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Taxless Corporate Income: Balance against White Income, Grey Rules and Black Holes

The potential of globalization and digitization is clearly manifested in international taxation, currently undergoing a complete overhaul. A key factor driving the transformation is "stateless income". Although this term is extensively used, its meaning is ambiguous. It might be said to comprise flexible income earned by multinationals or simple taxpayers through virtual or cyber transactions. Primary liability for its creation seems to lie with state legislators, who should hence act to remedy the situation.

1. Introduction

Global economic interdependence among subjects – persons and their activities – has enabled their newly obtained independence from the state. Such interdependence sheds new light on the antagonism between state/taxpayers, which manifests itself now principally in the form of state/multinationals (*rectius* transnational corporations).

Law is constructed[1] to regulate human behaviour within the confines of a state legislator.[2] It is hence intrinsically linked to a specific territory, where such a state exercises its powers. Destined to define and balance relations between the members of society amongst themselves and with the state, the creation of laws and their implementation has never been smooth. Nowadays, the universality of economic relations has sparked an increasingly polarized environment: the territoriality of rules conflicts directly with the globalism of the relations they try to regulate.[3] It is from this struggle between these two poles that a new world is being engendered, one that is increasingly difficult to regulate (or even capture) due to the tunnel vision of states.

Taxation is a key sector that is undergoing radical changes due to the phenomenon usually described as "globalization".[4] This is a phenomenon that has turned the tax world upside down in recent decades and continues to inspire awe. In particular, the force of change is concentrated on (re)establishing a fairer and more efficient worldwide tax system. The reason for this phenomenon is not that the previous system failed or was intended to be unfair and inefficient, or even worse, that it is broken. Instead, it is that globalization has transformed the context in which tax legislation is required to regulate. What was deemed acceptable a few years ago has now become insufficient, obsolete and unfit. The system is more like an incompat-ible transplant from the past, threatening the present and accelerating the need for adjustment.

2. The Problem of Stateless Income

A key notion in the ongoing debate is income that escapes taxation. Such income is the source of the problems of the current tax system and constitutes the target of actions that have already been undertaken or that are underway. The escaped culprit is often referred to as "stateless income". In fact, this income seems to be, in itself, a by-product of globalization, borne out of the death of distance, spawning a global economy without boundaries. In the absence of any concrete form or materiality, the pure essence of money is manifested. The immaterial flow of dematerialized money emerges in direct contrast with its concrete and material aspect, its sole aspect that is visible in the tangible world.[5] There are no longer any material constraints to force money to materialize. The framework prescribed is hence far beyond what tax jurisdictions and legislators used to know and have under their control.

In the heated debates dominating the tax world, the term "stateless income" has attracted the attention of politicians, tax authorities and international organizations, becoming one of their favourite themes, as is apparent from media headlines that greet stateless income as the holy grail of the location planning of enterprises.[6] At the other end of the spectrum, the ambitious base erosion and

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1. The theory that sees law as a "construction", known as "legal positivism", has been shared and developed by various philosophers of law, such as Hobbes, Hume, Bentham, Austin and later by Kelsen, Hart and Raz; for a comprehensive overview of the theory, *see Stanford Encyclopedia of Philosophy*, available at https://plato.stanford.edu/entries/legal-positivism/.
2. The origins of international law may also be found in the compromises agreed to by the states. This analysis, however, falls outside the scope of this article.
3. P. Valente, *Manuale di Governance Fiscale* (Wolters Kluwer 2011).
4. For further information on the effects of globalization on taxation, *see* R. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 Harvard Law Rev. 7 (2000); J. Hines & L. Summers, *How Globalization Affects Tax Design*, National Bureau of Economic Research (NBER) Working Paper Series, Working Paper 14664 (2009); P. Genschel, *Globalization, Tax Competition and the Welfare State*, 30 Politics & Society 2 (2002); and M. Kuman & D. Quinn, *Globalization and Corporate Taxation*, IMF Working Paper (2012).
5. P. Valente, *L'Impresa Invisibile* (The Invisible Enterprise), Il Sole 24 Ore (Apr. 2001).
6. Various authors, *Global Enterprise Management, New Perspectives on Challenges and Future Developments* (A. Camilo ed., Palgrave Macmillan U.S. 2015); and R. Newmann, *How Apple became the master of stateless income*, available at http://rickjnewman.tumblr.com/post/149716131950/how-apple-became-the-master-of-stateless-income.

profit shifting (BEPS) Project is committed to putting an end to the existence[7] of stateless income. Finally, the latest US Treasury Green Book targets arrangements likely to facilitate the creation of stateless income.[8]

This article will explore the basic idea of stateless income. It attempts to shed some light on its definition (section 3.), which is still blurry due to the extensive use – almost *passepartout* – of the term in very different contexts.[9] It will then explore its genesis (section 4.), which is mainly attributed to globalization, multinational corporations and the Internet, which has proven that nothing is impossible. Finally, its implications will be identified (section 5.) in order to establish that primary liability for the creation of stateless income, as well as the responsibility to remedy the situation, rests with states (section 6.).

