Moving to a (Properly Designed) Territorial System of Taxation Will Make America's Tax System Internationally Competitive

A territorial tax system is the standard employed by the rest of the world. However, it is important that the system employs similar guardrails as those employed by other countries.

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1. The existing U.S. worldwide system of taxation is uncompetitive and outdated.
    - This system subjects U.S. businesses to a double layer of taxation and complex rules not felt by other competitors.
    - It has also resulted in trillions of dollars of after-tax income stranded overseas, rather than reinvested in the U.S. economy.

2. Moving toward a modern, territorial system of taxation is a key part of a pro-growth tax reform plan.
    - The majority of countries in the developed world have a territorial system of taxation, with many countries adopting this system in recent years.

3. In practice, a territorial system of taxation requires base erosion rules to act as guardrails for the system.
    - However, base erosion rules must be carefully considered. Overly burdensome rules that create too much of a burden on taxpayers would continue to disadvantage U.S. businesses relative to foreign competitors.
    - Typically, foreign competitors have several types of base erosion provisions:
        - Rules on transactions with Controlled Foreign Corporations (CFCs) – subsidiaries of U.S. headquartered companies.
        - Dividend exemption systems
        - Limitations on deductibility of interest, also known as earnings stripping rules.

4. Base erosion rules typically do not apply to active business income. Provisions that apply to active business income may make the overall system closer to a worldwide system of taxation.
    - A broad based minimum tax on foreign profits may undercut the rationale from going to a territorial system of taxation.

Tax Reform Should Address America's Competitiveness Problem by Moving to A Modern Territorial System

Today, the United States is losing its competitive advantage in the global economy. Where it once attracted businesses, it is losing them due to its outdated taxation system and high corporate tax rate. Further, the U.S. tax system encourages the remaining U.S. companies to keep earnings made through their foreign subsidiaries overseas rather than bringing them back to be re-invested in America, whereby it's now less expensive for a foreign company to own a U.S. company than the other way around.

But this is not how it has always been.

Following 1986, the U.S. lowered its corporate tax rate to a competitive rate. In the years since, other countries, have lowered their tax rates and changed their tax codes to a territorial tax system in order to make themselves more competitive.

However, in 2017 the U.S. still has a worldwide taxation system. Under this system, the U.S. taxes the worldwide income of U.S. headquartered companies at a maximum rate of 35 percent. While this system provides exemptions, it is nevertheless burdensome on Americans' businesses.

As a member of the Japanese House of Representatives, Mieko Nakabayashi, correctly said:[1]

> *"With most of the world—Japan included—cutting corporate tax rates and employing territorial tax systems to remain competitive, the U.S. must surely know that its hesitancy to do these things is handing the advantage to its international competitors. They will suffer from that hesitancy while we and others outside the U.S. will benefit."*

This worldwide system has resulted in a "lockout effect" for after-tax income earned abroad. Under the existing worldwide system, almost $3 trillion in after-tax profits has been stranded overseas because of the outdated U.S. tax system. Under our existing tax code, businesses would be required to pay two layers of taxation on this income while foreign competitors face only one layer of tax on the income they generate outside their home jurisdiction.

The outdated tax code discourages American businesses from creating jobs in the U.S. and encourages overseas job creation and encourages the creation of jobs overseas. This inequity is far from hypothetical – it has led to a drastic decline in foreign investment in American ingenuity. Because of the uncompetitive tax system, the U.S. experienced a net loss in $1.7 trillion in business investment, largely due to the absurdly high tax rate. [2]

A Territorial System of Taxation is Becoming the Norm Across the World

In recent years, the world has become increasingly globalized. 95 percent of consumers live outside the U.S. and a total of 41 million jobs are tied to business operations overseas. Because of this globalized economy, labor has become more sensitive to the taxation of business. A high corporate rate or uncompetitive tax system results in

[1] Dittmer, P. (2012, August 10). A Global Perspective on Territorial Taxation. Retrieved October 28, 2017, from https://taxfoundation.org/global-perspective-territorial-taxation/

[2] Buying and selling: Cross-border mergers and acquisitions, and the US corporate income tax. (2017, September). Retrieved October 28, 2017, from https://businessroundtable.org/sites/default/files/EY%20BRT%20Cross-border%20MA%20report%202017%2009%2007%20FINAL.pdf

capital being reallocated outside of the U.S., where it is more efficient to deploy. In turn, this means workers bear an increasing share of the cost of an uncompetitive tax code.

