IS A TERRITORIAL TAX SYSTEM VIABLE FOR THE UNITED STATES?

Eric Toder

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ABSTRACT

Territorial tax systems require clear rules to distinguish between taxable domestic and exempt foreign-source income. Defining the source of a multinational company's profits is difficult, however, especially for profits that are attributable to intangible assets. Shifting of reported profits to low-tax countries with little economic activity is eroding territorial systems around the world. The OECD Base Erosion and Profit Shifting report would limit these abusive transactions, while attempting to maintain territorial systems that tax foreign affiliates of multinational companies as independent entities. Alternatives would abandon territorial systems altogether and seek different ways of taxing profits of multinational companies.

Eric Toder is an Institute Fellow at the Urban Institute and codirector of the Urban-Brookings Tax Policy Center.

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INTRODUCTION

Countries with territorial tax systems impose corporate income tax on all profits arising from activities within their borders (domestic-source income), but do not tax profits arising from activities in other countries (foreign-source income). For the US corporate tax system to be fully territorial, it would need to

- tax US-source income that US- and foreign-resident companies earn, and
- not tax the active foreign-source income of US-resident companies.

Except for the United States, every country in the Group of 7 (Canada, France, Japan, Germany, Italy, and the United Kingdom) and most countries in the Organisation for Economic Co-operation and Development (OECD) now mostly satisfy the second criterion by exempting the active foreign-source income of their resident multinationals. In contrast, the United States taxes the active foreign-source income of US-resident companies when they receive dividends from their foreign affiliates. Many political and business leaders have suggested that the United States follow other countries by exempting those dividends.

In a recent report (Altshuler, Shay, and Toder 2015), we examined the so-called dividend-exemption systems of four countries, two that recently enacted them (the United Kingdom and Japan) and two with long-standing systems (Australia and Germany). We identified wide differences in the economic circumstances and policy considerations these countries face, and concluded that none provide a precise model for policies the United States should enact. Still, as the economic differences between the United States and other countries narrow, and the US share of world output continues to decline, so will the ability of the United States to sustain international tax rules that differ from those of our leading trading partners.

Building on our 2015 report and a February 2014 discussion in an experts' conference on territorial taxation (Toder 2014), this brief explores the following questions:

- What does a territorial tax system require?
- Why is a true territorial system so hard to achieve in reality?
- What are the effects of the recent recommendations in the OECD base erosion and profit shifting (BEPS) report, and of policy changes in other countries following that report?
- Are there better alternatives for the United States and other countries for taxing multinational corporations than either territorial or worldwide taxation?

BASIC DEFINITIONS

A US territorial system would tax all income that US- and foreign-resident companies earn from investments within the United States, and exempt all active income that US-resident companies earn from investments outside the United States. In contrast, a worldwide system would tax all income of US-resident multinationals (including their foreign subsidiaries), whether from a domestic or foreign source and whether distributed from a foreign subsidiary or not. Foreign-source income that foreign-resident multinationals earn is outside the taxing jurisdiction of the United States under both systems. These definitions are illustrated in table 1.

TABLE 1

Territorial and Worldwide Systems for Taxing Income of Multinational Corporations

Corporate residence/source of income	US source income	Foreign source income
US-resident multinational corporations	Taxable by United States under both territorial and worldwide systems	Taxable by United states under worldwide system
Foreign-resident multinational corporations	Taxable by United States under both territorial and worldwide systems	Outside jurisdiction of US corporate income tax

The United States has a hybrid system that is part territorial and part worldwide. It is worldwide in the sense that repatriated foreign-source income of US multinationals is taxable at the full US corporate income tax rate, albeit with a credit for foreign income taxes to avoid double taxation. But the deferral by US companies of tax on most income of their foreign subsidiaries until it is repatriated as a dividend to the US parent company allows these companies considerable scope to accrue profits in low-tax foreign jurisdictions without US tax. In that sense, the US system can be viewed as a "quasi-territorial" system that effectively exempts a significant share of foreign profits.

