Tax Policy Center

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# REVIEW OF CONFERENCE ON WHAT THE UNITED STATES CAN LEARN FROM THE EXPERIENCE OF COUNTRIES WITH TERRITORIAL TAX SYSTEMS

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**ABSTRACT**

On February 28, 2014, the Urban Institute hosted an invitational conference on what policymakers in the United States can learn from the experience of other countries with territorial systems for taxing the income of their multinational corporations. Participants included academic experts, government officials, and private sector tax practitioners from the United States and overseas. The discussion focused on the experience of four countries – two (Australia and Germany) with long-standing territorial systems and two (Japan and the United Kingdom) that moved to a territorial system recently. This document summarizes the discussion at the conference.

*Eric Toder prepared this document from a recorded transcript of the meeting. The document reflects editorial comments and revisions by many of the participants in the conference.*

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## I. INTRODUCTION

On February 28, 2014, the Urban Institute hosted an invitational conference on what policymakers in the United States can learn from the experience of other countries with territorial systems for taxing the income of their multinational corporations. Participants included academic experts, government officials, and private sector tax practitioners from the United States and overseas. The discussion focused on the experience of four countries – two (Australia and Germany) with long-standing territorial systems and two (Japan and the United Kingdom) that moved to a territorial system recently. This document summarizes the discussion at the conference.

Eric Toder introduced the conference and thanked the Smith Richardson Foundation for its support, the participants for attending, including those who traveled long distances, Rosanne Altshuler and Stephen Shay, the co-organizers of the conference and Blake Greene for arranging the logistics.

The participants then introduced themselves. (A list of participants is at end of this document).

## II. SESSION 1: PRINCIPLES AND HISTORICAL BACKGROUND

Presenters: Rosanne Altshuler, Professor and Chair, Economics Department, Rutgers University; Ruth Mason, Hunton and Williams Professor of Law, University of Virginia School of Law

Moderator: Eric Toder, Institute Fellow, Urban Institute, and Co-Director, Tax Policy Center

Rosanne Altshuler spoke about the basic goals of an international tax system. She noted she was taking a U.S.-centric view because that is what she knows best. She then noted that she would discuss the principles and goals and then look at all the decision margins that worldwide and territorial tax systems could affect.

Altshuler began by citing a comment by Hugh Ault and David Bradford in a 1989 volume on international taxation that it is hard to state the optimizing problem to which the current rules are a solution. But she then added that rules for taxing international income are based on the premise that U.S. citizens and residents can be taxed on all their income, but people should not be taxed twice on the same income. Both these principles reflect notions of equity – the concept of income as a measure of ability to pay. Since the source of income doesn't affect ability to pay, the tax system should be based on worldwide income.

Referring again to Ault and Bradford, Altshuler noted that these simple and superficially plausible normative conclusions are supported by similarly plausible efficiency criteria. Altshuler reviewed the concepts of capital export neutrality, capital import neutrality and capital ownership neutrality, and noted why economists have traditionally favored capital export neutrality, which is preserved by residence-based taxation. She concluded that we in the United States have been obsessed with these neutrality concepts ever since the work of Peggy Musgrave in the 1960s, but then asked whether these concepts have gotten us anywhere or are a dead end. And she remarked that the debate among these concepts has not gotten us very far as a guide to international tax policymaking.

Citing the work of Harry Grubert, she noted that the familiar concepts are based on very simple models and ignore the many different decision margins that changes in taxes on international corporate income affect. These include issues such as where to exploit intangible assets, where to locate income, where to book expenses, and what types of financing to use, among others. Citing a remark by Dan Shaviro that welfare economics frameworks relied on a “battle of acronyms”, she commented that it might be called the “war of neutralities” and suggested rejecting any analysis that is based on optimizing along one single margin.

Altshuler then cited a long list of assumptions in the simple models that don’t hold up in the real world, including assumptions that a dollar of foreign investment displaces a dollar of domestic investment (capital export neutrality), capital is supplied at a fixed rate of return in an integrated world market (capital import and capital ownership neutrality), exports (from domestic production) are perfect substitutes for foreign investments, markets are perfectly competitive (implying no excess returns from U.S.-developed intellectual property), there are no foreign responses to U.S. policy changes, there are no intangible assets, and there is no tax planning that shifts the reporting of income. The simple models of neutrality do not take these factors into account.

Altshuler then distributed a list of all the margins that taxing cross-border transactions affect that Harry Grubert had compiled about 10 years ago, adding that others, such as where to locate corporate headquarters, would have to be added to that list today.

Altshuler noted that we in the United States have been obsessed with neutralities and the concept of efficiency and wondered whether similar considerations drove decisions to enact territorial regimes in the United Kingdom and Japan. She cited as evidence for this way of thinking that Jason Furman, chair of the U.S. Council of Economic Advisors, in a recent speech cited both capital export neutrality and capital ownership neutrality as being important factors in policy, along with the issues of where to locate investment and reported profits. Furman then concluded even if you could not achieve perfect neutrality on all margins, the President’s proposals would help on more than one of the margins. So this way of thinking is still important to U.S. economists.

Ruth Mason then spoke to three topics: the history of U.S. international tax rules, constraints imposed on U.S. policy by international norms, and constraints our trading partners face that we do not.

Mason began with the observation that ever since we have taxed corporations separately from their owners, Congress has realized that the separate entity status combined with the ability to invest abroad in different tax jurisdictions provided the opportunity for deferral. After several earlier efforts, Congress enacted Subpart F in 1962, which has been modified over time but retained its basic structure. In enacting subpart F, Congress was principally concerned about U.S. multinationals shifting income and passive investments to tax havens. Congress did not seem to be concerned that lower tax rates were available to U.S. multinationals for active investments abroad.

Congress was concerned with the avoidance of both U.S. tax and the tax of other high-tax countries. So subpart F was really about moving mobile investment and reported profits to tax havens. Based on equity concerns, Congress did not believe taxpayers with foreign income should pay a lower tax rate than U.S. residents without foreign income. Congress also talked about locational inefficiencies, but did not want to reduce the competitiveness of U.S. firms abroad, so they did not want to prevent real investment abroad because it was subject to lower local tax rates.

Mason goes on to note that there have been some significant steps back from the anti-deferral regime. The 1997 “check the box” rules make subpart F income disappear by making entities disappear. In 2005, we had the one-year repatriation exclusion and since then legislative proposals for exemption of dividends.

The second question Mason addressed, which she called the most intriguing question, was how much the norms of international tax rules constrain the United States. She distributed the American Law Institute’s restatement of foreign relations law and then raised the issue of what is customary international law.

Mason stated two conditions for a behavioral norm to become customary international law: 1) it has to become the practice of almost all the states and 2) the states have to follow the norm out of a sense of legal obligation.

Mason noted that Reuven Avi-Yonah (a participant in the conference) is the most prominent proponent for the idea that international law norms constitute customary international law. She shared one example Avi-Yonah cites – the adoption by the United States in 1995 of new transfer pricing methods based on profit splits that are closer to formulary apportionment than to the traditional arms-length method. When the United States adopted these other methods, it claimed that the methods were consistent with the arms-length method, which indicated to Avi-Yonah that the United States saw itself as bound by arms-length.

Mason describes this as a plausible account, but not the only possible interpretation. Another possibility is that the United States just wanted to make its new method more palatable by describing it as consistent with arms-length. The United States wanted to give the impression that it cares about international norms, even if it doesn't consider itself bound to follow them. So while Avi-Yonah provides one plausible account, other stories are also plausible. Either the United States did follow the arms-length standard out of a sense of legal obligation or it just wanted to give the impression it cared about the international norm, even if it was really doing something different. Or possibly the United States just wanted to forestall retaliation or to encourage other countries to adopt the same standard.

Mason went on to elaborate on the problems of defining customary international law. The basic idea for when a normal practice becomes customary law is that a norm has to be widely followed out of a sense of legal obligation. And when it does so, it becomes binding law even for countries that don't consent. But there is an evidentiary problem in determining whether countries following the norm already regard it as law.

She raised tax treaties as a best case example. There are 3,000 bilateral treaties based on the OECD model. But some scholars argue that for something to be customary international law there must be a sanction for violating it, either diplomatic or some other form of retaliation. And based on this standard, she concludes that tax treaties aren't customary international law because a state faces no problem if it doesn't have a tax treaty with another country or doesn't follow usual practices included in treaties where it doesn't have a treaty.

A better example might be the principle that a country will relieve double taxation of outbound investment either by a credit or exemption. Mason comments that the principle that double taxation must always be relieved doesn't satisfy the standard for customary international law either because double taxation can be unrelieved in the transfer pricing area if one state makes an adjustment in a transfer price, but the treaty does not require a matching adjustment by the other state.

But, she goes on to comment that customary international law may require a country to use some method for avoiding double tax. So, for example, if the United States eliminated the foreign tax credit but did not exempt foreign source income, other countries might be up in arms and there could be some form of retaliation.

Another set of candidates for customary international tax are those that reflect limits to a state's jurisdiction. So you cannot tax non-residents or non-citizens on their worldwide income, notwithstanding the advocacy by Monty Python to tax all foreigners living abroad. Countries don't follow the Monty Python standard, Mason argues, out of a sense of legal obligation.

If a country were to adopt the Monty Python tax plan, she argues, it would face criticism from other countries based on an appeal to law. So the question is: do countries not do so out of a sense of legal obligation? That is the type of question, Mason points out, that lawyers and law professors like to debate.

But what is the consequence? Even if we agree that the jurisdictional principle and the double tax principle are customary law, does that constrain the United States? She concludes that the legal constraint is in fact not very significant. If Congress passes a law to the contrary, subsequent federal law would prevail over the customary international law. She concludes that customary law does not serve as a real legal constraint, even though Congress will generally follow it on the grounds that it is not in the U.S. interest to do these things – e.g., replace the foreign tax credit with a deduction or tax foreigners living abroad.

Reasoning analogously, you can't make the case that if all countries went territorial, the United States would have to. So the United States could be a dissenter and would not be bound by customary international law. It could retain its practice of taxing worldwide income of companies, just as it retains other things such as taxing U.S. citizens who reside abroad on their worldwide income. Although a minority practice, the United States has been doing this for a century, putting it in the position of a dissenter.

So the conclusion is the United States is not bound to international tax norms, although it faces pressure to follow them. For example, the United States would have a hard time not adhering to the OECD transfer pricing guidelines, even though history shows the United States can alter those guidelines through unilateral action. The ability of the United States to alter those guidelines has to do with the special attributes of the United States, but smaller countries may not be able to do the same.

Mason cited other examples of U.S. "exceptionalism", such as its definition of corporate residence, "check the box" rules, worldwide taxation, and taxing non-resident citizens. Compared with smaller countries, the United States is freer both to articulate world-wide standards and to remain an outlier from international practice where that serves its interests.

Mason concluded with a brief response to the question of what constraints our trading partners face that the United States does not. The short answer is that European countries face many more constraints than the United States. An example is CFC (Controlled Foreign Corporation) regimes that, under European Court of Justice (ECJ) case law, can only hit artificial arrangements.

Eric Toder opened the floor to general discussion.

Reuven Avi-Yonah stated that he did not think customary international law was a factor for the United States and that we can basically do whatever we want.

He then went on to comment on Rosanne's presentation, opening up a debate between worldwide and territorial tax approaches. He pointed out that countries in the G-20 all have effective tax rates in the 20-30 percent range and each tax multinationals more or less as we do. They have territoriality, but we have deferral and the foreign tax credit. So he doesn't see any competitive disadvantage if we had full inclusion of foreign income at a 25 percent rate. And if people think that's too high, he would go with full inclusion at 20 percent or 15 percent.

But Avi-Yonah does object to the Camp proposal of having a 25 percent rate on domestic income and a 15 or 12 ½ percent rate on international, plus making section 954(c)(6) permanent. (Note: this code section relates to the exemption of certain foreign interest and dividends from the subpart F rules that would otherwise tax them as current income.) His view is that this would annoy other countries by encouraging profit shifting from the United States to Ireland and other places at a time when the OECD is working on this issue. Avi-Yonah asks why we are enacting this new preference, when we should be having just a single low corporate rate on all income, for example, 20 percent. This would stop all the horrible complexity.

Jane Gravelle added a point about taxing inbound capital before getting to the topic of worldwide taxation. She referenced the finding in the economics literature that the optimal tax rate on inbound capital should be the ratio of 1 over the elasticity of supply of capital. And since she believes most estimates of that elasticity for the United States are about 3.0, the optimal effect tax rate on inbound investment should be about 33 percent.

She then returned to the issue of worldwide taxation, pointing out that as economists we generally say that no tariffs are a good idea, even if other countries have tariffs because we can't improve our position by adding to distortions. By analogy, she believes capital export neutrality is the right approach even if other countries don't follow it and in addition is the only effective way to do anything about income shifting.

John Samuels offered an opposite point of view to Avi-Yonah and Gravelle, citing two examples showing how repeal of deferral produced a competitive disadvantage. The first example he cited was the experience of the shipping industry after the United States repealed deferral for shipping income in 1986. The United States promptly lost its world market share in shipping as U.S. companies were acquired by foreign shipping companies. The U.S. companies sold 51 percent of the shares in their controlled foreign companies (CFCs) so they became outside the scope of current taxation. Congress subsequently reversed its policy (restored deferral) because there wasn't enough U.S.-flag shipping and in an emergency we would have to commandeer U.S. ships. He offered this history as an example of the real distortion that repeal of deferral would produce.

The second example Samuels cited was the experience of New Zealand, which repealed deferral on all its companies. Over an eight to ten year period the share of the foreign direct investment (FDI) of New Zealand companies dropped dramatically, compared with their Australian counterparts. And then they reversed course and went back to a territorial system. He conceded that one might say it doesn't matter because New Zealand is a small country, but then offered the view that we are all small countries in a world of the internet and low-cost communications.

So in his view these are two laboratory examples in the real world that are evidence that current taxation of foreign income can be a competitive disadvantage. Samuels conceded that is a loaded term, but commented that there are real-world consequences to imposing higher current taxes on all companies in a particular country or industry.

Moving away from the world-wide vs. territorial debate, Stephen Shay raised the issue of whether the earlier comments by Ruth Mason and Reuven Avi-Yonah understated the effect of international law in the context of treaties. Shay agreed with their conclusion that we have the legal ability to over-ride treaties and added that he had been at the Treasury during a time of more treaty over-rides than anyone else had and had been required to defend them to other countries. But he added that in reality the treaty overrides we have adopted through statutes that are inconsistent with treaties have all been fairly marginal.

It would be a more than a trivial treaty issue, however, if we pursued one idea that has been floating around in the United States and allowed deductions instead of credits for foreign taxes, while lowering the tax rate. He raised this question not as a matter of customary international law, but as a question of international practice. If we do something that is so at variance and affects the interests of another country to such a degree that we create a legal right for them to terminate a treaty, should the United States care? He views this as the real context in which we have to think about the constraints of international law, not so much as a result of the consequences of customary law but of potential responses by other countries in practice.

Shay concluded by raising the question to others of what they would think if the Germans objected to a U.S. failure to give a credit to taxes on German-source dividends and only allowed a deduction for these taxes, while taxing the German-source income at a lower rate. If Germany in response were to terminate their treaty with the United States, how would that affect U.S. interests? And should the United States care? How much are we constrained?

