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Territorial Taxation: Choosing Among Imperfect Options

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Both territorial and worldwide systems for taxing income of multinational companies are difficult to implement because the concepts of income source and corporate residence on which the systems are based have become less economically meaningful. Recent legislation enacted by the House and Senate would move the United States toward a territorial system for taxing US multinational corporations by eliminating taxation of dividends that foreign affiliates repatriate to their US parent companies. To protect the domestic corporate tax base, the bills would introduce a new minimum tax on foreign-source intangible profits of US multinational companies and include measures to curb income stripping by foreign-based multinationals from their US-owned subsidiaries. They would also impose a one-time transition tax, paid over time, on the accumulated foreign earnings of US companies. By eliminating the repatriation tax, the bills would remove a tax distortion that has led US companies to accumulate more than $2.6 trillion of past profits in their foreign affiliates, but would retain incentives for US companies to shift investment and reported profits overseas and would continue to place some US companies at a competitive disadvantage compared with foreign-based companies that pay no home-country tax on their foreign-source income. Compared with current law, the new corporate income tax rate of 20 percent would reduce all these remaining economic distortions.

One major feature of the tax bills moving through Congress at the end of 2017, as well as the proposals of all major Republican presidential candidates in recent years, is a provision that would create a territorial tax system for the United States. Proponents have come to define territorial taxation as a system that exempts from tax the dividends that US-resident multinational corporations receive from their foreign affiliates. In contrast, under current law these dividends or repatriated profits are taxable in the United States, but with a credit for the underlying foreign income taxes paid on the profits that produced the dividends.[1]

[1] Late Friday night, December 1, before the final vote, the Senate added a provision restoring the corporate alternative minimum tax (AMT), which earlier versions of both House and Senate bills would have repealed. Commentators have

Overview

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Why the Push for Territorial Taxation? The push for a dividend-exemption system is a response to trends in foreign tax policies and responses of US corporations. Over the past several decades, other countries have lowered their corporate income taxes, while the US federal corporate tax rate has remained at 35 percent since 1993. (States impose corporate taxes at varying rates averaging about 6 percent, making the combined rate 39 percent, after accounting for the deduction of state taxes from corporate taxable income.) Over the same period, US multinational corporations have reported a greatly increased share of their profits to low-tax countries. Because these overseas profits have paid very little foreign income tax, some of the largest US companies have few accumulated foreign tax credits to offset the 35 percent US corporate rate on repatriated profits. To avoid this high potential repatriation tax, US corporations have accrued an estimated $2.6 trillion in overseas assets. Eliminating the repatriation tax would unlock these assets, enabling companies to use them to finance more domestic investment or increased payments to domestic shareholders, either through dividends or share repurchases.

In addition, other countries—most recently Japan and the United Kingdom—have enacted dividend-exemption systems, leaving the United States as the only country in the G7 and among relatively few globally that still tax repatriated dividends. Proponents of a dividend-exempt system argue that the repatriation tax places US corporations at a competitive disadvantage relative to foreign-based corporations and encourages inversion transactions in which the parent company of a multinational group changes its tax residence from the US to a more tax-friendly country. Although Congress has enacted laws to curb inversion transactions, corporate residence can shift overseas through other channels, such as mergers between equal-sized companies, buyout of US companies or divisions of US companies by foreign corporations, and the chartering of newly emerging multinational corporations overseas.

Options for Taxing Multinational Corporations. When capital and trade flows across borders occur within corporate groups so that corporations based in one country earn profits from production and sales in other countries, the global economic system requires rules for allocating the tax base of corporations among countries. These rules are needed to prevent multiple layers of taxation from impeding international trade and investment flows, while ensuring that corporate profits are taxable somewhere. The three polar options for this allocation are territorial taxation, worldwide taxation, and destination-based taxes, although countries use a mix of these approaches.

Territorial Taxes. Under a territorial tax system, corporate profits are assigned to the "source country," the country where the income originates. Countries prevent "double taxation" of corporate profits by allowing an exemption for income with a source outside their borders. Starting with the League of Nations in the 1920s, international bodies have recognized the right of countries to impose tax on profits earned within their borders by both domestic and foreign corporations.

Worldwide Taxes. Under a worldwide system, countries would still tax all income earned within their borders, but also tax the foreign-source profits of their resident companies. To prevent double taxation, they would allow tax credits to offset the foreign income taxes their companies pay. Usually, countries attempt to limit these credits to the tax rate they would impose on domestic corporate profits.

