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There are three possible forms for the U.S. international taxation system:

- the current hybrid deferral system;
- a territorial system; and
- some form of full inclusion system.

This article focuses solely on the big picture issue of whether international tax reform should take the form of a territorial system or an alternative full inclusion system. Of course, it is also necessary to compare these possible new systems with the current hybrid deferral system that has been in place for many years.

With little if any explanation of how it might be better for our nation and society as a whole, many persons and commentators whose companies or clients stand to benefit have called for a territorial system. Such persons have included CEOs, members of the professional tax community, business groups, and lobbyists. This article attempts to assess this issue on a more objective basis through a balanced, understandable summary of the principal policy issues and consequences.

This article assumes that the reader will be at least cursorily familiar with the current hybrid deferral system and the territorial system as proposed by the House Ways and Means Committee in a discussion draft released October 26, 2011. The full inclusion system would impose U.S. income tax at the normal corporate rates on all of a U.S.-based multinational corporation's (U.S. MNC) income, no matter where it was earned in the world and no matter whether it was earned by a domestic member of the U.S. MNC group or by a foreign member. Foreign taxes paid by domestic and foreign members of the U.S. MNC group would be allowed as foreign tax credits to avoid double taxation. The Joint Committee on Taxation has provided its comments on full inclusion approaches and consequences.[1] This JCT report also includes discussion on several mechanisms that could be used to implement a full inclusion system.

What Are the Principal Policy Concerns?

In no particular order, the policy matters that seem most important in evaluating the three forms of international taxation systems are discussed below.

Note that the problem of exporting jobs is covered in the ''Neutrality'' section, and revenue raising is covered under the ''Broadening the Tax Base'' section.

Policy matters covered are:

- competitiveness;
- neutrality;
- simplification;
- broadening the tax base;
- encouragement of ''game playing''; and
- ''trapped cash.''

The table summarizes these policy matters and how they are affected by each of the alternative international taxation systems.

Competitiveness

We often hear about competitiveness, or the lack of it, as a rallying cry. So what are we speaking of?

[1] ''Present Law and Issues in U.S. Taxation of Cross-Border Income,'' JCX-42-11, Sept. 6, 2011, p. 99 et seq., *available at* http://www.jct.gov/publications.html?func=showdown&id=4355.

Comparison of International Taxation Systems — Summary of Policy Issues

Policy Issue	Current Hybrid Deferral System	Territorial System	Full Inclusion System	System Best Achieving Policy Objective
Type 1 Competitiveness — U.S. MNCs vs. Foreign MNCs	Competitive advantage for foreign MNCs, but not so important	A more level playing field but differences will persist due to varying CFC rules amongst countries	Competitive disadvantage for U.S. MNCs vs. foreign MNCs	Territorial system
Type 2 Competitiveness — U.S. MNCs vs. Domestic Corporations	U.S. MNCs have advantages over domestic corporations	Advantages of U.S. MNCs over domestic corporations will increase further	More level playing field	Full inclusion system
Neutrality (including the export of jobs)	Encourages the movement of operations (including jobs) and the ownership of intellectual property from the U.S. to overseas	Even stronger encouragement to move operations and ownership of intellectual property from the U.S. to overseas	Neutrality achieved	Full inclusion system
Simplification	Complicated and plenty of subjective areas creating tax risk for taxpayers and government	Subjective areas even more important due to exemption of foreign earnings	Real simplification through elimination of subpart F, etc. and of several problematic subjective areas	Full inclusion system
Broadening the Tax Base (including ability to generate government revenue)	Ability to permanently retain overseas earnings and never repatriate as dividends lower the tax base	The participation exemption will lower the tax base, but this will be partly offset by stronger subpart F rules	True broadening of the tax base	Full inclusion system
Encouragement of ''Game Playing''	Strong encouragement	Even stronger encouragement	Real reduction in ''game playing''	Full inclusion system
Trapped Cash	Major issue	Should solve but the proposed mechanism will cause this to be a continuing issue; changing the mechanism could solve	Solved	Full inclusion system (and territorial system if presently proposed mechanism is corrected)

There are two types of competitiveness:

- Type 1 — Competition between U.S. MNCs and MNCs based in other countries.
- Type 2 — Competition between U.S. MNCs and domestic U.S. corporations with most or all of their business conducted domestically within the United States.