3. What Does Stateless Income Actually Mean?

"Statelessness" may be defined as a lack of citizenship. According to the UNCHR Convention Relating to the Status of Stateless Persons,[10] a "stateless person means a person who is not considered as a national by any State under the operation of its law". Consistency in international law would require that stateless income be defined, accordingly, as "income that is not considered taxable in any state under the operation of its law". This does not seem plausible. In principle, states take measures to attract income, rather than refusing to tax it.

Originally, stateless income was deemed to have the following distinguishing features:

(1) it was earned by multinational corporations;
(2) it was obtained through activities that were not carried out in the country of residence of the ultimate parent entity (UPE);
(3) it was not subject to tax in the country where customers or the production factors (i.e. land, labour, capital and entrepreneurship) were located; and
(4) it was not subject to tax in the UPE's country of tax residence; but
(5) it was subject to tax in another jurisdiction;
(6) which was a low-tax, source country; and
(7) the connection therewith was not substantial, but established, "without shifting the location of externally supplied capital or activities involving third parties".[11]

The above definition follows the typical pattern of territorial tax systems that extend their jurisdiction to subjects and objects connected with that national territory. Such systems depend on the existence of a reasonable link – residence or source – between the taxable transaction and the territory (what is referred to as a "nexus"). Although their viability can be questioned in view of the unprecedented changes globalization has brought about to the world order, most countries still have such tax systems in place. Hence, stateless income, as well as any other tax-related phenomenon, must be considered through this lens.

Under the aforementioned original definition, taxing power over the income was described in a rather negative sense, through identification of the countries that do not tax it. Non-taxation in the country of the UPE's tax residence sounds justified, taking into account that the activity producing the income does not take place there. What is striking is that the income is not taxed in either the country where such activities are actually conducted or where consumers/buyers are located. The definition was clear that the income is subject – at least in theory – to the tax laws of another jurisdiction; in other words, there is a taxing jurisdiction. Hence, the flaw lies in the link between the income and the jurisdiction taxing it. The connecting factor is unknown and seems weak. This puts into question, at least under the current framework of international taxation,[12] the accuracy of the term "stateless income",[13] which points to income over which no jurisdiction has a taxing right, rather than to income taxed/subject to tax in a jurisdiction with which it is barely linked.

Furthermore, the requirement that the taxing jurisdiction be a low-tax jurisdiction deserves special attention. It seems that if the income in question was moved to a jurisdiction with high tax rates, it would not be named or shamed. The paper or virtual connecting factor between the jurisdiction and the income does not seem to be sufficient to create stateless income. Instead, the original definition demands, as a necessary prerequisite for the existence of stateless income, evidence that it is subject to low or no taxation. In any event, no rational multinational would ever dare to deliberately move its income to a high-tax jurisdiction, unless there were other reasons therefor.

The aforementioned observations seem to indicate that stateless income was initially thought to cause:

(1) a lack of any/substantial taxation on the income; and
(2) a lack of taxation in the jurisdiction where the value was created.

It is debatable whether or not both are relevant to its definition. With regard to the former, requiring that the income in question must be "moved to a low-tax jurisdiction" equals negating or acknowledging its existence depending on the tax rate applied by such a jurisdiction. Irrespective of the tax rate, however (i.e. even if effectively

7. OECD, *Combating BEPS and making sure we have fair tax systems: An OECD/G20 Venture*, OECD Insights, Debate the Issues, September 2014, available at http://oecdinsights.org/2014/09/29/combating-beps-and-making-sure-we-have-fair-tax-systems-an-oecdg20-venture/.
8. Bureau of the Fiscal Service, US Department of the Treasury, *Green Book Revised* (Jan. 2016), available at https://www.fiscal.treasury.gov/fsreports/ref/greenBook/downloads.htm.
9. The uncertainty surrounding the concept is illustrated by the fact that the OECD approaches stateless income as "income that is not taxed anywhere". This, however, reflects a much broader scope than that of Professor Kleinbard, who introduced the term "stateless income" in 2007 (*see* sec. 3.). Such a difference suggests that the concept has evolved through the years.
10. The text of the *UNCHR Convention Relating to the Status of Stateless Persons* is available at http://www.unhcr.org/protection/statelessness/3bbb25729/convention-relating-status-stateless-persons.html.
11. E. Kleinbard, *Stateless Income*, 11 Florida Tax Rev. 9 (2011).
12. Alternatively, it may be said that this new notion challenges the existing framework. Such an analysis would, however, be outside the scope of this article.
13. M. Herzfeld, *The Power of A Name: Stateless Income and Its Failings*, Tax Analysts (2 Apr. 2015), available at http://www.taxanalysts.org/content/news-analysis-power-name-stateless-income-and-its-failings.

taxed), such income remains non-taxable in the jurisdiction in which it was earned. Although the multinational might be taxed effectively on such income in the host jurisdiction, the problem of base erosion of the source jurisdiction remains or (even worse, has been) underestimated. At the same time, focusing on non-taxation of the income instead of source base erosion does not seem justified, since any jurisdiction, including the source state, may decide not to impose tax on a specific item of income. For this reason, when referring to the notion of stateless income, the applicable tax rate should be irrelevant and the focus should rather be on the lack of sufficient connection with the taxing jurisdiction.

