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Jeffrey M. Kadet
University of Washington School of Law

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Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle.

The territorial system strongly lobbied for by U.S. multinational corporations that stand to benefit from that system is not what's best for our country or our society. It is bad tax policy for many reasons, including the strong motivation it provides our multinational corporations to continue moving operations, jobs, risks, and assets outside the United States to achieve double non-taxation. A worldwide full-inclusion system would severely curtail or completely eliminate that strong motivation because double nontaxation would no longer be possible because of a current federal tax on all earnings that cannot be eliminated through any tax schemes or creative avoidance. A worldwide system also would increase the tax base and help make possible the lower overall corporate tax rate that both political parties desire.

The territorial system strongly lobbied for by the U.S.-based multinational corporations (MNCs) that stand to benefit from it is not what's best for our country. It is bad tax policy in today's environment because it is so easy for MNCs, with their extensive resources, to shift profits from the United States to low-tax countries.

Before discussing specifics, I must say that even proposing a territorial system is simply ludicrous. Frankly, our politicians should be embarrassed that discussions have gone this far.

We live in a revenue neutral world. Our deferral system does cause some foreign earnings to be taxed despite the billions of foreign earnings that our MNCs permanently retain outside the United States. If we move to a territorial system, this income that is now taxable will be exempt.

This means our corporate tax base gets smaller because now it will include only domestic earnings. And to remain revenue neutral, we either have to raise the corporate tax rate above 35 percent or increase domestic taxable earnings by eliminating domestic tax expenditures. No one wants to commit political suicide by saying the tax rate should increase. So, we can only increase domestic taxable earnings by taking away domestic deductions such as accelerated depreciation on equipment and the 9 percent deduction for domestic production activities.

I think you'll agree that there's something wrong with this picture, something so wrong that a "simply ludicrous" label is appropriate. We exempt foreign earnings, something that benefits solely our MNCs, and we raise taxes on all domestic businesses, especially those manufacturing in the United States. If Stephen Colbert reported this on Comedy Central, we'd all get a good laugh.

Considering the above, rather than implementing a territorial system or continuing our current deferral system, our country, its people, and yes, even our MNCs, would be best served by a worldwide full-inclusion (WFI) system. Such a system

Oversimplifying for brevity, the terms "deferral system," "territorial system," and "worldwide full-inclusion system" are defined as follows:

Deferral system — most foreign operating earnings of a multinational corporation's (MNC's) foreign subsidiaries will be subject to U.S. taxation only when distributed as dividends — which often is never.

Territorial system — most foreign operating earnings, including those within an MNC's foreign subsidiaries, will never be subject to any U.S. taxation no matter whether distributed or not.

Worldwide full-inclusion system — foreign operating earnings, whether directly earned by a U.S. MNC group member or within an MNC foreign subsidiary, will be subject to U.S. taxation currently as earned.

Contrasting Territorial System and Worldwide Full-Inclusion System			
Policy Issue	**Territorial System**	**Worldwide Full-Inclusion System**	**System Best Accomplishing Policy Objective**
Competitiveness Type 1: U.S. MNCs vs. Foreign MNCs	A more level playing field but differences will persist because of varying CFC rules among countries	Competitive disadvantage for some U.S. MNCs versus Foreign MNCs	Territorial System
Competitiveness Type 2: U.S. MNCs vs. Pure U.S. Domestic Corporations	Advantages of U.S. MNCs over domestic corps increase further	More level playing field	Worldwide Full-Inclusion System
Neutrality (including the export of jobs)	Even stronger encouragement to move jobs and ownership of IP from the U.S. to overseas	Neutrality achieved	Worldwide Full-Inclusion System
Simplification	CFC rules and subjective areas like transfer pricing even more important because of exemption of foreign earnings	Real simplification through elimination of CFC rules, etc., and of some problematic subjective areas	Worldwide Full-Inclusion System
Broadening the Tax Base (ability to generate tax revenues)	The participation exemption will lower the tax base, but will be partly offset by stronger subpart F rules	True broadening of the tax base by making currently taxable all foreign earnings whether repatriated or not	Worldwide Full-Inclusion System This base broadening pays for corporate rate reduction
Encouragement of "Game Playing" to Shift Profits From U.S. to Low-Tax Countries	Even stronger encouragement than already exists	Real reduction in "game playing"; motivation to shift profits eliminated or significantly curtailed	Worldwide Full-Inclusion System
Trapped Cash	Should solve but the proposed mechanism will cause this to be a continuing issue; changing the mechanism could solve the issue	Solved	Worldwide Full-Inclusion System (and Territorial System if present mechanism is corrected)

