.[84] So while a territorial system would be preferable as a practical matter, lawmakers have thus far been loath to move in that direction. While the Tax Cuts and Jobs Act of 2017 offers a gesture towards territoriality, every version of the bill has retained some sort of tax on certain classes overseas earnings not connected to the United States that are ostensibly directed at preventing base erosion.[85]

In light of that, I offer a second best alternative: allowing companies to remain domiciled in the United States but "check the box" and elect to be treated as an offshore entity

82. *Id.* at 213.

83. *See* Graetz, *supra* note 22, at 261.

84. Recent efforts by the Treasury under the Obama administration to disregard certain inversion transactions is a perfect example of this. *See* Burns & McConvill, *supra* note 81 at 205.

85. *See, e.g.*, Tax Cuts and Jobs Act of 2017, H.R. 1 § 14401 (establishing a "base erosion minimum tax" on high-return foreign income) (as passed by the Senate on December 2, 2017).

for tax purposes. To put it another way, this is an *elective territorial system* that gives companies a self-help mechanism that limits their U.S. tax liability on foreign income. While such a system fails to move the country entirely to a worldwide system, it would achieve two main objectives. First, it would remove the charade of setting up offshore companies for tax purposes, helping isolate companies with legitimate offshore businesses from those who use the offshore tax economy for tax evasion and other nefarious purposes. Second, it would allow our tax code to simulate some of the benefits of a territorial system—while still retaining the anti-abuse provisions of transfer pricing and Subpart F—and thus move our system closer to optimal efficiency.

A. *The Theory of the Second Best*

In order to achieve a Pareto optimal solution, each of the necessary conditions for that solution must also be satisfied. A Pareto optimal solution is one in which no changes can be made to the system to make someone better off without making another worse off.[86] While in simple in theory, the application of this to the design of a tax system is not trivial and has been the subject of considerable academic debate.[87] For the purposes of this Article, however, an optimal solution can be understood as one that balances the interest of the U.S. government in raising revenues and implementing policy objectives in a way that is easily administered, the interests of taxpayers in paying an amount of tax corresponding to their relative economic contribution, and in the international context, the interest of countries in maximizing the allocation of located in their respective jurisdictions.

However, that may not be possible in all circumstances. The *theory of the second best* says that if one condition cannot be optimized, departure from the optimal condition for all of the conditions can produce a "second best" solution.[88] Suppose a given market is failing to achieve optimal efficiency because

86. *See* Joseph E. Stiglitz, *Pareto Optimality and Competition*, 36 J. FIN. 235, 235 (1981).

87. *See* A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55, 56 (1976).

88. R.G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUDIES 11, 11 (1956).

one market segment is failing. The best solution would be, of course, to fix the underlying failure. But supposing that failure could not be corrected, the theory of the second best suggests that an overall greater efficiency can be attained by departing from the ideal for other market segments. One might refer to this as the "one step back, two steps forward" approach. So when lawmakers are unable to improve one inefficient condition through policy changes, it may be that the best option available is to depart from the ideal on other conditions.[89]

However, while the theory demonstrates that the second best solution is not always achieved by optimizing all controllable conditions, it gives no indication as to *which* controllable conditions ought to depart from the optimum.[90] Indeed, Lipsey and Lancaster acknowledge "[t]he extraordinary difficulty of making *a priori* judgments about the types of policy likely to be required in situations where the Paretian optimum is unattainable, and the second best must be aimed at."[91]

B. *The First Best Solution for International Tax Law*

Scholars debate the relative merits of territorial versus worldwide tax systems, usually an extension of the debate over the competing goals of CIN and CEN.[92] Some have also argued that discussions about the nature of an international tax system ought to be broader than the dichotomy posed by CIN and CEN.[93] This continues to be an area of robust academic debate. Regardless of how this debate ends, however, most countries have moved away from the U.S.-style worldwide system and towards a territorial system. The United States is now the only G7 country with a worldwide system for active business income, and only 8 out of 34 OECD countries still have a

89. For an example of how this has been applied in the international tax regime, *see* Alexander Wu, *U.S. International Taxation in Comparison with Other Regulatory Regimes*, 33 VA. TAX REV. 101, 125 n.96 (2013) (explaining the international tax regime that we have in terms of the theory of the second best by recognizing the twin roles played by both regulation and tax policy in determining allocation of capital).

90. *See* Paul Krugman, Opinion, *The Big Green Test*, N.Y. TIMES (June 22, 2014), http://www.nytimes.com/2014/06/23/opinion/paul-krugman-conservatives-and-climate-change.html.

91. Lipsey & Lancaster, *supra* note 88, at 28.

92. *See supra* Part I.