At this point, statelessness becomes relevant to a better understanding of the notion. The use of the term "stateless" – albeit not fully reflecting the relevant concept – provides indications regarding its core concept. Someone (or something) becomes stateless because he (or it) migrates or is regularly on the move, like a nomad. In such instances, the links to the place of origin are broken or weak and the entity (or thing) moves to another country. This implies that not all types of income may become stateless, but rather only sufficiently flexible or mobile (dematerialized or dematerializable) flows of income.[14] This is the case with regard to items of passive income, the production of which is disconnected from active participation of the receiver, such as interest and royalties.[15] Once the flow is established, it may continue to operate without further intervention. Thus, it can change hands easily and conveniently through legal contractual (paper) arrangements. This is similar to income from e-transactions, where several providers located in different jurisdictions are involved. The contribution of each party is too vague to allow for a stable conception of links. Money is transformed in quanta, traveling at the speed of light, free from limits and borders. In essence, paper or virtual transactions are enough to disconnect value from the country where it was created, and connect it to another that provides tax asylum.

A simple illustrative example is the establishment of a subsidiary in a tax haven to receive royalties for the use of a patent.[16] All local law requirements for the establishment will – most likely – be fulfilled online. A patent licensing agreement will be concluded with the parent in a legal contract, always in compliance with the requirements and formalities set forth by the governing law. As the patent is intangible, no delivery is required. The subsidiary – and not any other member of the group – is then entitled to receive royalties for the use of the patent. Through the payment of royalties, income is effectively and legally shifted to the tax haven. Shrouded in (paper) invisibility cloaks, it disappears from the jurisdiction of production, invention or manufacture of the relevant products, and reappears in a haven. Part of the (reappearing) income was actually produced through the production factors of the multinational, wherever located. Astonishingly, part of it derives directly from the paper transaction and corresponds to the tax saved, i.e. the tax that would have been paid had the licensor of the patent not been located in a haven.

In a nutshell, the notion of stateless income refers to (i) flexible income that can be shrouded in an invisibility cloak, (ii) earned by either (a) multinational corporations through paper or virtual transactions functioning as the connecting factor between such income and its taxing jurisdiction, or (b) through digitized (cyber) transactions not allowing for identification of the provider. The absence of tax or high tax is a typical characteristic of stateless income; however, it is not a determinant feature thereof. In any event, nothing therein suggests illegality; in fact, stateless income is admittedly the outcome of lawful processes.[17] This being said, the most significant elements of the notion include a break from the chain of value creation and a virtual link with a tax asylum jurisdiction. As to whether the term "stateless" is appropriate enough to clearly reflect these aspects is debatable; an alternative term could be "paper-made/virtual homeless income" or "nomadic income" or simply "taxless corporate income" (TCI)[18] while "statefully taxless income" has also been suggested.[19] Nevertheless, for the purposes of this article, reference is made to the original term due to its widespread and acknowledged use.

4. The Origins of Stateless Income

The phenomenon of stateless income is usually explored in connection with a specific tax jurisdiction. The concept itself was inspired by the flaws of the US tax system and was introduced and developed in connection thereto.[20] Later, it was also dealt with in the European context.[21] Although it can be reduced to – and probably better explained within – a national tax framework, the mere fact that it has emerged in several jurisdictions all over the world proves its global nature. Therefore, its causes must be identified at a supranational level, based on the

14. For a deeper analysis of the mobility of income, its employment by enterprises and the relevant implications, *see* L. De Simone, L. Mills and B. Stomberg, *What Does Income Mobility Reveal About the Tax-Risk Reward Trade-off?* (The University of Texas at Austin 2014).
15. C. Seidl, K. Pogoreskiliy & S. Traub, *Tax Progression in OECD Countries: An Integrative Analysis of Tax Schedules and Income Distributions* p. 113 et seq. (Springer 2012).
16. Tax havens offer a safe harbour, where the tangible manifestation of dematerialized – stateless and taxless – money can be anchored to allow for its immaterial flows to establish links with the economy and come alive in the society. There, through complex and ill-defined aggregates of virtual transactions, perfectly legal while intentionally designed, the illicit or, in any event, arguable origin of capital can conceal itself behind an unquestionable mask of lawfulness.
17. *See* sec. 4.
18. Although taxless income can also be earned by non-corporations (individuals) especially in view of the potentials of digital economy, the involvement of a corporate entity is the most common scenario (which is consistent with the conclusions reached by the OECD in the BEPS Project).
19. C. Sanchirico, *"Stateless Income" Versus "Statefully Taxless Income"*, Tax Policy Center, Urban Institute & Brookings Institution (Nov. 2013), available at http://www.taxpolicycenter.org/taxvox/stateless-income-versus-statefully-taxless-income.
20. E. Kleinbard, *Throw Territorial Taxation from the Train*, Tax Notes (5 Feb. 2007).
21. Sanchirico, *supra* n. 19; C. Duhigg & D. Kocieniewski, *How Apple Sidesteps Millions in Taxes*, New York Times (28 Apr. 2012), available at http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html.

common characteristics of existing tax systems. Otherwise, there is a risk that the overall picture will be lost and, along with it, the chance to properly identify the problem and its solutions. Taking into account that stateless income is essentially the outcome of an effort to save tax where possible, its main causes are expected to largely coincide with those of tax avoidance in general.