would severely curtail or eliminate the strong motivation (even stronger under a territorial system) that MNCs now have to shift profits out of the United States and into low-taxed countries, thereby achieving double nontaxation. The motivation to shift profits disappears when double nontaxation is no longer possible because of a current federal tax on all earnings, a tax that cannot be eliminated through any tax schemes or creative avoidance.

What is needed is a taxation system that eliminates the strong motivation to achieve double nontaxation through operating, owning assets, and bearing risks outside the United States. These efforts, which shift profits and jobs out of the United States, distort the business and investment decisions of our MNCs. International tax reform must put in place a new taxation system that will leave our MNCs free to make their business decisions based solely on business and investment factors such as location of raw materials and customers, employee wage rates, transportation costs, and availability of qualified personnel. Only the WFI system accomplishes this.

The House Ways and Means Committee and its chair, Rep. Dave Camp, R-Mich., have invested significant time and effort in considering the territorial system as the vehicle for international tax reform. In taking advice on this from tax experts, Camp and committee members must recognize that 99 percent of those who actually understand any of the theory and detailed practice of international taxation are paid by the MNCs that stand to benefit from a territorial system. Those tax experts are either direct MNC employees or are with the law, accounting, and lobbying firms that advise the MNCs. This means that before embarking on international tax reform, the committee must consider alternatives to the territorial system, alternatives that take into account the interests of *all* Americans and not just the MNCs that are strenuously lobbying for this system.

The WFI System and Its Advantages

A WFI system is a taxation system under which all foreign earnings are subject to the federal corporate income tax as they are earned. As such, there would be current U.S. taxation of MNC profits earned not only within U.S. group members but also profits earned within group members established under foreign law. A foreign tax credit mechanism would prevent double taxation.[1]

The accompanying chart contrasts what would be achieved under the territorial and WFI systems. It is clear that overall a WFI system would give America a better international taxation system.

A WFI system would:

- broaden the U.S. tax base (the territorial system would shrink the U.S. tax base);
- allow a revenue-neutral reduction in the U.S. corporate tax rate because of the broadened tax base, thereby making a WFI system acceptable across a broad political spectrum and achieving something both major political parties desire (the territorial system would reduce the tax base and require higher taxation on domestic business activity in order to be revenue neutral);
- eliminate the incentive to export jobs, business opportunities and risks, and tangible and intangible assets (the territorial system would strengthen this incentive);
- reduce or eliminate taxation as a factor in corporate decisions of where to conduct business operations, assume risks, employ personnel, and own tangible and intangible assets (the territorial system would make taxation an even more important factor);
- eliminate the ''trapped cash'' problem of the deferral system, which has caused our MNCs to stockpile cash outside the United States;
- reduce the number of MNC profit-shifting schemes and structures that erode the U.S. tax base and require considerable IRS time and resources (the territorial system would strongly encourage more MNC profit-shifting structures);
- simplify the tax code by eliminating the need for, or reducing the importance of, complicated subpart F and transfer pricing rules (the territorial system would make those rules even more important);
- help level the competitive playing field within the United States among pure domestic businesses, U.S.-based MNCs, and foreign-based MNCs operating in the United States (the territorial system would increase the current advantages held by MNCs over pure domestic businesses); and
- promote a greater level of identity between publicly reported financial statement consolidated earnings and the federal taxable income computation (when there's identity between the two, management tends to be less interested in tax planning that reduces reported earnings as well as taxable income; by contrast, there would be no such identity under a territorial system).

The single item in the accompanying chart that favors a territorial system is Type 1 competitiveness, which involves the relative competitive position of U.S.-based MNCs versus their foreign-based counterparts. Whether this is a real issue, or perhaps a red herring to some extent, is discussed later in this article. Also included are some comments on Type 2 competitiveness, which is seldom if ever mentioned by the territorial system lobby. This is the relative competitive position of U.S.-based MNCs versus pure U.S. domestic businesses.