93. Graetz, *supra* note 22, at 276.

worldwide system.[94] Thus, irrespective of *academic* consensus on the issue, there is increasing *political* consensus in favor of the territorial system. U.S. international income taxation currently stands firmly in opposition to international norms on these issues.[95]

The fact that companies move offshore does not mean that they will not do business here, nor does it mean that they will no longer pay U.S. taxes. It *does* mean, though, that large and sophisticated companies are able to figure out ways to move offshore and bring their effective tax rates in line with global competitors, irrespective of domicile.[96] The companies that suffer the most are those with overseas operations, yet limited resources to set up sophisticated tax avoidance schemes. This becomes particularly problematic as corporate tax rates around the world continue to decline while the United States maintains a top marginal corporate rate of 35 percent.[97]

There have been some recommendations within the U.S. government to move to a territorial system for corporations. The National Commission on Fiscal Responsibility and Reform recommended moving the United States to a territorial system in order to "bring the U.S. system more in line with our inter-

94. Thornton Matheson, Victoria Perry, & Chandara Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries* (Int'l Monetary Fund, Working Paper No. 205, 2013), https://www.imf.org/external/pubs/ft/wp/2013/wp13205.pdf.

95. Nearly all tax systems have elements of both territorial and worldwide systems. MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 13 (2003). A true worldwide tax system, for example, would reject a foreign tax credit. The United States maintains a foreign tax credit, allowing people to at least partially offset their U.S. taxes by taxes paid to foreign governments. That said, in common parlance worldwide systems are defined as those which impose a tax (before credits and deductions) on a corporation's worldwide income; territorial systems are defined as those which impose a tax only on income earned within the country imposing the taxation.

96. Kleinbard, *supra* note 19, at 713.

97. Avi-Yonah & Lahav, *supra* note 18, at 375 ("The United States has the second highest statutory corporate tax rate in the Organization for Economic Co-Operation and Development (OECD) (after Japan)."). Note that Japan lowered its corporate tax rate to below that of the United States in 2015. Takashi Nakamichi & Toko Sekiguchi, *Japan to Lower Corporate Tax Rate*, WALL ST. J. (Dec. 30, 2014), http://www.wsj.com/articles/japan-to-lower-corporate-tax-rate-1419935308.

national trading partners."[98] In 2010, the President's Economic Recovery Advisory Board recommended moving to a territorial system to fix the distortion caused by "[t]he tax disincentive to repatriating foreign earnings."[99] Republican House Members, led by Speaker Paul Ryan, have advocated for a move to a territorial system as part of their blueprint for Republican policy reform.[100] And, as discussed *supra*, the Republican-backed Tax Cuts and Reform Act of 2017 attempts to move towards a territorial system.[101]

Perhaps politicians will yet implement a move to the territorial system. After all, groups on both sides of the aisle during at least the last two presidential administrations have advocated repeatedly for a move to a territorial system. I suggest four reasons why this move has not yet happened. First, there simply has not been enough political will or bipartisan consensus at the right moment in time to move the needle. Second, much of the frustration with U.S. international taxation has been misdirected. Rather than focusing on a system that taxes non-U.S. income, politicians malign companies inverting and expatriating as "unpatriotic" or as not "paying their fair share."[102] Thus, in focusing on companies and not on the broken system, politicians obscure the real problem. Third, unlike in countries like the United Kingdom and Japan, which were seeking to become more competitive in the global marketplace and repatriate foreign earnings[103]—including a move to a territorial system—the United States has not experienced large scale capital flight. Lastly, moving to a territorial system means giving up the right to revenue gleaned from taxing the

98. NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH (2010).

99. ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION (2010), https://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf.

100. *See* House Republican Members, *supra* note 5.

101. *See supra* note 85 and accompanying text.

102. President Barack Obama, Weekly Address (July 26, 2014) ("[S]topping companies from renouncing their citizenship just to get out of paying their fair share of taxes is something that cannot wait. That's why, in my budget earlier this year, I proposed closing this unpatriotic tax loophole for good.").

103. Barbara Angus, et al., *The U.S. International Tax System at a Crossroads,* 30 NW. J. INT'L L. & BUS. 517, 531 (2010).

overseas operations of U.S. companies. In other words, it will cost more. In 2010 (the last year statistics were available), American corporations reported $470.4 billion in foreign-source income.[104] While the resulting tax liability was reduced by $118.1 billion in foreign tax credits, the United States still gained substantial revenue on taxing the foreign income of U.S. corporations. While that is comparatively little in the overall federal budget, it also is large enough that some groups have suggested that the move to a territorial system would impose an unnecessary cost on U.S. government coffers.[105]