PROBLEMS IN DEFINING US-SOURCE INCOME UNDER A TERRITORIAL SYSTEM

A territorial system would require the United States to define sources of income as US- or foreign-source. Under a territorial system, there would be no US corporate income tax on active foreign-source profits accrued within foreign affiliates of US-resident companies, whether retained within those affiliate companies or repatriated as a dividend to the US parent company. This requires proper definitions of domestic-source and active foreign-source income.

These definitions are also required under the current system because US-resident companies can defer tax on profits accrued within their foreign subsidiaries until repatriation, and foreign-resident companies are taxable only on their US-source income. The definitions become more important under a territorial system, however, because there would be no residual tax on foreign-source profits of US-resident companies even when they are repatriated as dividends to the US parent company.

Income from Royalties and Exports

Under current law, royalties and 50 percent of revenue from export sales are defined as foreign-source income. Because the US has a worldwide tax system, defining a component of current receipts as domestic instead of foreign source does not directly affect US taxable income, although it can affect the tax liability of US companies by reducing the foreign tax credits they can claim.[1] The classification of receipts would matter for determining taxable income, however, under a territorial system. Royalties that the US parent company receives from a foreign affiliate should be defined as domestic-source income because they represent payments by the affiliate for the use of patents and other intangible assets the US parent company holds. In addition, the title passage rule in current law that treats 50 percent of export sales revenue as foreign-source income would need to be repealed to prevent companies from excluding exports from taxable income. Only the portion of the export revenue attributable to the value added of the foreign sales affiliate should be classified as foreign source under territorial taxation.

Transfer Pricing Rules

Current international practice treats foreign affiliates of multinational corporations that are organized as subsidiaries instead of branches as independent companies. Under this system, the prices that companies charge each other for goods and services traded within the corporate group (transfer prices) do not affect the group's total profit, but do affect the division of profit among affiliates in different countries. In trading with their affiliates in low-tax countries, US companies have an incentive to pay a high price for imports and charge a low price for exports to shift taxable profits to the low-tax affiliate.

The United States and its major trading partners have transfer pricing rules that require companies to set transfer prices equal to the "arms-length" prices at which comparable goods and services would trade between independent companies. Transfer pricing rules that reflect the proper split of income among affiliates of both US- and foreign-based multinationals are even more important under a territorial system than under the current system because a territorial system would completely eliminate the taxation of active foreign-source profits of US multinationals. As we will discuss, these proper rules are very difficult to achieve in practice.

Rules to Allocate Joint Costs among Affiliates

A territorial system also requires appropriate rules for allocating joint costs among affiliates of a multinational group. These costs include outlays for central management, interest payments, and research. Without allocation rules, US multinationals would have an incentive to allocate these costs to domestic production, thereby reducing taxable domestic-source income and increasing tax-free foreign-source income.

Controlled Foreign Corporation (CFC) Rules

Most countries have rules that tax some "passive" and "easily shiftable" income their multinationals accrue within foreign affiliates on a current basis (i.e., controlled foreign corporation [CFC] rules). The US Subpart F rules originally enacted in 1962 to limit tax avoidance by US multinationals are an example. The scope of CFC rules and the degree to which they are enforced differ among countries (Arnold 2012).

CFC rules can be viewed as a "belt and suspenders" approach to enforcing a territorial system. They effectively include some accrued foreign-source income in the corporate tax base to ensure that income whose source should be deemed domestic does not escape tax.

An important limitation of CFC rules is that they only protect against income shifting by home-based multinationals. The US Subpart F rules, for example, do not prevent foreign-resident multinationals with US-source income from shifting that income to low-tax countries, eroding the US territorial tax base and providing a competitive advantage to foreign multinationals operating within the United States. Preventing these companies from shifting income out of the United States requires other techniques, such as limits on interest deductibility or minimum taxes on returns from US assets.

WHY IS A TERRITORIAL SYSTEM HARD TO ACHIEVE?