How the WFI System Works

Under our current deferral system, U.S.-based MNCs are highly motivated to shift profits because they achieve these two objectives:

- reduction of tax imposed by the countries where actual business operations take place or where revenues from sales or services arise; and
- avoidance of tax in the United States (easily achieved under our deferral system by deciding against repatriating earnings and by avoiding the subpart F rules).

If either of those objectives cannot be met — especially the second objective concerning the avoidance of U.S. taxation — there will be much less motivation to undertake the often significant effort of planning and executing complex profit-shifting strategies. Our MNCs will change their behavior if all their international activities are subject to a full U.S. corporate tax on a current basis.

To achieve this current U.S. taxation, the United States should abandon its deferral system and replace it with a WFI system. Doing so would subject all foreign income, including profits in foreign subsidiaries, to current taxation at the regular U.S. corporate rates. An FTC mechanism would prevent double taxation.

Inability to Police a Territorial System

If we enact a territorial system, we would open the floodgates and then use simple patches or Band-Aids to keep the dike from collapsing (for example, strengthening the subpart F controlled foreign corporation and transfer pricing rules). And

[1]Professor Edward D. Kleinbard has long recommended a full-inclusion system using a worldwide consolidation mechanism. *See* in particular his article, ''Stateless Income's Challenge to Tax Policy,'' *Tax Notes*, Sept. 5, 2011, p. 1021, for a scholarly analysis of the workings of the deferral, territorial, and full-inclusion systems and his recommendation of a worldwide consolidation mechanism.

with the power of lobbyists, the chance of there being any strong patches or Band-Aids is slim.

The point is that a territorial system gives our MNCs the strongest possible motivation to continue their legal tax avoidance and profit shifting. The tax adviser community is well known for its century-long tradition of creatively and legally bypassing or sidestepping CFC and transfer pricing rules. And it is clear that the IRS will have limited resources to police the complicated structures and schemes that MNCs and their advisers will implement in response to any enhanced CFC and transfer pricing rules that are enacted to accompany a territorial system.

The Choice in a Nutshell

The United States has this basic choice:

- a territorial system that leaves in place strong motivation for tax avoidance and profit shifting, which the IRS can challenge only on a slow, resource-intensive, case-by-case basis that leaves many cases unchallenged; or
- a WFI system that would completely eliminate or severely curtail the motivation to conduct any tax avoidance or profit shifting by imposing a current home-country tax that cannot be avoided or reduced except through its FTC mechanism.

The answer is obvious: A WFI system will change our MNCs' collective behavior. A territorial system will only make things worse.

I acknowledge that there are some economic arguments for a territorial system because of its source-based structure. And it also can be said that residency is not a great theoretical basis on which to build a taxation system, because the place of incorporation and management and control can often be easily manipulated by corporations. However, the practical reality in our legal and tax environment is that our MNCs, with their mantra of maximizing shareholder value (as well as their executives' equity-based bonuses), will work diligently with their tax advisers to shift profits and avoid taxes. Any theoretical economic benefits of a source-based system are not worth the harmful tax policy aspects and future revenue losses that would accompany the adoption of a territorial system.

Type 1 Competitiveness — U.S. vs. Foreign

The rallying cry of the MNCs lobbying for the United States to follow other developed countries into a territorial system has been ''competitiveness.'' Our MNCs demand a level playing field.

Is this a real issue, or is it a red herring used to divert attention from the fact that a territorial system would significantly reduce our country's corporate tax base by inappropriately benefiting one class of taxpayer (the MNCs) over all others?

Various studies demonstrate that the effective tax rates of U.S.-based MNCs compare favorably with those of non-U.S.-based MNCs.[2]

This favorable result for U.S.-based MNCs reflects:

- the success of U.S.-based MNCs in shifting profits out of both the United States and the medium- to high-tax countries in which they operate or earn revenues (for example, China, France, Germany, Japan, and the United Kingdom) and into low- or zero-tax locations; and
- tax planning using the check-the-box rules or section 954(c)(6) to avoid current U.S. taxation through subpart F income inclusions.