Regardless of the reasons for why the United States has not followed its trading partners and moved towards a territorial system, the fact remains that the worldwide system of taxation stubbornly remains in place. This is so despite significant pushes from members of both parties and numerous think tanks to overhaul in the direction of a territorial system. Thus, our country's tax system does not meet Pareto optimal efficiency because we have failed to generate the political will necessary for major overhaul of the portion of the tax code dealing with international taxation.[106]

C. *A "Deemed Foreign Entity"—Second Best Solution?*

While it is difficult to identify all of the conditions that need to be satisfied for Pareto optimal efficiency, we can at least identify some of the key components. The overall goals for evaluating a tax system are widely recognized as equity (or fairness), simplicity, and efficiency.[107]

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104. IRS, CORPORATE FOREIGN TAX CREDIT, TAX YEAR 2010, https://www.irs.gov/pub/irs-soi/10corporateforeigntaxcredits.pdf.

105. CHYE-CHING HUANG, CHUCK MARR, & JOEL FRIEDMAN, CTR. ON BUDGET AND POLICY PRIORITIES, THE FISCAL AND ECONOMIC RISKS OF TERRITORIAL TAXATION 9 (2013), http://www.cbpp.org/sites/default/files/atoms/files/1-31-13tax.pdf (estimating $130 billion in lost revenue over ten years by switching to a territorial system).

106. *See* I.R.C. §§ 861-1000 (Subchapter N, "Tax Based on Income from Sources Within or Without the United States").

107. *See, e.g.*, Malcolm Gillis et. al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 728 (1996); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 153 (1999). *But cf.* Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 652 (2003) ("This argument . . . goes against the consensus among scholars that the three most important criteria

Achieving equity in the world of international tax would require that those with the greatest ability to pay will pay the most in taxes. Our current regime achieves precisely the opposite result.[108] Large companies with armies of tax lawyers are able to artificially lower their rates through various tax-saving measures, whether through offshore subsidiaries, corporate inversions, or simply careful tax planning.[109] A system of greater equity would focus on working to ensure that companies—regardless of place of incorporation—are not able to manipulate the offshore tax economy to lower their tax rate.

Simplicity—perhaps the top priority for many politicians[110] and the one that elicits the most skepticism among experts[111]—is clearly lacking in the current system, and the problem is made worse by the fact that the system of international taxation is a 1920s era framework that last saw major overhaul in 1986.[112]

As Graetz noted, the question of efficiency—particularly in the international tax context—is neither simple nor clear. Gratez argued that "[w]e should minimize the costs of compliance and administration and acknowledge that an unenforceable tax can be neither efficient nor fair."[113] While the current international tax regime is something of a compromise between capital export neutrality and capital import neutrality, an ideal system ought to do at least two things. First, it ought to minimize economic activity done primarily "for tax rea-

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for evaluating any tax system (or a particular rule or set of rules within a tax system) are equity, efficiency, and simplicity.").

108. *See* Kleinbard, *supra* note 19, at 714.

109. *See* Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT. TAX J. 409, 415 (2002); Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES (Apr. 28, 2012), http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html.

110. *See, e.g.*, Ted Cruz, Opinion, *A Simple Flat Tax for Economic Growth*, WALL ST. J. (Oct. 28, 2015), http://www.wsj.com/articles/a-simple-flat-tax-for-economic-growth-1446076134.

111. Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 652 (2003).

112. Graetz, *supra* note 22, at 263–64. ("Along with its complexity, the importance of the regime for taxing international income has also increased dramatically since the 1920's, even since it was last reexamined in the 1980's.").

113. *Id.* at 324–25.

sons." Second, it ought to recognize how the system affects the movement of capital across international borders.

Efficiency is a key part of the debate between territorial and worldwide systems. While territorial systems are not themselves immune from inefficiencies,[114] taxing overseas income creates a set of nontrivial distortions. James Hines argues, "Whereas some forms of international taxation, such as subjecting U.S. firms to U.S. excise taxes on their foreign sales, are transparently inefficient and self-defeating, others, such as the current U.S. regime of taxing foreign income, are no less inefficient, only somewhat subtler in their appearance."[115]

Currently, U.S. tax policy leads to gross inefficiencies. One such inefficiency is the outsized role that the offshore tax economy (which is beyond the juridical reach of the United States government) plays in tax planning. This is at least partially a consequence of the U.S. system of trying to tax worldwide income. In practice, though, the worldwide system operates as a trap for the unwary. Kleinbard argues that "[i]n practice the U.S. tax rules do not operate, as many presentations suggest, as a 'worldwide' system of taxation, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes."[116] One way (and indeed, perhaps the best way) of removing these distortions would be moving to a territorial system. Yet, with a move to a territorial system gaining little traction at this time, perhaps there is a second best way forward—allowing companies to elect into a territorial system by "checking the box," thereby making them a "deemed foreign entity."