Tim McDonald responded that it matters a lot because most enterprises ultimately become global, although he cited real estate as an exception that is less subject to global competitive pressure. Germany has the largest GDP in Europe and a higher standard of living for most of Europe. It matters for a consumer products company whether you can sell goods there.

McDonald commented that he favors having treaties with everyone for several reasons, including information exchange and limiting base erosion. He thinks going to a deduction is a terrible step in the wrong direction. In thinking about this, he would encourage economists, lawyers, and accounting to think like scientists instead. Test a theory to determine whether it is correct and then adjust the theory. In his view, experiments going on through the world are not going in the direction of worldwide taxation with no deferral, repeal of credits, or any other policy that might be theoretically desirable if everyone else in the world did it. One hundred years of income taxes shows it is clear there is no consensus to repeal deferral.

Policy, in his view, should be based on what's good for United States citizens and our standard of living, how we grow the economy, get better paying jobs, and fund the government. But the latter is not the sole purpose of tax policy.

Les Samuels commented that it was In the U.S. interest to have a robust tax treaty network because we have multinationals operating abroad and we want the high ground if Korea or China or India does something that is outside the international norms of what people think treaties are. We have a strong interest in maintaining our treaty network. We may at the margins have to over-ride a treaty, but it's at the margins, not on anything fundamental.

Samuels recalled occasions when our trading partners were upset about some of our domestic tax policies, including the CFC rules, transfer pricing rules, and the California unitary tax, which almost caused a tax war with the United Kingdom, who were threatening to terminate our treaty with them. Our trading partners at the time were trying to use the negotiation of the GATs (General Agreement on Trade in Services) agreement to prevent California from imposing a unitary tax and to prevent us from utilizing our CFC rules and transfer pricing rules. And that was very serious. It worked out ultimately, but our trading partners at the time were trying to corral the United States through using trade agreements to impose restrictions on how U.S. tax policy was going to be made. Ultimately, after some negotiation, the United States prevailed so that, in the GATs, other countries were not able to impose constraints on how Congress can make income tax laws.

Les Samuels also commented on the debates about tax policy, noting that there are a lot of distortions and the competitive issue is part of the debate, but so is the rule of law. He noted that the example John Samuels gave of the shipping industry did show U.S. policy to be non-competitive, but suggested that was an extreme example and there weren't many examples like that. He agreed there were many distortions, but noted that India has all kinds of onerous rules and people nevertheless invest there because they want to be in India. It's a question of degree and getting the balance right.

Brian Arnold suggested that the United States is too sensitive about treaty over-rides because we can't fly under the radar the way other countries can. Australia and Canada can over-ride treaties and Canada is about to introduce an anti-treaty shopping rule which would over-ride treaties and would not renegotiate them. He added there were good and bad overrides and that the example of introducing a deduction instead of a credit for foreign tax was a bad one, a breach of the treaty. But if the United States did that, what would Canada do? Canada would not terminate the treaty, because there are other things in the treaty unrelated to that provision that affect a lot of people. Besides, he added, Canadians are nice.

Dan Shaviro commented that the conference was trying to bring different audiences together in the hope that they will understand what others are talking about. He commented that Ruth Mason was talking about what lawyers think about, which he wanted to contrast with how economists might approach the issues.

On Mason's example of taxing foreigners who are not here, Shaviro suggested (agreeing with Monty Python) that there would be clear benefits if you could get away with it. The reasons we don't do it include we can't, it will just backfire, and it would be a violation of legal norms.

Lawyers usually want to think about what is the correct legal answer and this does not involve the kind of normative framework that economists work with. Therefore, what determines the correct answer is that a court agrees with it. Lawyers are used to situations in which a court actually decides. This may not apply in the international setting.

So, for example, suppose the United States clearly violates a treaty. Countries will react one or another way to the violation. It's really an empirical question, not a legal one, even though legal reasoning will be an input into how this all plays out. Some will respond based on how coherent the legal arguments are and that might to a marginal degree affect how others respond. But legal arguments often can be framed in different ways, so you may be able to do the same thing substantively in different ways and its legality will depend on how you frame it.

Shaviro briefly discussed two examples of treaty violations. The first example was a destination-based X tax. If the United States enacted such a tax, it would risk violating all our treaties because the WTO (World Trade Organization) hasn't recognized that it is just a VAT (Value Added Tax) plus a wage subsidy. Some people would say this would be such a stupid treaty violation that we shouldn't worry about it because no one would care. Others would say we would have to break the X tax into two separate instruments (such as a VAT with wage credits) and that would then be acceptable to the WTO.

The second example would be his proposal to reduce the current 35 percent rate with a foreign tax credit to, for example, a 10 percent rate with deductibility. That would be violating the treaty although we could keep the net U.S. tax on foreign source income unchanged. If one of the other countries cared, they would be right that there would be a technical treaty violation. He noted however that the Senate Finance Committee discussion draft showed you can reframe the proposal so that it is at least arguably not a treaty violation.

He concluded that because the legal norms are semantic instead of substantive they often can be manipulated so you can achieve the same result in a way that is not as legally questionable while effectively doing the same thing.

Peter Merrill cited the base erosion provision in the Camp bill as another interesting example of a possible treaty violation. Camp would subject intangible income of U.S. companies from exports, defined as gross income less 10 percent of depreciable assets, to a 15 percent tax rate. On the face of it, this looks like a lower tax rate on export income (than on domestic income). So this could be inconsistent with the WTO General Agreement on Tariffs and Trade. Merrill commented that if we went down this path this would be an interesting example of how other countries would react and whether that would be viewed as consistent with international law.

Merrill then followed on John Samuels' example about shipping and advanced the argument that in the long run all countries are territorial. He suggested that even if all countries adopted a worldwide system it wouldn't work if we could not get tax rates harmonized. If one country has a lower tax rate than other countries, shareholders would want companies in that country to own all the companies in the world. For example, any shareholder of GE would prefer to have an Irish company be the parent company of GE and be a shareholder in the Irish company. He conceded this is not going to happen to GE overnight, but over time there would be economic pressure to do that.

Merrill concluded that his point of territoriality is more obvious when looking at small jurisdictions, noting that the city of New York does not try to tax (corporate income) on a worldwide basis because they know then that companies will move out of New York. And states don't tax on a worldwide basis any more either. The EU is moving towards a common consolidated corporate tax base which is a territorial system with formulary apportionment. So he concludes that a worldwide system is not stable even if every country does it, unless you have uniform rates.

Stephen Edge commented that it is as likely for the United Kingdom to move to a consolidated tax base as it would be for the French agreeing to make English their official language.

On a more serious note, Edge expressed skepticism about whether there is such a thing as customary international law. He cited the example of the definition of the term "beneficial ownership", which means something different in different places. He does not believe there is a form of legal Esperanto where terms mean the same thing all over the world.

Edge added that there are normal customary ways in which civilized people behave when trading with other territories, based on notions of give and take. But also lots of countries, in looking at their tax laws, are considering first and foremost the effects on their own economies. If countries believe based on both politics and what is good for their economy that it's right to tax the foreign profits of their multinationals at a lower rate, that's what they will do. But we shouldn't fool ourselves into thinking tax is anything other than part of an overall political and economic package.

Each country, in his view, will tailor its tax regime to what will work for it. And Edge believes that countries will respond to the kind of dynamics that John Samuels and Peter Merrill are talking about, where ownership changes can occur.

Eric Toder raised two legal issues for discussion. The first question is whether and in what circumstances the United States can tax foreigners. If a company chartered in Bermuda is a CFC of a U.S. parent company, then our CFC rules (sub-part F) do tax something that is technically a foreign company. But if it was an independent company with a Bermuda residence that does not have a parent in the United States, we wouldn't be able to tax its income. So what makes something a foreign company that the United States can tax versus a foreign company that the United States can't tax?

The second question Toder raised had to with the fact that international trade agreements are multilateral, while in tax we have a series of bilateral agreements. The OECD is trying to develop a base erosion standard. How is it possible, legally or through some other mechanism, for the OECD to enforce any agreements that come out of its base erosion work?

Ruth Mason responded to the question of why international income tax agreements are bilateral and trade treaties multilateral. Her response is that there is more international agreement of what should happen on trade, where the standard is no taxes. There is less agreement in income taxes, where the idea isn't to end up with no tax, but to decide which state gets to collect how much under what circumstances. So because it is not clear what the normative endpoint is, the answer depends on the relative bargaining power of the two sides.

Stephen Edge responded to the question of when countries can tax foreigners by noting that countries can do whatever they want if they can enforce it. For example, when hosting sporting events, you don't tax Olympic officials under any circumstances, but the United Kingdom can and does tax non-UK sportsmen who win Wimbledon on both their winnings and sponsorship income. It is down to the practicalities of enforcement. Les Samuels agreed that the issue was one of enforcement. If there are no assets in the taxing jurisdiction, how do you enforce?

On Toder's OECD question, Edge responded that the OECD's role is to set standards and say what normal behavior should be. Les Samuels added that, unless they have a treaty, countries generally will not enforce a foreign country's tax judgment. There actually is an OECD-led multinational agreement on enforcement of taxes to which the United States has signed up. So there is a kind of international development of a multilateral tax agreement (on enforcement). He commented that it will be interesting to see how that translates into the BEPS (Base Erosion and Profit Shifting) process at the OECD. The OECD can encourage people, but ultimately only the countries that want to will sign up.

Miranda Stewart followed up by noting that 62 countries have signed on to a multinational convention to coordinate enforcement. Information exchange is part of that. But information is only a means to an end, the end being the collection of tax.

Stewart suggested that over time the world will move beyond information exchange, which is now OK to talk about, to mutual collection. And then countries will dispute whether they should collect taxes for another country if that country is trying to collect from someone outside their jurisdiction. She raised the possibility that the BEPS process might extend multilateral agreements to tax base sharing, based on an international norm of no zero tax. The historic norm has been no double taxation, but perhaps a new norm might be you can't have income that is not taxed at all. This leaves a lot of room for difference and there's no agreement on it. The BEPS process might include agreement on some provisions that deal with arbitrage transactions, but she doesn't see anything broader than that.

John Samuels provided his response to Toder's first question about taxing jurisdictions. What makes a company within the U.S. taxing jurisdiction? And he expressed the view that where a company is incorporated should be irrelevant and noted that countries like India and others are looking increasingly to source-based taxation. They will find a way to tax the incomes they believe were produced because of their market.

John Samuels added that the way to collect these taxes – easy conceptually, but hard politically – is through withholding. The United States imposes a withholding tax on rents, royalties, interest and dividends paid to foreigners who invest in the United States. If a foreign company is based in Germany, has an affiliate in Ireland, and the Irish affiliate is selling goods into the United States, the United States could impose gross withholding taxes on payments from the United States to the Irish affiliate that is accessing our markets. He noted that under the Camp bill's option C we are going to tax U.S. companies on a destination basis.

Harry Grubert interjected by asking John Samuels if we impose the tax even on sales that purely exported to the United States. Samuels responded yes, depending on what the rate is and commented that Reuven might agree with him. He concluded that we will be driven to source-based taxation in a world of mobile capital and withholding taxes will be one of the mechanisms for enforcing that.

Dan Shaviro commented that the technical legal answer on how the U.S. may tax foreign persons such as a Cayman subsidiary is that it doesn't. As a technical matter, it taxes the U.S. parent, not the foreign company. He added, however, that anti-inversion rules can overturn that principle. A company does a transaction so that there no longer a U.S. person. Our (anti-inversion) rule says no, you are still a U.S. person. So it as if Monty Python helicoptered into France and the British government said, guess what, you are still a U.K. citizen. We don't tax foreign persons as a technical legal matter, so our laws continue to treat you as a citizen of our country.

Following up on Shaviro's last comment, Avi-Yonah added that this what he has favored for 25 years, despite the Indians, but you have to rewrite all our treaties to get rid of the Permanent Establishment standard. In his view, we can tax foreign-subsidiaries of multinationals. As Shaviro said, we do this by taxing their shareholders, not the CFC itself. He believes tightening the anti- inversion statutes provides some potential to expand this. If you invert and too many of the shareholders are former U.S. shareholders, you would be treated as still being a U.S. company. Recently, lots of firms have found loopholes in the current statute so the rules need to be tougher and there needs to be a managed standard for defining headquarters. If you can get the G-20 to agree, then a firm can't go to Ireland or a tax haven.

Alfons Weichenrieder offered a different perspective. He said he would cheer it if our international system would converge to a source-based taxation. What we have now, however, is a special version where the source for some reason is in Bermuda, the Bahamas, Ireland or Luxembourg. That is our problem. So the discussion we are having here (source vs. residence) is completely alien to a European.

From a European perspective, we have companies like Amazon with a physical presence in Germany, but their one-click purchase technology is so valuable that by a miracle all the profits originate in Luxembourg, which has zero tax on royalty income. And therefore, because of source-based taxation, Germany gets no revenue.

The United States could address this by strengthening its CFC rules. But the United States believes it's mainly the European high-tax countries that pay the price for this profit-shifting. It is somehow not the American taxes that are reduced.

The implication is we don't have capital import neutrality because a local family-owned firm pays tax on a book sale in Germany, but Amazon is trading tax-free. The solution might be the Monty Python view. Germany would say we cannot tax the firm in the Bahamas or Bermuda, but as long as there is physical presence in Germany, there is a subsidiary of Amazon. We (Germany) could apply an inverted CFC rule saying the German affiliate (of Amazon) is liable for tax on the Bermuda profits because the United States is not effectively implementing its CFC rules.

And then, Weichenrieder added, Germany could hand over the revenues collected to the United States because, citing an earlier comment, revenues should not be the objective of fiscal policy. But he would gladly accept that the United States does not need the money.

Douglas Shackelford, noting that he is an accountant, not a lawyer or economist, commented that we are for all practical purposes a territorial country, based on accounting rules. This is because the indefinitely re-invested earnings provision allows companies to report there is no tax if there is no future repatriation. And U.S. multinationals have taken the position on their financial statements that they are never going to bring the money back.

For the companies that we are talking about in this discussion, companies like Amazon, GE, or Procter and Gamble, the books matter at least as much as cash taxes. And for these companies the territorial effects of the accounting rules are every bit as important as the non-territorial rules of the tax system.

Shackelford added that because we are already in a territorial system by accounting rules the adoption of a territorial system from a cash taxes perspective is a much subtler shift than the subject of the conference might imply. And one key place there might be differences is in transfer pricing because whatever transfer pricing changes might be occurring comes from a starting point in which companies are engaging in the same sort of transfer pricing to manage their book-tax expenses.

Harry Grubert responded that we are not already in territorial as Doug suggested. Tim Cook (Apple) has said he is willing to pay any single-digit repatriation tax. So Harry says we should not ignore the effects of the trapped cash. He and Rosanne Altshuler estimate that the burden on the margin for high tech companies is 5 to 7 percentage points, which is a high burden, and that the implication of relieving that burden is the subject of the conference.

Grubert then asked John Samuels whether if residence doesn't count should the location of where an intangible is created count in deciding where income should be reported?

John Samuels said no, the location of where the intangible was created should not count either because that can move too. The only thing companies can't move is where their customers are located. They can move the ownership patents and, albeit less easily, the location of where they do R&D. He suggested that Germany can tax Amazon by withholding tax on the payment from the German customer to Amazon on sales into Germany.

