TRANSFER-PRICING WITH SOFTWARE ALLOWS FOR EFFECTIVE CIRCUMVENTION OF SUBPART F INCOME: GOOGLE'S "SANDWICH" COSTS TAXPAYERS MILLIONS

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I. Introduction

A. PREFACE

"And remember . . . don't be evil, and if you see something that you think isn't right—speak up!"—Unofficial Slogan from Code of Conduct for Google, Inc.[2]

Every day millions of web users peer into the vast beyond of their proximate familiarities through the use of various internet search engines. These gatekeepers of information allow a remote user in Dallas, Texas to view news from the Middle East, sports scores from the United Kingdom, and stock market information from China. One such gatekeeper and world-renowned search engine servicer, Google, continues to make international headlines[3] by providing, often to the detriment of governments, access to free-flowing information at the click of a button.[4]

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[2] *See* Google.com, Code of Conduct, http://investor.google.com/corporate/code-of-conduct.html#VII (last visited Feb. 28, 2011) ("The Google Code of Conduct is one of the ways we put "Don't be evil" into practice. It's built around the recognition that everything we do in connection with our work at Google will be, and should be, measured against the highest possible standards of ethical business conduct. We set the bar that high for practical as well as aspirational reasons: Our commitment to the highest standards helps us hire great people, who then build great products, which in turn attract loyal users.").

[3] *See* Julianne Pepitone, *Google Search Working Again in China*, CNNMONEY, July 30, 2010, http://money.cnn.com/2010/07/29/technology/google_china/index.htm.

[4] *See* Google, Corporate Information, http://www.google.com/intl/en/corporate/ (last visited Feb. 28, 2011) ("Google's mission is to organize the world's information and make it universally accessible and useful.").

Although Google is a U.S.-based company whose worldwide operations are subject to local and federal U.S. taxation laws,[5] its cross-border transactions have significantly minimized its tax bill to Uncle Sam.[6]

Consider the following: Consumer A (a non-U.S. citizen) and Corporation Y (incorporated outside the jurisdiction of the United States) contract to do business, whereby A purchases widgets from Y for a certain value. Under general U.S. tax principles, Y's recognized income would be subject to tax in the jurisdiction in which the transaction occurred or the place of Y's incorporation.[7] As such, this transaction would generally not qualify as a taxable event subject to U.S. taxation rates.[8] Nonetheless, U.S. lawmakers have enacted a long-arm statute that broadly characterizes this situation as a taxable event in the case where Corporation Y is a wholly owned subsidiary of a domestic U.S. company with shareholders residing within the United States.[9] To avoid this result, multi-national corporations take advantage of legal tax havens in the form of off-shore entities that enable them to defer taxes on their income earned from foreign-based entities.[10] Congressional attempts to curb such behavior have largely proven

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[5] *See* I.R.C. § 61(a) (2011); Google, About Us, http://www.google.com/intl/en/contact/ (last visited Feb. 28, 2011).

[6] Jesse Drucker, *Google 2.4% Rate Shows how $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

[7] *See* I.R.C. § 61(a). (short form statute)

[8] *See* I.R.C. § 954(d)(1)(A) (2011); Treas. Reg. § 1.954-3(a)(2) (as amended in 2002) ("Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in subparagraph (1) of this paragraph if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized.").

[9] *See* I.R.C. §§ 951, 952(a)(2), 954(a)(2) (2011).

[10] *See* Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON L. REV. 667, 667-68 (2007):

to be fruitless,[11] as the number of corporations implementing similar tax maneuvers appears to be increasing every year.[12]

B. The Issue

The Internal Revenue Code dictates that U.S. corporations pay the standard corporate tax of 35% on profits earned domestically and abroad, one of the highest corporate tax rates in the world.[13] In October 2010, however, Bloomberg.com reported that Google reduced its overseas tax rate to 2.4%, resulting in a $60 billion loss to the U.S. government and harsh criticism from politicians for Google's injurious, although technically legal, use of international tax loopholes.[14] Google accomplished this feat by utilizing an income-shifting method known to tax lawyers as the "Double Irish" and the "Dutch Sandwich," which, as some commentators noted, "[t]he sandwich leaves no tax behind to taste."[15] Despite the criticisms, several other U.S. technology-based companies, such as Microsoft, Inc. and the social networking giant Facebook, have begun to utilize similar methods to avoid tax payments to the U.S. government.[16]

> Most U.S. multinationals avoid current U.S. taxation of their foreign business income by accumulating such income in controlled foreign subsidiaries: in essence, their offshore piggybanks. The ability to suspend the taxation of foreign business income in this manner is commonly referred to as 'deferral,' and it has become an important strategic objective for managers of U.S.-based multinationals.

[11] *See, e.g.*, I.R.C. § 965 (2010).

[12] *See generally* Boise, *supra* note 9.

[13] *See* I.R.C. § 11(b)(1)(D) ("The amount of the tax imposed by subsection (a) shall be the sum of . . . 35 percent of so much of the taxable income as exceeds $10,000,000."); *see also id.* §§ 951, 952, 954.

[14] Drucker, *supra* note 5.

[15] *Id.*

[16] *Id.* ("'Google's practices are very similar to those at countless other global companies operating across a wide range of industries.'").

Access to these strategies is widely available. For example, KPMG, one of the top four U.S. accounting firms, conducted a survey in 2010 on corporate and indirect rates of countries from various places around the world, which brought to light the incentives behind why companies elect to establish related businesses on international soil, rather than maintain full operations within U.S. borders.[17] This survey is one of many informal sources available to corporate directors, who will review information provided by KPMG and other similar resources to make business decisions in the best interest of the shareholders.[18] As a result, if lawmakers continue to ignore this issue, we will see more companies creating offshore subsidiaries to reallocate profits and escape paying domestic taxes.

Part I of this paper compares international corporate taxation rates to U.S. rates to provide a comprehensive understanding of why companies like Google would elect to utilize transfer pricing and shift profits from U.S. soil. Part II explains the "Double Irish" and "Dutch Sandwich" tax maneuvers and how Google implements these strategies to legally lower their effective corporate tax rates to minimal levels. Part III examines various legal measures that the U.S. government has enacted to counter-balance such practices and bring profits back within U.S. borders. It also examines the possible solutions to the problem with commentary on why amendments to the current taxation regime are necessary.

While the extent to which the global economy is affected by avoidance maneuvers implemented by Google and other similarly situated companies remains unclear, such maneuvers may eventually become commonplace practices for average-size businesses. Moreover, while some commentators claim that Google is ignoring its corporate slogan, "Don't be evil," by the

[17] KPMG, KPMG'S CORPORATE AND INDIRECT TAX SURVEY 2010 3 (2010), *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Corp-and-Indirect-Tax-Oct12-2010.pdf.

[18] *See id.*

creation of such a scheme,[19] these tax maneuvers may signify a more disturbing and potentially detrimental future for international bodies choosing to ignore such on-goings while the rest of the world embraces the ever-changing landscape and globalization of international business transactions.

II. Background

A. History and Historical Data on Corporate Tax Rates in the United States

Corporate law in the United States pre-dates the imposition of the federal income tax. Chief Justice John Marshall famously pronounced a corporation's essence in American jurisprudence in *Trustees of Dartmouth College v. Woodward*:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property, without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use.[20]

The idea that a corporation is separate from the individual has since continued thematically with the enactment of subsequent laws regarding liability of corporations.[21] Following the

[19] *See, e.g.*, Drucker, *supra* note 5 ("Google is 'flying a banner of doing no evil, and then they're perpetrating evil under our noses.'").

[20] Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819).