1. *Check-the-Box in Corporate Taxation*

Scholars and economists are largely in agreement that the corporate tax is a bad tax,[117] and all else being equal, integrating the corporate tax would reduce economic distortions im-

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114. *See* Kleinbard, *supra* note 19, at 714.

115. James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 298 (2009).

116. Kleinbard, *supra* note 19, at 714.

117. Noël B. Cunningham & Mitchell L. Engler, *Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax*, 66 TAX L. REV. 445 (2013) ("Even in the current polarized political times, there is an emerging consensus on two tax reform issues. First, there is a widely-shared bipartisan view that the corporate income tax is a 'bad' tax that is desperately in need of

posed by the two-level corporate tax.[118] The corporate tax has, however, proven extraordinarily difficult to remove. Yet even while the corporate tax remains in place for public companies and most older corporations, the United States took a significant step towards corporate tax integration in 1996 by removing burdensome regulations on entity choice and allowing businesses to simply "check the box" and therefore elect to be treated as either a corporation or a partnership.

The Code defines corporations to include "associations, joint-stock companies, and insurance companies."[119] The regulations further clarify the definition by including business entities "organized under a Federal or State statute" and "[a]n association."[120] The challenge for the Service has long been in properly defining what constitutes an "association," particularly with the advent of limited liability companies.[121] Before 1996, the Treasury had promulgated rules outlining four factors that determined whether a business association was subject to the two-level corporate tax: continuity of existence, centralization of management, limited liability, and free transferability of interests.[122] These four factors were drawn from *United States v. Kintner*, which also outlined two others: the presence of associates and a business objective.[123] However, with a knowledgeable financial planner, companies could figure out how to "become" the desired entity by attaining the foregoing characteristics,[124] notwithstanding attempts from the IRS to

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reform or repeal. The corporate income tax is complicated, inefficient, and is strewn with tax expenditures.").

118. Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 635 (1992) ("The various proposals for corporate integration can reduce, eliminate or even reverse these distortions, and most tax policy experts agree that, all other things being equal, a tax system free of these distortions would be superior to current law.").

119. I.R.C. § 7701(a)(3) (West 2014).

120. Treas. Reg. § 301.7701-2(b).

121. *See, e.g.*, Rev. Rul. 94-51, 1994-2 C.B. 407 (1994); Rev. Rul. 94-79, 1994-2 C.B. 409 (1994); Rev. Rul. 94-6, 1994-1 C.B. 314 (1994).

122. *See* Larson v. Comm'r, 66 T.C. 159, 172 (1976), *acq.*, *IRS Announcement Relating to: Am. Precision Metals, Larson*, 1979-2 C.B. 1 (Dec. 31, 1979).

123. United States v. Klintner, 216 F.2d 418 (9th Cir. 1954).

124. Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 527 (1996).

impose some sort of order on the definition of a corporation.[125]

In response to growing pressure, in 1996 the IRS promulgated revisions to the regulations that simplified the entity classification rules.[126] In its decision, the Treasury said that "[a]ny business entity that is not required to be treated as a corporation for federal tax purposes (referred to in the regulation as an eligible entity) may choose its classification under the rules of 301.7701-3."[127] Non-eligible entities are those that are otherwise classified as corporations under the regulations, such as companies organized as corporations under state law, banks, and certain foreign entities.[128] For eligible entities, the regulations now allow a business to choose whether to be treated as a corporation (thereby imposing the two-level tax) or as a partnership.[129]

When the IRS first announced "check-the-box," it was widely praised for reducing complexity.[130] An additional benefit provided by check-the-box, however, is that it removes the two-level tax for many non-public companies.[131] In effect, therefore, check-the-box is partial corporate tax integration. Full-scale corporate tax integration has proved to be a nearly intractable problem, and while most scholars agree that the first-best solution to the problems associated with a two-level tax is, of course, removing the second level of tax, check-the-box represents a second best solution.

2. *A Deemed Foreign Entity*

Currently, Section 7701 and the accompanying regulations define whether an entity is foreign or domestic.[132] The Code provides that, "[t]he term 'domestic' when applied to a

125. *See id.* at 522–32.

126. For an in-depth overview of the history behind check-the-box, see Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 447 (2005).

127. T.D. 8697, 1997-1 C.B. 215.

128. Treas. Reg. § 301.7701-2(b) (as amended in 2016).

129. Treas. Reg. § 301.7701-3(c)(1)(i) (2006).

130. *See, e.g.*, Dean, *supra* note 126, at 438; George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 125 (1998).