Grubert responded that you can't always identify the location of the customer either, giving the example of selling airplane engines to a leasing company in Ireland. John Samuels and Grubert exchanged views on the ease of determining where property is ultimately consumed, with Grubert noting that 70 percent of U.S. exports are either industrial materials or capital goods. Grubert noted further that the location of R&D might not be that easy to shift, citing the fact that the share of R&D performed by U.S. multinationals abroad has fluctuated in a very narrow range for a long period of time.

Tim McDonald agreed with Shackelford's point that accounting considerations are as important as cash tax liability, not only for Procter and Gamble but for all the executives he has dealt with. Relative to source taxation, his company has had at least two countries say they would tax 100 percent of the income (from sales in) their country, regardless of where the product was made. And P&G filed a brief arguing this is a violation of GATT. They asked the Minister of Finance if he knew what his tax administration was doing and said they would file a complaint under WTO if necessary.

He concluded that basing a source-based income tax on destination of sales, while theoretically possible, is a big lift and it would undermine all U.S. trade agreements.

Jane Gravelle differed with Shackelford's conclusion that going to a territorial tax won't make much difference because we are already close to one. She argued that if you go to a territorial tax and can't deal with transfer pricing, firms could freely shift their profits and then bring them back (tax-free). And she viewed that as a very different world than if you have to pay tax when you bring the profits back.

She further asserted that historically firms have repatriated what one would expect them to because they need to reinvest. When we had the repatriation holiday, we had a huge response, which suggests firms wanted eventually to repatriate the profits; otherwise, why would they pay any tax? And since then we have been tantalizing companies with the promise of a second repatriation holiday, creating a large case of moral hazard. She argued that this promise has affected the accumulation of cash abroad and that if the United States finally said no more holidays, we are sticking with what we have, companies would start bringing the money back. As an example she said she had heard that Pfizer made an immediate repatriation of billions of dollars after the Senate voted to reject a repatriation holiday in 2009.

Robert Stack commented on the BEPS process (in which the U.S. Treasury is participating). Stack noted the comment that the OECD has been the standard setter for a long time, but that was when the players were the 35 most developed countries. And now the OECD is thinking about whether it can be the basic arbiter of conflicts between countries about tax policy, in combination with the G-20.

Stack goes to BEPS meetings and describes it as a consensus-based process. This search for multilateral consensus has come about in part because the OECD sees itself in competition with the United Nations and also wants to include India and China and make everyone happy. The difficulty is that they are trying to resolve real conflicts of national interest on a consensual basis. He believes these difficulties will continue in the BEPS process. He commented further that he had not been aware that academics have thought about when tax agreements are done multilaterally instead of bilaterally and that the discussion of the reasons for choosing one or the other is helpful.

Ruth Mason returned to the source vs. residence issue, commenting that many of the domestic source rules embed the idea of corporate residence within them, for example when income is sourced based on where the owner resides. So you don't get rid of the residence problem when you have a source system.

On BEPS, Mason notes that their action plan says they are not to address the source vs. residence issue. That's a crucial question, but they're trying to avoid addressing it under BEPS. And the only domestic law the report mentions is check-the-box.

Jennifer Blouin observed that companies in the United States have planned themselves into a territorial regime so they could be competitive on the global platform. With check-the-box, the reduction in rates overseas, and the U.S. rate staying at 35 percent, the result is that the buildup of trapped cash has become bigger. And that's part of the problem.

First, the SEC is asking about permanently reinvested earnings and the size of the cash balance. Blouin would argue that Apple does not have a liquidity problem, with $120 billion in cash on its balance sheet, but the SEC is asking how much tax they would owe if they paid it out. Tim Cook told his investors Apple will not repatriate the cash and doesn't need to in order to pay dividends or repurchase shares. Blouin noted that a lot more U.S. firms are borrowing to access that cash. Other countries have tried to limit that borrowing, but testimony from HP suggests there's lots of ways around those limits.

Blouin concluded that we have to do something. These are big dollars out there and because of that (the trapped cash) U.S. firms are not completely competitive.

Tim McDonald made some additional points. First, if we do have de facto territorial, it's the world's worst system because it diverts management attention and having trapped cash is not a desirable state. Second, the repatriation buildup that Gravelle mentioned reflects history. When the United States dropped its rate in 1986 below the OECD average, blending credits to avoid a residual tax on repatriation was easy. But now that the rest of world has dropped its rate by 12 points, it is much harder to blend credits and avoid repatriation tax. Now there is a real economic cost to repatriation. If the tax were just a little nick, they would pay it. But as it gets larger, it pays instead to borrow and keep the cash offshore. Second, interest is deductible in the United States, so you borrow there as you leverage up. So McDonald describes the observed behavior as a result of choices in U.S. tax policy. P&G has put most of their profits back into the business, but to the extent they have cash balances it is a result of policy choices.

Third, with regard to the Wyeth acquisition (by Pfizer) that Gravelle mentioned, the transaction was perfectly rational and the accounting was perfectly rational.

Peter Merrill responded to comments made by Jane Gravelle and Reuven Avi-Yonah. He agreed with Jennifer Blouin that the buildup of cash has to do with the combination of lower foreign tax rates and check the box. The interesting question is whether the residual tax paid by U.S. companies has declined; it's very low now, but was also, he suspects, very low in the past (for different reasons).

And, in response to Avi-Yonah's proposal to tighten anti-inversion rules, Merrill argued that it was a question of what time frame one considered and how clever were taxpayers and government. He asserted that if we have a worldwide accrual system with a higher rate than elsewhere, there will be pressure for companies to put their foreign subsidiaries outside of the U.S. tax net. If we tighten the anti-inversion rules, in response we will get more real instead of fake acquisitions and management of companies will move elsewhere. Over time, new companies will start as foreign companies and the market share of U.S. companies will decline as they sell their foreign subs. So with foreign subs owned by someone else, we will eventually have a territorial system.

Alfons Weichenrieder brought up the trapped equity view of Alan Auerbach and others. He questioned whether it mattered for a U.S. parent whether their money is at home or abroad, except possibly for corporate governance issues. With perfect capital markets, the shadow value of a dollar in Luxembourg should be the same as the shadow value of a dollar in Delaware because it is possible to reinvest the Luxembourg dollar on the same capital market.

Annette Deckers agreed with Gravelle that the U.S. system is not the same as territorial. She commented that the United States is so big that it could set a new standard by changing its tax system. She added that the system of today is not stable and the Netherlands can't handle it by themselves.

Ruud de Mooij commented on some evidence on the effects of the repatriation tax, referring to a study by Johannes Voget that finds that a 10 percent increase in the repatriation tax increased the probability of relocation by one-third.

Eric Toder ended the session, observing that the discussion was fascinating but we did want to move on to learn more about other countries' tax systems.

## III. SESSION 2: EXPERIENCE OF COUNTRIES WITH LONG-STANDING TERRITORIAL SYSTEMS

Presenters: Miranda Stewart, Professor and Director, Taxation Studies, University of Melbourne School of Law; Alfons Weichenrieder, Professor of Economics and Public Finance, University of Frankfurt

Moderator: Brian Arnold, Professor Emeritus of Tax Law and Senior Advisor, Canadian Tax Foundation

Brian Arnold opened the meeting by pointing out that Americans do have important things to learn from other countries' experience with territorial systems, even if those lessons are mostly negative ones. He pointed out that 13 years ago he was in Washington at a conference discussing the possibility of the United States adopting territorial taxation. So either these are very difficult issues or we are slow learners!

Arnold recalled that at the time his advice was "don't do it." Stick with what you have, even though it is flawed, because you are familiar with it and not with an exemption system. Just tweak and massage what you have.

But Arnold noted the world has changed in 13 years. Additional countries have adopted exemption systems. Tax rates have come down. And we are engaged in the OECD's base erosion and profit shifting initiative, which raises the possibility of coordinated action on these issues. So it is valuable to go back and revisit the same issues from back then. He then turned the floor over to Miranda Stewart to present the Australian experience.

Miranda Stewart opened by commenting that the first session showed Americans don't have that much to learn from Australia. Australian's treaty with the United States is tailored to what the United States would like to happen with cross-border investment. And Australia is always responding to economic pressures and the positions of other countries, including the United States.

While Australia has at times had a little bit of a worldwide system, it has had an exemption system for most of the past hundred years. But one of the key messages is the interaction between the exemption system and other international and corporate tax rules. In particular, in Australia, one must consider the interaction between the participation exemption rules, the domestic shareholder tax system, the CFC rules, and the whole way Australia taxes passive and portfolio income.

Australians also talk about the norms of capital export and import neutrality. But, she added, Australians in addition talk about national neutrality; that is, policy should benefit Australia and who cares about the rest of the world. That is, Australia takes a deduction approach.

But beyond theory, Stewart characterizes Australian international tax policy as truly pragmatic. There is reference to principle, but in reality the government is compromising among domestic business interests, investment needs, and shareholder interests, particularly the interests of institutional investors, who are very important in Australia. Australia has historically relied heavily on corporate tax revenue, with some concerns about off-shore tax haven avoidance. Being a capital-importing country, Australia uses the corporate tax to collect money from foreign shareholders, but also has had to respond to international political pressures, especially from their historical colonial master, the United Kingdom.

Australia's original system, from 1915 to 1930, was purely territorial. The government then tried a worldwide tax system in the 1930s in an effort to collect more revenue. But the United Kingdom objected to Australia taxing U.K.-source income and Australia then said OK.

Australia did not have treaties in those days, Stewart continued, so they simply exempted all foreign-source income received by both companies and individuals as long as it was subject to some tax somewhere. This remained the law for a long time, until the 1980s.

The economic context for this is that Australia is and has been a capital-importing country. The purpose of the tax regime is to protect the resource base of Australia and attract foreign investment. (By implication, there was not that much concern about how outbound investment was taxed.)

In the 1980s, Australia removed capital controls and let the Australian dollar float. It soon became apparent that Australia was both a capital-exporting and capital-importing country; gross outbound investment is 60 percent of gross inbound investment. Most of the investment flows go in and out of the United States and United Kingdom.

In response to rising concerns that the removal of capital controls combined with exemption was encouraging Australians to put their money in tax havens, the government enacted a worldwide system in 1987 with a foreign tax credit. But, Stewart continued, this lasted only four years. In 1991, Australia re-introduced a participation exemption for companies, although this was limited to investments in countries with comparable taxation rules. Economically, the effect was not that different from a worldwide system with a credit, because there had to be a comparable tax to benefit from the exemption.

Only since 2004 has Australia moved to a full exemption system, which includes both subsidiaries and branches. So there is no tax on business income from other countries. The income does not need to have been taxed by the host country and the host country need not be a treaty country for exemption to be available.

In the late 1980s, Australia realized it needed to develop CFC rules to prevent accrual of income in tax havens. The first discussion paper on the topic in 1991 would have had full accrual on all income and no deferral. But Australia quickly retreated to the U.S. position of allowing deferral (subsequently, exemption) for active foreign business. So the issue of when to impose accrual taxation depends on whether the activity is active or passive, as in the United States.

Stewart characterized Australia's CFC rules as outdated. They are 15-20 years old and don't provide a very good definition of the boundary between active and passive income. Australia's transfer pricing regime is also inadequate, although it was reformed recently.

Stewart pointed out that the other interesting aspect of Australia's rules is the interaction with the imputation credit system. Suppose an Australia company has $100 of income, pays $30 of corporate tax, and distributes the after-tax profit to shareholders in the 45 or 50 percent bracket. The shareholder reports $100 of gross dividends as taxable income, but then gets a $30 credit for the corporate-level tax. This eliminates the double taxation of dividends, a position all have accepted. Yet if labor bears some of the corporate tax, then the justification for the tax relief is reduced.

Stewart noted that another important influence on the Australian corporate tax is the size of the managed fund sector. Australia has the fourth largest managed fund sector in the world, in part because of their superannuation (e.g., pension) system. Superannuation funds are taxed at a 15 percent rate, but they can reduce that rate by claiming imputation credits. These funds invest about 20-25 percent of their assets in Australian companies and this makes them important players in the domestic political debate on tax reform.

If an Australian company brings back tax-exempt foreign profit, it does not pay any repatriation tax. But shareholders don't get to take the imputation credit if no company tax has been paid, so this produces a national neutrality result for distributed profits. The foreign income tax is deductible, but there is no further credit when the after-tax proceeds are distributed to shareholders. So there is effectively a national neutrality system for distributed profits, but an exemption system for retained profits. Stewart concluded that the imputation system may have an important effect on Australian corporations and may place them at a disadvantage.

Stewart concluded by emphasizing again the importance of the imputation credit in understanding how the Australian system works. Lowering the corporate rate might make the imputation credit less valuable. But the participation exemption is now embedded strongly in Australia.

Summing up, Brian Arnold commented that the national sport in Australia was tax reform, not cricket or rugby, as one might suspect.

Alfons Weichenrieder then made a presentation on the German international tax rules. He began by addressing the question of why Germany was an exemption country. It's complicated, but basically it got there through historical evolution.

In the 1930s and 1940s, the legal default rule was a deduction system, but with exemptions for countries with which Germany had treaties. With lobbying and some administrative rulings, the exceptions eventually became the rule and until 1957 exemption was the default.

In 1957, the default rule became a credit system when there was no applicable treaty. Then, in 2001, Germany moved to exemption as the national default, even with respect to countries like the Cayman Islands and Bermuda where Germany did not and still does not have a double tax treaty.

One reasons for an exemption system is that the government wanted to foster German investment overseas. A potential influence was the OEEC, the predecessor of OECD, which was founded as a precondition for American funds under the Marshall Plan, which sought to promote recovery and trade and keep Western Europe from falling to the Russians. The trade orientation of the OEEC may have been the reason for adoption of exemption systems, even though credit systems were another possibility for avoiding double tax. Weichenrieder pointed out that all the six starting members of the EU – Italy, the Netherlands, Belgium Luxembourg, France, and Germany – were exemption countries.

Weichenrieder then turned to the question of whether income shifting is considered a problem in Germany. He said yes it is a problem, but more because of higher German tax rates than because of the exemption system itself. A 1999 paper by Huizinga and Laeven estimated that Germany may have lost as much as a quarter of its tax base due to profit shifting when it had the highest tax rate in Europe.

Germany has several safeguards against profit shifting in its exemption system. There are some activity clauses in double tax agreements that allow Germany to tax dividends paid out of passive investment income without CFC rules. There are also CFC rules which are in principle quite effective. In contrast to the United States and Canada, Germany considers loans to active affiliates as passive, unless the firm can prove that the funds were raised in local capital markets. This prevents "double dips" achieved through debt equity swaps with tax haven affiliates. Weichenrieder says there sometimes are double-dips, but they are rare. Germany also has a tax rule on the relocation of business functions. So if a firm sets up an affiliate in Poland or Ireland and sends patents there (and there is no economic activity there), the German tax authorities will request that the asset is valued and priced and impose an exit tax. In contrast, most other countries do not restrict the migration of assets. This practice (imposing an excise tax on transferred patents) is a nuisance for firms, which Weichenrieder regards as a good sign.

Overall, Weichenrieder thought the CFC rules were quite helpful. But in the Cadbury-Schweppes case the ECJ killed Germany's CFC rules when applied to other European countries.

Weichenrieder pointed out that between 1977 and 2000 Germany had an imputation system much like the one in Australia that Miranda Stewart discussed. The effect was similar to what happens in the United States when the U.S. parent firm has profits abroad but cannot bring it back without facing tax. (In the German case, the repatriation and payout of untaxed profits would have triggered a tax at the shareholder level under the imputation system.) The result was that firms used their foreign profits for reinvestment or to pay back debt and German firms were cash rich. It was said that Siemens was a bank with a small appliances section.

