

CLOSING CASE

Eager to benefit from the economic growth and the job creation that foreign direct investments generate, many nations have adjusted their tax codes to entice multinational enterprises to establish new factories and regional offices within their borders. The ensuing “tax wars” between countries have led to wide variations in the tax laws of countries, which have allowed multinational enterprises to slash their tax burdens through the aggressive use of transfer pricing and the establishment of shell corporations in low-tax jurisdictions.

The passage of the Tax Cuts and Jobs Act of 2017 by the U.S. Congress reflects the American government’s response in the tax war. When the previous comprehensive overhaul of the U.S. tax code—the Tax Reform Act of 1986—was passed, the United States statutory corporate income tax was the lowest of the OECD nations, at 35 percent. Fast forward to 2017: that same U.S. corporate income tax rate was now the highest. In the interim, countries like Japan had cut their statutory rate from 42 percent to 31 percent; the United Kingdom, from 35 percent to 19 percent; and Ireland, from 50 percent to 12.5 percent. This disparity in statutory corporate income tax rates led to a variety of tax-driven corporate decisions harmful to the U.S. economy. Some American firms engaged in a practice known as tax inversion, whereby they merged with or acquired a foreign firm and then, through a series of paper transactions, legally became a subsidiary of a new foreign corporation in which they retained dominant control. For example, in 2016 Milwaukee-based Johnson Controls merged with Tyco, an Irish-based firm. Johnson Controls became a subsidiary of a new Irish company, Johnson Controls International (JCI), whose legal headquarters is in Cork, Ireland, but whose operational headquarters remain in Milwaukee. The benefit: JCI’s profits will be taxed at Ireland’s 12.5 percent rate rather than the then existing 35 percent U.S. rate. Several dozen major U.S. corporations transferred legal ownership, but not operating control, to foreign jurisdictions in the 2010s.

Most countries utilize a territorial tax system, in which the country taxes the income of its corporations only on the income earned within the home country. Prior to the passage of the Tax Cuts and Jobs Act in 2017, the United States was the only OECD country that taxed the earnings of its companies regardless of where the profits were earned. This put U.S. firms at a distinct disadvantage relative to their foreign competitors. To lessen this problem, the U.S. tax code utilized the deferral rule. Under this provision, a U.S. parent corporation did not need to include the earnings of its foreign subsidiaries in calculating its taxable income, as long

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as those earnings were reinvested in the foreign subsidiaries. The **deferral rule** in the U.S. tax code stated such earnings would be taxed only when they are remitted to the parent in the form of dividends, thus allowing the parent to defer paying U.S. taxes on foreign subsidiaries’ reinvested earnings.

The deferral rule was intended to stimulate international business activity by U.S. firms. However, one important exception to the deferral rule tried to prevent U.S. firms from establishing shell corporations in tax havens that did little but provide the parent with the ability to defer U.S. taxes. U.S. tax law requires a parent corporation to determine whether each of its foreign subsidiaries is a controlled foreign corporation. A **controlled foreign corporation (CFC)** is a foreign corporation in which U.S. shareholders—each of which holds at least 10 percent of the firm’s shares—together own a majority of its stock.

According to the U.S. tax code, the income of CFCs is divided into two types: active income and passive income (also called Subpart F income). Active income is income generated by traditional business operations such as production, marketing, and distribution. Subpart F income, or passive income, is generated by passive activities such as the collection of dividends, interest, royalties, and licensing fees—the type of activities typically performed by subsidiaries incorporated in tax havens. U.S. firms may defer active income earned by CFCs they control. In calculating their U.S. taxes, however, they generally may not defer Subpart F income. In the absence of this restriction U.S. firms could escape federal corporate income taxes on earnings generated by their intellectual property and investment portfolios. The firms could do this by establishing subsidiaries in tax havens and transferring to those subsidiaries legal title to the firms’ trademarks, patents, brand names, and investment portfolios. The U.S. government, by treating active and passive earnings of foreign subsidiaries differently, was trying to walk a fine line between stimulating U.S. firms’ international business activities and limiting the firms’ ability to avoid U.S. taxes through the creation of subsidiaries in tax havens.

However, these efforts were thwarted by the imagination of tax lawyers and tax accountants who exploited other provisions of the tax code and by the efforts of other countries to attract multinational enterprises (MNEs) to their lands. Ireland, for example, has aggressively used its corporate tax code to promote economic development, attracting over 1,000 MNEs to locate their European headquarters in Ireland, drawn in large part by the country’s low taxes and pro-business policies.

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Google is one company that has benefitted from Ireland's pro-business tax code. It took advantage of two strategies created by international tax lawyers, dubbed the "Double Irish" and the "Dutch Sandwich," which allowed it to shield \$19 billion from taxation in 2016 alone. In 2006, Google entered into an advance pricing agreement with the U.S. Internal Revenue Service, establishing the terms under which it could transfer its intellectual property to its foreign subsidiaries. After signing the agreement with the U.S. tax authorities, Google licensed its intellectual property to Google Ireland Holdings, a wholly owned subsidiary. While established in Ireland, Google Ireland Holdings is managed in Bermuda, making it a nonresident corporation that is not subject to Irish taxation under Irish law. Google Ireland Holdings, however, is the owner of an Irish resident corporation, Dublin-based Google Ireland Limited—hence, the term "Double Irish." Google Ireland Limited's 2,000 employees sell advertising and provide support services to customers in Europe, the Middle East, and Africa, and account for about 88 percent of Google's non-U.S. revenues.