[21] Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 899 (2010) (holding that government may not, under the First Amendment, suppress political speech on the basis of the speaker's corporate identity).

advent of the federal income tax in 1861, only individuals were taxed on a percentage of their incomes.[22] It was not until the Revenue Act of 1894 that the U.S. government established the principle of treating corporations as taxable entities separate from their owners.[23] The Act was later overturned in *Pollock v. Farmers' Loan & Trust Co.*,[24] where the Supreme Court held 5-4 that the income taxes on interest, dividends, and rents imposed by the Act were unconstitutional because they violated the constitutional provision that direct taxes be apportioned.[25] In 1913, the Sixteenth Amendment reversed the decision in *Pollock* by granting Congress the express power to lay and collect taxes on incomes for individuals and corporations.[26]

The first federal corporate income tax brackets were set at rate of 1% for all income exceeding $5,000.[27] From 1913-1915, Congress eliminated the tax brackets and instead imposed the 1% rate on all taxable income.[28] Corporate tax rates steadily increased for the next few years until the advent of World War II, when economic conditions forced Congress to dramatically increase the rates on the upper corporate income earners to pay for war debts.[29] In 1939, corporations

[22] U.S. Dep't of Treasury, Chronology of Events 1800-1899, http://www.treasury.gov/about/history/Pages/1800-1899.aspx (last visited Feb. 22, 2011) ("August 5, 1861-The U.S. government levied the first income tax to help pay for the Civil War. All incomes over $800 were taxed three percent until the year 1872, when the tax was repealed.").

[23] Jack Taylor, *Corporation Income Tax Brackets and Rates, 1909-2002*, IRS.GOV, at 284, http://www.irs.gov/pub/irs-soi/02corate.pdf.

[24] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 429 (1895).

[25] *Id.* at 586.

[26] U.S. CONST**.** amend. XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.").

[27] *See* Taylor, *supra* note 22, at 287.

[28] *Id.*

[29] *See id.*

making over $25,000 per taxable year were subjected to a tax rate of 19%.[30] This rate increased to 24% in 1940 and rose as high as 40% during war times.[31] Corporate tax rates thereafter rose as high as 52.8% in 1969 before finally settling on the present day rate of 35% for the highest corporate earners.[32]

With U.S. corporate tax revenues totaling $191.4 billion, or 9% of total tax revenues for 2010,[33] it is no surprise that corporations are hiring tax attorneys to find ways to circumvent payments to the U.S. government and satisfy their shareholders. Some congressmen are currently attempting to curb this behavior as they work to close these loopholes amid the looming threat of ever-increasing debts.[34] The eventual outcome of these tensions remains unclear; but what remains certain is that corporations will continue to use all means necessary, including outsourcing business overseas, to lower their effective tax despite legislative attempts to the contrary.

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[30] *Id.*

[31] *Id.* at 287-88.

[32] *Id.* at 288; *see also* I.R.C. § 11(b) (2011).

[33] Jeanne Sahadi, *Corporate Tax Reform: Talk Grows Louder*, CNNMONEY, Jan. 15, 2011, http://money.cnn.com/2011/01/14/news/economy/corporate_tax_reform/index.htm?hpt=T2.

[34] *See, e.g., id.* ("Many business leaders and tax experts say the corporate tax code discourages foreign investment in the United States and hinders the ability of U.S. companies to compete internationally."); *see also* Drucker, *supra* note 5 ("U.S. policy makers, meanwhile, have taken halting steps to address concerns about transfer pricing. In 2009, the Treasury Department proposed levying taxes on certain payments between U.S. companies' foreign subsidiaries.").

B. SURVEY OF WORLD CORPORATE TAX RATES

With the second-highest gross domestic product (GDP) in the world in 2009, behind the European Union,[35] the United States imposes one of the highest marginal tax rates (35%) in the world on its top corporate income earners.[36] When this rate is coupled with the power of states and local governments to impose additional corporate taxes ranging from 1% to 12% (7.5% on average), U.S. corporations pay well above the world average of 24.99% of their annual income to the federal government.[37] As a result, companies like Google have chosen to establish subsidiaries in other countries with significantly more favorable corporate tax rates to increase profits and offset any of the costs in the process.[38]

Japan, which in 2010 imposed the world's highest corporate tax rate of 40.69%, has recently experienced the effects of that decision.[39] Because of recent economic woes and corporations moving business outside of Japan's borders, Japanese lawmakers chose to cut the corporate tax rate by around 5% to bring the rate more in line with that of the United States.[40] With a national

[35] *See* The CIA World Factbook, Country Comparison: GDP (Purchasing Power Parity), https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html?countryName=United%20States&countryCode=us&regionCode=na&rank=2#us (last visited Feb. 22, 2011).

[36] I.R.C. § 11 (2011); *see also* Sahadi, *supra* note 32 ("The 35% top corporate tax rate . . . is among the highest in the world.").

[37] *See* Drucker, *supra* note 5 ("Two thousand U.S. companies paid a median effective cash rate of 28.3 percent in federal, state and foreign income taxes in a 2005 study by academics at the University of Michigan and the University of North Carolina.").

[38] *See, e.g.*, *id.*

[39] *See* KPMG, *supra* note 16, at 13.

[40] Hiroko Tabuchi, *Japan Will Cut Corporate Income Tax Rate*, N.Y. TIMES, Dec. 14, 2010, http://www.nytimes.com/2010/12/14/business/global/14yen.html ("Lowering the corporate tax burden by 5 percentage points could increase Japan's gross domestic product by 2.6 percentage points, or 14.4 trillion yen ($172 billion), over the next three years, according to estimates by Japan's Trade Ministry.").

debt nearly twice the size of its $5 trillion economy, Prime Minister Naoto Kan explained that "[b]y daring to go with a 5[%] reduction, [Japan] will spur companies to invest domestically, expand employment and raise wages . . . [t]hat will stimulate the domestic economy, support growth and shake off deflation."[41] In the three months following the announcement, the Japanese economy grew by a reported 1.1%.[42] Although this is just a preliminary indication of signs that the Japanese economy is improving, several commentators from some of Japan's largest corporations have noted that having such a high corporate tax rate "has been one big barrier" to investment in Japanese corporations, and therefore a reduction in the corporate tax rate was "imperative to attract people, products and funds to Japan."[43]

The United Arab Emirates ("UAE"), a political unit comprised of the seven countries Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al Quwain, Fujairah, and Ras Al Khaimah, boasts the highest tax rate on a specific corporate sector within their boundaries, namely oil companies, which must pay 55% of their operating profits to the local government.[44] But citizens in the UAE are not subject to an individual income tax, nor do any other corporate sectors pay a corporate income tax, which likely offsets any detrimental effects to their economy.[45]

Other notable countries with relatively high corporate tax rates include France at 33.33%, India at 33.99%, Libya at 40%, Pakistan at 35%, South Africa at 34.55%, and Venezuela at 34%.[46]

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[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] The Federation of International Trade Associations, United Arab Emirates, http://www.fita.org/countries/uae.html?ma_rubrique=fiscalite (last visited Feb. 22, 2011).

[45] *See id.*

[46] KPMG, *supra* note 16, at 12-14.

While it may come as no surprise that these are also some of the largest economies in the world, companies from these countries have already or soon will likely implement tax avoidance maneuvers similar to that of Google or simply leave the country for one with a lower corporate tax rate. This could result in dire consequences for the long-term growth of these nations.

At the other end of the corporate tax spectrum, several countries, particularly those with smaller, or less developed, economies refrain from imposing taxes on corporations within their national borders. Several of these countries, such as the Bahamas, Bermuda, and the Cayman Islands are located just off the coast of the United States and provide tax incentives for U.S. companies that place subsidiaries at these locales.[47] Bermuda in particular has become a favorite offshore tax haven because it imposes no income tax, no capital gains tax, no withholding tax on dividends or interest, and currently has no double taxation treaties with other countries.[48] Other countries, like Bahrain, Guernsey, the Isle of Man, Jersey, and Montenegro, also have either negligible or non-existent corporate tax rates that attract investment from other countries around the world.[49] The reasons a country elects to have a certain corporate tax rate may differ from country to country because there are so many economic variables that go into a country's decisions to levy a corporate tax. But with the increased globalization of the world's economy and the pressures on corporate directors to maintain high profit margins, there is now a tremendous incentive for companies to send resources to foreign countries with lower tax rates at

[47] *See id.* at 12.