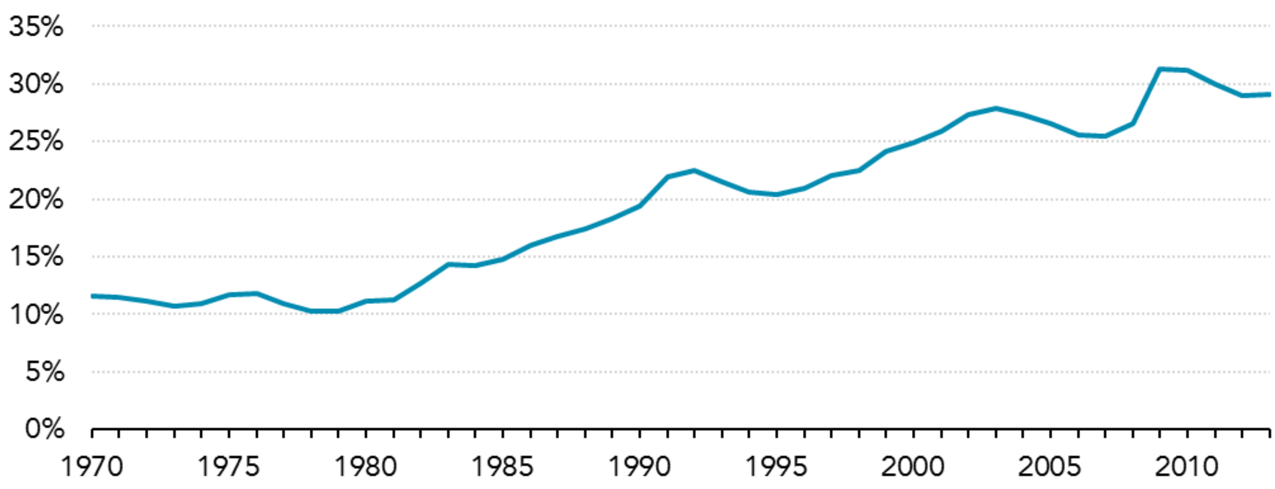
Preventing the erosion of the domestic tax base under a territorial system is hard for both technical and political reasons. Preventing tax base erosion is also difficult under the current quasi-territorial US corporate tax law, but would be even more difficult if foreign income were permanently exempt instead of being deferred until repatriation.

TECHNICAL ISSUES

The largest practical issue is determining the source of income for returns from intangible assets. Source is a reasonably well-defined concept for returns from physical assets, such as machines and buildings, for which the location of the asset is usually clear. But intangible assets such as patents and brand name recognition contribute value to production in all locations, and the question of where they should be taxable has no unambiguous answer. These assets are growing in importance, increasing from slightly over 10 percent of aggregate US investment in 1970 to almost 30 percent in 2013 (figure 1).[2]