Virtually all the attention paid to competitiveness in the debate on international taxation systems considers only the first type. The second type is typically ignored, despite its importance.

Current Hybrid Deferral System

Type 1 Competition. The 35 percent residual tax imposed when overseas earnings are repatriated as dividends back into the United States is definitely a higher tax cost than that faced by MNCs from many rival developed countries. So there is a Type 1 competitiveness issue.

How important is this? Is it evident that U.S. MNCs are hurting from this?

U.S. MNCs have successfully used international tax planning to achieve relatively low effective tax rates. Such planning can involve the division of business activities among related companies incorporated and resident in various countries, including tax havens, the placement of intellectual property ownership outside the U.S., and the use of cost-sharing agreements, not unreasonably aggressive transfer pricing, and supply chain planning.[2]

The well-publicized aggregate low-taxed foreign earnings now stated to be in excess of $1 trillion is evidence of this U.S. MNC success under the current hybrid deferral system. So is Type 1 competitiveness a serious issue? Maybe not for many U.S. MNCs.

[2]For some recent empirical research, see Edward Kleinbard, ''The Lessons of Stateless Income,'' Mar. 21, 2011, *available at* http://ssrn.com/abstract=1791783; Reuven Avi-Yonah and Yaron Lahav, ''The Effective Tax Rates of the Largest U.S. and EU Multinationals,'' Oct. 24, 2011, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1949226.

Another relevant point is that U.S. MNCs spend considerable effort to plan the use of any excess foreign tax credits that arise from any high-taxed foreign income they earn. This cross-crediting further reduces the pain of the 35 percent residual tax.

Type 2 Competition. The current hybrid deferral system provides some advantages to U.S. MNCs over their purely domestic competitors.

One example involves the existing ability to cross-credit foreign taxes paid on some types of foreign income against the U.S. tax on certain domestic income. This often allows U.S. MNCs with excess foreign tax credits to pay less U.S. tax on income from some U.S. manufacturing. It is not uncommon for a U.S. MNC to manufacture a widget in the United States and export it with the buyer taking title outside the United States. This U.S. MNC would pay less U.S. tax than a domestic corporation having no international operations that manufactures and exports the same widget.

A second example is that a U.S. MNC can choose to manufacture a widget overseas in a country with low tax rates or with tax holidays that encourage foreign investment. As long as the U.S. MNC avoids current U.S. taxation under subpart F (generally not an issue in this sort of manufacturing situation), the low-taxed foreign earnings can be retained indefinitely outside the United States so that the 35 percent residual tax (less any foreign tax credit) is never paid. Or there might be another repatriation holiday (as happened in the American Jobs Creation Act of 2004) that will permanently eliminate most of the 35 percent residual tax.

A domestic corporation that chooses to manufacture in the U.S. will be taxable at the 35 percent tax rate (ignoring for simplicity any effect from the deduction for income attributable to domestic production activities).

There is not only a cash flow advantage to the U.S. MNC, but with permanent reinvestment of the low-taxed earnings overseas, the U.S. MNC's financial statements can include as an expense only the actual foreign taxes. There is no need to accrue the up to 35 percent residual tax. This means that the U.S. MNC's financial statement net income and earnings per share will be comparatively higher than that of a pure domestic corporation.

Territorial System

Type 1 Competition. Without question, the implementation of a territorial system should eliminate any direct Type 1 competition.

However, Type 1 competition will still exist through differences in the various countries' controlled foreign corporation rules.

Say that a U.S. MNC and an MNC from country X are each bidding for a construction contract in Indonesia. Say further that the two MNCs each have an operating construction subsidiary in Singapore that will carry out the actual construction activity in Indonesia. Assume that through legal tax planning both MNCs would pay relatively little income tax to both Singapore and Indonesia.

If the CFC rules in the U.S. are relatively looser than those in country X so that the U.S. MNC will pay no U.S. tax while the MNC from country X must pay country X tax on some or all of the income from the construction activities, then the U.S. MNC will have a Type 1 competitive advantage. And in a contract bidding situation, other things being equal, this may allow the U.S. MNC to make a more competitive bid than the country X MNC can make.