Even though its California engineers and scientists developed most of Google's technology, this arrangement allows Google to avoid immediate U.S. taxation of its non-U.S. profits. That takes care of the U.S. Internal Revenue Service. To avoid Ireland's Revenue Commissioners, Google Ireland Limited then transmits what would appear to be its profits from selling this advertising to another Google subsidiary, Google Netherlands Holdings (the "Dutch sandwich"), in the form of royalty payments, thereby slashing Google Ireland Limited's Irish tax bill. (Payments are made to Google Netherlands Holdings because of favorable provisions in the Irish tax code dealing with royalty payments to companies based in other EU countries.) Google Netherlands Holdings, which has no employees, then remits 99.8 percent of the royalty payments it receives to Google Ireland Holdings, eliminating most of its tax liability to the Netherlands. And, of course, Bermuda has no corporate income tax, so the "profits" earned by Google Ireland Holdings remain untaxed so long as these profits are not repatriated to the parent corporation back in the United States. However, recent reforms of the Irish tax code will eliminate the use of the "Double Irish" strategy by 2020.

Other technology-intensive companies, such as Microsoft and Oracle, have established Irish subsidiaries for similar purposes. A Microsoft subsidiary in Ireland, Round Island One Ltd., "localizes" Microsoft products developed by American employees for the European, African, and Middle Eastern markets. The customized products are then licensed by a Round Island One subsidiary in Ireland, Flat Island Company, to customers in those markets. Earnings from these sales are taxed at Ireland's relatively low 12.5 percent corporate income tax rate. From the U.S. perspective, because the U.S.-developed products undergo transformation in Ireland, Round Island One's earnings are characterized as active income, allowing Microsoft to take advantage of the IRS's deferral rule and avoid U.S. taxation of that income.

Recognizing the dysfunctions of its tax treatment of international earnings of U.S. firms, in late 2017 the Congress passed and the president signed the Tax Cuts and Job Act. This Act cut the corporate income tax rate from 35 percent to 21 percent. Prior to this cut, the U.S. rate was the highest among the OECD nations; now this new rate is among the lowest. The U.S. corporate taxes are now assessed on a hybrid territorial basis, rather than a world-wide basis. Previously, U.S. corporations were taxed on all of their earnings; now, just on their American earnings, with a few notable exceptions.

As we mentioned earlier, prior to the 2017 Act, American firms using a CFC could defer paying taxes on foreign earned income until they repatriated the earnings back to the U.S. In total, some \$2 trillion to \$2.5 trillion of such earnings remained overseas. The 2017 Act imposes a special tax on the existing deferred profits of foreign subsidiaries of American parent corporations of 15.8 percent on such earnings held in cash form and 8 percent held in illiquid form, to be payable over an eight-year period. Because high tech and pharmaceutical firms were the most aggressive users of the deferral rule, these new repatriation taxes will fall most heavily on them. Apple alone is expected to pay some \$38 billion in repatriation taxes, while Microsoft will owe \$11-12 billion. This repatriation tax falls on past deferred earnings. To lessen the benefits of companies transferring their intellectual property to foreign subsidiaries and to encourage them to leave such assets in the United States, the Act imposes a new, but lower tax on future income derived from such transfers. At 13.125 percent, the so-called global intangible lower-taxed income tax, or the GILTI-tax, is significantly less than the general 21 percent tax rate on most corporate earnings. The Act also contains new, complex "base-erosion" rules to reduce tax-driven transfers of property and assets to foreign subsidiaries designed to lessen the parent corporation's U.S. taxes.

Whether these changes in the U.S. corporate tax code will prove successful in achieving their goals is to be determined. The supporters of these changes hope that they will increase federal revenues and reduce the ability of firms to avoid taxes through transferring nominal ownership of intellectual property to foreign subsidiaries and other such tax avoidance schemes. Skeptics warn that clever taxation specialists will figure out new ways of slashing the tax bills of their corporate clients.

Case Questions

- 18-21. Why do tax rates and tax treatment of corporate income vary so dramatically among countries?
- 18-22. Explain the use of the Double Irish and the Dutch Sandwich by Google.
- 18-23. How important is the advance pricing agreement that Google negotiated with the Internal Revenue Service to the success of its tax-minimization strategy?
- 18-24. Google's corporate motto is "Don't be evil." Is Google's use of the Double Irish and the Dutch Sandwich honoring that motto?

- 18-25. Explain how Microsoft uses its Irish subsidiary to cut its U.S. taxes. How does it get around U.S. regulations regarding passive income?
- 18-26. What is the impact of Microsoft's Irish subsidiary on the Irish economy?
- 18-27. Are Google, Microsoft, and Apple acting ethically? Are they being socially responsible?
- 18-28. Why did the U.S government change its treatment of income earned by foreign subsidiaries of U.S. corporations?

Sources: "Tax Change Aims to Lure Intellectual Property Back to the U.S.," *Wall Street Journal*, January 24, 2018; "Apple Plans to Pay \$38 Billion in Repatriation," *Wall Street Journal*, January 17, 2018; "How the Tax Law Will

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