[48] *See* Gov't of Berm., Office of the Tax Comm'r, About Us, http://www.taxbermuda.gov.bm/ (last visited July 10, 2011); *see also* ADAM STARCHILD, TAX HAVENS FOR CORPORATIONS 31-32 (1979).

[49] *See* KPMG, *supra* note 16, at 12-13.

the expense and to the detriment of their respective home countries, especially when the logistical barriers that may once have prevented them from investing abroad are gone.[50]

C. Direct Foreign Investment as an Indicator and the Case for Ireland

One indicator that corporations are taking advantage of global tax rate differences is direct foreign investment ("DFI") into a country.[51] DFI is the "value of all investments . . . in the home country made directly by residents—primarily companies—of other countries" during a given time period.[52] While DFI does not capture all of the economic benefits effectuated by a low corporate tax rate, it does help to explain why certain countries attract more foreign investment than others despite the lack of domestic resources to support such an investment.[53]

The Netherlands and Ireland, both of which are utilized by Google to make their tax avoidance scheme possible, are good examples.[54] They rank seventh and nineteenth, respectively, in the world for DFI[55] but have relatively low world rankings in population (Netherlands—60th; Ireland—119th),[56] members of the labor force (Netherlands—58th; Ireland—119th),[57] and GDP

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[50] *See* Drucker, *supra* note 5.

[51] *See* The CIA World Factbook, Country Comparison: Stock of Direct Foreign Investment—At Home, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2198rank.html (last visited Feb. 22, 2011).

[52] *Id.*

[53] *See id.*

[54] *See* Drucker, *supra* note 5.

[55] *See* The CIA World Factbook, Country Comparison: Stock of Direct Foreign Investment—At Home, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2198rank.html (last visited Feb. 22, 2011).

[56] *See* The CIA World Factbook, Country Comparison: Population, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2119rank.html (last visited Feb. 22, 2011).

[57] *See* The CIA World Factbook, Country Comparison: Labor Force, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2095rank.html (last visited Feb. 22, 2011).

growth rate (Netherlands—157th; Ireland—199th).[58] These rankings suggest that something other than an invaluable work force, such as more favorable tax situations, contributes to the high influx of foreign investment.

Two attorneys who agree with this hypothesis, Joseph B. Darby III and Kelsey Lemaster, found that Ireland has created an ideal situation for foreign investment, particularly for foreign technology companies like Google.[59] According to Darby and Lemaster, Ireland's ability to attract foreign investment stems from pressure from the European Union to remove discriminatory tax incentives and Ireland's subsequent decision to enact a uniform corporate tax in 1999.[60] As a result, Ireland imposes a meager 12.5% rate on taxable income of corporations, which is one of the lowest corporate tax rates in the world, especially among developed countries.[61] Ireland has also entered into several favorable tax treaties with other countries that have the effect of significantly limiting corporate income taxes on business transactions made between those countries.[62] When coupled with Ireland's well-educated, English-speaking

[58] *See* The CIA World Factbook, Country Comparison: GDP–Real Growth Rate, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2003rank.html (last visited Feb. 22, 2011).

[59] Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles Tax Savings: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation*, PRAC. U.S./INT'L TAX STRATEGIES, May 15, 2007, at 2, 11-16, *available at* http://gtlaw.com/portalresource/lookup/wosid/contentpilot-core-2301-5813/pdfCopy.name=/darby07g.pdf ("Ireland is attractive for low corporate tax rates and because it has yet to implement (or enforce aggressively) some of the more familiar "anti-abuse" mechanisms.").

[60] *See id.*

[61] *See id.*

[62] *See id.*

workforce "it is easy to see why Ireland has become a preferred foreign base of operations for U.S. software companies and other U.S. technology-driven enterprises."[63]

Ireland simultaneously refuses to enforce aggressively "anti-abuse" mechanisms related to transfer-pricing regulations.[64] Normally, countries with a high volume of economic activity will heavily regulate transfer-pricing transactions to prevent maneuvers, like the one employed by Google, where companies will shift taxable income to low-tax jurisdictions.[65] For example, the United States has adopted § 482 of the Internal Revenue Code:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[66]

This provision grants broad authority to the Treasury Secretary to "adjust" items that are reported by corporations seeking to game, or even abuse, the transfer-pricing regulations.[67] Without the ever-present threat that a corporation's income could be adjusted to reflect properly any abuses of income tax laws and regulations, Ireland attracts more international business at the expense of decreased tax revenues.[68] While the long-term effects of this decision still remain

[63] *See id.*

[64] *See id.*

[65] *See id.*

[66] I.R.C. § 482 (2011).

[67] *See id.*

[68] *See* Darby & Lemaster, *supra* note 58, at 12.

largely unclear, Ireland's recent seeking of bailout funds may, in part, be attributable to such shortsighted fiscal policies.[69]

D. BASIC INTERNATIONAL TAXATION CONCEPTS OF CORPORATIONS

The United States subscribes to a "residence-based" tax system whereby a corporation is subject to income tax if it is "created or organized in the United States or under the law of the United States or of any State," or "effectively connected with the conduct of a trade or business within the United States."[70] As such, U.S. corporations must pay federal income taxes on all sources of income whether earned domestically or worldwide.[71] This is true whether or not the taxes were paid in the foreign country based on the same receipt of income.[72] Accordingly, U.S.-

[69] *See* Joe Brennan & Stephanie Bodoni, *Ireland Seeks Bailout as 'Outsized' Problem Overwhelms Nation*, BLOOMBERG, Nov. 21, 2010, http://www.bloomberg.com/news/2010-11-21/lenihan-says-he-will-recommend-ireland-should-formally-ask-for-eu-bailout.html ("Ireland was one of the poorest countries in Europe when it joined the EU in 1973 along with Britain. Even with European subsidies, unemployment in the mid-1980s averaged 16 percent. In the 1990s, lured by a 12.5 percent corporate tax, companies such as Pfizer Inc. and Microsoft Corp. helped Ireland export its way into becoming the "Celtic Tiger." The jobless rate sank to 3.9 percent by 2001. In the decade through 2006, Ireland grew at an average annual rate of about 7 percent, the fastest among euro-area countries. That expansion, together with easy credit, fanned a real- estate bubble. Home prices almost quadrupled in the decade through 2007. It went disastrously wrong for Ireland following the 2008 demise of Lehman Brothers Holdings Inc., which turned the slowdown in the property market into an implosion that engulfed the economy. The ISEQ stock index has plunged 70 percent from its record in 2007.").

[70] Matthew J. Mauntel, *Stimulating the Stimulus: U.S. Controlled Subsidiaries and I.R.C. § 965*, 33 B.C. INT'L & COMP. L. REV. 107, 109 (2010) (citing I.R.C. § 11 (2011)) ("stating that all corporations are taxed on their income, but that is further limited to domestic corporations by I.R.C. § 882").

[71] Treas. Reg. § 1.1-1(b) (1974) ("[A]ll citizens . . . are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.").

[72] The Tax Code recognizes the existence of two types of corporations—domestic (one organized or created under the laws of the United States, or any of its states) and foreign (one which is not domestic). I.R.C. § 7701(a)(4)-(5) (2011). "The term 'domestic' when applied to a corporation or partnership means created or organized in the United States or under the law of the United

based corporations must recognize taxable income attributed to their foreign subsidiaries' business operations worldwide.[73] Company directors, therefore, often seek ways to alleviate the pressures of the "double taxation" by implementing strategic tax avoidance measures to satisfy corporate shareholders' interests.

One way that corporations avoid this double taxation, which has enjoyed longtime support since early Tax Court decisions, is "by transferring assets and/or business activities to a foreign corporation, such that neither the corporation nor the U.S. shareholder would be currently taxable in the U.S. on the corporation's income."[74] Corporations can set up and transfer assets to foreign subsidiaries, which are recognized as separate taxable entities and whose income does not automatically flow through the parent corporation.[75] In the event that the foreign subsidiary earns income from sources outside the United States and conjunctively does not conduct a U.S. trade or business, the foreign subsidiary is not subjected to taxation by the United States.[76] But any distributions by a subsidiary in the form of dividend payments[77] or payments for goods or

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States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations." *Id.* § 7701(a)(4). "The term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic." *Id.* § 7701(a)(5).