Because of the increasingly global economy, most other developed countries have moved toward a territorial system of taxation so that only income earned in their own country is taxed, and foreign earned income is exempt. In fact, 26 of the 35 OECD countries have territorial systems that only tax income earned within their borders and 10 of OECD countries having transitioned to a territorial system since 2000.

In 2009, Japan moved from a worldwide system to a more modern territorial system of taxation. Japan's leaders modernized their tax system to ensure that they would not lose more than $28 billion in foreign assets held overseas. Instead, these assets are still owned by Japanese innovators.[3] Importantly, the Japanese tax reform plan also lowered the corporate tax rate to a level below the United States'.

The result was as Japan hoped. 20 percent more in dividends were sent back to Japan from abroad, and more foreign earnings were repatriated. In addition, Japanese companies acquired foreign companies at a greater rate and increased their investment. The unemployment rate fell and wages rose, although these changes were not entirely due to the change in the taxation system. Even as tax rates decreased, corporate tax revenue increased.

Similarly, the United Kingdom decided to implement a territorial tax system in 2008. In part, this reform occurred because of concerns that the UK was becoming uncompetitive.[4]

After the change was announced, several companies that had left the UK because of the uncompetitive tax system announced they would return.[5] Tax reform also did not affect unemployment or corporate tax revenues. While the rate of unemployment rose slightly, this was more because of the economic crisis felt throughout the European Union. Economic conditions would have arguably been worse had tax reform not been enacted. In fact, tax revenues have increased since then due to strong GDP growth recovery.

Base Erosion Rules Exist As Guardrails Around Territoriality But Must Be Targeted and Limited

While territorial tax systems are becoming increasingly common and necessary for a competitive tax system, there are many details that must be carefully considered in creating this system. In practice, a territorial tax system requires provisions known as base erosion rules to act as guardrails.

Taxing international income is inherently difficult because it is hard to determine where this income is earned and whether it should be sourced to a parent company or one of its Controlled Foreign Corporations (CFCs, commonly known as foreign subsidiaries of a company). This is commonly a problem related to passive income (income related to royalties and dividends, or income related to IP etc.) rather than active business income (income earned through normal activity.) These problems inherently require base erosion rules.

[3] Dittmer, P. (2012, August 10). A Global Perspective on Territorial Taxation. Retrieved October 28, 2017, from https://taxfoundation.org/global-perspective-territorial-taxation/
[4] Dittmer, P. (2012, August 10). A Global Perspective on Territorial Taxation. Retrieved October 28, 2017, from https://taxfoundation.org/global-perspective-territorial-taxation/
[5] Tax Foundation Staff. (2012, November 14). The United Kingdom's Move to Territorial Taxation. Retrieved October 29, 2017, from https://taxfoundation.org/united-kingdoms-move-territorial-taxation/#_ftn9

Even so, these rules must be carefully considered. Rules that create too great of a burden on taxpayers will mean that U.S. businesses continue to be disadvantaged relative to foreign competitors.

Rules need to be constructed in a way that does not undermine the rationale of moving to a territorial system of taxation. In other words, they need to be constructed in a way that does not treat American businesses differently on their outbound taxation than it treats foreign companies operating in the U.S. on their inbound taxation or foreign companies operating overseas on their outbound taxation with other countries.

Why Are Base Erosion Rules Needed?

There are many cases where it is unclear where to apply taxation to a parent company and where to apply it to a CFC. International, inter-company business transactions cross over borders multiple times. Rules must therefore distinguish when income belongs to one country and when it belongs to another.

Below are some examples where transactions between parent companies and CFCs require base erosion rules to properly determine where income is earned. Each one is intended to demonstrate the complexity around international taxation and the varying different transactions that need to be covered by base erosion provisions.

Direct Manufacturing: Under this scenario, a parent company licenses its intellectual property to a subsidiary in another country. The subsidiary then uses this license to manufacture a product and sells it worldwide. The subsidiary pays taxes on its earnings within the country it is located.