The core of the issue lies in the co-existence of several fragmented territorial tax systems. Globally, there are as many tax regimes as there are tax jurisdictions.[22] Until now, states have been reluctant to agree on a common definition of "source of income" and on the link that should be established between income and taxing jurisdictions. It follows that different locations imply different taxation of the same item of income. With regard to cross-border transactions, the tax treaties network[23] is an additional relevant factor. Depending on the tax jurisdictions at the two ends of the transaction in question, the applicable tax treaty may be more or less favourable to taxpayers.[24] This patchwork of national tax regimes and tax treaties inspires taxpayers to optimize their tax liability by seeking the best option, but the patchwork of rules was always there; its deficiencies only appeared in light of globalization.[25] In addition, today, the well-known race to the bottom through harmful tax practices makes it more and more beneficial (and hence tempting) for taxpayers.[26]

The implications of fragmentation are maximized when taking into consideration the intrinsic porousness of legal rules,[27] implying that a certain degree of non-compliance with the rules of a (single) legal system seems unavoidable. Rules are theoretical rather than concrete, constructions and principles (rather than walls) aimed at directing the behaviour of the members of a given society through the threat of sanctions for non-compliance.[28] They are flawlessly implemented where such members consider that the benefits they can gain by non-compliance do not justify taking the risk.[29] In the taxation scenario, this would involve an evaluation of the amount of tax that can be saved relative to the probability that the tax structure will be (i) investigated; (ii) found not to be legitimate; and (iii) subject to a penalty in an amount that exceeds the gain. Since overly severe sanctions might deter even desirable behaviours[30] and hence cannot be enacted, it seems that legislators must accept that there will always be some members of the community for whom non-compliance will constitute the best/most profitable option. It follows that a rule is effective if it manages to restrict unavoidable non-compliance to a level or form that does not harm its purposes.[31] This represents a challenge for local/national legal systems, in support of which a lot of ink has been spilled. From an international viewpoint, the lack of coordination of tax rules at the international level implies that there has been no targeted consideration of the above challenge; it is also questionable whether or not such considerations have been taken into account as part of the ongoing process to rewrite the rules.[32]

The variety of (porous) tax regimes leads to tax avoidance due to transnational activity, a significant part of which is undertaken by multinational corporations, i.e. groups of companies with common interests, located in different tax jurisdictions. Such entities reflect an important aspect of globalization of which they, themselves, are a product. Their presence in different jurisdictions, along with the overlap of their goals, subjects them to fragmented laws and concepts. Acting as a single entity, they structure their activities in the most tax-efficient way. Actors playing on several stages around the world at the same time, they ensure tax efficiency by exploiting mismatches between the different (inconsistent) tax laws applying at the location of each stage and their aggregated pores.[33] They do so through transfer pricing and freedom of contract.[34] At the other end of the spectrum, states insist on only concerning themselves with the group member located in their jurisdiction, ignoring or undermining its intrinsic link

22. An overview of the different tax systems existing today is available at: https://dits.deloitte.com/#TaxGuides.
23. Currently, there are more than 3,000 tax treaties. *See* P. Valente, *Convenzioni Internazionali Contro le Doppie Imposizioni* p. 3 et seq. (7th ed., Wolters Kluwer 2016).
24. For a deeper look at the interactions of fragmented tax systems with multinational enterprises, *see* R.J.S. Tavares, *Multinational Firm Theory and International Tax Law: Seeking Coherence*, 8 World Tax J. (2016), Journals IBFD.
25. At this point, reference should be made to the ongoing effort to harmonize this patchwork system and fill its loopholes in the context of the BEPS Project. In particular, Action 15 advocates a multilateral convention that will amend the existing tax treaty network to this effect. *See* P. Valente, *The release of the Multilateral Instrument*, 45 Intertax 3 (2017).
26. Tax competition was defined by Richard Teather as the "use by governments of effective low tax rates to attract capital and business activity to their country. *See* R. Teather, *The Benefits of Tax Competition*, The Institute of Economic Affairs (2005).
27. The concept of "rule porousness" is extensively analysed in *Rule Porousness and the Design of Legal Directives*, 121 Harvard Law Rev. 8 (June 2008), available at https://harvardlawreview.org/wp-content/uploads/pdfs/rule_porousness.pdf.
28. S. Shavell, *Law Versus Morality as Regulators of Conduct*, 4 American Law and Economics Rev. 2 (2002).
29. The authors, in *supra* n. 27, consider that "compliance [with a rule] is a function of the benefit of breaking the rule, the probability that non-compliance will be detected, […] the sanction for noncompliance, […] the effects of social norms and moral commitment to following the law".
30. By way of example, imposing overly high sanctions for international tax schemes considered to enable tax avoidance could discourage the undertaking of cross-border investment in general and hence harm the global economy.
31. *Supra* n. 27.
32. It is said that international tax rules are being rewritten in the context of the BEPS Project. *See* OECD/G20, *Base Erosion and Profit Shifting Project: Information Brief* (2015).
33. Transfer pricing allows multinationals to determine the transactions that must be undertaken amongst the members of the group and the prices therefor. It includes an elaborate evaluation of the best route and final destination for their income in terms of taxation. Contracts are concluded to give effect to the outcome of transfer pricing. The result is that the income of the multinational is allocated per group member depending on the advantages, disadvantages, allowances and burdens of the applicable tax regime. For further information on tax-motivated transfer pricing, *see* K. Clausing, *Tax Motivated Transfer Pricing and US Intrafirm Trade Prices*, 87 Journal of Public Economics 9-10 (2003); S. Ekstrom, L. Dall & D. Nikolajeva, *Tax Motivated Transfer Pricing* (Lund University Publications 2014); and J. Blouin, L. Robinson and J. Seidman, *Conflicting Transfer Pricing Incentives and the Role of Coordination* (Tuck School of Business at Dartmouth 2013).
34. Transfer pricing is relevant to profit shifting; for further information regarding such evidence, *see* J. Heckemeyer & M. Overesch, *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels*, ZEW Discussion Papers 13-045 (2013).