FIGURE 1

Share of Aggregate Investment in Intellectual Capital, 1970-2013



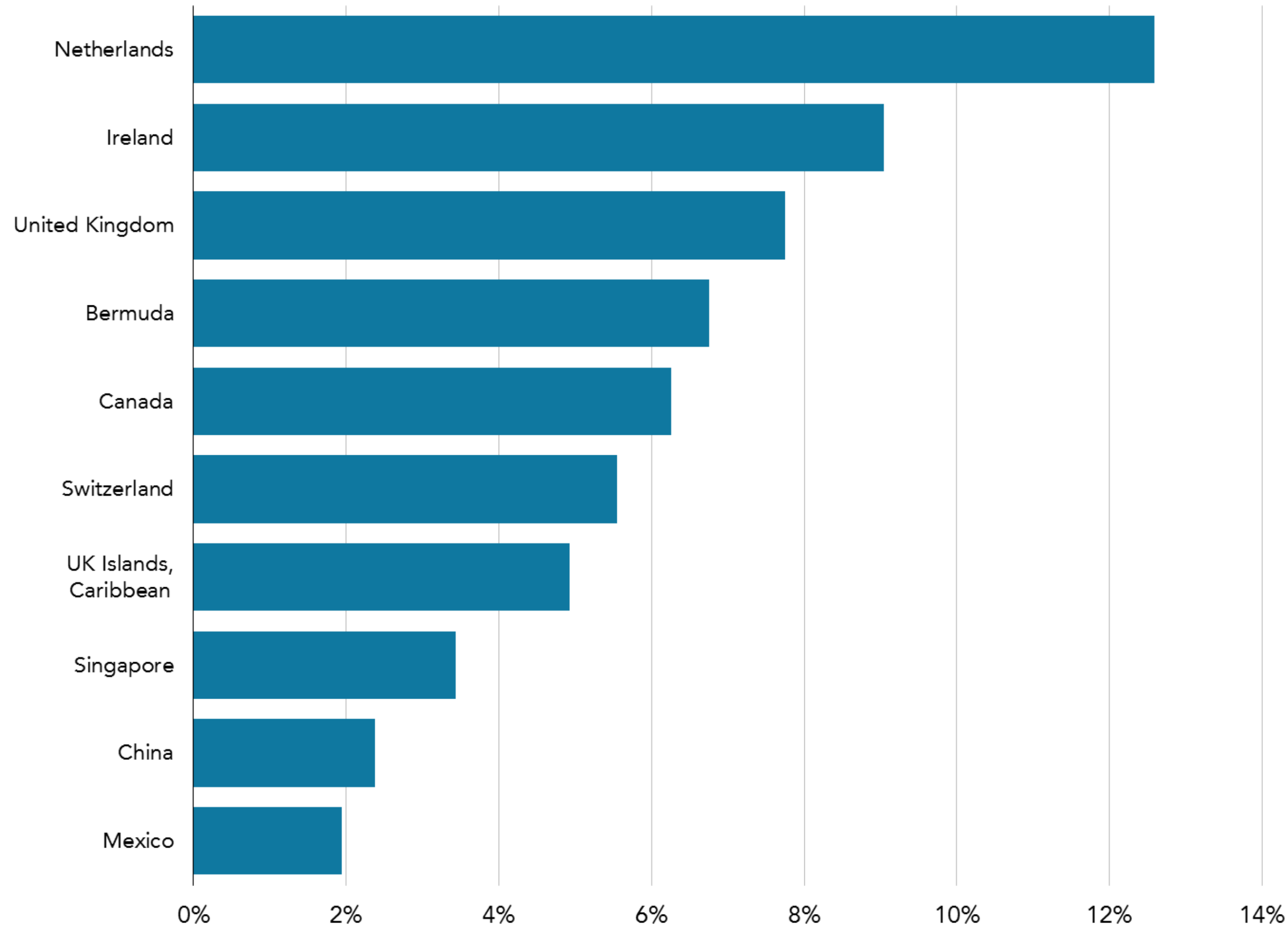
Source: Authors' calculations based on Bureau of Economic Analysis data.

US companies have become very skilled at shifting reported profits to low-tax jurisdictions. US Department of Commerce data illustrate the extreme concentration of reported profits of US multinationals in a handful of low-tax countries where they engage in little real economic activity. In 2014, three of the top four destinations for foreign profits of US multinationals were the Netherlands, Ireland, and Bermuda—small countries accounting for a relatively minor share of their foreign investment and employment (figure 2).

FIGURE 2

Top Countries for Profits of US Multinationals

Profits as a percentage of total, 2013



Source: Bureau of Economic Analysis. 1981–2013. "Operations of U.S. Parent Companies and their Foreign Affiliates." Washington, DC: Bureau of Economic Analysis.

POLITICAL ISSUES

Countries have been competing with one another to bestow more benefits on their resident companies. This "tax mercantilism" has launched a race to the bottom as countries seek to remain attractive places for multinational corporations to establish the residence of their parent company. Examples include the following:

- The *check-the-box rules* that the US Department of the Treasury introduced in 1997 made it easy for companies to select their organizational form. These rules have enabled US-based multinationals to shift taxable profits from high-tax foreign countries to tax havens without being subject to the US CFC rules.