Considering those studies and the reasons behind their results, it is clear that the evidence of any significant competitiveness problem under our current deferral system is questionable at best.

To judge Type 1 competitiveness under a WFI system, we need to understand a little more. What is the position of MNCs based in other developed countries that use territorial systems? Do they always pay tax solely in the countries where they operate and never in their home countries? If the answer is yes, those MNCs would often have an advantage over U.S.-based MNCs, which would always have some U.S. taxation under a full-inclusion system (unless the U.S. tax was fully offset by available FTCs).

Countries with territorial systems must protect their own tax bases. Just as the October 2011 Ways and Means Committee discussion draft includes options for protecting the U.S. tax base, other countries have protection mechanisms, one of the most important being the CFC rules. Under those rules, an MNC's home country may apply the home-country tax rate to some or all of the MNC's overseas income. When that occurs, a foreign competitor of a U.S.-based MNC is in a similar economic position as the U.S.-based MNC would be under a WFI system.

A detailed review of other countries' CFC rules is beyond the scope of this article. However, something general can be said about this U.S.-versus-foreign competitiveness issue when the United States has a WFI system and the home country of the foreign competitor has a territorial system. Whether there is in fact any disadvantage at all to a

[2]A good, condensed discussion and numbers can be found in Reuven S. Avi-Yonah and Yaron Lahav, ''The Effective Tax Rate of the Largest U.S. and EU Multinationals,'' University of Michigan Law School Program in Law and Economics paper 41 (Oct. 2011).

U.S.-based MNC (or, in some cases, even an advantage) typically will depend on the CFC rules imposed by the home countries of the foreign competitors. Some countries tax the home-country parent currently on some active business income that has been subjected to relatively low local taxation.

To summarize and simplify a complex area:

- There will be many cases in which a foreign competitor has an advantage — for example, the U.S.-based MNC under the WFI system is taxable at the normal U.S. corporate rate less allowed FTCs, while the foreign competitor is free of any home-country taxation and is taxed only in the countries where operations take place or where revenue is earned.
- There will be other cases in which a foreign competitor's advantage is small, nonexistent, or even negative. This will occur when the foreign-based MNC's foreign income on a particular transaction or project is taxable in the home country under its CFC rules. This puts the foreign-based MNC on a par with a U.S. competitor that is subjected to U.S. tax under a WFI system.

Interestingly, the OECD's base erosion and profit shifting (BEPS) project issued its first report on February 12. The BEPS project hopes to issue its second report early in the summer before the next G-20 meeting. The second report is expected to include suggested actions that countries could take to minimize corporate profit shifting. One suggestion might be strengthened CFC rules. If other countries do strengthen their CFC rules, thereby subjecting more income to home-country taxation, there will be fewer instances of foreign-based MNCs holding a competitive advantage over U.S.-based MNCs. The BEPS project might recommend a full-inclusion system. If other countries followed that recommendation, the principal competitiveness issue would be how high or low an MNC's home-country corporate tax rate is.

In sum, this single item of Type 1 competitiveness, while generally favoring a territorial system over a WFI system, is not as clear cut as our MNCs and their lobbyists would have us believe.

Type 2 Competitiveness — MNC vs. Domestic

Type 1 competitiveness is normally all one hears about. Type 2 competitiveness is the relative competitive position between U.S.-based MNCs and U.S. corporations that operate solely within the United States.

Under our deferral system, U.S.-based MNCs have several well known but not well publicized competitive advantages over purely domestic corporations. As one simple example, an MNC can choose to manufacture in another country such as Singapore where there is a much lower tax rate and maybe even a full tax holiday. A pure domestic corporation, on the other hand, will manufacture in the United States and currently pay both the 35 percent federal tax and applicable state and local taxes.

We have to consider both types of competition — not just the Type 1, U.S.-versus-foreign category. I believe fairness and a level playing field between U.S.-based MNCs and pure domestic U.S. corporations is the more important tax policy matter to get right. The WFI system accomplishes this. The territorial system simply increases the MNCs' advantage.