On the subject of potential reforms, Weichenrieder noted that the discussion in Germany is not about the treatment of outbound investments (the main potential concern of an exemption system), but about how to counter aggressive tax planning strategies with respect to inbound investments. One way is through increased use of withholding taxes. Germany cannot raise withholding rates on royalties, dividends, or intra-company interest payments. But the Austrians are now discussing whether the deduction of royalties should be restricted to situations where they are taxable in the hands of recipients. The question is whether the European Court of Justice would permit that. Another approach is the idea Weichenrieder raised in the first session of inverting the CFC rules (imposing German tax on income of CFCs of companies that sell into Germany).

Brian Arnold asked Weichenrieder to sum up what are the lessons for the United States.

Weichenrieder's first suggestion was that the United States should not apply for membership in the EU! Beyond that, he suggested the United States should not adopt some of the measures Germany had enacted in the past, such as allowing losses from participations and allowing the use of capital losses from disposing of foreign holdings against German profits while exempting capital gains. Basically, don't do things that open up more arbitrage opportunities.

Brian Arnold summed up by noting that the discussion of exemption raised many related issues concerning application of CFC rules. One has to do with the thresholds for applying CFC rules and another has to do with treatment of shareholdings that are below the CFC thresholds. The United States has its PFIC rules and Germany has some similar rules that are combined with CFC rules.

Miranda Stewart responded to Arnold's questions about treatment of passive foreign investments. Australia had foreign investment fund rules, similar to the PFIC (passive foreign investment company) rules in the United States, but repealed them in 2010. The idea was the rules needed reform, but they were not replaced, leaving a hole for non-corporates, for trusts, and the intermediate uncontrolled case where the CFC rules don't apply.

Arnold suggested that the real deal-breaker for an exemption system was interest deductibility. If dividends from foreign-source income are exempt, countries should in principle not allow the deduction of interest attributable to foreign shares. That's easy to say and hard to do.

Arnold went on to briefly describe the Canadian system. Canada had an exemption system beginning in 1917. But in 1972, Canada enacted a major tax reform and moved to a combined credit and exemption system. Canada only allowed exemption for a 10 percent or greater-owned interest in foreign companies that are resident in countries with which Canada has a tax treaty for income earned within the treaty country.

The underlying theory is you don't enter into a treaty with tax havens, but someone forgot to tell Canada's treaty negotiators. Canada has 92 treaties. Dividends come back first from the "good stuff" and Canada has no restrictions on interest deductibility. Canada also has provisions that deem passive income to be active income and facilitate financing structures. And when a Canadian corporation distributes dividends to its shareholders, the shareholders get a dividend tax credit. This credit goes to shareholders even if the company's income consists entirely of exempt foreign-source income.

Alfons Weichenrieder pointed out that Canada could do what Australia has done and provide dividend credits only if the firms had paid income taxes to Canada. That way Canada would still give a preference for Canadian shareholders to invest in Canadian firms, but would not allow Canadian shareholders to hold U.S. shares through a Canadian parent to get the credit.

Arnold responded that the United States was more important as a market to Canada and the United States was then getting credits from France and the United Kingdom, so was going to demand the same from Canada on behalf of U.S. shareholders.

Harry Grubert raised the question of how Germany treats hybrid securities. Weichenrieder said German switchover rules potentially applied to hybrids, but the published data did not permit identification of hybrids apart from other securities. He wasn't sure whether or not Germany's rules could be or were being circumvented. Miranda Stewart noted that hybrids are used substantially in Australia in tax planning. She hoped that BEPS would help develop rules to control these instruments. In response to a follow-up question for Grubert, she commented that there are both hybrid security issues (debt/equity) and hybrid entities used in planning (helped by U.S. check the box rules).

Les Samuels observed based on the presentations that although the Australian and German systems are called territorial, both are hybrids as is the U.S. system. So it is a question of balance. And if the United States switches to a "territorial" system, it would also be a hybrid. It's a question of degree.

Samuels went on to comment that one also has to look at overall tax collections in countries with exemption systems. Our big trading partners collect a lot of consumption tax and have very high individual income tax rates that start at incomes at lot lower than ours. So a country could say they are happy with having an exemption system and favor some of their national champions while still raising enough revenue.

Samuels also noted that a lot of the discussion of the BEPS process has focused on the Googles (e.g, U.S. companies), but in his experience some very large German and Australian multinationals also reduce the U.S. tax base on their investments. The BEPS process should focus on the fact that it is not only U.S. multinationals, but our trading partners' multinationals that engage in base erosion behavior and you need a balanced approach.

Ruud de Mooij raised two questions for Alfons Weichenrieder. The first question was how does the ordinary corporate income tax combine with the exit tax on German companies that transfer IP to another country? Weichenrieder pointed out that you don't really sell IP to an affiliate; you establish a new affiliate and give it material assets plus equity. So the normal transfer pricing rules don't apply. In that case, he would want to apply transfer pricing rules to the asset donated to the affiliate. So you don't have overlapping measures, you have one provision to avoid a tax loophole and bring into the base the income from the asset transfer.

The second had to do with the treatment of royalty payments that leave Europe, but first go through the Netherlands and Luxembourg which has the best treaty network with the United States. Has there been discussion of an EU-wide treaty applicable to all countries? Weichenrieder responded no, he was not aware of any consideration of an EU-wide approach to royalty payments.

Dan Shaviro asked the two presenters and moderator what their underlying thought process is with regard to income shifting. He offered two potential approaches. The first would say we should get rid of all profit shifting. If Amazon is coming in to our country, we want it to pay income tax on its local sales just like a mom and pop bookstore and not shift the profits somewhere else. The second approach would concede that multinationals are very mobile, so the approach would be to allow them a little bit of profit shifting, akin to giving them a lower rate, but not zero.

Miranda Stewart responded that she can't speak for the Australian government, but believes their approach is closer to Shaviro's second one. Australia can't enforce transfer pricing 100 percent although they are going to try. A lot of hybrid tax planning is currently tolerated in the U.S. tax treaty, as it was last negotiated. It's hard to address without a legislative fix. So she thinks there is a level of private tax planning that has been deemed acceptable, but that may be coming to an end.

Weichenrieder responded that it is hard to define the optimal tax system, but he thinks source taxation would be an improvement over the current system. He does think Germany has some rules that aren't consistent with the national interest and suggested there may be a need for the type of CFC rules he discussed before to prevent US firms from siphoning profits out of Germany, while conceding that German multinationals play the game as well.

Brian Arnold amplified Weichenrieder's point. Canada is quite happy to subsidize the foreign investment of Canadian multinationals and make it easy for them to reduce their foreign taxes. But they don't like the idea of nonresidents reducing Canada's tax base and don't tolerate it a little bit.

John Samuels responded to an earlier point that countries with exemption systems have a VAT, the implication being that US companies can't move to an exemption system because we don't have a VAT. He said that argument was a red herring because we don't raise any money from the current worldwide system, so it isn't as if we raise money through worldwide taxation that other countries do through a VAT. There followed a back and forth between John Samuels and Jane Gravelle, joined by Reuven Avi-Yonah and Stephen Edge. Gravelle pointed out that we do collect some money on foreign source income and Avi-Yonah pointed to the potential revenue from taxing the repatriation of the $2 trillion in cash sitting overseas. Samuels concluded that he just wanted to address the VAT point as a red herring.

Peter Merrill raised a different point, commenting on the Australian system of imputation as a way to address the incentive for income shifting under a territorial system. The reasoning is that when an Australian multinational shifts income abroad to avoid tax, it is hurting its shareholders by denying them imputation credits. So there is a built-in tension between the incentive to reduce corporate level tax and the corresponding reduction in shareholder credits. So Australia has solved two big problems at the same time, eliminating the distortion caused by double taxation of corporate income and reducing the incentive for income shifting. He expressed chagrin that this wonderful idea may have some practical problems.

Miranda Stewart responded that Australia does have a high ratio of corporate tax collections to GDP and that there is some speculation, although not much empirical research supporting it, that the imputation system is the reason for that. She further went on to note that tax planning between Australia and New Zealand hollows out the New Zealand tax base. For example, Commonwealth Bank in Australia gets a deduction in New Zealand for a hybrid instrument. In Australia, they pay tax on the income, where it is treated as frank-able equity and passed through as a credit to shareholders. So Australian shareholders get what they want, while the firm deducts out of the New Zealand tax base.

But, she went on to point out, the world has moved away from imputation systems. And if you accept the latest modeling that says the incidence of the corporate income tax is shifting to labor, then the effect in Australia is not good because Australia is then subsidizing investors at the expense of workers by giving them credits for corporate taxes that workers bear. Australia has rising unemployment in the long term, which is not good for the economy.

Doug Shackelford asked Brian Arnold whether his position on territorial taxation has changed since 13 years ago when he advised the United States not to enact a territorial system. Does he now think the U.S. should move to territorial? Or should Canada move away from territorial?

Arnold responded that Canada is on the wrong path. It is too generous a system, providing a perverse subsidy for Canadian multinationals. It especially doesn't make sense to allow exemption if the investment is debt-financed.

He would not suggest that Canada withdraw its exemption system, now that almost all their competitors have one. But he would give it more integrity by making CFC rules more robust, and limiting interest deductibility.

An exchange followed between Harry Grubert, Jane Gravelle, Tim Dowd, and John Samuels about the revenue effect of moving to a dividend-exemption system with worldwide fungibility and allocation of interest deductions. The discussion was inconclusive with Tim Dowd pointing out that the devil is in the details.

Stephen Shay commented on the high ratio of corporate tax to GDP in Australia. He noted that there is considerable variation in effective tax rates across industries and so the industry mix will affect the overall ratio of corporate taxes to GDP. And the industry basis of multinationals in Australia and Germany are very different. The U.S. multinational base has a high share of pharma and tech relative to other countries.

Harry Grubert noted that our non-corporate sector was very large relative to those of other countries, which could be a source of our low corporate tax to GDP ratio.

Stephen Shay agreed that the United States was an outlier because of our disproportionate share of pass-through enterprises, but then pointed out that Australia has a very significant resource sector. Miranda Stewart replied that there are only two mining companies among the top 20 Australian firms, so the role of resource companies in explaining Australia's corporate tax rate should not be overstated.

Shay then went on to add the United States has relatively large sectors which are drivers of income-shifting, including high-tech, pharma, and finance.

Alfons Weichenrieder agreed it has been established empirically that profit shifting varies among industries and those with a lot of R&D have an easier time profit shifting.

He went on to say there are two views of the world. One view is that profit shifting is good and you should allow it because you don't want to drive out industries with high elasticity. And tax havens in this view are helpful because if you can move more easily there, I then tax you more lightly. The other view, to which he subscribes, is that tax havens prevent tax differentiation. For example, China once had a differentiated tax rate for foreign investment. But tax havens allow investors in China to pretend their income comes from a foreign (not Chinese) source, so it effectively nullifies the Chinese tax preference. As a result, China did away with its differentiated tax system.

Tim Dowd raised the question of whether the UK's move to an exemption system was linked in any way to its increase in the VAT rate. Stephen Edge responded that no, it was not. It's true that VAT was raised to help deal with the financial crisis at the same time that exemption was introduced. But, as John said earlier, the amount collected from foreign dividends had been relatively small. The VAT was raised to pay for the large deficit following the financial crisis (not to offset a perceived revenue loss from eliminated taxation of repatriated dividends).

Tim Dowd then asked Weichenrieder how much revenue was raised from the exit tax and whether companies could manage their way around it with cost-sharing arrangements and the like. What rules have the Germans instituted to prevent that?

Weichenrieder responded that there is no empirical research on this and no database that would make the research possible. So it is possible firms and consultants have found ways to work around it.

John Samuels asked if the origin of these taxes, of which Italy has one, were to tax the goodwill element of businesses moving to Ireland. Les Samuels added Eastern Europe as well. A discussion followed on whether that could be stopped.

Tim McDonald raised a point about profit shifting. He noted that businesses always have to decide where to locate and it is not profit shifting if they choose a country based in part on its tax rates, its legal system, and its total business environment. If a U.S. company puts a plant in Windsor, Ontario instead of Detroit because Canada has a lower tax rate, that is not profit shifting.

He then asked Miranda Stewart why Australia uses an imputation credit instead of just having a lower tax rate on dividends at the individual level.

Miranda Stewart responded that the reason for using an imputation system as opposed to an exemption is to differentiate the shareholder rate instead of taxing all corporate income at a flat rate and also to link the credit directly to whether or not corporate tax has been paid. But 25 years later that system, which has always been problematic from an international perspective may need to change, although moving out of that will be politically challenging and maybe challenging from a revenue perspective as well.

Brian Arnold thanked Alfons and Miranda and closed the session.

## IV. SESSION 3: EXPERIENCE OF COUNTRIES THAT HAVE RECENTLY TRANSITIONED TO TERRITORIAL SYSTEMS

Presenters: Gary Thomas, Partner and Head of Global Tax Practice, White and Case, Tokyo Office: Stephen Edge, Partner, Slaughter and May, London, United Kingdom

Moderator: Stephen Shay, Professor of Practice, Harvard Law School

Stephen Shay opened the session by passing out a handout with facts about economic data in the different countries we are discussing today.

Stephen Edge commented that the figures on outward FDI (foreign direct investment) relative to the size of the economy and the share of government revenue from corporate income tax were very interesting.

Stephen Shay agreed, but noted a caution Harry Grubert mentioned about the United States and its pass-through sector. So the data are just for background, not for deep discussion.

Shay then introduced the presenters, Gary Thomas and Stephen Edge.

Gary Thomas went through the questions that the session organizers had prepared.

The first question was why did Japan decide to move to a territorial tax system? Thomas pointed out that prior to April 2009 when Japan adopted its territorial system, its' international tax regime closely resembled that of the United States. Japan taxed corporations on a global basis, including dividends from foreign subsidiaries, and avoided double taxation by means of direct and indirect foreign tax credits. Japan in principle allowed deferral of profits of foreign subsidiaries until repatriation but restricted deferral for CFCs that operated in low-tax countries, unless prescribed exceptions (largely focused on active business requirements) applied. Japan has transfer pricing rules that were based on the arms' length principle and are broadly similar to the U.S. rules under section 482 and the OECD transfer pricing guidelines.

But on April 1st of 2009, Japan adopted a territorial tax system by exempting 95 percent of the dividends received from qualified foreign subsidiaries from the Japanese national and local corporate taxes and abolishing its indirect foreign tax credit system. The foreign dividend exemption system doesn't apply to interest, royalties, or profits of foreign branches. At the time the rules were adopted, there was mention that Japan might consider applying profits of foreign branches as soon as a consensus was reached at OECD as how to compute branch profits. That happened in 2010 and, in this year's tax reform bill in Japan, which is now before the National Diet and will be passed sometime next month, Japan will incorporate the AOA (authorized OECD approach for attributing income to a branch) into its domestic tax law. This is a major change, which moves away from the existing force of attraction rule to an attributable income principle, allows for recognition of branch headquarter dealings, taxes foreign-source profits attributable to a Japan branch and allows foreign corporations to take foreign tax credits for taxes imposed on such attributable profits in the source countries.