131. Public companies are generally taxed as corporations, regardless of choice of form. I.R.C. § 7701 (2014).

132. I.R.C. § 7701(a) (2014); Treas. Reg. § 301.7701-5 (2006).

corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations."[133] Mirroring this, the Code provides that, "[t]he term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic."[134] While this is certainly straightforward, it does not reflect economic reality. Ugland House in the Cayman Islands is famous for serving as the place of incorporation for thousands of companies—companies that are therefore classified as foreign for tax purposes.[135] U.S. companies reported $51 billion in offshore income from the Cayman Islands alone in 2010.[136] The only problem is that the Cayman Islands' entire GDP is only about $2.5 billion.[137] Thus, the tax story and the economic story show very different pictures of what is happening, meaning that something is awry with our tax code.

The notion that a company's locus is its place of incorporation is mere fiction. Decisions about where to incorporate are made with little, if any, reference to where the business is operated or whether the business even has any presence in the jurisdiction of choice. There is no reason why that fiction cannot simply be extended to allow companies to elect their tax status as either a foreign or a domestic company. This movement would have little substantive effect on an entity's tax status (as companies currently domiciled offshore would be more likely to be domiciled onshore with this change in law), but would allow companies to avoid having their place of incorporation be dictated by tax law. Such a regulation could mirror the check-the-box regulations, because while foreign domiciled companies would still be classified as foreign companies, U.S.-domiciled companies could elect to be treated as foreign companies for tax purposes. The current system is already an

133. I.R.C. § 7701(a)(4) (2014).

134. I.R.C. § 7701(a)(5) (2014).

135. Robert M. Morgenthau, Opinion, *These Islands Aren't Just a Shelter from Taxes*, N.Y. TIMES (May 5, 2012), http://www.nytimes.com/2012/05/06/opinion/sunday/these-islands-arent-just-a-shelter-from-taxes.html.

136. MCINTYRE ET AL., *supra* note 10, at 14.

137. CIA, CAYMAN ISLANDS, THE WORLD FACTBOOK (last updated May 5, 2016), https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html.

elective system for all intents and purposes—so long as an entity has the resources to structure their tax position properly.[138]

3. *Getting from Here to There*

The original check-the-box was accomplished via regulations, but there remains significantly greater clarity in the Code regarding the distinction between foreign and domestic companies compared with the Code's definition of a corporation. Section 7701 defines a corporation to include associations, but does not define the term;[139] by contrast, the Code clearly defines domestic entities as those "created or organized in the United States or under the law of the United States or of any State."[140] Thus, it may prove more difficult to redefine whether a corporation is domestic or foreign without legislative change. The Treasury Department is limited in its ability to issue regulations in instances where the meaning of a statute is plain.[141] In reviewing an agency's interpretation of a statute, courts use a two-step process (known as the *Chevron* analysis) whereby they first analyze "whether Congress has directly spoken to the precise question at issue."[142] The definitions of domestic and foreign corporations are quite clear, which makes the second step of the *Chevron* analysis a nullity: "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[143]

Making a regulatory change would be very aggressive—almost certainly too aggressive to be feasible—but it is worth thinking about what such regulations might look like. Such a regulation would be similar to check-the-box and would in-

138. Kleinbard, *supra* note 19, at 714 ("[T]he current U.S. tax system, which purports to tax the worldwide income of U.S.-resident multinational firms, in fact, affords those firms the opportunity to operate in a quasi-territorial tax environment and to earn stateless income in the same manner that their territorial-based competitors do.").

139. I.R.C. § 7701(a)(3) (2014).

140. I.R.C. § 7701(a)(4) (2014).

141. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984).

142. *Id.* at 842.

143. *Id.* at 843.

clude several different points.[144] First, it would establish a default rule in the statute—absent election, domestic or foreign business entities would be defined by their place of incorporation. Second, it would establish that business entities organized under the laws of the United States can elect to be treated as foreign entities. Third, it would specify that any business electing to be treated as a foreign entity would be treated as "a United States person transfer[ing] property to a foreign corporation," making it subject to the rules and associated regulations of Section 367. Among other things, this could require the domestic company to recognize all gains before expatriating.[145] This would accomplish two things: (a) it would prevent *all* domestic entities from seeking foreign treatment; (b) it would dissuade companies from switching back and forth between foreign and domestic status for different tax years. Fourth, the regulation would require companies to elect their domestic or foreign status prior to the taxable year, thereby preventing companies from choosing whether they want to be treated as a domestic or foreign company solely based on their annual tax burden for the year in question.

In order to keep the regulation in line with the words of the statute, only companies eligible to be treated as partnerships could elect to be treated as foreign entities.[146] Of course, some offshore entities would still want to be treated as corporations for tax purposes, so election for either corporate or partnership tax treatment would be made subsequent to the election to be treated as a foreign or domestic entity. Thus, the new system would allow eligible domestic entities a double election: first, they would elect whether or not to be treated as a foreign entity; second, they would elect whether or not to be treated as a corporation.