From a worldwide societal perspective (as well as from the goal of protecting each country's domestic tax base), there would be a more level playing field for all MNCs if all countries' CFC rules were of roughly equal coverage and strength. As there are differences that will have varying effects on business situations, some Type 1 competition issues will remain.

Type 2 Competition. Type 2 competition will be significantly worsened under a territorial system.

The second example given above in the current hybrid deferral system discussion is applicable here. As such, a U.S. MNC choosing to manufacture a widget overseas in a country with low tax rates or with a tax holiday that encourages foreign investment will be in a much better tax position than a similar domestic corporation manufacturing the widget in the United States.

This Type 2 competition advantage will be an important factor in any U.S. MNC's decision on where to manufacture a product or conduct movable income-producing activities. As such, it will encourage even more than the current hybrid deferral system the export of jobs from the United States.

Full Inclusion System

Type 1 Competition. A full inclusion system would place U.S. MNCs at a competitive disadvantage in some situations.

For example, assume the Indonesian construction contract example discussed above.

When preparing its bid, the U.S. MNC would include in its calculations as one factor the U.S. tax and available foreign tax credits.

When country X MNC prepares its bid, if the country X CFC rules force current home country taxation, then the only competitive difference will be the difference between the U.S. and country X home country tax rates. However, if the country X CFC rules capture only a portion or none of the income from the contemplated construction activities, then the country X MNC could prepare a more competitive bid, all other things being equal.

Type 2 Competition. With both domestic corporations and U.S. MNCs taxable on a full inclusion basis, there should be no tax rate competition issues since both will be taxable at the regular U.S. corporate tax rate on a current basis. Unless corrected in some manner, though, the cross-crediting of foreign taxes could continue to be a competitive advantage to U.S. MNCs over domestic corporations.

Summary

Type 1 competition issues for U.S. MNCs will be reduced but not eliminated under the territorial system. On the other hand, the territorial system makes the Type 2 competition inequities that domestic corporations face in competition with U.S. MNCs much worse.

Under the full inclusion system, U.S. MNCs may have some Type 1 competitive disadvantage. However, the principal Type 2 inequity hurting domestic corporations will cease.

Neither the current hybrid deferral system nor either of the two international taxation systems under discussion solve both Type 1 and Type 2 competition concerns. As such, Congress must make a value judgment regarding which type to correct. My personal belief is that Type 2 competition issues creating inequalities between domestic corporations and U.S. MNCs are a particularly inappropriate result of tax policy. As such, I believe that a full inclusion system should be seriously considered since it would best solve this issue.

Neutrality

Neutrality involves two perspectives — physical location and legal ownership location.

Regarding the physical location perspective, where does a U.S. MNC decide to place its personnel and assets for manufacturing or other physical operations? Does a tax system encourage U.S. MNCs to move manufacturing and other activities overseas (other things such as employee costs, logistical factors, and so forth being equal)?

Regarding the legal ownership location perspective, an active business may be carried out through personnel and tangible assets located in one or more physical locations. However, the legal ownership of that business or any intellectual property (IP) and other intangibles used in the conduct of that business can normally be placed, at the discretion of the U.S. MNC, in a group member established or tax resident anywhere in the world.

So, for example, does an international taxation system encourage placing the benefits and risks of ownership of a U.S. MNC's business operations (such as the proprietor of a supply chain) in a foreign group member rather than in a domestic group member? Does the system encourage U.S. MNCs to place ownership of their valuable IP in tax havens or elsewhere outside the United States?

It is fair to say that major taxation differences arising out of a wholly discretionary decision, such as in which country to incorporate a new company, is not good tax policy.

Does an international taxation system generate roughly the same amount of tax, including the same timing of payment of that tax, no matter how a U.S. MNC chooses to spread legal ownership and physical operations among its group members? For example, how will taxation change when certain business operations are alternatively conducted:

- solely within one or more domestic group member companies; or
- wholly or partially in one or more foreign group member companies?