with other members.[35] They restrict their view to their national boundaries, surprisingly overlooking what takes place beyond such boundaries. This divergence between the views of taxpayers and tax legislators is liable to lead to a corresponding mismatch between the former's practice and the latter's counteraction.

Furthermore, the appearance of stateless income is related to another aspect of globalization, i.e. new technologies, the facilitation of communication and information sharing, amongst others. Digital economy increasingly allows for the performance and justification of virtual or paper transactions. New business models have appeared, turning attention to, amongst others, the collaborative economy, while heavily questioning the existing tax norms and ever widening the gaps between them. Services can be provided without the need for any infrastructure whatsoever in the customer's country or even in the provider's country. The relationship between the service provider or the seller and the final receiver or purchaser may involve numerous intermediaries, located in various countries. The Internet allows for efficient communication and coordination. More agreements are signed through email than in writing. Invoices are issued electronically. Companies are established all over the world with a series of "clicks" through simple computers. The volume of e-transactions, increased mobility of taxpayers and extreme volatility of the tax bases under such circumstances make the identification of any nexus between a particular legal system and a given economic activity extremely difficult. Modern technology has thus neutralized space and time and minimized national frontiers, along with whatever power was dependent on them, including state sovereignty and taxing rights.[36]

The inability of states to renounce even parts of their tax sovereignty is another factor, contributing largely to the preservation of the existing fragmented system, despite the "newcomers", i.e. multinational corporations and digitization. The continuous lack of a common definition of a link between income and taxing power, as well as its successful exploitation by taxpayers, can be illustrated and explained allegorically. In a chess tournament, all players are divided into two competing teams. On the one side, there are companies – members of the same multinational group committed to one goal, or, in any event, taxpayers with parallel interests – that aim to achieve the least possible taxation for the whole team. On the other side, there are single sovereign states, as single players, albeit of the same team (or that could potentially form a team). Not only do they lack any team spirit, but most importantly, they always chase to win over their (potential) co-players. The strategy of each of them is exhausted in a double line of defence against the perceived intrusiveness of the other states. They defend their taxing rights (i) over their tax residents (subjective dimension) and (ii) over any income produced on their territory (objective dimension), i.e. over the standard links justifying tax power up until now. This strategy frustrates any possibility of coordination and agreement. It is not hard to guess which team will win the taxation/chess tournament (even when it loses certain battles).

Another catalyst of stateless income relates to the value of intangibles. The 21st century is nothing less than an era of ideas, intangibles prevailing over tangibles.[37] The value of a patent or a trademark may go far beyond all imagination, at levels that material assets could never possibly reach. This means that the profits to be gained therefrom and, subsequently, the taxes to be paid or saved in connection thereto, are too high to resist.[38] In addition, intangibles are mobile. Hence, they allow for the movement of significant value, free from constraints, leading to the creation of even more value, through tax-driven schemes, whether aggressive or not.

In summary, stateless income is generated as a result of a patchwork of fragmented national tax regimes, failing to address the challenges of globalization and the modern business models driven by digitization. Transfer pricing within multinational groups sees no boundaries and no territory; only a single entity acting as a single mind with multiple eyes.[39] The same applies to e-commerce. Jurisdictions nevertheless perceive their taxing power based on territoriality criteria built on the existence of links between taxable transactions and national territory. In addition, the criteria applied by the different jurisdictions are fragmented and inconsistent. Consequently, where states see limits, taxpayers see opportunities; where territories find borders, cyberspace finds loopholes. While states are accustomed to a fragmented view, related companies act as one for all and all for one. Indeed, the existence of different regimes would be irrelevant if taxpayers did not have the ability to choose between them. Globalization, however, has been a game changer: states' sovereignty means tax arbitrage is part of the game.

5. Rights and Wrongs of Stateless Income

Stateless income is not named and shamed due to its inherent nature, but rather as a result of its consequences, which have sparked worldwide debate.[40] Such implications coincide with the well-known implications of tax avoidance in general. Its special characteristic, the fact that its sole connection with a taxing jurisdiction is a paper or virtual transaction without the need for any type of engagement of production factors, does not change the nature of its implications as a tax minimization strategy. It can only be blamed for making the phenomenon more intense –