144. *See* Treas. Reg. § 301.7701-5 (2006) (giving regulatory guidance on the definition of domestic and foreign business entities).

145. I.R.C. § 367 (2004); *see also* Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 494 (2005).

146. The reason for this is that the statute defines domestic entities as those "created or organized in the United States or under the law of the United States or of any State *unless, in the case of a partnership, the Secretary provides otherwise by regulations*." I.R.C. § 7701(a)(4) (2014) (emphasis added). Thus, the law provides the ability for Treasury to define domestic entities independent of the statute—but only for partnerships.

This proposal may indeed be both overly aggressive and too cute by half, but such a regulation may still have interesting consequences worth considering. Unlike the original check-the-box, there is no apparent need to require a lock-in,[147] as expatriation rules provide sufficient penalty for companies electing to switch from domestic to foreign status. Additionally, it is not entirely clear who would have the legal standing to challenge these regulations. In order to challenge regulations, a plaintiff must first establish Article III standing, which, among other things, requires a plaintiff to demonstrate "an injury in fact—an invasion of a legally protected interest which is (a) concrete and particularized and (b) actual or imminent, not conjectural or hypothetical."[148] Since the goal of this regulation is taxpayer friendly and designed to allow taxpayers to elect the classification that would minimize their tax burden, it is not clear how a plaintiff could establish this injury in fact. That said, it was not clear that anyone would have standing to challenge the original check-the-box regulations.[149] It took ten years, but eventually those regulations were challenged in *Littriello v. United States* as an invalid exercise of the Treasury's authority.[150]

The plaintiff in *Littriello* had organized an LLC and had apparently forgotten to elect treatment as a corporation—making him personally liable for the LLC's unpaid taxes.[151] The court went through the *Chevron* analysis and found that the Treasury had not in fact abused its discretion.[152] It is hard to imagine an analogous situation under the election system proposed here, because at the heart of Littriello's argument is the notion that he was liable for a tax that he would not have had to pay prior to check-the-box. This would not be an issue in electing between either a foreign or domestic entity because

147. Once an entity elects to be treated as either a partnership or a corporation, it generally cannot change its election for five years. Treas. Reg. § 301.7701-3(c)(1)(iv) (2006). Without such an election, businesses could change their election without penalty to take advantage of the form best suited for that year's financial statement.

148. Lujan v. Defs. of Wildlife, 504 U.S. 555, 560 (1992) (internal quotations omitted).

149. *See* Fleischer, *supra* note 124, at 550 n.157.

150. Littriello v. United States, No. CIV.A.3:04CV-143-H, 2005 WL 1173277 (W.D. Ky. May 18, 2005), *aff'd,* 484 F.3d 372 (6th Cir. 2007).

151. *Littriello*, 484 F.3d at 374.

152. *Id.* at 380.

the default rule in this proposed regulation would remain the same as it is today: it would look to the place of incorporation. Still, ingenious litigants may still find a way to challenge the rules, and given the aggressive nature of such a rule, it is not clear that such a challenge would withstand scrutiny under the *Chevron* doctrine.[153] Furthermore, as a matter of public policy it may not be advisable for a presidential administration to pursue policies that are in contravention of the duly enacted laws of Congress, even if such policies are immune from challenge on the basis of a standing argument.

Thus, the far more plausible fix would be through legislative change, which would either empower the Treasury to apply rules to define domestic and foreign corporations or would place the regulations described above directly into law. Given the level of public scrutiny that corporate inversions receive, the proposal above may be able to gain some political traction. This would be a small change and would therefore not require wholesale overhaul of the tax code. For that reason, it may be more palatable to legislators than moving entirely to a territorial system. It would, in fact, represent Congress' first move towards a territorial system, thereby following the international trend away from worldwide taxation.

IV. THE COMPLICATIONS AND ADVANTAGES OF BEING A "DEEMED FOREIGN ENTITY"

The theory of the second best suggests that when one condition cannot be optimized, a second best solution deviating from the Pareto optimal solution can be achieved by making other conditions suboptimal.[154] The consequence of this, of course, is that while the overall result becomes more efficient,

153. In reviewing whether or not Treasury could index capital gains for inflation under its regulatory authority, Lawrence Zelenak concludes that such a regulation would be invalid. Despite that, "indexing would probably be immune from judicial challenge," so "there would almost certainly be no one with standing to challenge the new regulation." Nevertheless, he argues that "[a]s tempting as that course may be, the administration should remember that an illegal activity is still an illegal activity, even when you are sure you will not be caught." Such an analysis would be appropriate in this circumstance as well. Lawrence Zelenak, *Does Treasury Have Authority to Index Basis for Inflation*, 55 TAX NOTES 841, 841–42 (1992).