Additional Issues

The following are several issues requiring attention when considering a WFI system:

> **Reduction of corporate tax rate.** If a territorial system is enacted, our tax base will be reduced. Yes, that reduction will be offset to some extent by an expected expansion of subpart F or the tightening of our transfer pricing rules. But given the strong MNC lobby and the few who actually understand anything about the economic effects of possible subpart F and transfer pricing changes or the enforceability of those changes, the chances of serious expansion of these rules are slim at best. Because of this tax base reduction, keeping international tax reform revenue neutral will require significant cuts to domestic tax expenditures such as accelerated depreciation and the domestic production incentive.
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> Adopting the territorial system would add insult to injury: Not only would we increase the tax incentive to conduct operations, move jobs, and own assets outside the United States, but we would offset the cost of doing so by reducing incentives for operating and owning assets domestically. Considering this, it is ludicrous that we are even discussing a territorial system.
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> If a WFI system is enacted, our tax base will increase. And that increased tax base will provide a real basis for reducing our 35 percent overall maximum corporate tax rate.
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> That reduced corporate tax rate would benefit not only all U.S. corporations but would further encourage foreign companies to invest and conduct business in the United States.
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> Finally, a reduced corporate tax rate is something both political parties support.
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> **Tightened FTC mechanism.** Double nontaxation can be effectively achieved when an FTC

mechanism liberally allows an MNC to cross-credit excess FTCs. This is the ability of an MNC to apply excess FTCs from one type of foreign income or country against the U.S. corporate tax on other types of foreign income or income earned in other countries where that income has been subjected to little or no foreign taxes. When double nontaxation can be achieved, our MNCs have strong motivation to continue profit shifting.

To curtail that motivation, the FTC mechanism that would accompany the WFI system would have to be tightly drawn. By ''tightly drawn,'' I mean it would have to be a country-by-country or other FTC limitation mechanism that would severely limit the MNC's ability to cross-credit high foreign taxes paid on some income against U.S. tax on low-taxed foreign income.

Mechanism for implementing a WFI system. The Joint Committee on Taxation has considered several possible mechanisms for implementing a WFI system.[3] They include (1) using the CFC subpart F rules; (2) applying a worldwide consolidation that includes all subsidiaries no matter where established; and (3) treating CFCs as transparent vehicles.

The House Ways and Means Committee and other tax reform participants should analyze these alternatives and decide on an approach. In doing so, one corollary issue they should consider is how to address situations in which there is current taxable income from earnings within foreign subsidiaries but the U.S. taxpayer has no access to the cash necessary to pay the tax. The committee may identify situations in which it is reasonable to defer the actual payment of U.S. tax until some future time or event. In those cases, the U.S. taxpayer should pay an interest charge to the treasury on the deferred tax.

Corporate inversions. A WFI system will further encourage corporate inversions and other transactions through which MNCs may attempt to escape U.S. taxation on foreign earnings. Consideration should be given to whether the present anti-corporate-inversion rules of section 7874 are sufficient or whether strengthening amendments are needed.

Reconsider the definition of U.S. residency and the treatment of cross-border joint ventures. The federal tax system defines corporate tax residency based on the place of incorporation. With the introduction of a WFI system, there will be an incentive for individual and other noncorporate investors in potentially global businesses to incorporate new ventures outside the United States. Also, a U.S. investor (whether an individual, partnership, or corporation) may hold an interest in a joint venture corporation established in a no- or low-tax jurisdiction.

The WFI mechanism chosen may or may not cover U.S. owners of those foreign structures. After an overall mechanism is chosen, it will be necessary to consider other amendments to counteract available planning that would otherwise avoid current taxation under the WFI system. Those mechanisms could include:

- a management and control rule for corporate residency;
- expansion of the definition of U.S. shareholder in the subpart F rules to include U.S. persons owning less than a 10 percent interest; and
- an interest charge on earnings from some foreign joint ventures (like the charge applied under section 1291 to passive foreign investment companies).

Taxation of accumulated overseas earnings. Following the 2004 repatriation holiday under the American Jobs Creation Act, many MNCs stepped up their efforts to maximize earnings in tax havens and other low-taxed foreign subsidiaries with the expectation that there would be another repatriation holiday down the road.

On the other hand, some MNCs conducted overseas operations and structured those operations without attempting to shift profits to low- or zero-tax vehicles.