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observed that restoring the AMT could (inadvertently) nullify the international reforms in the legislation. For this paper, it is assumed the corporate AMT will be repealed or modified so that the international reforms remain in place.

Table 1. US Tax Rules Under Worldwide and Territorial Tax Systems

Residence/Source	US-Source Income	Foreign-Source Income
US-Resident Corporations	Taxation at US corporate rate under both systems	No US taxation under a territorial system; taxation at US rate with a credit for foreign income tax up to the US rate under a worldwide system
Foreign-Resident Corporations	Taxation at US corporate rate under both systems	No US taxation under either system

Source: Author's analysis.

The difference between ideal territorial and worldwide taxes is in the treatment of foreign-source income earned by domestic-resident corporations (see Table 1). Under both systems, US-source income of multinational corporations is meant to be taxed at the US rate applied to domestic corporate income, and foreign-source income of foreign-resident corporations is outside the jurisdiction of the US tax law. Under a territorial system, US corporations pay the foreign tax rate in the country where they earn the profits. Under a global system, US corporations pay the higher of the foreign rate or the US rate that would apply to the same income if earned domestically.

Because corporate tax rates differ among sovereign countries and the US imposes income taxes on profits earned outside the United States by foreign-resident corporations, it is impossible to achieve a fully neutral tax based on either residence or source. Residence-based taxation applies the same tax rate on US corporate income whether earned at home or overseas and therefore does not interfere with US companies' decisions of where to invest, produce, or report income. But a residence-based tax places US-resident companies at a disadvantage compared with foreign-resident companies that do not pay tax on the profits they earn in low-tax foreign countries. Pure source-based taxes treat US and foreign-resident companies equally, but provide an incentive for US-resident companies to earn and report income in lower-tax foreign countries.

Destination-Based Taxes. Under a destination-based system, corporate income would be based on the location of sales. Profits of both US and foreign-resident companies from sales in the United States would be taxable, regardless of where the goods and services were produced. Profits from sales overseas would be exempt. No country has a destination-based income tax, although some US states using combined reporting systems allocate US profits under their state corporate income tax to their state based on the share of total US sales within the state's boundaries. In contrast, consumption taxes around the world are destination based. Value-added taxes achieve this result by fully taxing consumption of imported goods, while exempting export sales and allowing exporters to claim a credit for value-added taxes paid by their suppliers. In the United States, state retail sales taxes and federal excise taxes attempt to achieve this result by taxing consumption of taxable goods within their borders, wherever produced, while exempting sales outside their jurisdiction.

The 2016 House Republican "A Better Way" blueprint would have created a form of destination-based consumption tax by allowing corporations to expense investment, eliminating net interest deductions, and allowing US corporations to exempt export sales from tax, while denying a deduction for import purchases. The proposal had many advantages as a method of allocating the corporate tax base among countries, but was controversial and poorly understood. Because the destination-based approach was scrapped in this year's reform effort, it is not discussed further here.

What Is the Current US-Based System? The US tax law's treatment of foreign-source income is a hybrid between a worldwide and a territorial tax. US corporations are taxable on their global profits with a credit for foreign income taxes, but income that US multinationals accrue in their foreign subsidiaries is generally tax-exempt until the income is repatriated as a dividend to the US parent corporation. The United States raises little revenue from this residual tax on repatriated dividends. In the past, when many foreign countries imposed higher tax rates than the United States and there was less profit shifting to tax havens, US corporations could offset most of the repatriation tax with credits for foreign income taxes paid, using excess credits earned in high-tax countries to offset taxable profits in low-tax countries. Today, with smaller foreign tax credits available to offset US taxes, US corporations retain more profits in their foreign subsidiaries, while using loans against these assets and other methods to finance domestic investments and payouts to shareholders. The resulting inefficiency in portfolio allocation can be viewed as an "implicit tax" on the foreign-source income of US multinational corporations—an inconvenience that burdens corporations without producing revenue for the US Treasury. The late Treasury economist Harry Grubert has estimated this implicit tax burden at about 7 to 8 percent of foreign profits, much lower than the tax rate payable if the profits were repatriated, but nonetheless an important and growing source of efficiency loss.

Implementation Issues

In practice, pure territorial and pure worldwide taxes have become extremely difficult to implement because both the source of corporate income and the residence of corporations are no longer meaningful economic concepts.