Current Hybrid Deferral System

The current system is not neutral. The major taxation differences that can result between conducting activities and earning income within domestic group members and foreign group members has strongly encouraged the movement of physical activities and business and IP ownership to locations outside the United States in order to maximize what can economically be earned outside the United States.

Territorial System

A territorial system would not be neutral. The participation exemption allowed would be an even stronger incentive than the current hybrid deferral system to maximize foreign earnings through moving physical operations and business and IP ownership overseas.

Full Inclusion System

A full inclusion system would be wholly neutral or close to it. With the same U.S. taxation applied to all of a U.S. MNC's income, regardless of whether earned by domestic or foreign group members, business decisions on location of physical operations and business and IP ownership will reflect commercial, legal, and local tax considerations, and should not include significant U.S. federal corporate income taxation issues. (State taxation issues could, of course, still be relevant.)

Summary

It is clear that the territorial system would actually increase the current incentive to move physical operations (including jobs) and business and IP ownership overseas. Only under the full inclusion system would neutrality be achieved with no incentive to move operations and IP overseas.

Simplification

Simplification has many potential meanings, the more significant being:

- the simplicity of taxpayer compliance and tax authority oversight; and
- the reduction of areas of subjective judgment that create significant disputes between taxpayers and the tax authorities.

Current Hybrid Deferral System

No one would suggest that the current hybrid deferral system allows simple taxpayer compliance and tax authority oversight.

The current system has many difficult subjective areas that create tax risk for taxpayers and the government alike. Taxpayers are unsure of their actual tax liability and must sometimes include in their financial statements significant reserves against possible future tax, interest, and penalty payments. And the U.S. government is unsure of its proper revenue and must go through significant effort, sometimes including litigation, to audit taxpayers and collect tax.

Particularly difficult subjective areas in the international tax arena include:

- the pricing of goods and services between related taxpayers;
- the level of royalties between related taxpayers;
- the valuation of intangible property sold or exchanged between related parties;
- the application of the section 367 rules to some cross-border tax-free exchanges;
- the application of subpart F to some activities;
- the determination of income source; and
- the allocation of expenses between different classes of income.

Territorial System

Adoption of the territorial system as currently proposed in the Ways and Means Committee discussion draft would make several compliance matters simpler. For example, the proposed legislation would eliminate the deemed-paid foreign tax credit and the foreign tax credit limitation ''basket'' system.

Regarding areas of subjective judgment, the territorial system will only make matters worse. Because of the higher benefit to taxpayers of maximizing their overseas earnings (full exemption versus the current deferral), U.S. MNCs will be even more aggressive in making this happen. As such, transfer pricing issues involving goods and services, intercompany royalties, and intangible property transfers should escalate, as will various forms of tax-free cross-border exchanges to which section 367 must be applied.

Recognizing the increased benefit to U.S. MNCs of maximizing overseas earnings, the proposed legislation will strengthen the subpart F rules to help prevent complete erosion of the domestic tax base. With this strengthening of subpart F and the presumably increased auditing efforts by the tax authority, there will likely be greater uncertainty causing increased tax risk to taxpayers and the government alike.

Full Inclusion System

Exactly how compliance would be affected would depend on how a full inclusion system was implemented. I believe that after painful effort and learning of new reporting procedures, the compliance would not be significantly more difficult than at present. Because U.S. MNCs and other taxpayers that hold interests in foreign corporations need to calculate earnings and profits and report details, it seems unlikely that a full inclusion system would require significantly more effort than is already being expended.

The big simplification benefits that would arise from a full inclusion system are:

- effective elimination of several areas of difficult compliance; and
- the disappearance of several areas of subjective judgment that create significant disputes between taxpayers and the tax authorities.

In brief, once all foreign earnings are put into the same consolidated taxable income pot with all domestic earnings, three major areas of compliance should be eliminated. And with these eliminations, major areas of subjective uncertainty should disappear, virtually without a trace.

First, the major transfer pricing issues mentioned above will disappear since groupwide U.S. taxable income will be the same no matter what transfer prices are used between the members of a group. This will be true for all categories of intercompany transactions, including sales of goods and services, intercompany debt and license agreements, and transfers of IP. (While intercompany transfer prices will cease to be important in calculating U.S. taxable income, such prices will still be important in calculating foreign country taxes and will sometimes be relevant to calculating the foreign tax credit limitation.)