[73] *See id.* § 11(a) ("A tax is hereby imposed for each taxable year on the taxable income of *every* corporation."); *id.* § 882(a)(1) (defining as "taxable income" that income which is "effectively connected with the conduct of a trade or business within the United States.")

[74] *See* Darby & Lemaster, *supra* note 58, at 2.

[75] *See* PHILLIP F. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 5 (1980).

[76] *See id.* at 5-6.

[77] I.R.C. § 316(a) (2011) (the term "dividend" is defined as "any distribution made by a corporation to its shareholders—1) out of its earnings and profits accumulated after February 28, 1913, or 2) out of its earnings and profits of the taxable year . . . without regard to the amount of the earnings and profits at the time the distribution was made.").

services that are repatriated back into U.S. soil are taxable upon receipt by the corporation's shareholders.[78]

Due to the stringent nature of Tax Court decisions, corporate tax advisors must strategically plan around these provisions and study world corporate tax rates to incorporate federal tax avoidance measures like the "Double Irish" and "Dutch Sandwich." As shown, anyone who studies the Tax Code and applicable case law quickly realizes the ever-present struggle between both individuals and corporations and the IRS for payment and non-payment of taxes, which serves as a viable starting point for this paper's analysis of Google's tax avoidance mechanisms.

E. FOREIGN TAX HAVENS

Since the rise of the corporate fiduciary duty by directors to protect shareholder interests, corporations have sought ways to increase earnings and decrease operational costs—one such operational cost being taxes. Unfortunately for those companies incorporated within U.S. borders, complete avoidance of taxation is tricky because income tax calculations are based on U.S. citizenship.[79] Consequently, the U.S. corporation cannot completely avoid federal taxation without simultaneously relinquishing its U.S. citizenship.[80] Companies not willing to take such extreme action will instead take advantage of the Nineteenth Century principle that corporations,

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[78] *See* POSTLEWAITE, *supra* note 74, at 6.

[79] *Id.* at 11.

[80] *See id.* ("For most American businessmen, relinquishing U.S. citizenship is neither necessary nor desirable. The most commonly used method of establishing the tax haven company, therefore, is to incorporate in the tax haven country (or countries, if a tiered structure is desirable), thereby taking advantage of the principle that is observed world-wide—a corporation has the legal status of a separate legal person.")

under the U.S. Constitution, enjoy separate legal status from their employees.[81] When applied, the separate "legal person" principle entitles a foreign-based corporation "to the same privileges, as any citizen of that country."[82] Such privileges entitle the corporation to benefit from the tax laws governing that particular country, aside from any multi-national tax treaties senior to those laws.[83] Similar behaviors are observed in companies located solely within U.S. borders—for example, many companies elect to incorporate in the state of Delaware due to more favorable liability protections.[84] While incorporating in another state does not give the corporation more favorable federal income tax treatment, the basic principle remains the same: businesses will constantly seek avenues to lower costs and avoid risk exposure in the form of liabilities, taxes, or any other cost-inducing mechanism.[85]

The foreign tax haven can be recognized in basically any form of business genre found in the United States. Companies in one of the most popular industries—shipping (or aircraft) services—regularly establish tax haven companies by incorporating in low-tax jurisdictions. Due to the transient nature of their business and near-universal demand, shipping corporations, like DHL (originally founded in San Francisco, CA in 1969 and reincorporated in Germany in

[81] Santa Clara v. S. Pac. R. Co., 118 U.S. 394 (1886) ("One of the points made and discussed at length in the brief of counsel for defendants in error was that 'Corporations are persons within the meaning of the Fourteenth Amendment to the Constitution of the United States.'") (comments of court reporter in preamble to opinion).

[82] *See* POSTLEWAITE, *supra* note 74, at 11.

[83] *See id.* at 11-12.

[84] *See id.*

[85] *See id.* at 12.

2001), have either been bought out or established their headquarters overseas because of lower corporate tax rates.[86]

Google, a producer of mainly intangible computer and internet software, utilizes entities formally known as "patent holding companies" to create tax havens. Although primarily based out of California, Google creates licensing agreements with its international subsidiaries by allowing them to realize profits from the use of Google's software outside U.S. borders.[87] Because the local laws in which the subsidiary is located (in this case, the Netherlands) allows the subsidiary to deduct royalty payments from gross income calculations on distributions made to Google in accordance with the licensing agreement, the Dutch subsidiary avoids Dutch withholding taxes on dividends.[88] Therefore, Google and its Dutch subsidiary set the royalty rate at an optimum level to minimize Dutch tax exposure and maintain operations abroad.[89] Although Google's system is significantly more complicated, as the next section explains the underlying theme remains the same: Google (a publicly traded company since August 2004[90]) ultimately answers to its shareholders, whose stock appreciates in value when Google is able to report high profit margins.

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[86] DHL, Company Portrait, http://www.dhl.com/en/about_us/company_portrait.html (last visited June 27, 2011).

[87] *See generally* Erik Sherman, *How Google Hides its Profits from the Tax Man*, BNET**,** Oct. 21, 2010, http://www.bnet.com/blog/technology-business/how-google-hides-its-profits-from-the-tax-man/6296; *see also* Google, About Us, http://www.google.com/intl/en/contact/ (last visited June 27, 2011).

[88] *See* POSTLEWAITE, *supra* note 75, at 26-27.

[89] *See id.*

[90] Paul R. La Monica, *Google Sets $2.7 Billion IPO*, CNNMONEY, Apr. 30, 2004, http://money.cnn.com/2004/04/29/technology/google/ ("In the filing, Google said that it generated revenues of $961.9 million in 2003 and reported a net profit of $106.5 million. Sales rose 177 percent from a year ago although earnings increased by just 6 percent. Google also revealed that [it] has been profitable since 2001.").

F. APPLICABLE PROVISIONS TO MAKE THESE SCHEMES POSSIBLE

As corporate tax strategists continue to discover more complex ways to circumvent recognition of taxable income, Congress has attempted to counteract the transfer of assets by enacting "anti-deferral rules" and transfer-pricing rules to prevent or penalize the use of a foreign corporation to avoid taxes on sources of income.[91] Anti-deferral rules seek to curb a domestic corporation's ability to defer recognition of income attributed to a foreign subsidiary.[92] One such anti-deferral rule is codified in Section 951 of the Tax Code, which requires U.S. shareholders to currently recognize parts of their income from "controlled foreign corporations" ("CFC's").[93]

The Internal Revenue Code provides for the taxation of CFC's, which are controlled by U.S.-based parent companies.[94] A CFC is defined as:

> Any foreign corporation if more than fifty percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.[95]

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[91] *See* Darby & Lemaster, *supra* note 58, at 10.

[92] *See id.* at 11.

[93] I.R.C. § 951(a)(1) (2011) **("**(1) In general. If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends, (A) the sum of (i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year.").

[94] *See generally id.* §§ 951-964.

[95] *Id.* § 957(a).

Consequently, a U.S. shareholder must have ownership of the CFC's company stock to satisfy the "control" requirement for purposes of taxation.[96] The U.S. shareholder is then taxed at the applicable tax rate based on the receipt of income from the CFC.[97]

Because U.S. parent corporations generally qualify as "U.S. shareholders,"[98] if the parent corporation's ownership of the subsidiary's stock rises to the level of 50% or more, then their parent/subsidiary relationship meets the definition of a CFC and all income will be currently recognizable during the taxable year.[99] While this rule as codified can be used to give corporations generous tax breaks, Tax Court decisions have limited the availability of these breaks by strictly enforcing the requirements of § 957(a). For example, the Tax Court in *Framatome Connectors USA, Inc. v. C.I.R.*[100] held that a U.S. corporation failed the "control" requirement of § 957(a) where it did not own 50% or *more* of the "voting power" in stocks of the foreign subsidiary.[101] The Tax Court found it dispositive that the six veto powers and an 80% supermajority permitted the Japanese-based subsidiary to block important company decisions, and, as a result, the U.S. parent company did not exercise "control" over the requisite voting power for § 957(a) recognition.[102]

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[96] *See id.*

[97] *See id.* § 951(a).