35. T. Pogge & K. Menha, *Global Tax Fairness* (Oxford University Press 2016).
36. For further information on the implications of digital economy for international taxation, *see* M. Olbert, *International Taxation in the Digital Economy: Challenge Accepted?*, Master thesis for the University of Mannheim Business School (2016).
37. E. Tome, *Building the Intangible Cube: Assessment of Relevant Organizational Dimensions of Intangible Assets*, 6 Business Excellence 2 (2012).
38. This impacts the outcome of the evaluation between the risks of non-compliance and expected gains in favour of non-compliance.
39. For a forward-looking perspective on the implications of transfer pricing in the modern economy, *see* J. Wheeler, *An Academic Look at Transfer Pricing in a Global Economy*, Tax Notes (4 July 1988).
40. A. Fischer, *A Comprehensive Approach to Stateless Income*, 83 GW Law Rev. 3 (Apr. 2016), available at http://www.gwlr.org/wp-content/uploads/2015/07/83-Geo-Wash-L-Rev-1028.pdf.

and hence more threatening to – national tax bases. In fact, stateless income signals that it has become customary for taxpayers to shift part of their income to tax-friendly jurisdictions. It theoretically implies that there is no need even to pretend that some value is created in the taxing jurisdiction. Value creation is endangered, as it appears to have become old-fashioned, with stateless income being independent therefrom.

Stateless income has implications both at a national and international level. Primarily, its creation is related to base erosion of the tax jurisdiction that would have had the right to tax such income, but for the virtual transaction or series of transactions. This is the place where the value was created[41] through invention, production, supply and any actual contribution to profits, as per the applicable norms of the national law and tax treaties. Through its resources, this place contributed – more than any other – to the creation of income, tax revenue being the consideration for such a contribution; taxation allows for the country to continue offering and even improving its resources.[42] Depriving that state from the right to tax the income implies a loss of anticipated revenue and undermines the potential for economic development, with the result that other taxpayers are obliged to compensate for the loss through higher taxes.[43] Furthermore, it affects competition conditions in the national market. Domestic companies, which cannot exploit stateless income operations, are unable to compete against multinationals that reduce their costs in this manner. They are hence faced with either failure or the need to transfer operations outside the national market. At an international level, a disconnect of taxation from value creation implies a non-optimal allocation of tax revenue at the expense of high-tax jurisdictions (where the value was produced), to the benefit of tax havens (the economies of which are largely based on the attraction of investment through tax incentives). This implies a race to the bottom through a vicious cycle of harmful tax practices.[44]

Another important implication of stateless income and tax avoidance in general – which is very often overlooked – is that its existence undermines the certainty and stability of societal institutions. The existence of stateless income evidences the fact that rules can be legally circumvented even in an official manner. Each and every public and private discussion on taxation ends up estimating the hundreds of billions of dollars lost annually in corporate income tax (CIT).[45] This phenomenon is a part of the everyday life of modern societies, which unavoidably lose faith in rules, including tax rules; this might well be the beginning of the end. It puts the rule of law into question, directly harms the merit of compliance and minimizes the shame of non-compliance. Consequently, it is likely to create a culture of circumvention with implications that extend far beyond the field of taxation, undercutting the very foundations of society.

Although stateless income can be challenged on the basis of its harmful implications to the international community – and not without due cause – it cannot be blamed for being illegal;[46] in contrast, it is perfectly legal. In fact, it is a by-product of the relevant laws. Furthermore, e-transactions have the privilege of being vague. They do not clearly link any value created to a specific territory. Multinationals do not violate any laws in creating stateless income; they use legal contractual transactions to transfer legally earned profits, or established passive income flows, to companies lawfully incorporated in countries in which the income is finally taxed or not taxed, but always in perfect compliance with such countries' tax regimes. Stateless income is also a creature of the law itself, at least in part, as it is through the said legal and lawful arrangement that the multinational prevents a reduction in its income by an amount corresponding to the tax that would be payable in the source jurisdiction. By minimizing cost, the multinational maximizes its profits. All this occurs legally. The law, in the sense of co-existing national regimes and international law, enables this, willingly or not.[47] The whole mechanism is solidly based on the lack of a commonly accepted definition of the factors properly linking an item of income to the taxing jurisdiction. Different legal systems provide different definitions, and taxpayers simply apply them. Among the choices they have, they pick the most convenient ones. In contrast to income from fraud or crime, i.e. black money, stateless income is white money. Its source? Grey legal systems, composed of vague rules interacting with each other in ways that create black holes in which income disappears, but which, in any event, are in force and demand compliance.

6. Who Is to Be Blamed and Who Should Remedy the Problem?

It is widely acknowledged that multinationals are the first to be accused of the harms of tax avoidance. They are the beneficiaries of the income, as well as the ones that put into motion the money-making mechanism. This is not the full picture, though, and stakeholders are already becom-

41. The alignment of taxation with value creation is a main goal of the ongoing BEPS Project. For more information thereon, *see* P. Valente, *Elusione Fiscale Internazionale* p. 3 et seq. (Wolters Kluwer 2014) and OECD, *supra* n. 32.
42. R. Knuutinen, *Corporate Social Responsibility, Taxation and Aggressive Tax Planning*, Nordic Tax J. (2014).
43. Kleinbard, *supra* n. 11; Fischer, *supra* n. 40. For further analysis of the social implications of stateless income generated from the interaction of globalization and harmful tax competition, *see* Genschel, *supra* n. 4 and Avi-Yonah, *supra* n. 4.
44. *See* sec. 2.
45. OECD, OECD presents outputs of OECD/G20 BEPS Project for discussion at G20 Finance Ministers Meeting, available at http://www.oecd.org/tax/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm.
46. Knuutinen, *supra* n. 42; D. Hansen, R. Crosser & D. Laufer, *Moral Ethics v Tax Ethics: The Case of Transfer Pricing Among Multinational Corporations*, 11 J. of Business Ethics 9 (1992); and Ekstrom, Dall and Nikolajeva, *supra* n. 33.
47. The mismatches and loopholes between the legal systems that allow for the adoption of tax avoidance practices by multinationals are considered a failure of modern legal systems to keep pace with economic developments worldwide. Such failures were not desired by national legislators and actions are already underway to remedy the situation. *See* OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD. For further analysis on the mismatches and loopholes identified in the international tax system, *see* G. Zucman, *Taxing Across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. of Ec. Perspectives 4 (2014).