Thomas mentioned three key reasons for the adoption of the foreign dividend exemption system. First, the Japanese government had concluded it was vital to encourage the repatriation of profits from foreign subsidiaries that had been building up in order to assist in revitalizing Japan's economy. There had been a significant increase in profits in overseas subsidiaries of Japanese corporations, but Japan's tax regime prior to the change imposed considerable additional Japanese corporate taxes upon repatriation, thereby creating a disincentive to repatriation. It was also felt that a failure to repatriate the profits to Japan raised the risk that R&D activities and jobs would be shifted overseas, while the repatriation of profits would encourage investment in R&D and capital in Japan and lead to further growth in Japan.

Second, Japanese policymakers recognized that maintaining the competitiveness of Japan's multinational enterprises would ultimately lead to additional investments and job creation within Japan and the promotion of Japan's economy by eliminating the bias in capital flows within corporate groups, which were critical for achieving this objective.

Third, the government was deeply concerned about the increasing compliance burdens imposed by the indirect foreign tax credit system. The adoption of the foreign dividend exemption system, together with the abolition of the indirect foreign tax credit, would relieve Japanese companies of those burdens. In particular, small and medium-sized Japanese companies increasingly are required by market demands to establish additional operations in other countries in Asia and, consequently, reducing these compliance burdens was viewed as particularly important.

Thomas added that it is noteworthy that, in adopting the foreign dividend exemption system, Japan explicitly rejected capital export neutrality as a key guiding principle in what they viewed as the "new global business environment." Although this principle had been imported into Japan from the United States and recognized for many years, the position of the foreign tax credit approach itself, based on the capital export neutrality principle, was characterized in the debate in Japan as having "declined as the era of the United States as the dominant capital-exporting country in the world was ending."

However, considering this new regime, Japan did not ignore the potential downside of adopting this foreign dividend exemption system. The government was worried about the possible hollowing out of Japan's economy through the shifting of jobs overseas. But the government recognized as an unavoidable reality that growth in foreign markets will be significant as compared to growth in Japan, taking into account the relative population growth and the age of the population within and outside of Japan. As a result, they concluded that it was inevitable that Japanese companies would continue to need to establish manufacturing sites and other facilities in the growing markets overseas and also decided that the adoption of the foreign dividend exemption system itself would not unduly influence corporate decisions as to whether to establish or move operations overseas.

Thomas commented that one interesting aspect of this whole process was the speed with which it occurred. Somebody was mentioning reform taking 13 years, 15 years, or more. In Japan, this proposal to change to a foreign dividend exemption system was tabled for discussion in mid-2008, a conclusion was reached to adopt this system at the end of 2008, and the law went into effect in 2009, within 10 and 12 months of when it was first publicly proposed. There wasn't a great deal of public debate about this change. The people who were most concerned, including the Government Tax Commission, the Ministry of Finance, the Ministry of Economy, Trade and Industry (METI), and the Japanese business community certainly did have a dialogue. But this change went through very quickly.

Thomas noted that the United Kingdom's adoption of its territorial system when it did may have been a tipping point, because Japanese policymakers always follow what is happening in other countries. They periodically send study groups out from the government or from academics or other tax experts on study trips overseas to collect information. These groups return to Japan, they draw up their comparison tables, and then consider what other countries are doing and why. They typically look at the United States, the

United Kingdom, France, Germany, and a few other jurisdictions. After confirming what everybody else is doing, they ask themselves what Japan should do and often they will decide that it would make sense to make a change if it appears this represents a trend overseas.

The second question is, how did reforms in Japan treat repatriations of income accrued prior to the effective date of the proposal? Thomas explained that Japan did not distinguish between income that arose before the effective date and income that accrued after the effective date. The new rules applied to all dividends that were received during taxable years commencing on or after April 1, 2009. However, they did allow a transition period of one year after the effective date, during which corporate taxpayers could elect to apply the old rules (the indirect foreign tax credit and taxation of the dividends received) because in some cases those rules were preferable for the taxpayers. Consequently, they did allow a soft landing for certain taxpayers.

The third question has to do with the favorite topics of international tax planning and/or tax avoidance by Japanese multinational companies before the change to the territorial system and how they have changed since then. Thomas characterized this is as an interesting topic because the international tax planning or avoidance culture of Japanese multinational companies can be described as weak at best. Although there are some exceptions, he believes that even today the typical Japanese multinational does not have a robust in-house tax department which is comprised of a large number of tax experts who are closely involved in trying to plan international business structures, investments, and transactions that minimize taxes to the extent possible, either outside Japan or in Japan. The typical in-house tax department is devoted mostly to tax compliance, preparing tax returns and other documents necessary to comply with the tax laws.

Thomas added that the size and budgets of in-house tax departments typically reflect this limited view of the role that the tax department generally plays in Japan. In the past, some people have said Japanese companies felt paying taxes was a matter of loyalty to the state. He heard many years ago some executives assert that they’re happy to pay a lot of taxes because that shows they have a successful company. Normally, the in-house tax departments rely on outside advisers to ensure that investment structures and transactions don’t result in double taxation or unforeseen tax liabilities or tax controversies, although they also endeavor to take advantage of clearly provided tax benefits, such as tax holidays provided in some countries, particularly in Southeast Asia. But, in his experience, it is rare for a tax department in Japan to be leading an effort to structure investments or transactions in a manner to aggressively push down the group’s overall tax liability.

He added that he had seen numerous situations where outside advisers would propose a comprehensive study of a global structure that was welcomed by the in-house tax department but then rejected by upper management because they didn’t want to spend the money to study or implement the proposed plan and/or take the time and effort to do it and they often were also a bit concerned about how the government might react.

This weak planning culture may benefit from the adoption of the new system. Over the years, this lack of aggressive tax planning has led to a wide disparity between the effective tax rates or tax burdens in Japanese multinationals and their competitors in the United States and elsewhere. The adoption of this foreign dividend exemption rule could be viewed as almost leveling the playing field with foreign multinationals. Now, Japanese multinationals don’t really have to engage in significant tax planning to take advantage of lower tax rates that are effective overseas.

The fourth question is what additional or new measures Japan adopted to prevent a shifting of income to low-tax jurisdictions that might accompany the elimination of taxes on their repatriated dividends. Thomas noted that the government implemented and continues to study a number of design features to cope with the risk of shifting of profits. But it’s also important to note that the Japanese government opted to move ahead quickly to adopt this new regime while they continue to monitor and improve the system over time.

He added that Japan, unlike many countries, has an annual tax reform process. It starts in the summer when the Ministry of Finance begins to collect proposals for tax reform from various constituents, largely other ministries and some major business and tax professional organizations. These are given to the Government Tax Commission (a consultative committee to the Cabinet) in September. The Commission begins reviewing them in September or October. The ruling party tax committee carries out their review in October and November. The Government Tax Commission issues its analysis, conclusions, and an outline of their recommendations normally in early December. At the same time, the Ministry of Finance is working in parallel to draft the actual legislation (the statute and related Cabinet orders) that may be necessary. The draft legislation is delivered to the Cabinet in January for review and approval. The final legislation is completed in February. It's delivered to the National Diet usually during late February. And, in March, it is virtually always passed to go into effect as of April 1 (although there have been some exceptions in recent years). Because Japan has this annual tax reform process, it's very easy for them to look at existing tax rules periodically and tweak them if necessary. They don't have to wait for every five or more years and effect a major change.

The Japanese did make some changes to their CFC rules. Most of these changes actually made the rules somewhat less restrictive, except for a new rule that for the first time eliminated deferral for passive income. In 2010, they also adopted transfer pricing documentation rules. In 2011 they adopted the most appropriate method rule into Japan's transfer pricing rules, eliminating the priority rule that had existed since that legislation was adopted. This change actually was intended to make it easier for Japan's tax authorities if necessary to issue transfer pricing assessments.

While it's not directly a Japan development, the OECD had issued, in July 2010, updated transfer pricing guidelines, including a new chapter on business restructuring. Japanese authorities are following those developments very closely.

Furthermore, in recent years, the Japanese field examiners have sometimes applied so-called "donation" rules which deny deductions for, or impute income to corporate taxpayers, in order to deal with certain cross-border transactions which, in the examiners' view, may be difficult to address effectively with transfer pricing regulations. The criteria for applying these rules are quite vague, leading to considerable uncertainty for any taxpayer planning an outbound transfer of a business or intangible property. This enforcement development has had a chilling effect on potentially abusive transactions.

Thomas added that another recent development has been the expansion of Japan's treaty network and the conclusion of a number of tax information exchange agreements with non-treaty countries, including well-known tax havens. The Japanese tax authorities are making very extensive use of these exchange-of-information rules. If a company under audit does not respond promptly to a request for information from overseas, its foreign subsidiary may soon get a knock on the door from its local tax authority which requests the same information. So that's a significant change.

In addition, he continued, Japan has in recent years reduced its corporate tax rates. In 2011, after considering the trend that they saw occurring overseas, the government proposed a reduction in the overall corporate tax burden from 40.7 percent to 35.6 percent on a combined national and local basis. These changes were to be adopted in March 2011 and then the March 11th disaster occurred and that delayed everything. Toward the end of the year, the basic national corporate tax rate was reduced as planned, but at the same time Japan imposed a temporary reconstruction surtax of 2.55 percent on corporations for 2012, 2013 and 2014 due to the disaster. (They also imposed a separate surtax on individuals for a much longer period.) However, as part of the 2014 year tax reform proposal, Japan is revoking the corporate surtax for 2014, a year earlier than scheduled. And, about three weeks ago, Prime Minister Abe announced the formation of a special subcommittee within the Government Tax Commission to study an additional reduction of Japanese corporate tax rate and they're hoping to come up with some proposals perhaps as early as June of this year.

The Japanese are continuing to evaluate potential measures to reduce the risks of outbound transfers of intangible property while encouraging R&D, but there's nothing specific in this year's tax reform that deals with those issues.

And finally, expense allocations are often raised as a concern for the introduction of a territorial tax system. Japan's system does grant an exemption for only 95 percent of the dividends received, leaving the remaining 5 percent subject to tax. This is considered to be a proxy for costs incurred to obtain and hold shares in the foreign subsidiaries.

The next question is, did Japan estimate that going territorial would raise tax revenues, reduce revenues or keep revenues the same? If the revenue was projected to decline, were there proposals to make up the revenue loss? Thomas noted that, during the time that this proposal was being considered in 2008, there wasn't a great deal of transparency in terms of the detailed anticipated benefits or costs of measures that were adopted and then later Japan experienced a change in government, so it's not entirely clear what the projections (if any) might have been at the time .

But at the time that the new system was adopted, it was reported that the METI had conducted a survey of overseas business activities of Japanese firms in May of 2008, according to which the METI concluded that at the end of fiscal year 2006, which would have been March 2007, a total of 17 trillion yen in profits was being retained overseas and that this amount was increasing by about 2 to 3 trillion yen each year. METI's position was that, if such profits were repatriated back to Japan, this would lead to a "virtuous growth cycle" and an increase in investments in R&D. Japan's rules did not impose any restrictions or requirements on the use of the profits that were distributed back as dividends for particular types of investments or activities. Again, although there may have been some internal data, Thomas said he has not found specific estimates of what the tax revenues were expected to be from increased repatriation of profits and that some officials suggested that they thought those types of estimates would probably be quite speculative in any event.

Stephen Shay at this point said he would turn the floor over to Stephen Edge for his presentation and Gary Thomas could address any remaining questions later.

Edge started by recalling Tim McDonald's earlier point that raising revenue was not the sole purpose of the corporate tax. In the United Kingdom, the corporate tax has been used to attract and retain business in the United Kingdom.

Edge recalled the status of the British economy when he began practicing at Slaughter and May in 1973. They had a three day work week because there was no power and they had to work in the dark the other two days because of labor disputes. The United Kingdom was the sick man of Europe. The dockers' union was resisting containerization. People made risky investments that may not have been profitable because of government grants while profitable business followed lower tax rate with equally good infrastructure. And that experience colored his attitudes.

During the 1980s, Toyota and Nissan came into the United Kingdom, not for the weather, but not for the tax system either; Toyota received no government subsidies. They were looking at the total package.

When Edge joined the tax department, the individual tax rate was 83 percent on earnings and 98 percent on investment income of individuals; two years previously, it had been 101 percent. The chancellor in ’74 said he was going to squeeze the rich until the pips squeaked. Edge commented that was quite an interesting environment to be in. And in 1972, the U.K. corporate tax rate had gone up from 40 to 52 percent. If anybody wondered why the United Kingdom gave an ACT (Advanced Corporate Tax), or imputed credit refund to Americans under the treaty, the reason was they wanted the Americans to continue to invest in the United Kingdom. The corporate tax rate had been 40 percent. The ACT refund took the effective tax rate on their distributed profits from 52 down to 40 percent. So the United Kingdom had that interesting phenomenon, a negative withholding tax.

The United Kingdom, he went on, spent a good period competing with the United States as to which country had the worst tax system in the world. Things began to change with Reagan and Thatcher in ’79. Until then, the United Kingdom had exchange controls left over from the war that had effectively policed the non-U.K. activities of U.K. corporations. CFC rules came in a little bit after the lifting of exchange controls. The United Kingdom kept the ACT system through 1997, when Gordon Brown came into office and realized that a repayable tax credit system was a license to print money for tax-exempt institutions and others, so to maintain revenue the government was better off abolishing the ACT, giving up the interest-free loans it produced for the government, and not having to pay back the tax credit to pension funds and others. Then the U.K corporation tax rate started dropping during the 1990s, consistent with these other changes.

With consolidations in business leading to more multinationals, there was a lot more pressure on businesses to reduce their effective tax rates. Many businesses began to compare their effective tax rates to that of their peer group, the idea being that companies can get taken over if the acquirers are in countries with CFC rules that are better than theirs. Edge went on to say that people in the United Kingdom worried about foreign takeovers. This happened with two of the big chocolate companies, Rowntree and Cadbury. Rowntree was absorbed by Nestle, which produced a huge storm because of the fear of British production being lost, and Cadbury at the time found itself sadly unable to take over a Swiss competitor because that wasn’t deemed to be very convenient by the Swiss authorities. And so the United Kingdom thought that having a very open economy did not produce a level playing field for U.K. companies but EU freedoms prevented putting barriers up. Cadbury was then taken over by Kraft a few years later.

Edge went on that people in the United Kingdom then began focusing very much on what would be the desired attributes of a tax system. The goals were to attract enough inward investment to keep people happy while trying to maintain a balance between domestic and overseas taxpayers, which could be done either through an exemption system or a liberal foreign tax credit system. And business wanted a good treaty network because if you are a foreign investor, foreign governments are collecting more than their fair share through their withholding taxes. A low domestic corporation tax rate helps matters as does a participation exemption. The United Kingdom has these and also no interest allocation rules, though he agreed with Brian Arnold’s comment that it’s mad not to have them. But one wants reasonable CFC rules and no withholding tax on outbound dividends. And if you have all that, you’re in great shape.

Edge continued with the background to the U.K. reforms. Prior to the change, the United Kingdom had a foreign tax credit system, but did not collect much tax because firms were able to pool credits. They did not have the equivalent of the U.S. section 956 rules, which made it easy to bring property back to the United Kingdom. They had a decent corporate tax rate, but rudimentary CFC rules. There was a lot of avoidance and passive income of companies could escape tax.

In 2007, Gordon Brown put forward a proposal to tax passive income in foreign subsidiaries. In response, a number of companies left the United Kingdom. Others said they could leave the United Kingdom, but if the tax system is wrong we should try to persuade the government to change.