[98] *See id.* § 951(b) ("[T]he term "United States shareholder" means, with respect to any foreign corporation, a United States person . . . who owns . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.").

[99] *See id.* § 957(a).

[100] *Framatome Connectors USA, Inc. v. C.I.R.*, 118 T.C. 32, 32 (2002).

[101] *Id.* at 60-61.

[102] *See id.* at 49.

Shareholders of CFC's are taxed according to the rules for "Subpart F" income.[103] Subpart F income includes: 1) income from the insurance of U.S. risks, 2) foreign base company income, and 3) amounts attributable to international boycott participation or to illegal bribes or kickbacks.[104] Most relevant to this article, "foreign base company income" includes: 1) foreign personal holding company income, 2) foreign base company sales income, 3) foreign base company services income, and 4) foreign base company oil related income.[105] To prevent corporations from abusing the recognition provisions of § 957(a), Congress, under § 952(a)(2), requires CFC's to report "foreign based income," defined by § 954(a) to mean, in part, "the foreign base company sales income for the taxable year."[106] Accordingly, if a CFC receives income earned abroad, it must report it to the parent company located in the United States, who subsequently must recognize the earnings as taxable income under the Tax Code.[107] For many software-based companies who sell and license software products to foreign-based CFCs, this catch-all income recognition provision generally prevents tax avoidance on the sale of software products to CFCs, because even though they are outside U.S. borders, when the CFCs turn around to sell the products, the U.S. corporation will have to recognize the income from these transactions.[108]

These rules fall short of capturing Google's strategy, which utilizes a transfer-pricing model that avoids § 954 recognition through an exception to the Tax Code on transfers of intangible

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[103] *See* I.R.C. § 952(a)(1)-(4) (2011).

[104] *See id.*

[105] *Id.* § 954(a).

[106] *Id.* § 954(a)(2).

[107] Darby & Lemaster, *supra* note 58, at 2, 11.

[108] *See id.* at 11.

property. As a service-based internet company that provides advertising and search engine products, Google takes advantage of the exemptions provided by the Tax Code for "foreign base company sales income" from its advertising programs.[109] Generally, when a U.S. corporation transfers a product to one of its foreign-based subsidiaries, § 367(d)(2)(A)(i) necessarily deems the property to be sold "in exchange for payments which are contingent upon the productivity, use, or disposition of such property."[110] Sections 954(a)(2) and 954(b)(5) generally mandate distributions to domestic shareholders made by CFCs to be taxable events if the following four requirements are met:

1) the purchase or sale must be to or from a related party
2) the transaction must involve personal property
3) the purchase or sale must be for use or destination outside the base company jurisdiction
4) the personal property must not have been manufactured, produced or constructed by the foreign base company.[111]

The term "related parties" is defined to include all entities and individuals that own more than 50% of the CFC's stock.[112]

Conversely, and as is the case with Google, the foreign base provision is inapplicable if the personal property is "manufactured, produced, or constructed by the CFC."[113] The Treasury

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[109] I.R.C. § 954(d)(1).

[110] I.R.C. § 367(d)(2)(A)(i).

[111] POSTLEWAITE, *supra* note 74, at 249-50; *see also* I.R.C. § 954(a)(2), (b)(5), (d)(1)(A-B).

[112] POSTLEWAITE, *supra* note 74, at 250; *see also* I.R.C. § 954(d)(3). The term "related parties" also includes corporations controlled by the CFC or by the same persons who control the CFC. POSTLEWAITE, *supra* note 74, at 250.

[113] POSTLEWAITE, *supra* note 74, at 250.

Regulations provide that this exemption is only applicable if the CFC manufactures the property in its totality or conducts a "substantial transformation of the property."[114] The Tax Court historically takes a relaxed approach when addressing the issue of "substantial transformation," making the determination on a case-by-case analysis by looking at the totality of the surrounding facts and circumstances.[115] On the other hand, if the property purchased by the CFC is not "substantially transformed," but instead is utilized as a component part in the end-product (i.e. computer hard drives purchased for the manufacture of assembled computers), then the income generated from the sale becomes taxable income under the Code.[116] The court in *Dave Fischbein* sided with a U.S. corporate taxpayer in its holding because the operations of its subsidiary established in Belgium were "substantial [enough] in nature . . . to constitute the manufacture of [the] product."[117] Even though the U.S.-based corporate stock holder was fully capable of developing the end product, the court found it dispositive that the lower labor and overhead costs, tariff and quantity restrictions, and the subsidiary's purchase of some of the machine's components from unrelated local entities were sufficient to warrant the exclusion of the income generated from the reach of U.S. taxation.[118]

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[114] *Id.*; *see also* Treas. Reg. § 1.954-3(a)(4)(ii) (2009) and examples thereunder.

[115] *See* Dave Fischbein Mfg. Co. v. Comm'r., 59 T.C. 338, 352, 360 (1972) (income from individual parts of portable bag-closing machines was not includable as Subpart F income because the parts "were not perfect, that many of them had to be individually tailored and tested in order to have a completed, functioning sewing machine, that the mechanics were trained and experienced and used skill and judgment in performing their tasks, and that they were not performing purely ministerial functions.").

[116] *See* Treas. Reg. § 1.954-3(a)(4)(ii) ("If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation.").

[117] *Dave Fischbein*, 59 T.C. at 357.

[118] *See id.*

Ordinarily, software companies that develop their product solely within U.S. borders subsequently must recognize the income attributed to these transfers as taxable income because of their "sale" recognition.[119] But § 367(d) recognition does *not* apply to cross-border transfers of intangible property if the intangible property is developed by the CFC outside of the United States.[120] Moreover, if the software is a product of joint development through a "cost-sharing" arrangement, whereby the rights to utilize the intangible property in the United States are retained by the U.S. company (i.e. Google), and the rights to utilize the property outside the United States are vested in the CFC, then the non-U.S. rights are treated as being created in the jurisdictional location of the CFC.[121] It is under these circumstances that software companies, like Google, can avoid § 945 and § 367 recognition through the cost-sharing arrangement of transfer-pricing.

[119] I.R.C. § 367(d)(2)(A) (2011) ("[T]he United States person transferring such property shall be treated as-- (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and (ii) receiving amounts which reasonably reflect the amounts which would have been received--(I) annually in the form of such payments over the useful life of such property, or (II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.").

[120] I.R.C. § 367(d)(1) (2011).

[121] *See* Darby & Lemaster, *supra* note 58, at 11; *see generally* Treas. Reg. § 1.482-7A (2009).

III. Discussion

A. THE ISSUE OF TRANSFER PRICING

Due to the rise in communications and increased economic globalization, the world has witnessed a relatively new phenomenon—the "Multinational Enterprise" ("MNE").[122] Because MNEs do not have to adhere to one single, internationally recognized tax code, the use of MNEs creates increasingly complex taxation issues for tax administrations around the world.[123] Consequently, various tax administrations use transfer-pricing guidelines as a means to govern MNE activity as they, like most consumers, search for ways to re-capture those profits otherwise lost to taxation.

Transfer-pricing is the practice of making payments from one business entity to another affiliated business entity for the receipt of goods or services.[124] MNEs may elect to utilize transfer-pricing for marketing or policy reasons, or to avoid the higher taxation rates imposed upon market-based transactions, as in Google's case.[125] Because commercial transactions between two related business entities are not subject to the same market forces as those pertaining to non-related entities, members of the Organization for Economic Co-Operation and Development ("OECD") have agreed to abide by a principle known as the "Arms-Length

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[122] Organisation for Economic Co-Operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at P-1, ¶ 1 (1995) ("The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in broad international context.").

[123] *See id.* at P-1, ¶ 2.

[124] OECD Centre for Tax Policy and Administration, About Transfer Pricing, http://www.oecd.org/about/0,3347,en_2649_33753_1_1_1_1_1,00.html (last visited June 26, 2011).