154. *See* Lipsey & Lancaster, *supra* note 88.

it comes at the cost of making other conditions *less* efficient. Therefore, if allowing the election of either foreign or domestic classification is indeed a second best solution, we should expect *overall* benefits, while at the same time sacrificing some efficiency.

A. *Potential Complications of the Second Best*

Perhaps the most obvious potential disadvantage is the fact that once a company is treated as a foreign entity, its foreign source income becomes, with some exceptions, immune from U.S. taxation. Not only that, but generating income not taxable to the United States could very well become stateless income, or income not attributable to a multinational's natural locale (that is, the domicile of its parent, residence of its customers, or location of its production facilities).[155] One could therefore imagine a business domiciled in the United States declaring itself as a foreign entity for tax purposes. Under current law, this move would free such a business from paying anything on its foreign source income. However, while its U.S. source income would be taxed at normal U.S. rates, its foreign source income may not be attributed to any particular country if no other country claimed that income under its own source rules.[156]

This is an existing problem, however, and not a problem that either this proposal or the status quo purports to solve. Indeed, identifying the "source" of income has become something of a Sisyphean task and requires international cooperation well beyond the debate over moving to a territorial system. As it currently stands, the offshore tax economy already provides the framework for companies to claim income without paying tax to any jurisdiction on that income. The problem of untaxed foreign income (i.e., stateless income) is a problem more generally in a world without unified tax principles.[157] This proposal would merely extend to U.S. companies what foreign companies operating in the United States already

155. Kleinbard, *supra* note 19, at 701.

156. Sourcing rules vary from country to country, and the friction between different countries in how various types of income are defined as well as how income is sourced are what give rise to stateless income. *See id.* at 706.

157. *See* OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), http://dx.doi.org/10.1787/9789264202719-en.

have: the right to have foreign-source income exempt from U.S. income tax. Most countries have already granted this right via a territorial tax system, and it is time for the United States to provide that right as well.

Another potential concern is that domestic companies would rush to elect foreign treatment, in much the same way that we currently see companies trying to invert. However, very few companies have substantial foreign revenue to report, and many current multinationals have already structured their overseas operations into separate legal entities.[158] Thus, there would be almost no advantage for most companies in avoiding paying U.S. tax on foreign income.[159]

Additionally, while foreign companies have the benefit of non-U.S.-sourced income avoiding U.S. taxation, the companies are also subject to additional regulations and withholding taxes under current tax law.[160] The overarching goal of U.S. tax policy with regards to foreign entities would remain the same, ensuring both that income connected with U.S. activity remains taxed and that foreign income remains untaxed.

If this proposal were to be implemented—particularly via regulation—the temptation for Congress or a future administration to revert to present-day policy could be very high. Currently, if Congress wanted to tax offshore companies, it would be limited in its ability to enforce such a tax beyond U.S. borders. By definition, however, this proposal would involve companies domiciled in the United States that are treated as foreign for tax purposes. Thus, the only thing preventing Congress from "flipping the switch" and reclassifying these entities as domestic (thereby opening these businesses up to massive

158. As of 2010, the IRS reported that just 6,922 corporations reduced their taxable income using the foreign tax credit. While these companies generate substantial revenue, this illustrates the fact that companies have either domiciled overseas and taken advantage of tax deferral using CFCs or do not have significant overseas operations. IRS, *supra* note 104.

159. Note also that U.S. companies are given a foreign tax credit on taxes paid to foreign countries, meaning that being taxed by the United States on foreign income ultimately matters only for companies that maintain significant activities abroad. Because most countries have a lower corporate tax rate than the United States, the foreign tax credit generally does not eliminate U.S. tax liability for foreign source income. I.R.C. § 901(a) (2010).

160. *See, e.g.*, I.R.C. § 897 (2015) (imposing a withholding tax on the sale of any U.S. real property interest); I.R.C. § 1441 (2014) (imposing a withholding tax on various forms of income for foreign persons).

tax liabilities unexpectedly) would be the reputational hazard imposed by such a move. Congress would, in effect, have lured businesses to organize in the United States with the promise of not having their foreign income taxed—only to do an about-face. For this reason alone it may be wise to allow Congress—and not the Treasury—to implement this proposal, because it would immunize the policy from the criticism of administrative overreach.