There are several transactions that the subsidiary may be involved in. In basic terms:

1) The subsidiary could sell the product to unrelated customers or to unrelated distributors.
2) The subsidiary could also sell the product to another subsidiary based in another country.

Depending on the transaction, the distributing subsidiary could sell the product to customers while the subsidiary that made the product would manage global marketing and would cover the unexpected expenses, i.e. buy back excess inventory. In this case, the distributor would receive a small payment for selling the product.

In another scenario, the distributing subsidiary could take on a greater level of risk and would be responsible for marketing and sales. In this case, the distributor would get a larger payment – base erosion rules would be needed to determine this payment.

Inter-Company Royalties. Under this scenario, a subsidiary in one country funds research and development to produce intellectual property. This subsidiary then licenses this intellectual property to other subsidiaries of its parent company. These subsidiaries use the property to make and sell goods around the world. The subsidiary that produced the intellectual property receives royalty payments and services payments from the other subsidiaries for the services, e.g. repairing equipment for its customers. It pays tax in its country on the earnings.

The subsidiary could fund the research and development of the other subsidiaries through contracts in its country. It could also fund the research and development outside of its country. Another option is where the subsidiary pays its parent for the intellectual property and part of the research and development costs. In this scenario, the subsidiary could also significantly manage the research or development or perform the research and development itself.

Inter-Company Financing. Under this scenario, a subsidiary in a foreign jurisdiction lends funds to other subsidiaries for active business operations. This subsidiary receives interest payments and pays tax on the interest earnings in its country.

This subsidiary could fund its loans through equity contributions from its parent company or through excess cash deposits from other subsidiaries and equity contributions from the parent company. The subsidiary could also perform foreign-exchange management services for the other subsidiaries for larger payments, or it could raise capital by issuing debt to third parties.

What Kind of Base Erosion Rules Are Used by Other Countries?

As the above examples illustrate, base erosion rules (as well as the problems they aim to address) are by definition, complex. It is important that the U.S. implements rules that are relatively similar to those of other countries so as not to disadvantage American companies relative to foreign competitors.

Countries commonly apply base erosion provisions in several ways:

-through providing rules governing taxation of CFCs;
-providing rules around dividend exemption systems;
- limiting the deductibility of interest for CFCs.

Countries also generally have rules requiring that transactions between companies and their CFCs operate on an "arm's length basis," or that it occurs on the same terms as if the transaction were occurring with unrelated parties. In addition, most modern countries with a competitive tax system restrict their base erosion provisions to passive income.

Examples of countries and their base erosion rules include Japan, the United Kingdom, France, and Canada. Generally, these countries have certain tests on sale of goods and services, as well as payments on royalties and interest. The country then applies full corporate tax based on the outcome of these tests.

As part of its territorial system, Japan exempts 95% of foreign-source dividends received from CFCs from tax – meaning that 95 percent of income earned overseas is exempted from taxation. This 95 percent exemption is subject to conditions. For instance, if a subsidiary pays less than 20% in taxes and cannot prove it was actively engaged in business in that country, the company does not receive the dividend exemption. The CFC is also prohibited from deducting large amounts of debt.

The UK has a 100 percent exemption system. Like Japan, there are limits on interest payment deductions and regulations that make diverted income from intellectual property taxable. Also, there are rules that ensure that taxes on income from foreign subsidiaries aren't avoided in low-tax countries. Finally, taxes on patents are lowered to 10% to keep intangible property in the UK.

In Canada, inter-company royalties are taxable unless the royalty cost is deductible from active business outside Canada.

In France, there is generally a tax on foreign sources of income if the local effective tax rate is less than 50% of the French rate, and the primary purpose and effect is tax avoidance. However, CFCs are exempt from this system if they are located in the EU. In fact, the EU also recently adopted rules requiring the 28 EU member countries to enact CFC rules that meet one of two requirements:

1) Rules that exclude active business income but allow current taxation on specified types of passive CFC income.
2) Rules that impose current taxation on CFC income where income arises from a "non-genuine" arrangement – one in which the CFC would not have made the transaction had it been with an independent entity.

The U.S. is no exception in the world in this regard. The U.S. has CFC rules to prevent income being improperly allocated that apply to different types of passive income but do not apply to active business income. Section 163(j) of the tax code limits the deductibility of interest, so that taxable income cannot be shifted to subsidiaries in low tax areas.