[125] *See id.*

Principle" to ensure that the tax base of MNEs is divided fairly.[126] Article Nine of the OECD Model Tax Convention explains:

> [When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[127]

Abiding by this principle treats transactions between related companies as though they were non-related, "arms-length" dealings, thereby theoretically subjecting them to equivalent tax treatment.[128] The OECD member countries believe that adoption of this creates broad parity of tax treatment between MNEs and independent enterprises.[129] Accordingly, the principle seeks to eliminate any tax advantages or disadvantages that would create distortions of relative competitive advantages associated with related or non-related status.[130]

As mentioned above, national tax laws like § 482 of the U.S. Tax Code allow tax administrations to enforce the "Arm's Length Principle" by "apportion[ing] or allocat[ing] gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if [they] determine[ ] that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations,

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[126] *See id.*

[127] *See* OECD, *supra* note 121, at I-3, ¶ 1.6.

[128] *See id.*

[129] *See id.* at ¶ 1.7.

[130] *See id.*

trades, or businesses."[131] Nevertheless, because the tax laws and regulations have failed to adapt to the changing times, Google has found several tax loopholes between various OECD member countries to allow it to reduce their effective tax rate to a meager 2.4%.[132]

B. EXPLANATION OF THE "DOUBLE IRISH" AND "DUTCH SANDWICH"

Utilizing a complex scheme of transfer-pricing agreements, conflicting tax codes, and bi-lateral tax agreements, Google has amazed many on-lookers that its system remains legally viable. The company accomplishes this feat through the creation of two subsidiaries in Ireland, one subsidiary in the Netherlands, and one subsidiary in Bermuda.[133] In 2003, Google, a United States corporation, initiated the process when it negotiated and received approval from the IRS for its confidential transfer pricing arrangement with a newly established subsidiary, Google Ireland Holdings (Ire. sub. 1) ("GIH").[134] In accordance with the principles of transfer-pricing mentioned above, Google, as a software developer, could set up the joint development transfer-pricing arrangement with its GIH subsidiary so that Google retained the domestic rights for use of the software and GIH obtained the international rights for use of their software through an amortized buy-in agreement.[135] As such, GIH controlled access to Google's famously popular search engine software, advertising banners, and the Android platform.[136]

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[131] I.R.C. § 482 (2010).

[132] *See* Drucker, *supra* note 5.

[133] *See id.*

[134] *See id.*

[135] *See* Treas. Reg. § 1.482-7A(a) (2009) ("A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.").

[136] Sherman, *supra* note 86.

By allocating all of their international revenues to Ireland, Google could continue to research and develop products in the United States while simultaneously earning profits abroad and avoiding high U.S. corporate taxation rates.[137] GIH next established its operational "anchor" off the U.S. coast in the British overseas territory of Bermuda.[138] This Bermudian subsidiary claims to be the "effective centre of management" for GIH, thereby exempting GIH from Irish taxation.[139] Furthermore, by filing a "check-the-box election," the Bermudian subsidiary, as a "foreign eligible entity,"[140] can elect to be classified as an entity that is disregarded as separate from its parent-company, Google, for U.S. tax purposes.[141] As a result, any exchange of "royalty" payments between GIH and its Bermudian tax haven transfers tax-free from any tax administration because the U.S. or Irish taxation laws do not recognize the Bermuda subsidiary as a taxable entity for purposes of their tax codes.[142]

Returning to the Irish mainland, GIH, as a licensee of Google's software, allows one of its wholly-owned subsidiaries, Google Ireland Limited ("GIL") to utilize Google's software to perform its global marketing operations and receive all international advertising profits.[143] This tax maneuver earns the nickname "Double Irish" for its employment of two Irish-based

[137] *See* Drucker, *supra* note 5.

[138] *See id.*

[139] *See id.*

[140] Treas. Reg. § 301.7701-3(b)(2) (2006) (A "foreign eligible entity" is any foreign entity that (i) engages in a threshold quantum of business activity such that is not properly classified as a trust and (ii) is not explicitly listed in the regulations as a "per se" corporation.); *see also* Treas. Reg. § 301.7701-3(a), -2(a), -2(b)(8) (2006) for listing of "per se" corporations.

[141] *See* Darby & Lemaster, *supra* note 58, at 12.

[142] *See* Sherman, *supra* note 86.

[143] *See* Drucker, *supra* note 5.

subsidiaries for its international operations.[144] In turn, GIL receives all foreign-based income[145] that, subsequently, is subjected to the favorable 12.5% corporate tax rate in Ireland as a beneficiary of the cost-sharing agreement.[146] In 2009, GIL was credited by Google with 88% of its $12.5 billion in non-U.S. sales.[147]

Conversely, Irish tax law allows GIL to write off its royalty payments for use of GIH's software rights as trade expenses that, in 2008, permitted GIL to deduct $5.4 billion in royalties, and left GIL paying at a nominal 1% effective tax rate.[148] If GIL immediately tried to return these profits back to GIH, the transfer would create taxable income under Irish law.[149] Instead, GIL and GIH set these royalty payments at an optimal level so that GIL can reduce its taxable income to a nominal amount to be taxed at the Irish 12.5% corporate rate.[150] Therefore, to evade Irish withholding taxes, payments from GIL must take a brief detour in the Netherlands—a maneuver characterized as the "Dutch Sandwich"—before finding their way back to GIH.[151]

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[144] *See id.*

[145] *See* I.R.C. § 954(a)(2) (2011) ("The term 'foreign base company income' means . . . (2) the foreign base company sales income for the taxable year.").

[146] *See* Treas. Reg. § 1.482-7A (2011)("A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement."); *see also* Darby & Lemaster, *supra* note 58, at 12.

[147] Drucker, *supra* note 5.

[148] Sherman, *supra* note 86.

[149] *See id.*

[150] Darby & Lemaster, *supra* note 58, at 14.

[151] Drucker, *supra* note 5.

By exploiting a low rate of corporate taxation and generous European Union ("EU") agreements, GIL is able to make "royalty" payments to another EU member, the Netherlands.[152] Per the "Taxation of Cross-Border Interest and Royalty Payments" agreement by the EU member states in June 2003, corporations in one member state are allowed to make interest and royalty payments to subsidiaries located in other member states, provided that the beneficial owner of the payment is a company or permanent establishment in another member state.[153] GIL, therefore, pays royalties to an employee-less shell corporation in the Netherlands, Google Netherlands Holdings BV (Dut. sub.) ("GNH"), with the sole purpose of receiving these payments from GIL, and immediately redirecting them to the Bermuda holding company.[154] All of the income received by the Bermudian subsidiary, in turn, enjoys the luxury of sandy beaches and Bermuda's non-existent corporate taxation rates.[155] The reported income remains on the island until Google decides to repatriate the income through dividend payments, whereby the payment will be subjected to the applicable U.S. dividend rate of taxation.[156] Assuming Google has no plans to repatriate these revenues back into the country any time soon, Google shareholders continue to benefit from skewed annual reportings, while the U.S. government, to date, reports losses upwards of $60 billion.[157]

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[152] *Id.*

[153] European Commission Taxation and Customs Union, Taxation of Cross-Border Interest and Royalty Payments in the European Union, http://ec.europa.eu/taxation_customs/taxation/company_tax/interests_royalties/index_en.htm (last visited June 26, 2011) ("These interest and royalty payments shall be exempt from any taxes in that State provided that the beneficial owner of the payment is a company or permanent establishment in another Member State.").

[154] *See* Sherman, *supra* note 86.

[155] *See* KPMG, *supra* note 16, at 12.

[156] *See* Darby & Lemaster, *supra* note 58, at 13.

[157] *See* Drucker, *supra* note 5.