The real disadvantage to this system is that it inserts a legal fiction where one may not be required. Put another way, it is an encumbrance that imposes regulations on companies for which the regulations were not designed. The easiest way to deal with this potential problem would be, of course, to simply move to a territorial system. So introducing the option to elect whether an entity will be treated as foreign or domestic would inject a level of unnecessary complexity—at least with respect to the Paretian optimal solution. It may also open the doors for companies to use the framework for tax planning strategies in similar ways to how companies currently take advantage of generous tax rules in other countries to avoid taxes. This would make the United States *more* complicit in the tax charades that the international community is trying to thwart.[161]

B. *Advantages of a Second Best Election*

Achieving a second best solution can require deviation from the optimum for certain conditions in order to achieve an more efficient solution overall. Despite the sacrifices in efficiency described above, this proposal does deliver net benefits over the status quo. First, U.S. companies gain the benefit—already granted to foreign companies—of avoiding U.S. income tax on their foreign income. Not all companies may be able to benefit immediately, but eventually, U.S.-domiciled Color Corp. from the example above in Part II.B, would be taxed in the same way as its British competitor, Colour Corp.[162]

Second, it would eliminate certain sham transactions made solely for tax purposes. Ideally, people who were formerly setting up entities in tax havens such as the Cayman Islands for legitimate purposes would set them up domestically.

161. *See generally* OECD, *supra* note 157.
162. *See supra* Part II.B.

This would give these companies predictability by being subject to U.S. laws in a way that may be unavailable when setting up the entities overseas. Second, it would limit tax haven incorporation to companies that either have non-tax reasons[163] or illegitimate tax reasons for setting up overseas. Not all companies use tax havens for legitimate purposes; some use them to hide money beyond the reach of the U.S. government. It is no secret that trillions of dollars are stored offshore in tax havens, with much of that sum illegally avoiding taxation.[164] While tax information exchange agreements with various tax havens have proliferated in the last decade,[165] the United States does not maintain formal tax treaties with most of those countries.[166] Thus, even while tax treaties and tax information exchange agreements have sought to prevent tax evasion, offshore tax havens and associated shell companies remain widely used by the wealthy and powerful both to avoid taxes and also to skirt sanctions.[167]

The final benefit is that it would provide guidance for future changes in law. It would reveal flaws in how we currently treat foreign entities from a tax perspective, since it would help isolate techniques used to generate stateless income. Additionally, it would pave the way for a true territorial system of taxation—the first best solution. This mechanism rejects the notion that a company moving its place of incorporation overseas via inversion or other means is doing anything other than saving money on its *foreign* taxes. Of course, when quintessentially "American" companies move their domicile overseas, it

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163. For example, recall that Chinese companies listing on U.S. markets will use an offshore VIE as the company going public. *See supra* Part II.A.

164. *Special Report: Storm Survivors*, THE ECONOMIST (Feb. 16, 2013), http://www.economist.com/news/special-report/21571549-offshore-financial-centres-have-taken-battering-recently-they-have-shown-remarkable.

165. *See, e.g., U.S. - Netherlands Antilles Tax Info. Exch. Agreement Enters into Force*, Treas. HP-336 (Mar. 29, 2007).

166. The United States maintains tax treaties with a number of countries, which generally exist "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income." United States Model Income Tax Convention, Nov. 15, 2006.

167. *The Panama Papers: A Torrential Leak*, THE ECONOMIST (Apr. 9, 2016), http://www.economist.com/news/international/21696497-huge-trove-documents-has-revealed-secrets-offshore-business-presaging-tougher (describing the so-called "Panama Papers"). Ironically, the first major inversion transaction, McDermott Inc., moved its domicile to Panama in 1982.

often strikes taxpayers as being unfair.[168] And in a way, it *is* unfair, particularly for small-to-medium sized companies unable to afford an army of tax lawyers to build complicated inversion structures. So let's democratize the ability for companies to become foreign entities. Let's allow domestic companies the choice to be treated as a foreign company for tax purposes so that they can compete on equal footing with competitors from around the globe.

Conclusion

The narrative among the media and politicians regarding international tax tends to focus on companies leaving the United States, thereby getting out of paying their taxes. The narrative has some truth to it, but ultimately misstates the problem. Large multinational companies are able to manipulate the worldwide system of taxation such that they compete on a level playing field with businesses in countries that have a territorial system—and yet the United States insists on trying to capture the worldwide income of any company with the misfortune of having a U.S. mailing address.

Despite recommendations from both sides of the aisle and a consensus among America's major trading partners, Congress has made no move to overhaul the tax code in favor of a territorial system of taxation. Thus, with the first best solution unavailable, I propose a second best solution that allows companies the chance to elect their tax treatment. This would allow companies without the resources to structure themselves into a territorial regime to nevertheless acquire the benefits of a territorial system. This does not obviate the need for large-scale overhaul of an outdated system of taxation; nevertheless, such a move would prove to be a step forward in improving the United States tax code.

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168. *See* Danielle Douglas-Gabriel, *These Are the Companies Abandoning the U.S. to Dodge Taxes*, WASH. POST (Aug. 6, 2014), https://www.washingtonpost.com/news/wonk/wp/2014/08/06/these-are-the-companies-abandoning-the-u-s-to-dodge-taxes/.