Implementing a Tax Based on the Location of Profits Is Hard. Determining the source of profits was relatively straightforward when the source of profitability was returns to physical assets with a fixed location—plant, equipment, and structures. Today, however, an increasing share of profits comes from returns to intangible assets, such as patents, other sources of production know-how, and brand-name reputation. These assets have no fixed location and contribute to the output of firms throughout the world. One could possibly assign as a source the place where they were developed, but US companies can transfer their ownership to affiliates in low-tax countries before there is evidence of how much they are worth, making it almost impossible for the IRS to determine the value of the assets transferred. Through this and other mechanisms, firms in the technology, pharmaceutical, and other sectors with valuable intangible assets have successfully transferred ownership of their intangible property to affiliates in low-tax countries, who then reap a large share of the reported global profits from the companies' activities.

Other ways of shifting reported income to low-tax jurisdictions include allocating larger shares of fixed costs to high-tax countries, using debt-equity swaps and other transactions that exploit differences in the tax rules among assets and countries, and strategic use of provisions in bilateral tax treaties that were designed to prevent double taxation. These transactions make the tax bases of the United States and other leading economies highly vulnerable to efforts by multinational companies to shift reported profits to low-tax countries where little real economic activity occurs.

Governments have two basic strategies for countering these forms of base erosion. The first is enactment of detailed rules for determining the source of profits. Companies can shift their profits to lower-tax jurisdictions by paying high prices for goods they purchase from their affiliates in low-tax countries and charging low prices for goods they sell to them. The United States and other countries require firms to set these "transfer prices" for goods traded within a multinational group equal to prices of the same goods in "arms-length" transactions between independent entities. Often, however, with transactions in intangible assets, there are no relevant comparable transactions, and the potential for setting prices to minimize taxes of the corporate group is high. Governments have also imposed rules for allocating common costs such as interest, management overhead, and research among affiliates and to limit interest deductions on debt between related parties. The recent Base Erosion and Profit Shifting report by the Organisation for Economic Co-operation and Development recommends a long list of strategies to curb income shifting to low-tax countries.

A second approach uses limited worldwide taxation as a backup to territorial taxation. The United

States and most of its leading trading partners have enacted rules that tax some of the income of their resident multinationals' foreign affiliates on a current basis. The Subpart F rules are one example; under Subpart F, passive income and other "easily shiftable" income of foreign affiliates of US multinationals are taxable as earned instead of when repatriated. Subpart F limits the ability of US-resident multinationals to strip income from their US activities. For example, if a US-resident company capitalizes an affiliate in a tax haven and then borrows from that affiliate, its benefit from deducting interest payments is offset by taxation under Subpart F of the interest receipts of the tax haven affiliate. Subpart F, however, does not prevent foreign multinationals from stripping profits from their US affiliates and, since the Treasury adopted check-the-box rules in 1997, no longer effectively prevents US multinationals from stripping profits from their foreign affiliates in high-tax countries.

The bottom line is that enforcing a territorial tax is extremely difficult. While in theory, the US taxes all corporate income with a US source, in practice much of that income goes untaxed. And because enforcement strategies that rely on limited worldwide taxation can apply only to US-resident companies, foreign-resident companies have an advantage over US-based companies in avoiding tax on their US-source income, while US companies have an incentive to invest overseas in high-tax countries where Subpart F is less effective in preventing income stripping.

Worldwide Taxation Is Also Problematic. Because taxing multinational corporations based on the location of their profits is hard, one might consider as an alternative simply taxing US corporations' worldwide income by eliminating deferral. If the United States enacted a true worldwide system, US multinationals would no longer have an incentive to earn income or report profits in lower-tax foreign countries. Foreign-resident multinationals, however, would still have an incentive to invest in lower-tax countries, so the global tax rules would still not be neutral between investment locations. And corporate residence itself is increasingly a meaningless economic concept, now that multinationals have production, employment, sales, share ownership, and even research and some central management functions in multiple jurisdictions.

Worldwide taxation, therefore, would greatly increase incentives for corporate residence to shift away from the United States. Inversion transactions are only one way for residence to shift. Other mechanisms include mergers between equal-sized firms, buyouts of US companies or divisions of US companies by foreign purchasers, and contracting out production by US companies to locally resident corporations to take advantage of lower foreign corporate income tax rates.

How Current Legislation Addresses Issues in Moving to a Territorial Tax

The tax bills recently enacted by the House and Senate would eliminate the taxation of repatriated dividends that US-resident corporations receive from their foreign affiliates and the foreign tax credits attributable to the profits from which those dividends were paid. Both bills contain new provisions to curb income shifting to low-tax foreign countries and would impose a one-time tax on assets that US corporations have accrued in their foreign affiliates before the effective date. Finally, by reducing the corporate tax rate to 20 percent, the bills would reduce the cost of provisions that impose different tax rates based on the residence of corporations and the location of their profits.