ing aware of this fact.[48] In general terms, multinationals implement practices and arrangements in full compliance with the law. This is sufficiently alarming in itself. Such practices may be criminalized since they circumvent/abuse the law, contradicting its very spirit or intrinsic purpose. Such concepts are too vague to fit into the world of taxation; they are unable to effectively and definitively eliminate the targeted problem, if it can be referred to as such. In addition, it is a fundamental right of every taxpayer to rely on the law. Since questionable practices are unquestionably permitted by the laws in force, the former should be accepted. If they are not to be permitted, legislative action clarifying their proper treatment is both desirable and appropriate. A lack of such action is attributable to legislators. Tax must be spelled out in the law.[49] If countries do not like their own laws, they must simply change them.

Another argument in support of primary liability not lying with multinationals relates to the widely-recognized duty of a company's management to maximize shareholder value.[50] As a group of companies, this duty applies equally to multinational corporations. It follows that their management is faced with two occasionally contradictory duties: (i) to adopt practices that – legally – minimize the costs of taxation and consequently maximize corporate profit and (ii) to reject any tax planning, since it might be construed as abuse of law.[51] Legislators seem to charge a corporation's management with these twin duties and then wash their hands of the consequences of the choices made. Given that the two obligations are equally valid, managers are, in essence, asked to act in substitution for legislators and define the limits and balance of their duties. At the same time, legislators find themselves in a convenient position to be able to blame ex post any of the options taken as being non-compliant with the spirit of the duty imposed, which is manifestly unfair.

As per the analysis herein, the cause of stateless income is the lack of a widely accepted definition of a suitable link between taxable income and a taxing jurisdiction, i.e. the precise location in which the value that is to be taxed is created. Transplanting territorial tax legislation from the past to the new context of globalization creates mismatches. Tax avoidance in general is generated by mismatches and loopholes stemming from hundreds of co-existing tax regimes, as well as from their constant failure to face the challenges of a digital economy. Tax avoidance, also through the creation of stateless income, is a symptom of a pathological system. Where there is a pathology, there are symptoms, and symptoms are essential to signal a dysfunction, enabling activation of a remedy. In this context, it is indisputable that this dysfunctional system has not been engendered by taxpayers. It is rather the result of a failure by legislators to reach consensus among themselves and to keep up with developments in technology and business practices. Until now, legislators seem to prefer the use of "analgesics", such as widening the tax base of domestic corporations or individual taxpayers, to momentarily ease symptoms and pain. It is certain, though, that this will not alleviate the symptoms or cure the dysfunction. It is high time that different, more innovative actions be taken.

One of the accusations made against legislators is that they not only missed an opportunity to keep pace with modern economic rhythms, but did so deliberately.[52] One of the most important facts invoked in support of this claim is that the very jurisdictions that are considered tax havens[53] are usually dependent on other jurisdictions, which – ironically – are driving the fight against tax avoidance. If this were true, the discussion on abuse of law would be entirely meaningless. It would imply that the legal norms are purposely structured in order to enable a sharing of the relevant income between high-tax jurisdictions – able to contribute to its production – and low-tax jurisdictions, which, given the lack of any other resources, boost their economy through attractive legislation. In such a scenario, tax avoidance operations would seem to perfectly capture and be aligned with the spirit of the law.[54] If that were previously the case, but now no longer is, because legislators have changed their mind in view of the consequences, it would be up to the masters of the system to adjust it to their new goals.

In any event, the flaws of modern legal systems, regardless of whether or not the outcome is of deliberate and deliberated decisions, need to be remedied if tax avoidance and stateless income are to be countered. Changes in legal systems are clearly task-assigned to legislators; multinationals have nothing to do with them. Time is up and legislators need to take the responsibility and face the situation as it is. It is their choice to either align and update the rules in order to pursue the establishment of a long-

48. In the words of Raffaele Russo, head of the ongoing BEPS project, "BEPS is recognition of the fact that the (tax) structures [implemented by multinational enterprises in order to reduce their tax bills] are in most cases legal so the problem is not the structures but the rules. What we are doing is changing the rules so that these things are not legal any more" (*see* C. Keena & C. Taylor, *OECD says LuxLeaks revelations not surprising*, The Irish Times (6 Nov. 2014), available at http://www.irishtimes.com/business/economy/oecd-says-luxleaks-revelations-not-surprising-1.1990609.