Second, with all foreign earnings of CFCs being included in a group's U.S. taxable income, there will no longer be any need for subpart F and its considerable complexity.

And third, for the same reason, many of the serious complexities of section 367 will no longer be relevant when tax-free transactions involve cross-border issues.

Summary

It is clear that after a period of perhaps difficult adjustment to a full inclusion system, there would be considerable simplification and reduction in areas of subjective judgment and taxpayer/tax authority disputes.

Broadening the Tax Base

Broadening the tax base is key to the seemingly universal desire that the overall corporate tax rate be lowered.

Current Hybrid Deferral System

The current hybrid deferral system has allowed U.S. MNCs through tax planning to achieve for many billions of foreign earnings:

- little or no foreign country taxation; and
- avoidance of subpart F.

It is these low-taxed foreign earnings that are being retained outside the United States and are not being repatriated. As long as repatriation is deferred, which is within the sole discretion of each U.S. MNC, these earnings will never enter the U.S. tax base.

Territorial System

Overall, it is to be expected that a territorial system will narrow the U.S. tax base. There are, though, two offsetting aspects to this.

First, the participation exemption will mean that the income that is currently taxable when repatriated will no longer be part of the tax base.

Second, if seriously stronger subpart F rules are put in place that force inclusion into the tax base of some low-taxed foreign earnings that currently fall outside subpart F, that will be a broadening of the tax base to some extent.

Considering these offsetting factors, some study that includes the evaluation of various approaches to strengthening subpart F would be required to determine the size and extent of the expected negative effect on the tax base.

Full Inclusion System

Only the full inclusion system will significantly broaden the tax base. This is because the billions of dollars of low-taxed foreign earnings that avoid subpart F and are currently earned in tax havens and other low-tax countries by U.S. MNCs would be taxed at normal corporate tax rates.

Summary

Only the full inclusion system will broaden the tax base, thereby providing a basis for a reduction of the overall corporate tax rate.

Encouragement of 'Game Playing'

The term ''game playing'' refers to the aggressive manner in which many U.S. MNCs have worked in their international tax planning to legally circumvent the general intent of tax laws in both the United States and in the countries where operations take place. Such planning often involves the use of tax havens in which low-taxed earnings are indefinitely retained.

Game playing is legal and is systemically encouraged by the economic advantages it confers. There are cash flow benefits from deferring U.S. taxation until low-taxed earnings are repatriated, and U.S. tax can be completely avoided when foreign earnings are indefinitely reinvested outside the U.S. Where such indefinite reinvestment is established, the financial accounting rules that govern public reporting allow U.S. MNCs to exclude from their tax expense the residual U.S. tax that would only be due upon dividend repatriation. This means higher publicly reported earnings and higher share prices. This also means higher bonuses for CEOs and others having incentive compensation wholly or partially based on a public company's share price.

Game playing was given both legitimacy and a strong boost from the temporary incentive tax rate of 5.25 percent allowed on certain repatriated foreign earnings of CFCs by the American Jobs Creation Act of 2004. Once the precedent of providing this incentive was set, it was understandably expected to happen again. And sure enough, statistics have shown the increasing levels of overseas earnings accumulated by U.S. MNCs following that 2004 incentive. The success of many U.S. MNCs in increasing their foreign earnings and low-taxed stockpiles of cash is reflected in the chutzpah shown by top corporate executives who strongly lobby for a repetition.

International taxation systems should be judged on how much they encourage U.S. MNCs to aggressively game the system, as is occurring under the current hybrid deferral system, to achieve both:

- low taxes in the various countries where they actually manufacture or make sales (typically reducing taxable income in such countries through planning involving intragroup transfer pricing and royalty and interest payments); and
- avoidance of current U.S. corporate taxation under the subpart F rules.

As noted above, under the current system, successfully achieving these two goals typically means that significant profits are left within tax haven group member companies.

Current Hybrid Deferral System

The current hybrid deferral system clearly encourages game playing.