- *Patent boxes* in many other countries reduce tax rates for intellectual property returns that multinationals report to their home country. These rules aim to encourage research in the home country, but the tax benefit is often unrelated to where the research is performed.

- *Less stringent CFC rules and elimination of taxes on repatriated dividends* in some countries make it easier for their resident multinationals to shift reported profits to low-tax countries, both by removing profit-shifting barriers and removing tax on profits brought home.

Competition among countries to benefit their own resident multinationals pressures the United States to do the same. But because many of these benefits allow erosion of the tax base on domestic-source income, they make it hard to enforce our current tax law and would make it even harder to enforce a territorial tax.

MOTIVATION AND FINDINGS

The OECD/G20 Base Erosion and Profit Shifting (BEPS) project (OECD 2015) was a response to increasing shares of multinational profits being reported to tax-free jurisdictions. It focuses partly on so-called hybrid transactions in which companies claim deductions in a jurisdiction with high tax rates to generate tax-free or very lightly taxed income in other jurisdictions. This often results from differing rules and definitions being applied to the same transaction by different taxing jurisdictions. The OECD recommends eliminating many of these “abusive” transactions and calls for a major data-collection effort to generate better information on where companies report their profits. OECD recommendations can influence member countries’ policies, but do not have the force of law.

While the reforms in the BEPS project are far reaching, the proposed rules accept the continued use of separate-entity reporting for the affiliates of multinationals in different countries, and of the arms-length standard to allocate the profits of multinationals among jurisdictions. The proposed reforms seek to strengthen existing territorial systems by eliminating abusive transactions that shift taxable income where economic activity is occurring to tax havens, but provide no clear guidance on how profits attributable to a company’s intellectual property should be allocated among taxing jurisdictions.

RECENT DEVELOPMENTS

Countries are continuing to champion their own resident multinationals, but negative publicity about tax avoidance has led them to adopt measures to impose taxes on profits from intangible properties of other countries’ resident companies. An example is the “diverted profits” tax in the United Kingdom (Ross and Maruca 2015). In addition, in a series of State Aid cases, the EU has sought to deny retroactively tax benefits that some of its member countries, including Ireland and Luxembourg, have granted through rulings to US and non-US multinationals.

Recently announced US Treasury (2016) regulations would raise taxes on foreign-resident companies by limiting interest deductions on transactions with their affiliates.[3] Although developed as part of a larger series of measures to deter inversion transactions (in which US-based companies merge with foreign partners and then reorganize the group with a foreign instead of a US parent), the regulations also limit the ability of companies that are currently foreign resident to strip reported profits from their US affiliates.

These new measures are reversing the global erosion of corporate tax bases, but leave unresolved the issue of which country should tax the profits from intangibles of multinational companies. The result could be a new form of international competition, in which different countries assert rights to the same tax base, leading to a system characterized both by “stateless” income and double taxation that impedes international capital flows. This is far from the OECD’s goal of a territorial system with clearly defined standards for how the taxable profits of multinationals are divided among countries.

ARE THERE BETTER ALTERNATIVES?

A territorial system requires both exemption of foreign profits and taxation of domestic-source income. As this report has discussed, the latter is hard to achieve for many reasons, the largest being the inability to define satisfactorily the source and amount of profits from companies' intangible assets. Attributing source based on the legal ownership of intangibles has led to massive profit shifting by multinational companies to low-tax jurisdictions with comparatively little economic activity, thereby eroding territorial systems around the world. Countries today are competing to help their own resident companies avoid tax on their global profits, while attempting to collect more tax from nonresident companies.

The OECD BEPS recommendations seek to bolster territorial systems through limits on abusive transactions that shift the location of reported income to tax havens. An alternative is to abandon territorial systems altogether and seek a different way of taxing the profits of multinational companies.