So there were two dynamics that were forcing change. Business was complaining that life was getting difficult for them. They were litigating against the proposal as inconsistent with the EU rules, while also setting up companies in Ireland to avoid the rules. The Gordon Brown proposals were quickly withdrawn.

The second dynamic had so to with the imputation system. The U.K. combination of an exemption system for domestic dividends and a credit system for foreign dividends was upheld by the European courts, but only on the basis that the two systems “did the same thing”, which they did not. This created pressure for the United Kingdom to decide whether it wanted a domestic credit system or a foreign exemption system. Another factor, he added, was that it was easy for companies to leave the United Kingdom because the U.K. system allowed them to leave without imposition of an exit charge. So the United Kingdom wanted a participation exemption because without exemption companies would leave and they wouldn’t collect any revenue from then anyway.

Edge went on that the focus of tax policy had changed over the years. In the 1970s and 1980s, as he had said, the United Kingdom gave investment incentives to try to encourage inbound investment. Now, policy shifted to protecting U.K.-based multinationals from the effects of their CFC rules and encouraging the United Kingdom to be the jurisdiction of choice in a merger. The emphasis shifted from a focus on domestic investment to a focus on fostering “national champions”. So the document the coalition government introduced in 2010 was based on developing confidence and making the United Kingdom an attractive place for business to base their operations.

Edge said that the United Kingdom is now happy to have an exemption system as long as their CFC rules work to protect the U.K. tax base. But the United Kingdom is not going to penalize a U.K. company from doing business abroad. And a key part of that is bringing the corporate tax rate down to 20 percent. He would deny that makes the United Kingdom a tax haven.

He concluded by describing what was done. The United Kingdom did reforms its CFC rules, which he believes are EU compliant even though the documents explaining them don’t refer to EU compliance. Provisions for finance companies are very generous. They are exempt if funded by capital not coming from the United Kingdom and otherwise taxed at a 5 percent rate. Transfer pricing rules back up the system. He rejected the comment made by Jeffrey Owens at an OECD Munich conference in January that the CFC rules are a joke. The United Kingdom also decided, on pragmatic grounds, not to introduce interest allocation rules. Although he agrees with Brian Arnold in principle, they rejected allocation rules to become a more attractive location for foreign investment, although they are keeping them under review.

U.K. multinationals are happy with the new rules, although they wish Mrs. Hodge (a Labor MP who favors more taxation of multinationals) would be quiet. Edge has not seen any sign of offshoring of business. And corporate tax yields as a percentage of total taxes have not dropped significantly. Interest allocation rules may be reviewed, but the low domestic tax rate and higher rate offshore are causing people to borrow offshore instead at home. And inversions to the United Kingdom are an unintended benefit.

Edge asked what lessons have been learned. First, he thinks inversions are good. Second, the thinks the United Kingdom gets benefits from having headquarters operations there. Third, he doesn’t see any sign that lots of income has been lost offshore. The absence of transitional rules for old profits was thought to be brave, but he thought that had the U.K. responded, people would have gone offshore and the U.K. would not have collected the revenue anyway.

Stephen Shay opened the floor for comments. But, first, he asked about interest allocation rules and the effect of not having them. And he asked Gary Thomas if it was true that there were no interest allocation rules in Japan and if so how that affected tax planning. Thomas responded that there have been general interest allocation rules for applying foreign tax credits but that, given that interest rates in Japan are so low, interest allocation apparently has not been a major issue.

Stephen Edge responded that the United Kingdom has a whole raft of interest expense restrictions. The most significant are anti-arbitrage rules introduced in 2005 to protect the U.K. tax base and interim worldwide rules to stop U.K. companies from making profits abroad and up-streaming the loan. The idea was you shouldn't deduct more interest in the United Kingdom than the group does as a whole.

Paul Oosterhuis commented that most U.K. multinationals have more debt in the United States than they have externally. Stephen Edge agreed. Oosterhuis commented that the debt birds have migrated to the United States. Edge noted that the United Kingdom has thin cap rules on inbound debt which are more restrictive than the U.S. rules and Oosterhuis agreed.

An exchange followed between Edge, Oosterhuis, and Shay on how interest income could be routed through Luxembourg to escape tax.

Gary Thomas then addressed the experience of Japan since enacting dividend exemption. From 2009 to 2010, the amount of dividends from overseas subsidiaries increased by 20 percent. He estimates if this continued it would have been about 15 percent of the total of accrued cash overseas in both 2011 and 2012. But these are still early days and no one is sure about the actual experience. Massive flooding that occurred in Thailand in 2011 may have required considerable local reinvestment, so maybe dividends did not increase very much.

Thomas explained that Japan did not have any requirement of how the repatriated dividends had to be used. He also noted that some preliminary evidence suggests that repatriated dividends were used largely to fund dividend payments to shareholders instead of for increased capital investment in R&D. But it is still early days. Some people claim the reform was unsuccessful because investment and R&D have not increased. But people in the Ministry of Finance think it's too early to tell and do not currently intend to fundamentally revise the system.

He also noted that the Government Tax Commission in September set up an international discussion group, but this group is talking mostly about BEPS, the digital economy, consumption taxes, and cross-border provision of services and so far has not discussed revisiting the territorial system reforms. They might move to exempt branch profits, but as of now nothing is on the table.

Jane Gravelle asked Gary Thomas if he knew what the percentage change in repatriated dividends was between 2010 and 2011 and between 2011 and 2012. Thomas replied that the last figure he had was for 2009 to 2010. Gravelle commented that we then had only a transitory effect and it wasn't very big.

Reuven Avi-Yonah asked Gary Thomas how ending the requirement that Japanese companies make their tax returns public may have affected the tax culture. He expressed the opinion that a requirement to make tax returns public would have a big effect on the tax culture in the United States and the United Kingdom.

Gary Thomas responded that there is sufficient information that Japanese companies have to disclose in public financials statements so that people know what their tax burdens are and that the weak tax planning culture they have had continues to exist.

Avi-Yonah then asked Stephen Edge about the status of patent box rules.

Mr Edge replied that patent box was a reward to big U.K. pharmaceutical companies for being helpful in the process. Glaxo stayed in the United Kingdom, even though they have a French-American CEO, and others such as Astra Zeneca have also stayed. He added that the United Kingdom does not have a Silicon Valley, but would like to have one and that maybe patent box was a small measure that would help. An exchange followed between Edge and Avi-Yonah and about where meetings had to take place to be able to establish residence in the United Kingdom.

Tim McDonald asked Gary Thomas about the culture in Japan because of the battle he had with the authorities there. He was told when you litigate against the NTA (National Tax Authority), there was a 98 percent chance the government would win. A discussion followed between Tim McDonald and Gary Thomas about how taxpayers fared under assessments and in transfer pricing cases and on what rules taxpayers and the government could invoke.

Thomas concluded the discussion by re-asserting that Japanese companies don't want to have controversies with the government. He also noted that the NTA has embarked on a program to engage the top management of companies to view tax compliance as a matter of good corporate governance. And specifically the NTA has tried to engage top management on transfer pricing issues and compliance. He doesn't know how successful they are with their new program on transfer pricing, but they have made a big deal about rolling it out.

McDonald added that there was a bias toward reporting income in Japan and one of the criteria to get into the Nikkei index is sales of the parent company. Thomas replied that trying to over-state profit in Japan maybe is a different form of transfer pricing.

Paul Oosterhuis commented that there was a misunderstanding in the United States about how tough Japan's CFC rules are. He asked how much the rules that trigger inclusion based on low tax income apply with people who have substantial business activity. For example, is a Japanese pharma company with a plant in Singapore picked up under Japan's CFC rules?

Gary Thomas replied that the CFC rules apply in principle to companies that are subject to 20 percent or less tax, but there are exceptions. A firm can be exempt from the CFC rules if it possesses all the following attributes: (1) it must not have as its principal business activity the holding of shares, investments or debts securities; the provision of industrial property rights or copyrights; or the leasing of ships or aircraft; (2) it must have a physical facility in its country of residence that's recognized to be necessary for the conduct of its principal business activity; (3) its management and control must be conducted locally; and (4) either it must engage in its principal business activity principally with unrelated parties, if its activity is wholesaling banking, securities, insurance, or air transportation, or it must engage in its principal business activity principally in its country of residence if it's not engaged in one of the mentioned activities.

Oosterhuis asked for clarification about the pharma company with a plant in Singapore. Thomas said it would get the benefit of exemption from the CFC rules. He added that Japan has modified the rules to make them less onerous, but the major change was the denial of deferral for passive income in 2010.

Harry Grubert asked for confirmation that if you are an active business under our definition and not passive you are exempt. Thomas agreed, but added that if you have an active business that involves the provision of industrial property rights or copyrights, you will still be denied exemption. Grubert asked if that meant a passive holding company and Thomas agreed.

Thomas added, however, that looking at the Japanese culture he doesn't know how many Japanese companies are moving their patents to other jurisdictions. But offshore financing through a tax haven would be treated as passive income.

John Samuels responded further to Grubert's question, asserting that you could set up an offshore finance company to strip the tax bases of other countries under Japanese law, but Japanese companies don't do it because of the culture.

Les Samuels commented based on Stephen Edge's presentation that the United Kingdom has done a very good job of meeting their objective of being the most competitive corporate tax home. The only thing left to do is to make it a little easier to pay interest to foreigners.

But Samuels had a question about the public reaction. The U.K. press is very interested in international tax these days. Is there a concern about cutting taxes on foreign subsidiaries of U.K. multinationals when jobs are lost in the United Kingdom? And Japan's economy has been struggling for a decade. What is the political aspect and was this done too quickly?

Stephen Edge criticized the attacks by Margaret Hodge in parliament about the revenue service being too cozy with business, which he termed political grandstanding. Edge argued that the revenue service had done quite a good job. Hodge and the NGOs are very active in the United Kingdom, but he doesn't think they have really focused on the change, other than to say in general terms that the government should be taxing companies instead of cutting welfare to individuals. Edge said that was an easy point to make politically and understandable, but did not get across the government's goal of making business prosperous and having a feedback effect on the rest of the economy.

Gary Thomas reiterated that the process in Japan was very quick. The Finance Ministry was not enthusiastic, but the business community and METI form a very formidable team to convince the government to move ahead. Japan doesn't have NGOs that perform the kind of role that they did in the United Kingdom, certainly not during the legislative process itself.

John Samuels commented that the United States was unique in that the U.S. government does not champion U.S. major multinationals to help them succeed in foreign markets. Jane Gravelle disagreed, noting that the United States has championed multinationals through decades of deferral. Samuels responded that deferral was not as good as exemption and they had to fight for that. He added that the United States has had a huge market to itself for many years and did not have to depend on trade like countries with small domestic markets (e.g., the Dutch) but now most of our growth is outside the United States. But our tax system is one designed when we had three big companies in Detroit who owned the U.S. market and only GE sold all its light bulbs in the United States.

Tim Dowd said he was fascinated by the concept that the Japanese culture is so different regarding aggressive tax planning. He asked if Japanese foreign subs were also not engaging in tax minimization.

Gary Thomas responded that Japanese companies will seek to obtain tax holidays when they can get them and they want to avoid double taxation. But they generally are not interested in sophisticated tax planning. The manufacturing and sales divisions are driving transfer pricing decisions, not the tax departments.

Stephen Shay re-framed Dowd's question. He described debt-equity swaps as akin to shooting fish in a barrel, from an American tax planning perspective. But John Samuels was saying if it is perceived as being for tax planning purposes only, their culture would say that may not happen.

John Samuels responded that every country in the world would allow the kind of structure that had been described to avoid their CFC regimes and most countries' multinationals do it. The Japanese system allows it, but Japanese companies don't do it.

Ruth Mason asked about the U.K. documents on their tax change and wondered why they focus exclusively on competitiveness and say nothing about international agreements.

Stephen Edge replied that it had to with EU law and how the United Kingdom did not want to acknowledge they are in the EU and are affected by it.

Gary Thomas commented on how Japan was planning to raise its consumption tax rate from 5 to 8 percent on April 1 and then to 10 percent in October 2015, while planning to reduce the corporate tax. He commented that some people are becoming concerned about that trend.

Stephen Shay raised the question about the level of protection (of the tax base) in moving to exemption. He commented that the culture thing was interesting to him. But the level of protection in the United Kingdom seems very sparse. But he added he thinks Stephen Edge is saying there is more to the U.K. CFC rules that we perceive here.

Stephen Edge responded that people would be surprised under the U.K. system if an allocation to profits to an overseas territory was not matched by appropriate substance.

Shay said the tax-planning culture in Japan appeared less powerful than he thought before today's meeting. But he was also struck by how quickly change was effected in both countries and that policymakers were making decisions as a global financial crisis was rolling over them. And he asked to what extent the financial crisis that began in 2008 affected the process.

Gary Thomas replied that he couldn't recall any commentary that raised even an indirect link between the financial crisis and the proposal. He did say that there was interest in bringing back profits to Japan to help the economy, which had been languishing for about 20 years.

Stephen Edge commented that the process started under the Labour government and they were working closely with business in 2008 and 2009. Margaret Hodge was very critical of the tax authorities' relationship with business and complaining that the government was letting prisoners rewrite the laws. Edge pointed out that the amount of tax being collected on foreign dividends was not significant.

An exchange followed between John Samuels and Jane Gravelle on how much revenue one might lose from going to a territorial tax.

Stephen Shay closed the session.

## V. SESSION 4: LESSONS FOR THE UNITED STATES

Presenters: Harry Grubert, Senior Research Economist,, Office of Tax Analysis, U.S. Department of the Treasury; Daniel Shaviro, Wayne Perry Professor of Taxation, New York University Law School.

Moderator: Alan Auerbach, Professor of Economics and Director, Burch Center for Tax Policy and Public Finance, University of California at Berkeley

Alan Auerbach introduced the session.

Harry Grubert was the first presenter. Grubert started by saying he was relatively pessimistic about what the United States could learn from other countries' experiences because the systems are different, the countries are different and the goals are different. For example, because the United Kingdom was the only country without a 956 dividend, their multinational companies were much less burdened by the repatriation tax than others. He referenced a paper by Peter Egger on repatriations in the United Kingdom. They found that the burden of the repatriation tax was about 1 to 2 percentage points. In contrast, he and Rosanne Altshuler estimated the burden (of the U.S. repatriation tax) at between 5 and 7 percentage points. This means base erosion is a big issue for the United States. Grubert stated that everyone agrees the repatriation tax is a bad idea, but people differ whether they want to eliminate it by full inclusion with no deferral or by going territorial.

Grubert went on to cite the many ways the systems are different. Very few countries have rules for interest allocation. The treatment of banking systems differs. And companies are different, with intangibles on the whole much more significant for U.S. companies. Royalties received as a percentage of stock value are much higher in the United States, he stated, than in Australia, the United Kingdom, Japan, or Germany.

Intangibles are what create the opportunity for base erosion, which is much more serious in the United States than elsewhere. And, he continued, it is clear from the presentation by Stephen Edge that policy goals differ. The main concern of the United Kingdom was companies expatriating, so they did not want to make the United Kingdom a less desirable headquarters country. And Grubert thinks the United Kingdom will lose revenue from their reforms, even though the authorities wanted them to be revenue-neutral.