There has been some discussion about how accumulated earnings within MNC foreign group members might be taxed. For example, the October 2011 Ways and Means Committee discussion draft suggested that all be taxed through a subpart F mechanism, but it also provided for an 85 percent participation exemption, resulting in an effective 5.25 percent tax rate ((100 - 85) x 35 percent). The discussion draft proposed optional installment payments over a period of up to eight years with an interest charge.

While this favorable taxation of accumulated overseas earnings seems appropriate for the MNCs that did not shift profits, good tax policy cannot reward the behavior of those MNCs that worked hard following the 2004

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[3] Joint Committee on Taxation, ''Present Law and Issues in U.S. Taxation of Cross-Border Income,'' JCX-42-11 (Sept. 6, 2011).

act to maximize their low- or zero-taxed overseas earnings through profit-shifting structures.

A more appropriate approach would be to find an administratively simple way to (1) apply the suggested 5.25 percent rate only to accumulated overseas earnings that were earned within countries where actual operations took place, and (2) apply some higher rate (say 35 percent but with an FTC offset) to that income earned within "tax-structured vehicles."

A simple approach to identifying tax-structured vehicles would be to publish a list of countries that can be used for profit-shifting arrangements. All companies formed in those countries would be presumed to be tax-structured vehicles. An MNC could then rebut that presumption by establishing to the satisfaction of the IRS, based on a facts and circumstances review, that an applicable company should not be classified as a tax-structured vehicle. If that presumption is not successfully rebutted for a company, its accumulated overseas earnings would be subject to the higher 35 percent tax with an FTC offset in the hands of the MNC.

Background to Recommendations

Despite our deferral system, which in theory will eventually subject all overseas profits to federal taxation, many U.S. MNCs have succeeded in significantly lowering their effective tax rates through double nontaxation.

Our federal tax system and bilateral tax treaty network work conscientiously to ensure that U.S. taxpayers are not subjected to double taxation. This is accomplished through bilateral tax treaties that reduce foreign taxes and through the FTC mechanism found in the tax code.

While our domestic taxation system and treaty network generally prevent double taxation, highly motivated MNCs work hard to achieve double nontaxation — that is, no taxation in countries where activities take place and revenues are earned and no taxation (or permanently deferred taxation) in the United States.

There are many "environmental" factors that contribute to MNCs' motivation and success in achieving double nontaxation. They include:

- the acceptance by tax authorities and courts worldwide that corporations and other legal entities are separate and independent legal persons, no matter where they are established and who owns them;
- MNCs' ability to contractually "break up" their business activities by freely placing functions, assets, and risks within both newly created member entities and existing member entities, all of which contract among themselves in any manner they please since the terms of those intercompany contracts will have no economic effect on the MNC group as a whole (aside from desired beneficial tax effects);
- international acceptance of those intercompany contracts, despite their inherent non-arm's-length nature, so long as they reflect some degree of commercial reasonableness — even though the related-party contracts have been structured largely to achieve profit-shifting and other taxation goals;
- the arm's-length standard in transfer pricing, which, by its nature, causes some subjectivity in developing ranges of arguably acceptable pricing that spreads group profits among all the MNC group members;
- the total discretion that U.S. MNCs have to decide when, if ever, to repatriate the profits earned by foreign subsidiary group members;
- U.S. generally accepted accounting principles that allow MNCs to accrue no future U.S. federal income tax that would arise upon profit repatriation based on the MNC's intention to permanently reinvest those profits overseas, thereby lowering their effective tax rate and increasing reported earnings;
- capital markets rewarding reductions in an MNC's effective tax rate and the resulting higher reported earnings through higher share prices; and
- equity-based compensation based in whole or in part on share price personally motivating MNC management personnel to minimize effective tax rates.

All those factors are integral to our U.S. and worldwide legal, tax, and investment environment. As a practical matter, they cannot be changed.

The combination of these factors and our deferral system creates an incredibly strong motivation for MNC management teams to conduct operations, spread group risks, and own group assets among the MNC group members in ways that shift profits out of the United States and other countries where the MNCs conduct operations and earn revenue into zero- or low-taxed group members. Adoption of a territorial system would only strengthen this profit-shifting motivation and the desire for double nontaxation.

An alternative approach that actually reduces or eliminates MNC management's strong motivation for profit shifting is what's needed. Only the WFI system accomplishes this.