One alternative would shift tax liability from corporations to individual shareholders. Proposals by Grubert and Altshuler (2016) and Toder and Viard (2016) would reduce the US corporate income tax rate to 15 percent, while taxing US shareholders on their worldwide capital gains and dividends at ordinary income rates. To prevent shareholders from avoiding or deferring tax by holding assets instead of selling them, Grubert and Altshuler propose imposing a deferral charge on capital gains realizations and taxing realized gains at death, while Toder and Viard propose taxing gains from assets in publicly traded companies as accrued annually on a mark-to-market basis. Basing tax liability on individual shareholder residence is better than basing it on corporate residence or the source of corporate income, because individuals are much less mobile across borders than either the reported source of profits or corporate residence.[4]

A second alternative would shift the basis of taxation from the source of corporate income to its destination (Auerbach 2010). Under this approach, corporations' export sales would be exempt from tax and imports would be taxable. Corporate tax liability would no longer be based on the source of a corporation's income or the residence of a multinational group's parent company. This would remove the incentive for US multinationals to shift reported income to low-tax jurisdictions and engage in inversion transactions to change their corporate residence. Its disadvantages include possible incompatibility with international trade rules, treatment of exporter losses, defining the location of consumption of services and intangibles, and whether exchange rates would adjust as anticipated to prevent increases in import prices. The 2016 reform blueprint introduced by the House Republican leadership (see Nunns et al. 2016; Toder 2017) follows this type of approach.

Yet another alternative approach that moves partly toward destination-based taxation would be to reduce the top individual and corporate rates and replace the lost revenues with a value-added tax of the credit-invoice type similar to those used in over 150 countries (Graetz 2010)

Territorial systems need not be abandoned entirely; in some industries, such as natural resource firms where the location of income is well defined, a territorial approach still may capture location rents effectively. Generally, however, the territorial approach is breaking down, and countries need to consider alternatives. It is encouraging that many scholars, tax practitioners, and political leaders are thinking seriously about new approaches to taxing income of global companies.

NOTES

[1] To avoid double taxation, current law allows US corporations to claim credits for foreign income taxes associated with taxable foreign-source profits, but only up to the tax rate that US companies otherwise would pay on those profits. Some companies have “excess credits,” meaning they cannot claim credit for all the foreign income taxes they pay, because their average foreign tax rate is higher than the US rate that would apply to the same income. But royalties paid by US affiliates are typically deductible against foreign income tax bases, and export revenue generated through US production by US-resident corporations is not taxable in foreign countries. Therefore, redefining these US-company revenue sources as foreign-source instead of domestic-source allows US multinationals in an excess-credit position to claim those foreign tax credits and thereby lower their US tax liability.

As foreign corporate tax rates have declined, and US multinationals have increased the share of profits that they report in very-low-tax foreign jurisdictions, the number of companies in an excess credit position has declined, along with the tax benefit from treating royalties and 50 percent of export receipts as foreign source. But continuing to define royalties and 50 percent of export receipts as foreign source income would significantly erode the domestic US corporate tax base under an exemption system.

[2] One can argue that the profits from intangible assets should be allocated to the country where the intangible was produced. This is hard to do properly, however. Suppose a US high-tech company patents a new product and sells the patents to its Irish affiliate. If the product is not yet being marketed, the value of its patents is difficult to ascertain. The US parent company charges its Irish affiliate a low price, minimizing its taxable income from developing the new product. Once the product’s success is established, the Irish company can then charge a high royalty to a contract manufacturer in China, causing a large share of the profits of the corporate group to be reported to Ireland, with a 12.5 percent rate. Further techniques then can be used to shift the reported profit from Ireland to a subsidiary in the Cayman Islands or Bermuda, eliminating even the low Irish tax (Kleinbard 2011).

[3] These regulations use Treasury authority under a 1969 statute to determine whether a financial instrument is debt or equity, and therefore affect whether payments to related parties are deductible under US corporate income tax law.

[4] The 15 percent corporate rate would reduce but not eliminate incentives for income shifting and expatriation. Grubert and Altshuler propose to limit income shifting by imposing a 15 percent minimum tax on accrued foreign-source income. Toder and Viard do not address the international rules but note that at a 15 percent corporate rate, the distortions from taxing on a source or residence basis are much reduced.

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