So the question is what would we like to learn about the design of territorial systems? Grubert believes some version of territorial will eventually appear because no one likes the repatriation tax. So the main issue is base erosion. And on that subject, we haven't learned much about what might happen in the United States. Japanese business does not seem to want to avoid tax as much American business would. And, as for the United Kingdom, the fact that they weakened their CFC rules when they went territorial indicates that they were not much concerned about base erosion.

Stephen Edge interjected that the United Kingdom has gone to CFC rules that look at substance and are less likely to be subject to manipulation than the previous rules. He said they were trying to be consistent with the OECD transfer pricing guidelines. The prior rules were more likely to be subject to manipulation than the new ones. He agreed there were issues with financial companies, but other than that asserted the rules are quite realistic in ensuring profits are taxed where they are generated.

Alan Auerbach asked if there was a change in the focus of the U.K. CFC rules from addressing foreign-to-foreign type base erosion versus U.K. to foreign. Edge replied that they did not worry about foreign-to-foreign transfer pricing, only that between the United Kingdom and the rest of the world.

A discussion followed on the subject of whether the United Kingdom had solved the base erosion problem. Edge said they had changed the focus from the CFC rules to transfer pricing rules. He concluded that if base erosion means activity is in one place and recorded income in another, be does not believe the United Kingdom has solved it, but they have a system that is consistent with solving it.

Grubert continued that neither the United Kingdom nor Japan seemed to have taxed past accumulations when they eliminated the repatriation tax. He continued that some think that the tax should apply to cash, not to all assets abroad. He asked what the tax rate was in the Ways and Means bill.

Tim McDonald replied that the tax rate was 8.75 percent. John Samuels added that the 8.75 percent came about because some tech companies told the Ways and Means Committee they would be happy to pay anything in single digits to get their money back home. A discussion followed on why the transition tax on cash in the Camp bill was only 8 percent instead of 9.9 percent.

A discussion followed among Harry Grubert, Stephen Edge and others on expense allocation rules. Edge agreed with an observation by Grubert that the UK expense allocation rules were a bit like transfer pricing rules; they tried to apply an arms-length standard to the amount of debt a company would incur from its affiliates.

Grubert and others discussed the pros and cons of interest allocation systems based on assets and income flows. Grubert expressed the view that assets could be manipulated, so that cash flow would be a better standard. And there are issues in defining whether assets are debt or equity.

Gary Thomas asserted that Japan has straightforward definitions of what is debt and what is equity.

Stephen Edge commented that there are massive problems with trying to disallow deductions in a place where income is not being taxed. If you try to trace where borrowed money goes to work and estimate the taxes that were paid on those investments, you would solve the problem of global unemployment! If the United States has inadequate measures on inbound investments, it is up to the United States to protect its own base. The United Kingdom faces the same issues. Should they deny deductions to Starbucks unless the United States taxes Starbucks' royalty payments? He doesn't think that is his place to decide.

Alan Auerbach asked Grubert to finish his presentation and reserve the general discussion until later. After some further discussion, he turned over the floor to Dan Shaviro for his presentation.

Dan Shaviro said he would tee up a few issues for the group to discuss. First is the comparison of the United States with Japan and the United Kingdom and what we learned today. The United States is obviously less small than Japan and the United Kingdom, but one question is whether it is less small enough. But a lot of the discussion has not been about whether we're significantly less small or whether everyone is small.

For Japan, we have heard today about their extraordinary tax planning environment. And the inbound and outbound sectors are smaller relative to the national economy than for other countries.

For the United Kingdom, we learned today about the importance of their being in the EU and thus subject to the ECJ (European Court of Justice). We heard that their headquarters companies could actually move another place quickly, while the United States enacted an anti-inversion statute.

We also know that the United States faces less short-term pressures to change the system.

Shaviro continued that everyone recognizes that companies face costs with respect to using internal funds as they like without having a taxable repatriation. We have heard that this dead weight loss could be between 1 and 2 percent of income or between 5 and 7 percent. He noted that we have seen Apple able to borrow at a very low interest rate and avoid having to make a taxable repatriation. But we also create governance issues by discouraging firms from distributing profits. He concludes that he honestly doesn't know how great the deadweight loss from avoiding the repatriation tax actually is.

Shaviro added two final points about repatriation. First, uncertainly about the future U.S. repatriation rates makes a lot of companies willing to bear dead-weight losses by having the funds stay abroad. And once you have the idea that we might enact exemption, it becomes especially important for companies to delay a taxable repatriation.

He also noted the multiple margins point. When you think of a classic worldwide foreign tax credit system in a classical territorial system, at least two margins are important, he commented. The first is whether there is a positive tax burden on investment and the second is how foreign taxes are treated, which affects the company's sensitivity to foreign taxes.

Under a foreign tax credit system with no deferral and no limits on foreign tax credits, he continued, firms would be completely indifferent to the foreign taxes they pay. When you add deferral to the system and you may never have to bring the money home, then companies become more foreign-tax conscious. So deferral makes foreign tax credits less of a problem. Likewise, foreign tax credits make deferral less of a problem because if you have enough credits you can bring the money home without paying any additional tax. This creates a problem for international tax reform especially for the pro worldwide tax people; when you improve one of those two sets of rules, you make the other one worse.

For example, the pooling proposal by the Obama Administration in 2009 would make companies less eager to bring money home because they can't play games to avoid the residual tax.

Shaviro added that thinking about the distortions created by deferral and by foreign tax credits is conceptually separate from thinking about how much we want to tax foreign-source income. In the current system, the United States uses these two rules (deferral and the foreign tax credit) to lower the burden on outbound investment relative to what it would be in a pure worldwide system with no deferral and foreign tax deductibility. But whether those two rules are bad ones that should be eliminated is conceptually distinct from whether we should want to raise the U.S. tax burden on foreign source income.

An advantage of going to territorial, he added, is that it is a treaty-compliant way to wipe out deferral and the foreign tax credit. But it is a separate issue whether a zero tax burden on outbound investment is too low.

Shaviro then addressed the issue of tax havens. When a U.S. or other multinational reports income in a tax haven there is reason to suspect that it wasn't actually earned there. It makes a difference, however (albeit hard to tell) whether it is our own taxes or another country's taxes that are being avoided. Territorial systems of major industrial countries generally have provisions that limit the tax benefits of putting income in tax havens. In the United States, subpart F operates similarly to restrict deferral.

Shaviro commented that subpart F and territorial countries' subpart F-like rules can take either or both of two different approaches. One looks at whether the income was actually reported as arising in a tax haven. The other looks at whether income items are of a type of income that we suspect will end up in a tax haven. So the subpart F rules address passive income. We figure it's also easy to shift the income to tax havens through the use of conduit-like base companies and other similar techniques.

So the questions are to what extent are multinationals avoiding taxes and what do we think of the avoidance. Again, you could like your multinationals avoiding other countries' taxes, or even (up to a point) reducing your own taxes, but if it goes too far (with respect to one's own taxes) this may be a serious problem.

On that point, Shaviro ended his presentation.

Alan Auerbach raised several questions that were touched on in both presentations and offered to let Grubert and Shaviro respond to them. The first is the issue of the United States being a large country. Is the United States different in terms of the mobility of corporations or perhaps the size of our foreign direct investment and is that a reason to not have a territorial system?

The second question, influenced by the Australian experience, is to what extent we over-emphasize the distinction between worldwide and territorial systems because we are looking simply at corporate taxes. If we had a free hand in the design of individual taxes, would there be such a big distinction between worldwide and territorial systems? Would we have to worry as much about profit shifting under a territorial system? If we could focus on comprehensive tax reform, would we be spending as much time thinking about the issue of whether to adopt a territorial system? His view is the answer is no.

Shaviro responded on the bigness issue that the obvious difference is that U.S. companies can't "get on a plane" immediately. John Samuels and Peter Merrill argue that we aren't any different than the United Kingdom or Japan, but they are talking about a longer time frame so it is debatable. In contrast, the United Kingdom feared that all the planes were leaving Heathrow. So for them, there is a greater empirical certainty about companies' ability to change residence).

The nub of the problem, Shaviro continued, is that we have entity-level corporate income taxation. Neither corporate residence nor the source of income can readily be made meaningful. But if you believe in having an income tax on individuals, you get drawn to defending the corporate tax. And lawyers say a perfect flow through system doesn't work.

But if we could design a perfect flow-through of corporate income to individuals, these problems would be gone. The United States would then simply be taxing U.S. individuals on their worldwide income and would probably not provide foreign tax credits except in reciprocal deals. And we wouldn't be taxing anything earned by foreign people unless we could withhold the tax and we hadn't made a deal with the other country to negotiate it away. The closer you get to taking individuals at the individual level on corporate income without needing the corporate income tax, the closer you are to this world of flow-through and the more you starting thinking the same way.

Harry Grubert responded that he was between John Samuels and Dan Shaviro on the bigness issue. It is an empirical question how much you risk companies choosing between locating their capital in high-tax and low-tax countries. Grubert added that he and Rosanne Altshuler have been saying for some time that we should lower the corporate tax rate and raise the personal tax rate, either on everyone or specifically on capital income.

Dan Shaviro then asked why it is that everybody in the United States agrees that corporate or at least business-level tax changes should be self-financing. Why is that an accepted aspect of the discussion? It seems puzzling since we could have more flexibility in the design of our tax system if we didn't have that constraint.

Harry Grubert pointed out that 1986 was sold because there were increased revenues from the corporate sector. A discussion followed of the Camp proposal and its treatment of corporations and unincorporated businesses. Auerbach pointed out that those numbers don't include the effects on shareholders.

Shaviro said the constraint has to do with distributional concerns and that no matter what the long-run incidence of a change in the corporate tax was, a surprise overnight cut would benefit shareholders.

A discussion on the questions raised by Auerbach followed.

John Samuels said that bigness meant nothing to him and the issue was the mobility of headquarters. The U.S. headquarters are not as mobile as others because of Code section 7874. We passed a statute that stops a naked inversion. Economists should hate that because what we are seeing now is real merger activity occurring, which is much worse than the naked self-help inversion. But assume we could follow Reuven's (Avi-Yonah) prescription and put up a wall that prevents U.S. companies being acquired by foreign companies. Then all U.S. companies would be, like P&G and GE, unable to leave the United States But then new companies would be formed outside of the United States.

Moreover, he went on, the elephant in the room is portfolio capital. GE shareholders will get tired of paying high U.S. tax rates on their investment in China when Siemens is investing in China and paying lower tax rates, so shareholders will sell their GE stock and buy Siemens stock, assuming Germany has a territorial system. So we will have shuttered all our windows, but left the front door and back door wide open to the loss of capital.

You cannot ignore portfolio flows, he went on, so you cannot wall us off. And if we lose capital at the shareholder level, what will happen to rates of return.

Jane Gravelle asked what would happen if we had a revenue-neutral proposal that lowered the corporate tax rate. Then, GE would just lose to another American company.

John Samuels responded that he was thinking about operations outside of the United States. Jane Gravelle said that if you taxed foreign-source income and used the revenues to lower the corporate tax rate, the aggregate investment in U.S. companies ought not to change. An exchange followed between Gravelle, Samuels, and Paul Oosterhuis. Samuels asked if you wouldn't be lowering the tax rate in the United States for foreign companies as well. Gravelle said yes. (This would appear to imply that the revenue-neutral trade would raise worldwide taxes on U.S. companies.)

Gravelle then pointed out that the United States would still have a full inversion system that other countries do not have. Samuels responded there is a long list of U.S. companies that would like to invert. He mentioned the Perrigo-Elan deal as an example, where Perrigo, a Midwest pharmaceutical company, merged with Elan, an Irish company, with a lot of cash and some royalties.

Grubert asked what was in it for Perrigo, was it earnings stripping or something else?

John Samuels responded it was based on getting access to their foreign capital and getting out of the U.S. CFC regime.

Paul Oosterhuis said that inversions present at least three potential advantages. First, they present the opportunity to put intercompany debt into the United States, like any foreign parent multinational typically does. Second, it gives greater flexibility in using cash held by foreign affiliates. Third, it permits growth outside the United States through foreign affiliates that are not CFCs. A discussion of details followed among Oosterhuis, Grubert, and John Samuels.

Eric Toder responded to Alan Auerbach's question about the revenue constraint for tax reform, noting that was how the Administration had framed the corporate reform issue. But others, including Simpson-Bowles and especially the Bipartisan Policy Center would have lowered revenue from corporations and raised them from individuals and were distributionally neutral.

Stephen Shay asked Dan Shaviro why we were so clear that we should tax worldwide income of individuals, but not corporations. Why do the arguments change so dramatically when corporations enter the picture? How much difference does it make if we tweak shareholder versus corporate?

Shaviro responded that the reason a country has an income tax is to figure out who should pay based on how well-off if they are. And if one person is rich because he earned $1 billion in France and one earned it at home and both live in the United States, then they both have $1 billion and you would want to tax them the same. In the world of 50 years ago, you would say Americans invested through U.S. companies and no one else invested in U.S. companies, then the existence of a corporate tax doesn't change anything. You would still want to tax the corporation's foreign-source income.

Now you may still want to tax U.S. companies' foreign-source income because U.S. individuals own the companies, but U.S. individuals also own foreign companies and you can't tax the foreign-source income of foreign companies. You also have the problem of what happens when foreign investors are investing through your companies. There is no particular reason to tax that unless you think you can stick them with the incidence of the tax. You'd have to be rather hopeful to think that.

Shaviro added that you would want an individual investing through a corporation to face the same tax burden, including what is paid at the corporate level, as someone who invests directly and if there is a rate difference you would worry about that.

And, Shaviro said, he was concerned about cutting the U.S. corporate rate below the individual rate. Even though you are right to want to lower the rate if you are thinking about global capital, you are also making the corporate tax into a tax shelter for owner-employees in the United States. If you think of Steve Jobs paying himself $1 per year and getting his income through stock appreciation and Apple isn't paying any tax to the United States, that's a problem. And at death his whole tax liability goes away.

Tim McDonald commented enterprise competitiveness has a reality. And one thing that proves it is that there are only seven companies left from the original Fortune 100 list. Over time, it is also increasingly a globally competitive market where U.S. dominance of commerce is diminishing because the rest of the economy is getting larger and national champions in other countries are prospering. And increasingly more of them are from developing countries.

If you have a competitiveness focus, the core issue is source taxation. You need to render to Caesar what is Caesar's. So the focus of a base rule should be to draw the line defining what is truly U.S.-source income.

The other issue, he continued, is IP. For every American company that's in the news in the UK press, the issue is how did the IP profits get out? In McDonald's view, the core issue is cost-sharing if you are worried about base erosion. We should have a rule that looks at where the problem is, because P&G is operating in almost every country where they legally can and over half of their worldwide management is not American. The United States does not have a monopoly on talent or creativity or productivity and not all the intangibles have a U.S. nexus. The rule has to recognize that.

What if we have a rule that puts all the income in the United States and explain to these other countries why Americans are uniquely more productive, creative, and profitable? It offends the conscience. So, McDonald concluded, we should really think about what is truly U.S.-source and frame a rule to deal with the source issue.

Peter Merrill made two observations. First, the U.K. documents said one of the key reasons for going to a territorial system was that U.K. multinationals now earn only a small part of their total income in the United Kingdom. Going back 50 years, U.S. multinationals earned 99 percent of their income in the United States but now they on average earn more than half of their income outside the United States. Second, the global economy is not very friendly to the taxation of corporate income because we have a very hard time knowing the source of income and the residence of corporations is quite mobile as well.