49. The existing risk of tax uncertainty was recently confirmed in the Report on Tax Uncertainty compiled jointly by the OECD and the IMF. *See* OECD, IMF, *Tax Uncertainty, IMF/OECD Report for the G20 Finance Ministers* (Mar. 2017), available at http://www.oecd.org/tax/tax-policy/tax-certainty-report-oecd-imf-report-g20-finance-ministers-march-2017.pdf.

50. This duty was first established in US: Michigan SC, *Dodge v. Ford Motor Co.*, 170 NW 668 (Mich. 1919); For further information on this issue, *see* M. Friedman, *The Social Responsibility of Business is to Increase Its Profits*, New York Times (13 Sept. 1970).

51. M. Corwin, *Sense and Sensibility: The Policy and Politics of BEPS*, Tax Notes (6 Oct. 2014) and T. Bender & D. Broekhuijsen, *Great Debate: The Relationship Between CSR and Tax Avoidance*, Working Paper (Apr. 2015).

52. Herzfeld, *supra* n. 13.

53. Such as Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Guernsey, Isle of Man and Jersey, being overseas territories or crown dependencies of the United Kingdom. *See* Herzfeld, *supra* n. 13.

54. Tax havens try to establish a symbiotic coexistence with the international community that occasionally turns parasitic. When their presence is accepted by other states, symbiotic-like interactions signal a balanced co-existence – or rather a tolerated parasitism, which could be said to be serving the interests of both. Nevertheless, if the competition (on the side of tax havens) is perceived as harmful, which is the message conveyed in the context of the ongoing BEPS Project, states – (potential) victims of invasive sorts of manifestations by the tax havens ("income leeches") – embark on fights against them. *See* P. Valente, *Manuale di Governance Fiscale* (Wolters Kluwer 2011).

awaited fair tax system or remain stubbornly stuck to their old norms, made for times of yore. By hiding behind the alleged wrongdoings of others, they are only delaying the process. By maintaining grey legal concepts, they are merely strengthening the view that flawed rules were deliberately enacted to enable tax avoidance. Refusing to act – and act promptly – makes it appear as if they themselves are the real producers of stateless income.

7. Remedies and Conclusion

Given that the main cause of stateless income is a lack of a stable link between items of flexible income and the right of a jurisdiction to tax them, the solution to the problem should move in the direction of establishing this link. To eliminate – or at least reduce – stateless income, a clear link/nexus must be established with the place of origin of the income. The link must be strong enough such that no paper or artificial or insubstantial transaction may break it. The place of birth of human beings can never be changed; accordingly, the place of value creation of an income flow should be equally unchangeable, known and sure. What is particularly annoying about stateless income – and at the same time its distinctive feature – is the fact that it is virtually made. To counter its creation, contracts alone should not be enough to produce links. It should be ensured that any activity giving rise to income in any way marks the income and cannot be separated therefrom, except to the extent that new activity takes place.

Identifying a suitable link is the next big challenge. The manner of doing business today barely reflects the business models that were predominant one or two decades ago, let alone those existent at the time the basic principles of the current tax systems were formed.[55] Searching for an appropriate link in what is already familiar does not look promising. The current reality has changed the idea of the law from within; existing general and abstract dictates are obsolete. What is necessary is to think outside the box in crafting new principles leading to the creation of a new law. Digitization, collaborative economies and multinationals are here to stay and must be duly taken into account in the establishment of a new taxation link. Until now, a significant effort has been made to fit developments into existing norms. If this were possible, it would be convenient; however, laws need to be able to adjust to society, not the other way around. If the problem of stateless income is to be finally resolved, a radical reform is absolutely essential and should already have been undertaken. In this process, new technologies should be seen as an ally, not as the enemy. Allowing for the collection and analysis of a huge volume of data, they enable a proper construction of business relations and due and prompt identification of the value creator and its jurisdiction. This potential ought to be unleashed and used to the greater benefit of all players.

Moreover, and even more importantly, there is a need to ensure that any link or links selected will be greeted favourably by all tax jurisdictions. Disagreement would be fatal; it is the very cause of mismatches and loopholes that inspire avoidance practices. The longer it takes to agree on common criteria regarding source of income, the more the international community will suffer the consequences of stateless income. Closed-minded legislators, refusing to see farther than their national borders, can thus destroy any hope of fair and efficient taxation everywhere, including their own jurisdiction. A lack of consent implies increasingly unfair tax practices. A total overhaul demands and presupposes a changed mindset in this direction as well. There is no room for egoistic and self-serving approaches. Nations need to be united. Governments need to adapt a holistic and proactive position. No jurisdiction can succeed in the protection of its tax base alone. Across-the-board cooperation would be the optimal solution for the future, while division prolongs multinationals ruling the world. A metamorphosis of international taxation seems to be underway,[56] and where there is a will, there is a way. Although it is still arguable whether the actions envisaged have the potential to put into place the new vision of the law, a step towards more unity seems, at least, to have been made.

55. OECD, *Addressing Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD, also available at http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm.

56. One of the keys to the metamorphosis of the international tax system is the Multilateral Instrument, envisaged in Action 15 of the BEPS Project and published in November 2016. It constitutes a multilateral convention with the potential to introduce consistent and coherent amendments to all existing (more than 3,000) bilateral tax treaties. For further analysis of the Multilateral Instrument, *see* P. Valente, *BEPS Action 15: Release of Multilateral Instrument*, 45 Intertax 3 (2017).