Preventing Base Erosion. The tax base of the US and other leading economies is vulnerable to erosion from several sources.

Expanded Global Taxation to Prevent Income Shifting. To offset the increased incentive for US companies to invest and report profits overseas that eliminating the repatriation tax would create, both bills include proposals for a new minimum tax on the profits that US companies accrue within their foreign affiliates. Both bills would impose a tax rate of 10 percent (12.5 percent after 2025 in the Senate bill) on a US company's foreign high returns (sometimes called Global Intangible Low Tax Income, or GILTI). The House bill defines foreign high returns as returns in excess of 7 percent plus the federal short-term interest rate on the affiliate's adjusted basis in depreciable tangible property, while the Senate bill defines them as returns in excess of a 10 percent return on tangible property. Both bills would allow foreign tax credits to offset only 80 percent of foreign income taxes on those high returns and would not allow firms to use the credits to offset tax liability in prior or future years. The House bill would also not allow firms to use the credits to offset US taxes on other foreign-source income.

The minimum tax proposals are aimed at intangible profits: the returns from patents, trademarks, brand-name reputation, and other sources of firm value unrelated to tangible capital assets. The deductions of a portion of profits in the Senate and House bills are meant to exempt "normal" returns to tangible investment from the tax. The proposals are modeled on a proposal by economists Harry Grubert and Rosanne Altshuler (2013) to impose a minimum tax at half the corporate rate on accrued foreign-source income, while exempting normal returns by allowing firms to claim an immediate deduction for all foreign investments. Grubert and Altshuler propose exempting normal returns for two reasons. First, the location of tangible capital is not as responsive to tax rate differentials as intangible capital because the former involves changing real investments instead of just financial structures. Second, US multinationals could more readily avoid a US residual tax on tangible profits by contracting out production to a foreign-resident company, while they are not likely to surrender ownership of their intangible assets.

Replacing full taxation of intangible profits on repatriation with a minimum tax as the profits accrue may be a tax increase or decrease, depending on the value of deferral. If firms repatriated profits annually, it would be a big decrease; if profits were never repatriated, it would be a big tax increase. The Joint Committee on Taxation (US Congress 2017) estimates that, for the Senate bill, revenue from the minimum tax on intangible profits in 2027 (when the rate is 12.5 percent) would replace almost 90 percent of the revenue loss in that year from repealing the repatriation tax. Firms would also benefit because the tax system would no longer interfere with the decision of whether to repatriate accrued foreign profits or reinvest them overseas.

To further reduce the incentives for firms to shift reported profits to low-tax jurisdictions, the Senate bill would apply the same preferential rate (12.5 percent after 2025) to intangible profits reported to the United States that support export sales. US firms using their intangible assets for foreign sales would not need to move their intangible assets to foreign affiliates to benefit from the preferential tax rate. While this provision would reduce income shifting, it is estimated to lose additional revenue. The lost revenue on intangible profits already earned in the United States would exceed the additional taxes from shifting profits back to the United States. And expanding the preference the US tax law already provides to firms with intangible assets because their development is expensed and can sometime qualify for research credits would place US firms with tangible assets at a relative disadvantage. Finally, because the new tax benefit would apply to only intangibles used to support export sales, it might be subject to challenge from the World Trade Organization as an export subsidy.

The estimated revenue loss in combination with the reduced efficiency losses from eliminating the repatriation tax suggests that substituting a minimum tax for the repatriation tax may modestly increase the incentives for US multinationals to invest and report profits overseas instead of at home. In contrast, reducing the corporate rate to 20 percent would reduce that incentive because at the lower statutory rate all differences in tax treatment among investments matter less.

Preventing Income Shifting by Foreign-Based Corporations. The other source of base erosion is the shifting of profits outside the United States by foreign-resident companies with US affiliates. Reducing the corporate tax rate to 20 percent would increase the incentive for these companies to invest and report profits in the United States. The House and Senate bills contain additional provisions to prevent profit shifting by these firms. Those provisions reduce the incentive for foreign-based firms to invest in the United States by increasing the effective tax rate on their US profits, but they limit the shifting of those reported profits outside the United States. They also reduce the incentive for inversion transactions by US-resident companies that occurs because foreign-resident companies can engage in profit-shifting transactions that Subpart F limits for US-resident companies.