So we are facing a very difficult task to keep the corporate income tax alive in a global economy. Part of our struggle is the real conundrum of how to catch corporate income in a global economy.

Miranda Stewart commented that if you have a problem somewhere it is like a balloon, you squeeze it and the problem emerges somewhere else. Australia has moved to trying to define what is active or passive income. But Australia has confusing rules about the source of income and confusing rules about the definition of passive income.

She added that we need to worry also about foreign portfolio direct investment. She wonders whether the disadvantage for Australian corporations has led Australian investors to invest offshore through portfolio holdings of other corporations, but there isn't much research on that. She also observed that the debate in Australia was not so much about revenue, but about the effect of their rules on economic activity in Australia. So she asked whether the U.S. tax reform debate was about the economy or was it a debate about corporate tax revenue.

Jane Gravelle answered both.

Alan Auerbach replied that it is about the economy, but people who have different concerns favor different policies. People who don't want to move to a territorial system are convinced American jobs are going offshore and people who want a territorial system are worried about the competitiveness of U.S. companies.

Jane Gravelle asserted that both concepts are wrong. Competitiveness is a wrong concept and job loss is a wrong concept because the economy will create jobs. Miranda Stewart interjected that she agreed with Gravelle on competitiveness. Gravelle went on that the idea of going to a territorial tax will have a big effect on jobs is baloney. And the idea that there will be a flowering of investment abroad and everything will be rosy also is wrong. All debates in the United States are based on the wrong concepts no matter how long you try to talk about the right ones.

Les Samuels responded that part of the discussion of tax reform is conditioned by the pressure in the United States on the middle class. People see jobs being eliminated by technology or because they are moving abroad. That has been part of the political debate for a long time. He recalled the NAFTA debate and the fear of the great "sucking sound" scaring people about jobs going overseas.

He continued that if we want to make progress the current system needs to be re-designed, but we are not going to eliminate the corporate tax and we are not setting up a wall to keep companies in. So while there are companies that want to expatriate, it is also true that Facebook and Apple and Google all set up here even though it wasn't a new idea to set up a startup offshore. They must have thought there was a good reason to be here.

Dan Shaviro commented that we should look at where they put their intellectual property.

Les Samuels responded yes, but they are here, although they could have started abroad. He observed that tax intellectual technology has grown exponentially, so the ability to have your IP wherever through complicated structures took a long time to develop, but it is here. But while these companies used structures with money trapped in Ireland, they nevertheless are not incorporated overseas.

The bottom line, he continued, is we are going to have some kind of hybrid system, so what kind of reasonable choices do we need to make, including choices about interest deductions and how to allocate expenses? You are going to have to come up with some practical answers. The question was raised, what about individuals and taxing individuals on a worldwide basis. He personally pays a lot of foreign tax, but is very happy with the worldwide system. It is a better than a territorial system for him.

So countries make different choices. Because of EU rules, the United Kingdom was more concerned about companies leaving. He doesn't think we are in that position here.

It is interesting to see what other countries have done and it will help us identify problems. We see that nobody had dealt with the interest deduction problem in designing their type of hybrid territorial system. And if there is an interest allocation rule of some type, it has to be net interest because otherwise you have a problem with the financial services sector. At the end of the day, however, you are going to be in the middle and while competitiveness is a factor it is not the only consideration.

Douglas Shackelford commented that there is more to the tax reform debate than just competitiveness or the economy. One needs to have a tax system that is administrable. The corporate income tax system is built on a financial accounting model that was designed for a bricks and mortar economy that no longer exists. Today virtually everything can be converted into intangibles. We do not have an underlying foundation for a house that is designed to handle intangibles. And Apple and Google are just a couple of generations ahead of every other company that is moving down the same path. So we have a system that will collapse because the house has a bad foundation that cannot hold it.

We need a reform, he continued, that would build a pragmatic practical system that can support taxation of business. He doesn't want to move to a world where we just can't tax anything that has to do with intangible activity. The international area is just the vanguard where the fault line Is greatest. If we ignore the problem of administering a system with intangibles, we are missing the boat.

Dan Shaviro commented that we had shown a lot of forbearance in not mentioning destination-based corporate taxes.

Tim McDonald returned to the issues of taxation, jobs and corporate headquarters. He argued that the U.S. is a strong economy and recalled what happened in the 1990s to mid-size companies, when the dollar was strong and the stock market was soaring. If you are using your stock as currency and have high P/E ratios, you should be the acquirer in merger deals. But the opposite happened to U.S. companies in 60 to 70 percent of all deals. He mentioned as an example Budweiser, which owned a part interest in 30 different breweries around the world. They were, he said, probably the world's best brewer. So why were they not the headquarters survivor?

He concluded there are two types of problems. If we are talking about production jobs in an industry that is easy to shift location, the high corporate rate is the problem. But if you are talking about maintaining U.S. headquarters in the long-run, territorial is the answer because why would you have a worldwide enterprise and subject yourself to a net tax that you wouldn't pay if your residence was someplace else?

Reuven Avi-Yonah disagreed. He wondered why we keep focusing on the importance of a corporate tax when it is only 9 percent of total revenues. He added that nobody thinks about corporate tax when starting a company; people think about whether their idea will be successful or not and make them rich. In the United States, we should not be driving the individual rates too high. He referred to a post by Len Burman on Tax Vox (the Tax Policy Center blog) that showed the effective marginal rate as high as 67 percent on some people in the Camp proposal. And the current rate in New York City and some other places is over 50 percent.

He asked whether we do see a big increase in expatriations. And he asked where the next Sergey Brin will immigrate to. Would an entrepreneur come to the United States if they are going to pay such a high marginal tax rate plus a 40 percent estate tax on anything about $10 million?

Avi-Yonah concluded that what makes this country great is the people who found companies here that make really innovative things. All of the immense profits of Apple and Google were generated by really bright people with really good ideas.  And he worries that will happen somewhere else because there are lots of nice places to live in the world that have very low tax rates.

John Samuels commented that he agreed with Avi-Yonah on his last point. And he added that the United Kingdom has changed the rules of the game. It is not a tax haven and has no palm trees, but is a very attractive place to be located. But, Avi-Yonah pointed out, attractive for corporations, not for individuals.

A discussion followed between John Samuels, Stephen Edge, and Jane Gravelle about the pros and cons of living in the United Kingdom, which is a nice place but very dark in the winter most of the time. John Samuels then talked about base erosion and manufacturing and how bad it would be incrementally to go to a territorial system. He argued that tax savings do affect the location of real investment. That is because it is easy to move intellectual property to Ireland, while keeping headquarters in the United States. But the real problem is once the IP is placed offshore, you can't exploit it by manufacturing in the United States. If the United States pays a royalty to its Irish affiliate, that becomes subpart-F income and the United States parent loses the ability to use its' Irish tax haven

He referred to an article in the New York Times about the great manufacturing facilities Apple had in Northern California in the 1980s. Apple today manufactures nothing in this country. And Samuels imagined that the tax advisor must have told the CFO that you can save billions of dollars of tax by moving your IP to Ireland, but you don't have to manufacture in Ireland. You can manufacture in Taiwan or China with contract manufacturing, but not in the United States.  (John) Samuels then noted how there was a Commerce study on the loss of U.S. manufacturing in the high-tech sector.

He went on to compliment the Camp bill for moving toward a destination based system and neutralizing the margins of where you own your IP. He doesn't think these companies need a territorial system because they are not capital-constrained. Apple and Pfizer have unlimited access to capital markets in the United States, so the residual tax on repatriations is not constraining them.

So why do they need a territorial system? John Samuels says the problem is they have so much cash outside the United States that they don't know what to do with it. Apple can't find another Apple to buy. Microsoft bought Skype. GE is taking lower returns in their financial services businesses. So we need to fix that problem.

Alan Auerbach offered his views after listening to the discussion. He commented that he had not heard a good defense for having a territorial system. He can only think of three arguments for having such a tax, but none of them work very well.

The first argument is that it is a backstop to the individual income tax. But if you wanted to back-stop the individual income tax, you would not have a source-based tax. A second argument is to take advantage of market power because the United States is a big country and we might want to stick it to foreigners. For that, you might want some tax, but he is not sure it would be 35 percent or even 25 percent. And a third reason would be because of fixed resources, like domestic energy which won't move. But that strikes him as an argument for a natural resource tax or a tax on Hollywood or something else, not a source-based corporate tax.

Auerbach continued that countries that are rich in natural resources do have special tax regimes, and the United States is picking up some location-specific rent with its corporate income tax. But that doesn't seem a sufficient reason for a broad-based territorial corporate income tax unless you can rule out 17 better alternatives.

He added that we have been talking about how to develop administrable rules for such a tax that can be enforced. But we have not asked whether it is a coherent policy in the first place.

Miranda Stewart noted that we do have a very substantial national and international legal and institutional infrastructure that knows how to deal with corporate tax. We have a network of 3,000 treaties (world-wide) and administrations that know what corporations are. She doesn't think moving away from all of this is costless.

John Samuels asked Auerbach what are the 17 better alternatives.

Auerbach mentioned a resource tax or a more comprehensive individual income tax that just used the corporate tax as a withholding mechanism. Jane Gravelle suggested taxing dividends at ordinary rates, for starters. Auerbach added that you can reform capital gains taxation. Avi-Yonah mentioned a VAT, but Auerbach suggested leaving that issue for another day.

Auerbach noted we had hit our time limit and thanked the panelists.

Eric Toder said there were 15 minutes left for a wrap-up session. After thanking the conference organizers, he brought up the suggestion by Stephen Shay that we conclude by asking everyone at the table to say what they learned today or what they believe that they did not coming in.

Jane Gravelle said she thought she understood interest allocation rules but apparently does not. She thought you could just take total worldwide interest and multiply it by the ratio of U.S. to worldwide profits and that's how much interest you could deduct, but apparently that is not how it works.

Stephen Shay suggested taking a quick tour around the table.

Eric Toder began saying he learned two things. The first is the Luxembourg tax avoidance technique. The second was Gary Thomas' presentation on tax culture, which raised the question of whether we want to take aggressive tax planning and a highly rules-based system as a given. He said he doesn't have a conclusion, but thought it was interesting how culture drives the way systems work.

Gary Thomas said his takeaway is the policy debate here is far more complicated and will definitely take more than the 8 or 10 months it took in Japan.

Alan Auerbach said there was a silver lining to the fact that it takes the United States forever to enact tax legislation and that is that we might at some point figure out what to do.

Peter Merrill learned that Brian Arnold 13 years later may have reached a different conclusion on territorial taxes. He also found the culture of Japanese corporations to be fascinating and learned from Brian Arnold in a sidebar conversation that they offer a blue return to corporations that are most on the up and up. He wondered if we could offer some kind of carrot to U.S. corporations that might encourage less tax avoidance.

John Samuels said we should lower our tax rate.

Doug Shackelford also mentioned the Japanese culture issue and some side discussions he had with Tim McDonald on his personal experiences with it.

Jane Gravelle mentioned interest allocation and also that she has to learn more about section 956.

Annette Deckers said she did not know about the exit tax on German companies. And she thinks she learned that the present U.S. system of worldwide income tax with deferral is considered as pretty good because nobody seems to really want to get rid of it.

Dan Shaviro said he was glad to have been at the second and third panels to learn of the experience of other countries. And the Japanese experience was the most eye-opening because he knew the least about it.

Paul Oosterhuis said he learned he should have been at the morning session. And it was particularly interesting in the afternoon session to learn how easy it was to enact tax reform in the United Kingdom and Japan.

John Samuels learned that concern about base erosion is a peculiarly U.S. phenomenon; the Japanese for cultural reasons are not worried about it and the United Kingdom is not worried either. He wondered if it was because as Steve Shay suggested we have more intellectual property or if it is because we have more people like Paul (Oosterhuis), Steve (Shay), Les (Samuels), and himself thinking about it.

Stephen Edge said politics clearly plays a much larger role in the formulation of tax policy in the United States than it does in the United Kingdom. This was a shame if it was damaging the business economy and encouraging U.S. companies to invest overseas.

Les Samuels found the discussion of the United Kingdom and Japan quite interesting and, together with the history in Australia and Germany, it gives a better understanding of what brought about the changes.

Bill Randolph commented that the insightful discussion at the conference left him more pessimistic about whether there are any satisfying answers in the quest for making the corporate income tax system work in an international environment.

Jennifer Blouin commented that the cultural norm in Japan was definitely a surprise to her. But she also found it interesting to compare the Australian and Canadian imputation systems and to see how different imputation regimes could act as a countervailing force against some earnings stripping, something she had not thought of before.

Alfons Weichenrieder said he was reminded that he knew very little about 10 of the 12 margins that Grubert had mentioned.

Robert Stack said he learned that the British have strong CFC rules, which he did not know before. He also learned from Harry and others that the individual characteristics of a nation, its industry, history, tradition, and competitive position, are very strong drivers of policy, something which one might think is obvious. He thought it was difficult to try to homogenize these rules and may be a fools' errand to try.

Rosanne Altshuler said it came out strongly that different countries have different policy goals.

Ruth Mason learned that in other countries OECD projects take a larger role than in the United States. She also wondered if it was easier to change the law or the culture.

Harry Grubert said it was interesting learning what the Germans thought of their system and that the Japanese rules seemed very tough except for active business.

Brian Arnold learned that there are some Americans who are interested in what is going on in the rest of the world.

Annette Deckers suggested they are all in this room.

Brian Arnold also told Peter Merrill he learned he can change his mind.

Miranda Stewart said she enjoyed learning about Luxembourg, but also learned how deeply embedded the worldwide system is in the United States. And it reminded her that what looked like an easy policy change in Australia is a very difficult change to make in the United States.

Mark Steinmeyer asked if one could predict what a country's tax system would look like based on its economy. And when he hears discussions about other countries, thinking of economic development or some tool to strengthen the economy, he wonders if there is some consistency there and do we fall above or below some line?

Stephen Shay commented that in working on this project he has occasionally pulled out the IBFD (International Bureau of Fiscal Documentation) data and looked through the attributes of taxes in each of these countries. And this gives him a much more textured sense of why countries have different rules.

And speaking for himself, he thanked all the presenters and everyone who came and participated because he really got much more out of this than he was expecting to get.

Eric Toder added one final thing that he learned from Ruth Mason's presentation about the reasons for the subpart F rules -- how much the debate today is the same as it was 50 years ago. He suggested that in 50 years this group all meet again.

**LIST OF PARTICIPANTS**

Rosanne Altshuler, Rutgers University
Brian Arnold, Canada Tax Foundation
Alan Auerbach, University of California at Berkeley
Reuven Avi-Yonah, University of Michigan Law School
Jennifer Blouin, University of Pennsylvania, Wharton School of Finance
Annette Deckers, Embassy of the Netherlands
Timothy Dowd, Joint Committee on Taxation
Stephen Edge, Slaughter and May (London, United Kingdom)
William Gale, Brookings Institution and Tax Policy Center
Jane Gravelle, Congressional Research Service
Harry Grubert, U.S. Treasury Department
Ruth Mason, University of Virginia Law School
Timothy McDonald, Procter and Gamble
Peter Merrill, PricewaterhouseCoopers
Geerten Michielse, International Monetary Fund
Ruud de Mooij, International Monetary Fund
Paul Oosterhuis, Skadden and Arps
William Randolph, U.S. Treasury Department
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