Key Elements of the U.S. Tax System

What is a territorial tax and does the United States have one now?

Q. What is a territorial tax and does the United States have one now?

A. Under a territorial tax, the United States would not tax profits earned overseas by US-resident corporations. The Tax Cuts and Jobs Act effectively exempted some of these profits, but retained taxation on some categories of foreign profits and imposed a new minimum tax on another.

When corporations based in one country earn profits from production in other countries, the countries involved must decide on the appropriate tax base. Such rules should prevent multiple layers of taxation from impeding international trade and investment flows while providing that corporate profits are taxable somewhere.

One option is a territorial tax system that taxes only the portion of a corporation's income originating within the country's borders. This prevents double taxation of cross-border flows because resident corporations' foreign-source income is exempt from tax.

Another option is a worldwide system that taxes all domestic-source income, as well as the foreign-source income of resident corporations. To prevent double taxation, countries with worldwide systems allow their resident corporations to claim tax credits to offset their foreign income taxes. They also typically allow their resident companies to defer tax on active profits earned by foreign affiliates (controlled foreign corporations, or CFCs) until those profits are repatriated to the parent company. This feature of tax systems—known as deferral—substantially reduces effective tax rates on foreign-source income in countries with worldwide systems, making them not that different from territorial systems.

Territorial and worldwide systems would be the same if all countries had the same tax rates. Then, credits under a worldwide system would exactly offset otherwise-payable taxes on foreign-source income. But the systems are different if countries have different corporate tax rates. Territorial systems encourage a country's resident multinational corporations to shift real investment and reported profits to low-tax foreign countries. Worldwide systems (with deferral) reduce this incentive because resident corporations pay the domestic tax rate when they repatriate profits earned in low-tax countries. But worldwide systems place resident corporations at a disadvantage compared with companies based in countries with territorial systems that impose no domestic tax on the profits their resident companies earn in low-tax foreign countries. Most countries have moved closer to territorial systems by eliminating taxation of the repatriated dividends their resident companies receive from their CFCs.

Key Elements of the U.S. Tax System

What is a territorial tax and does the United States have one now?

IMPLEMENTING TERRITORIAL TAXATION

Implementing territorial systems requires defining the source of a multinational corporation's profits. This was straightforward when most profits were attributable to physical assets with a fixed location, such plant, equipment, and structures. Today, however, an increasing share of profits comes from returns to intangible assets, such as patents, trademarks, and copyrights. Firms in technology, pharmaceuticals, and other sectors have been able to reduce their tax liability by shifting ownership of and profits from intangible assets to low-tax jurisdictions where little real economic activity occurs. By charging affiliates in high-tax jurisdictions a royalty for these intangible assets, such firms lower their overall tax bills. Also, firms can often allocate corporate debt and overhead costs among jurisdictions in ways that reduce their tax burdens.

Countries have two basic strategies to prevent companies from eroding the domestic corporate tax base by assigning reported profits to low-tax foreign jurisdictions. The first approach is to enact detailed rules that define the source of profits. These include rules to determine the "transfer prices" companies can report on goods traded within a multinational group; rules for allocating interest, overhead, and research costs; and provisions to limit interest deductions on debt between related parties. The recent report on base erosion and profit shifting by the Organisation for Economic Co-operation and Development includes a long list of recommendations for how to curb income shifting.

The second approach applies limited worldwide taxation as a backup to territorial taxation. Most advanced countries have enacted so-called CFC rules that subject some forms of "passive" income (such as interest and dividends) their resident multinationals earn within CFCs to current taxation. The subpart F rules in the US Internal Revenue Code, enacted in 1962, are an example of such a provision. By taxing certain types of easy-to-shift income on a worldwide basis, CFC rules limit the benefit of income shifting. CFC rules, however, only apply to a country's resident multinationals and therefore do not prevent foreign-resident companies from shifting profits earned within a country's borders to low-tax jurisdictions.

THE CURRENT US TAX SYSTEM

The current US system is a hybrid between a territorial and a worldwide system. The Tax Cuts and Jobs Act (TCJA) eliminated taxation of repatriated dividends but expanded taxation of income accrued within CFCs. The current system can be characterized as a territorial system for normal returns from foreign investment, defined in the US tax law as return of up to 10 percent on tangible assets, because these returns face no US corporate income tax. The result is that US companies investing overseas and foreign-resident companies from countries with territorial systems both pay only the local corporate income tax rate in countries where they place physical capital assets. In addition, US companies no longer have an incentive to avoid US taxation by contracting production to locally owned firms, as they would under worldwide taxation.

The new tax law, however, departs from territorial taxation in its treatment of intangible profits, which represent the bulk of profits for some of the largest US multinational corporations. Because TCJA eliminated the tax on repatriated dividends, it increased the rewards for income shifting: profits now not only accrue tax-free overseas, but are also tax-free when brought back to the US parent. To counter this, TCJA included GILTI, the tax on global intangible low-taxed income. A low-rate tax on intangible profits as they accrue will reduce the incentive to shift these profits out of the United States.

Finally, the new tax law retains the long-standing rules in subpart F for taxing the passive income US firms accrue within their foreign affiliates. These rules, and similar rules in other countries, have long been viewed

as a needed backstop to prevent base erosion in territorial systems.

Bottom line—the US system is a hybrid between a territorial and a worldwide system. It still retains some incentives of a pure territorial system to invest in lower-tax foreign countries instead of at home and to shift reported profits to lower-tax jurisdictions. And it still retains some features of a worldwide system that may place US multinationals at a competitive disadvantage compared with multinationals resident in other jurisdictions. But the hybrid nature of the system makes the problem of income shifting smaller than it would be in a pure territorial system and makes the competitiveness problem smaller than it would be in a pure worldwide system. And the lower 21 percent corporate rate in the new tax law makes both problems smaller than under the previous corporate rate of 35 percent.

Finally, the system continues to be extremely complex. How companies will adjust their behavior in response to revised incentives and how effective the IRS will be in enforcing the new rules remains to be seen.

Further Reading

Gravelle, Jane G., and Donald J Marples. 2018. "Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)." CRS Report R45186. Washington, DC: Congressional Research Service.

Grubert, Harry, and Rosanne Altshuler. 2013. "Fixing the System: An Analysis of International Proposals for Reform of International Tax." *National Tax Journal* 66 (3): 671–712.

Organisation for Economic Co-operation and Development. 2018. *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017–June 2018*. Paris: OECD.

Toder, Eric. 2017a. "Is a Territorial Tax System Viable for the United States?" Washington, DC: Urban-Brookings Tax Policy Center.

———. 2017b. "Territorial Taxation: Choosing among Imperfect Options." AEI Economic Perspectives. Washington, DC: American Enterprise Institute.