Both the Senate and House bills impose minimum taxes in the form of excise taxes on a portion of the gross domestic receipts of US companies with foreign affiliates. The House bill implements a 20 percent excise tax on gross receipts of US companies by denying deductions for certain payments to related foreign parties. US companies can offset this tax by claiming foreign tax credits for income taxes the foreign parties pay on profits from their sales to the US companies. The foreign tax credit effectively eliminates most of the tax on payments to affiliates in high-tax countries. The tax credit was added to the original proposal after complaints from companies that an excise tax on all payments would seriously disrupt global supply chains. The foreign tax credit in this proposal is the reverse of the usual situation in which foreign tax credits are available. Instead of allowing credits to offset taxes US companies pay on their foreign-source income, this proposal allows US companies to claim credits for taxes foreign companies pay on income for which the new law would deny a deduction to the US affiliate.

The Senate bill imposes a base erosion minimum tax of 10 percent, less certain applicable credits, on payments to a related foreign party, with exceptions for smaller corporations and for base erosion payments of less than 4 percent. The Senate bill would also reduce base erosion from excessive borrowing by limiting the deduction of interest by US corporations that are members of a worldwide affiliated group and would limit deductions for certain hybrid transactions with a related party for which there is either no reported income or an associated deduction in the country in which the related party is a tax resident.

The minimum taxes are a response to transactions that often result in an understatement of taxable income by US affiliates of foreign-resident companies. But taxpayers may be able to avoid both minimum taxes by conducting transactions through independent distributors. In addition, because the proposals deny deductions for costs incurred by purchases from foreign entities, they may raise issues of compliance with US obligations under the World Trade Organization.

Taxing Profits Accumulated Under Prior Law. Eliminating the tax on dividend repatriations going forward raises the issue of how to treat dividends from profits accrued under the prior tax law. Corporations accrued those profits with the expectation they would be taxable at a 35 percent rate when repatriated. But many of these profits would not have been repatriated for many years, if ever. A transition rule that avoids either rewarding or punishing companies compared with how their past investments would have been taxed under prior law requires that these profits be taxable, but at a substantial discount from the current rate on repatriated profits.

Both bills would impose a low-rate transition tax on deferred profits in foreign affiliates of US companies. The House would tax cash assets at a 14 percent rate and other assets at a 7 percent rate. The tax would be payable over 8 years at 12.5 percent of the net tax liability due each year. The Senate would tax cash assets at 14.5 percent and other assets at 7.5 percent. The tax would be imposed on a more back-loaded schedule of 8 percent of net liability for each of the first five years, 15 percent in the sixth year, 20 percent in the seventh year, and 25 percent in the eighth year.

The transition taxes in the two bills should not be confused with the repatriation holiday enacted in 2004, which allowed companies to repatriate profits for a single year at a tax rate of 5.25 percent. The tax on foreign assets in this proposal is not voluntary; it is imposed on all deferred assets whether or not they are repatriated. And it is not meant as a temporary tax break, but instead as a transition tax to accompany a change to a different system of taxing the foreign-source income of US multinational companies.

Conclusions

Territorial taxes have the advantage in theory of equalizing the treatment of US-resident and foreign-resident corporations by eliminating the residual tax the US imposes when a US-resident company repatriates the profits earned by its foreign affiliates in low-tax countries. But they have the disadvantage of increasing the benefit to US corporations of investing and reporting income overseas instead of at home. A territorial system is also quite difficult to enforce because of the difficulty in determining the location of corporate profits, especially those attributable to intangible assets.

The recent tax-restructuring bills enacted by the US House and Senate move toward a territorial tax system by eliminating the taxation of repatriated dividends paid to US parent companies from the future profits of their foreign affiliates. This will eliminate the increasing incentive for US companies to accumulate profits in their foreign affiliates, which has led them to accumulate more than $2.6 trillion of these assets. The proposals, however, are not fully territorial in that they introduce a new minimum tax on foreign-source intangible profits to prevent dividend exemption from contributing to further erosion of the US corporate tax base. In addition, by lowering the corporate tax rate to 20 percent, the bills reduce the distortions and disincentives from any set of international taxing rules.

The bills include provisions intended to address concerns about the new territorial system, including profit shifting out of the United States by both US multinationals reporting foreign-source income and foreign multinationals with investments in the United States. Whether these base-erosion provisions prove effective and at what cost remains to be seen. The reforms are addressing extremely difficult and complex issues, and these provisions will likely continue to be debated and refined in the coming years.

About the Author

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