There are also requirements for a U.S. based company to provide detailed information on its foreign subsidiaries including reporting dividends, interest, and other gains from subsidiaries, as well as sales income from selling or buying goods from a related party where the goods are made and used outside of the subsidiary.

Imposing A Broad Based Minimum Tax Would Create A Quasi Worldwide System

As noted above, countries typically impose several targeted rules designed to protect their tax base. This would seem to largely rule out one option that has been proposed in the past – a broad based minimum tax. This is an inferior option because it would fail to fix the problems that moving to a territorial system of taxation would solve because such a tax system is not used by our competitors.

In essence, this proposal would reinforce the existing worldwide system of taxation. An example of a minimum tax can be found in President Barack Obama's fiscal year 2016 budget which included a broad based 19% minimum tax on foreign earnings. It also included an 85% credit of the per-country foreign effective tax rate or the residual minimum tax rate. The minimum tax would be applied based on an aggregate basis of all CFCs, determined by multiplying the residual minimum tax rate by the minimum tax base for the country.

The proposal also repealed deferral of profits and applied a one-time 14% tax on the approximately $2 trillion foreign earnings that had not been repatriated. This plan was seen as a way to stop so-called foreign loopholes, as one white house official explained.[6] However, it would have only punished U.S. businesses and failed to fix the underlying problems of the tax code.

Ultimately, this proposal only exacerbated the problems caused by the U.S. worldwide system of taxation.

A new minimum tax on foreign earnings regardless of whether they are repatriated would do nothing to ease the lack of investment in the U.S. economy and would not do anything to create jobs in America.

A report by former Clinton Administration economic official Robert J. Shapiro and Aparna Mathur, a Research Fellow at the American Enterprise Institute, suggested that President Obama's proposal could result in as many as 2.2 million fewer American jobs.[7]

[6] Mason, J., & Drawbaugh, K. (2015, February 01). Obama plans 19 pct tax on U.S. companies' foreign earnings. Retrieved October 29, 2017, from https://www.reuters.com/article/usa-budget-tax/obama-plans-19-pct-tax-on-u-s-companies-foreign-earnings-idINKBN0L51KO20150201
[7] Ellis, R. (2009, June 8). Double-Taxing U.S. Firms on Foreign Profits

A broad based minimum tax risks disadvantaging U.S. businesses by punishing certain types of business activity that is not taxed by foreign competitors. While the alternative – more targeted, and complex base erosion provisions, make the code more complex and may discriminate against certain types of behavior, they also place U.S. businesses and the tax code on a more level playing field when compared to the tax codes used overseas.

Terminology

Active business income is income from goods and services that the business has sold.

Base erosion occurs when companies try to avoid taxation by moving operations or intangible assets from their home country to lower tax jurisdictions.

Passive income is income from rental activity or business activities that the taxpayer doesn't participate in, i.e. royalties and dividends. The income has to be received on a regular basis.

A **controlled foreign corporation (CFC)** is a foreign corporation where 50% of the total voting power is owned by U.S. shareholders. CFCs are commonly subsidiaries.

Intangible income is income from intangible assets, like patents, copyrights, trademarks, etc.

Earnings Stripping occurs when multinational corporations make loans to subsidiaries in countries with high taxes. These subsidiaries can then lower their taxes by deducting interest payments on their loans.

A **dividend exemption system** is a taxation system where dividends are exempt.

Inbound taxation refers to taxation on income from the United States earned by non-U.S. citizens or companies.

Outbound taxation refers to taxation of U.S. citizens or companies on foreign income.

Transfer pricing are the rules that countries adopt so they can adjust the prices of transactions between companies under common ownership. These adjustments stop companies from avoiding taxation by moving profits through purported transactions. This occurs especially with cross-border transactions.

Territorial taxation refers to only taxing income earned inside the country. With some exceptions, income earned outside the country is not taxed under this system.

Worldwide taxation refers to taxing residents on all of their income, including foreign income.

Would Cost Economy 2.2 Million Jobs. Retrieved October 29, 2017, from https://www.atr.org/double-taxing-u-s-firms-foreign-a3350