While policymakers search for ways to close these gaps that cost the U.S. Treasury millions of dollars each year, Google has benefited greatly from employing this scheme. In 2001, Google reported revenues of nearly $86.5 million, of which only 18% were attributable to international revenues.[158] By 2004, the year of Google's Initial Public Offering, revenues had nearly quadrupled from 2001 reportings to $3.2 billion, and international revenues accounted for 34% of Google's revenues.[159] Six years later, Google's financial statements have been off the charts as the effects of increased market globalization and internet usage have made Google one of the highest revenue-grossing corporations in the world. To date, Google reports 2010 unaudited gross revenues totaling more than $29.3 billion, of which 52% are attributable to international revenues.[160] Even though much of these revenues do not translate into taxable income to the U.S. government, profits lost to foreign taxable entities cost taxpayers millions in lost revenue. While the U.S. government tries to close a national debt in excess of $1.4 trillion, Google and other U.S.-based companies implementing the "Double Irish" and "Dutch Sandwich" tax avoidance arrangements have their proverbial cake and eat it too by reaping the benefits of the U.S. economy and more favorable tax laws abroad.[161]

[158] Google, 2003 Financial Tables–Investor Relations, http://investor.google.com/financial/2003/tables.html (last visited June 26, 2011).

[159] Google, 2004 Financial Tables–Investor Relations, http://investor.google.com/financial/2004/tables.html (last visited June 26, 2011).

[160] Google, 2010 Financial Tables–Investor Relations, http://investor.google.com/financial/2010/tables.html (last visited June 26, 2011).

[161] *See generally* Drucker, *supra* note 5.

IV. Possible Solutions to the Problem

A. APPLICATION OF I.R.C. § 965

In 2005, the IRS reported nearly $804 billion in earnings and profits earned abroad by controlled foreign companies of U.S. corporations.[162] Conversely, only $362 billion of those earnings were subsequently repatriated back into the U.S. economy and taxed at the U.S. corporate income tax rate.[163] That same year, Congress, as part of the American Jobs Creation Act of 2004, enacted § 965 of the Tax Code in an attempt to offer companies a one-time opportunity to repatriate profits earned abroad at greatly reduced tax consequences to the company.[164] The reasoning behind § 965's enactment was the belief that the repatriation of profits would stimulate the economy and create jobs for American workers in the process.[165] Instead, commentators observed the following:

> Economists concluded that the repatriation holiday produced a windfall gain for companies with large amounts of accumulated earnings in low-tax countries. They found that companies used the funds principally for share repurchases. And they found that companies that benefited from the holiday were no more likely to spend on growing their businesses than companies that did not benefit.[166]

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[162] Lee A. Sheppard & Martin A. Sullivan, *Repatriation Aid for the Financial Crisis?*, 53 TAX NOTES INT'L 275, 276 (2009).

[163] *Id.*

[164] Celina Rogers, Risk and Section 965 Repatriation, CFO.com, Oct. 20, 2005, http://www.cfo.com/article.cfm/4486225/c_5541231/?f=archives.

[165] I.R.C. § 965 (2004); H.R. Rep. No. 108-548(l) (2004) ("The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings. The Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad. The Committee emphasizes that this is a temporary economic stimulus measure.").

[166] *See* Shephard & Sullivan, *supra* note 161, at 276-77.

While the U.S. economy never fully realized the potential benefits of § 965 as a means to recapture those foreign profits avoiding high U.S. corporate tax rates, § 965 serves as a reminder that the process may not be an easy one, considering corporations willingness to dole out large sums of cash to protect their bottom line.[167]

In its current form, § 965 allows MNEs from the United States to benefit from an 85% tax break from income earned by foreign subsidiaries given that the payments were repatriated through cash dividends to their U.S. parent company within a one year time frame.[168] Section 965(b)(4) requires the dividend payments to adhere to the Domestic Reinvestment Plan ("DRIP") requirements, in that they: a) be approved by the taxpayer's president, or chief executive officer (or equivalent) along with subsequent approval by the taxpayer's board of directors (or its equivalent), and b) be provided for reinvestment in the U.S. economy as a source of "worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation."[169]

Not surprisingly, many corporations who took advantage of the tax holiday seemingly ignored the federally-mandated requirements,[170] as the U.S. Treasury reported only $16.5 billion in revenues from its enactment.[171] Some companies even cut jobs domestically after repatriating billions in cash dividends.[172] Section 965 had a second side effect because it incentivized companies to ship intangible assets abroad in hopes that Congress would either extend the

[167] Mauntel, *supra* note 69, at 128.

[168] *Id.*

[169] *See* I.R.C. § 965(b)(4) (2011).

[170] *See* Shephard & Sullivan, *supra* note 161, at 278-79.

[171] *See* Mauntel, *supra* note 69**,** at 113.

[172] *See id.* at 120-21.

applicable period or reintroduce the bill at a subsequent date.[173] Despite lobbying efforts by companies like Oracle Corp., Eli Lilly & Co., and Hewlett-Packard Co. to have Congress grant such relief, Congress has repeatedly declined to re-enact § 965, likely due to the previous abuses and marginal returns of its existence.[174]

One method to accomplish essentially the same goals as those provided by § 965 would be to completely eliminate the DRIP requirements before reenacting a Tax Holiday program like the one provided by § 965. However, taking into account the potential for abuse of another tax holiday and the fact that billions of dollars in corporate profits remain stationed abroad until a time when it becomes profitable to repatriate them back into the United States, it is still a question how the U.S. government, likely with the help of other foreign governments, can close this gaping hole in the Tax Code while avoiding the dire consequence of forcing U.S. corporations to move their headquarters abroad. Moreover, how much does the U.S. government care that these sorts of tax havens continue to exist in the face of historically high federal deficits? Recent political history would suggest not much.

B. IMPLEMENTING A NEW SYSTEM OF FOREIGN TAXATION

A simpler solution, considering its ranking among other developed nations, would be to follow in the footsteps of Japanese lawmakers and lower the tax rate for all U.S. corporations to a level on par with, or lower than, other developed nations. Currently, the U.S. marginal corporate tax rate ranks at the top of industrialized nations.[175] Yet the current state of affairs of its tax system

[173] *See id.* at 126.

[174] Ryan J. Donmoyer, *Lilly, Oracle Lose Senate Bid for Overseas-Profits Tax Discount*, BLOOMBERG, Feb. 4, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anUvSkYMAtT8&refer=us.

[175] *See* KPMG, *supra* note 16, at 12.

advocates continual defectors and circumventors who aimlessly sink profits into tax avoidance schemes to gain a larger piece of the consumer-driven economy of the United States. Alternatively, providing incentives in the form of tax breaks or lower rates for U.S. corporations who, in fact, derive profits from CFCs could recapture lost tax revenues while mitigating the unwarranted externality of shipping corporate business abroad. U.S. resistance to such a system has seemingly backfired on the Treasury and IRS, as they both waste millions of taxpayer dollars per year in oversight and monitoring of the tax schemes, only to arrive at the all-too-obvious conclusion that U.S. corporations are setting up these schemes and the government has no real way of stopping it.[176]

Notably, Matthew J. Mauntel offered similar advice in his article *Stimulating the Stimulus: U.S. Controlled Subsidiaries and I.R.C. 965*, where he suggested that the United States look to the recent overhauls in the Canadian approach to CFCs.[177] Currently, Canadian tax regulations provide tax exemptions for foreign-based income derived from certain countries privy to tax-information-sharing agreements with the Canadian government.[178] This system exempts almost 90% of foreign-based corporate income produced by Canadian subsidiaries.[179] Due to the similarities between the U.S. and Canadian tax systems and the free trade agreement between the countries,[180] it would significantly benefit the United States to follow in Canada's footsteps before it loses business in a similar fashion to its neighbors to the north.

[176] *See* Drucker, *supra* note 5.

[177] *See* Mauntel, *supra* note 69**,** at 127.

[178] *See id.*; *see also* U.S.-Canada Tax Treaty art. XXIV, § 2(b), Sept. 26, 1980, 1986-2 C.B. 258.

[179] *See* Mauntel, *supra* note 69**,** at 127.

[180] *See generally* North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289.