If the current system is not changed to either the territorial or full inclusion system, consideration should be given to strengthening the subpart F system to significantly reduce the game playing that now exists.[3]

Territorial System

A territorial system would only encourage and increase game playing since the prize of the participation exemption would be even more enticing than under the current hybrid deferral system.

Any strengthening of subpart F will decrease game playing, but with the importance of this prize and with the ingenuity and creativity of professional tax advisers, U.S. MNCs are likely to stay a step ahead of subpart F changes.

Further, intercompany pricing rules under section 482 (including section 367(d) royalty calculations), even if strengthened, will always be subjective areas fertile for gaming the system and difficult for tax authorities to effectively administer and oversee.

Full Inclusion System

While I am sure that some game playing will continue under any new system, most of its current forms

[3]*See* JCT, ''Present Law and Background Related to Possible Income Shifting and Transfer Pricing,'' JCX-37-10, July 20, 2010, *available at* http://www.jct.gov/publications.html?func=showdown&id=3692. This document provides excellent background.

will cease once there is corporate income tax applied to all domestic and foreign members of a U.S. MNC group.

Summary

Only a full inclusion system will reduce significantly the game playing that U.S. MNCs spend so much time and effort on.

'Trapped Cash'

The success of game playing leads to the obvious tax policy issue regarding how a new tax system would affect U.S. MNCs' decisions on cash management. This is sometimes referred to as trapped cash, in which excess cash from accumulated profits is retained in a U.S. MNC's foreign subsidiaries to delay the U.S. corporate tax that arises upon repatriation as dividends. Good tax policy would leave MNCs free to make their profit repatriation decisions based solely on operational considerations and nontax legal and financing needs. The amount of taxation and the timing of tax payments would be unaffected by any repatriation decisions.

Current Hybrid Deferral System

The current hybrid deferral system has been problematic, causing some U.S. MNCs to accumulate cash in foreign group members while having domestic group members borrow for their business and corporate needs.

Territorial System

On the surface, a territorial system should solve the trapped cash problem since the participation exemption allows dividends to be made without home country taxation.

The House Ways and Means Committee discussion draft that proposes a territorial system will leave a significant enough incentive to delay the payment of dividends that the problem of trapped cash will not go away.

In brief, the proposed legislation provides a 95 percent rather than a 100 percent dividends received deduction. The stated reason is not to impose a partial tax on the repatriation of foreign earnings. Rather, it is to theoretically eliminate expenses related to exempt foreign earnings incurred by domestic group members that should not be deductible against domestic earnings. To allow such deductions would understate tax on domestic earnings.

Despite its theoretical basis, this 95 percent dividends received deduction mechanism causes the payment of a dividend to be a taxable event. As such, to avoid this tax, U.S. MNCs will likely choose not to pay dividends, but will rather retain their foreign earnings within their foreign group members — and the trapped cash problem will remain.

The discussion draft would also eliminate the section 956 investment in U.S. property rules, which would allow those pools of trapped cash to be loaned to domestic group members. The interest paid by the domestic group members to the foreign group members would cause some amount of further domestic tax base erosion and a nice tax arbitrage to encourage game playing.

Full Inclusion System

Under a full inclusion system, the payment of a dividend should no longer be a taxable event. As such, the problem of trapped cash should be fully solved.

Summary

Both the territorial and full inclusion systems should solve this trapped cash problem. However, unless the currently proposed mechanism in the Ways and Means Committee discussion draft is amended to eliminate the payment of dividends as an effective taxable event, the trapped cash problem will continue under the territorial system alternative.

Conclusion

I believe that the weight of tax policy and societal concerns strongly supports the adoption of a full inclusion system.

If it is ultimately decided to not change from the current hybrid deferral system to either a territorial or full inclusion system, consideration should be given to strengthening subpart F to force inclusion in the U.S. tax base of more low-taxed foreign earnings. This action could broaden the tax base, reduce Type 2 competition inequities, increase neutrality, and reduce the benefits of gaming the system.

Many claims that U.S. MNCs are behind competitively point out the need for the United States to catch up with various European countries and Japan, which have adopted the territorial approach. Maybe, as in the mid-1980s, it is time for the United States to come up with a better mousetrap (a full inclusion system) and then see the rest of the world change their systems to catch up with us. ◆