To date, the United States has tax treaties established with sixty-seven countries around the world.[181] This list includes countries relevant to the "Double Irish" and "Dutch Sandwich" maneuvers, like Ireland and the Netherlands.[182] Similarly (and unlikely by coincidence, given Google's contemporaneous undertakings), in 2003, the United States and the Bahamas entered into an information-sharing agreement that took effect on Jan. 1, 2004.[183] These types of treaties and agreements are intended to increase the transparency of international tax mechanisms and, in some cases, tax individuals and entities at reduced rates on certain items of income they receive.[184]

Yet by allowing for an exemption for most, if not all, of foreign-earned corporate income, whether from countries sharing treaties or information agreements or on the whole, internationally-based corporations would likely find it economically advantageous to repatriate profits stationed abroad or move businesses into the United States. Moreover, the United States may find the economic stimulus package it has so desperately sought over the past decade, notwithstanding the repeated failures of raising and lowering of the prime rate and ineffective domestic tax credits. As Mauntel is quick to point out, "the United States and Canada are two of the last industrialized countries to attempt world-wide taxation and Canada is prudently in the process of abandoning it after finding it uncompetitive and unwieldy."[185]

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[181] IRS, United States Income Tax Treaties–A to Z, http://www.irs.gov/businesses/international/article/0,,id=96739,00.html (last visited Feb. 28, 2011).

[182] *See id.*

[183] Amanda Banks, *Bahamas Commits to Information Sharing Agreement with United States*, TAX-NEWS.COM, Dec. 18, 2003, http://www.tax-news.com/news/Bahamas_Commits_To_Information_Sharing_Agreement_With_United_States____14475.html.

[184] IRS, Tax Treaty Overview, http://www.irs.gov/businesses/small/international/article/0,,id=96434,00.html (last visited Feb. 28, 2011).

[185] *See* Mauntel, *supra* note 69**,** at 127.

For example, § 954(b)(3)(A) currently provides an exclusion of foreign-based income if the sum of the foreign base company income constitutes less than 5% of the gross income of the entire corporation.[186] The Code further requires that the U.S. parent company report all income from the CFC if the sum of the foreign base company income exceeds 70% of the U.S. corporation's gross income for the taxable year.[187] Corporations often attempt to undermine these threshold requirements with careful tax planning so that they can exclude these foreign profits. As previously mentioned, Google's reported revenues totaled $29.3 billion in 2010, of which 52% are attributable to international revenues.[188] Under current application, the "de minimus" provision encourages cross-border corporations to elude § 954(b)'s reach by establishing a scheme whereby foreign profits are apportioned among thousands of smaller shell corporations so that each individual entity never surfaces above the 5% threshold. Instead of utilizing significant taxpayer dollars to police this possibility, why not raise the "de minimus" provision to a "majority" threshold? In other words, a corporation could exclude amounts less than 50% of the parent-corporation's gross income, and remove the application of § 954(b)(3)(B), which forces the taxpayer to recognize all foreign profits above the 70% threshold. While, admittedly, any definitive threshold amount would still present opportunities to avoid U.S. taxation, a 50% threshold would serve a two-fold purpose: 1) it would properly reflect that

[186] I.R.C. § 954(b)(3)(A) (2011) ("If the sum of foreign base company income (determined without regard to paragraph (5)) and the gross insurance income for the taxable year is less than the lesser of--(i) 5 percent of gross income, or (ii) $1,000,000, no part of the gross income for the taxable year shall be treated as foreign base company income or insurance income.").

[187] I.R.C. § 954(b)(3)(B) ("If the sum of the foreign base company income . . . and the gross insurance income for the taxable year exceeds 70 percent of gross income, the entire gross income for the taxable year shall . . . be treated as foreign base company income or insurance income (whichever is appropriate).").

[188] Google's 2010 Financial Tables, *supra* note 159.

percentage of a corporation subject to foreign taxation laws in their proportionate share of total gross income, and 2) it would increase the tax base of cross-border corporations by allowing for a larger exclusion and encouraging more corporations to incorporate within the United States.[189]

Under the current tax regime, the Code allows for the shareholder to exclude those portions of his earnings and profits from his or her taxable income whenever a CFC makes a distribution to the parent company.[190] This system is designed to prevent any ill-effects of "double taxation" that may occur as a result of the distribution.[191] However, the situation where a U.S. shareholder who owns stock in a foreign-operated corporation that earns income from non-U.S. sources and concurrently must comply with non-U.S. standards is subjected to U.S. taxation seems to completely contravene a system that constantly preaches "substance over form."[192] Furthermore, this system simultaneously relieves a corporate shareholder of the adverse effects of "triple-taxation", in which the foreign-based earnings of the corporation are subjected to taxation by the foreign jurisdiction and to "double-taxation" at the U.S. corporate and shareholder levels.[193]

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[189] I.R.C. § 954(b)(3)(B) ("If the sum of the foreign base company income. . .and the gross insurance income for the taxable year exceeds 70 percent of gross income, the entire gross income for the taxable year shall. . .be treated as foreign base company income or insurance income (whichever is appropriate).").

[190] *See* I.R.C. § 959(b) ("For purposes of section 951(a), the earnings and profits of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a), shall not, when distributed through a chain of ownership described under section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder (or to any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder in the controlled foreign corporation).").

[191] *See id.*

[192] *Contra* I.R.C. § 482.

[193] *See* I.R.C. § 954(a).

Although there are no current plans by either the House of Representatives or the Senate to amend the legislation surrounding foreign-based income to ameliorate the effects of Subpart F income recognition, there have been several attempts by various Members of Congress to do so.[194] While it remains to be seen what the future holds for foreign-based income, one can certainly expect that corporations like Google will continue to find various methods to circumvent the harsh inequities derived from U.S. taxation on income clearly attributable to transactions where neither party resides within U.S. borders.

V. Conclusion

The United States and other international taxation bodies will certainly face unfavorable outcomes if they continue to expand the reach of their taxation laws to transactions in which none of the parties directly avail themselves of their domestic protections. While those jurisdictions claim they have a right to apply their taxation laws to such events, they simultaneously risk deterring any future direct foreign investment and alienation of their own domestically-created businesses. As previously mentioned, such ill-effects are already being felt by the United States as corporations like Google continue to establish and operate subsidiaries outside U.S. soil to avoid U.S. taxation. One can reasonably assume that these practices will continue to be implemented. Furthermore, as the United States tries to close the historically high national deficit, it appears to be economic suicide to continue to dissuade businesses from

[194] *See* H.R. 5328, 111th Cong. (2010) ("Repeal of Look-Thru Rule for Royalties Received From Controlled Foreign Corporations. Paragraph (6) of section 954(c) of the Internal Revenue Code of 1986 is amended-(1) by striking 'rents, and royalties' in subparagraph (A) and inserting 'and rents', and (2) by striking ', rent, or royalty' both places it appears in subparagraph (B) and inserting 'or rent'."); *see also* S. 45, 112th Cong. (2011).

operating on a global level for fear that their earnings and profits will be further decreased by Uncle Sam's greed.

Instead the United States and similar taxation bodies should shift their economic focus to encouraging investors to expand business operations. As one commentator put it, "[i]t is better for the United States to abandon taxation on foreign subsidiaries than to continue the farce of stated taxation that does not actually occur."[195] By allowing these companies to repatriate the foreign-earned profits back into the United States without fear of high taxation rates, the economy would reap the benefits, as shareholders would reintroduce these monies back into the U.S. economy and the Treasury would be able to tax accordingly. As Congress aimlessly continues its search for a more effective substitute for the previously enacted § 965,[196] more domestically-owned corporations will be drawn to implement measures to increase profit-margins for the benefit of their shareholders. Ironically, the greedy taxing powers of the United States should heed the words of Google's corporate slogan—"Don't be evil."

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[195] *See* Mauntel, *supra* note 69**,** at 127.

[196] *See id.* ("Section 965 was helpful as a herald for change in the taxation of international controlled corporations, but that call was ignored in 2004. Now with the economic crisis in full force, the United States Congress has a duty to reevaluate the international corporate taxation system, beginning with a reintroduction of section 965. The financial gains from repatriations will then fuel a more complete overhaul of the system, closing loopholes which allow transfer of assets abroad and eliminating taxes that other developed nations have abandoned. These steps will ensure a more effective taxation system and more robust competition by U.S.-based multinationals.").