Should the United States Adopt a Territorial Tax System:

The Effects of Tax Policy and Administration on Foreign-Earned Income

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Abstract

This thesis compares and contrasts two different systems for taxing US multinational corporations' foreign-earned income to determine whether the US should adopt the alternative territorial tax approach. This thesis begins with discussing the pros and cons of the current worldwide tax system in the US. It then follows with the comparison of the alternative territorial approach. Like the worldwide, the territorial system has important pros and cons the US needs to consider before deciding to switch from its current approach. To help strengthen the argument towards adopting a territorial tax system, this thesis evaluates the tax systems of other relevant and comparable countries, focusing on Japan who transitioned from a worldwide to a territorial in 2009. This thesis finishes with outlining specific policy actions that the US should implement when transitioning to a territorial system to not only ease the transition but also maximize the value of a territorial approach. Therefore, this thesis concludes that the US should adopt a territorial tax system in place of its current worldwide approach due to the territorial's superior tax policy and administration.

"In this world nothing can be said to be certain, except death and taxes."[1] Although inevitable, taxes constitute an essential part of most personal, business, economic, and political decisions. Taxes serve as a mean for governments to raise revenue to fund their various operations, which in turn protect the welfare of individuals, businesses, and the economy. "Total tax revenues account for more than 80% of total government revenue in about half of the countries in the world and more than 50% in almost every country."[2] Focusing on the United States (US), the federal tax revenue derives from multiple tax sources, such as individual income, payroll, corporate income, goods, and estates. In 2015, consistent with prior years, federal tax revenue consisted of 47% individual income taxes, 33% payroll taxes, 11% corporate income taxes, and 9% excise, estate, and other taxes.[3] Specifically looking at corporate income taxes, one type of tax contained within the 11% is taxes on foreign-earned income. The US manages its corporations' foreign-earned income under a worldwide tax system. However, many are debating whether the US should reform the current strict worldwide tax system or implement a new territorial system. The two approaches differ primarily in their tax treatment of repatriating foreign-earned income back to the US. One goal among tax policy creators remains unchanging; whichever system the US decides, the tax should be sufficient, convenient, efficient, and fair. These four standards qualify as a good tax, and the US should strive to tax its citizens in this way. Because its tax policy and administration on foreign-earned income qualify it as a good tax, the US should adopt a territorial tax system

[1] "The meaning and origin of the expression: Nothing is certain but death and taxes," The Phrase Finder, accessed May 4, 2017, http://www.phrases.org.uk/meanings/death-and-taxes.html.

[2] Esteban Ortiz-Ospina and Max Roser, "Taxation," Our World in Data, accessed May 4, 2017, https://ourworldindata.org/taxation/.

[3] "Policy Basics: Where Do Federal Tax Revenues Come From," Center on Budget and Policy Priorities, last modified March 4, 2016, http://www.cbpp.org/research/policy-basics-where-do-federal-tax-revenues-come-from.

The US currently practices a worldwide international corporate tax system. Overall, a worldwide system taxes US multinational businesses headquartered in the US on repatriated dividends from their foreign subsidiaries' income earned abroad. In order to help explain further, dividing the present system into what, when, and at what rate the income is taxed, reveals both pros and cons to a worldwide approach. First, the US Treasury Department taxes all income earned abroad, which, basically, treats the income as if the corporation had earned it domestically. Second, with the exception of passive and portfolio income, which is taxable immediately, when the income is taxed depends on the organization of the multinational corporation's foreign entity. If the corporation, which must be headquartered in the US, organizes its entity as a branch, an unincorporated entity, the Treasury taxes income on an accrual basis. Accrual basis recognizes income when earned and therefore, recognizes taxes due in the period earned. On the other hand, if the corporation organizes its entity as a subsidiary, an incorporated entity, the corporation only owes taxes on their subsidiary's active income when distributed as a dividend back to itself, the domestic parent. This timing difference represents a deferral of income. Third and last, as long as the US corporate, not state, tax rate exceeds the foreign tax rate, the taxes paid to the Internal Revenue Service comprise of the difference between the income earned taxed at the US corporate rate and the amount of taxes already paid to the foreign country at the foreign rate. In situations when the foreign rate possess the higher percentage, corporations only pay their entity's foreign taxes. As these three components of the worldwide system suggest, the US expects its multinational businesses to pay, at a minimum, the amount of tax at US corporate rates on income earned abroad.

Whether or not this expectation encourages or hinders businesses, the worldwide approach offers other pros and cons to US corporations. As a great benefit, foreign subsidiaries

can defer paying taxes on their income earned abroad as long as they reinvest that income in normal and ordinary business activities, and unless they choose to take a deduction, multinational corporations can elect a foreign tax credit to avoid double taxation on their foreign entities' income. Deferring taxable income lowers the effective tax rate, or the total tax per dollar of total income, by incorporating the tax planning strategy of the time value of money. In other words, because a dollar today is worth more than a dollar in the future, deferring a cash outflow decreases the present value of taxes paid. Of course, this condition works best when tax rates are constant over time or at least when corporations can defer paying taxes to lower tax rate years. In addition, the choice to defer depends on many factors, such as after-tax income, economic or business circumstances, opportunity costs, and nontax considerations. The other benefit the US gives corporations under the worldwide system prevents double taxation on the same income. As previously discussed under income tax rates, a foreign tax credit allows corporations to offset their US taxes payable on income earned abroad with their foreign tax liability only if the US has the greater corporate tax rate. Moreover, the foreign tax credit provides the options for cross-crediting. Cross-crediting permits "excess credits generated by one type of foreign income, [either active, passive, or portfolio] to flow over to other income in the same category and shield that income from any residual US tax."[4] Cross-crediting even applies to royalty payments from intangible assets and income from export sales. Indeed, like deferrals and most tax credits, corporations who claim the foreign credit face limitations that

[4] Rosanne Altshuler, Stephen Shay, and Eric Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," Tax Policy Center, last modified January 21, 2015, http://www.taxpolicycenter.org/publications/lessons-united-states-can-learn-other-countries-territorial-systems-taxing-income/full.

they need to consider before making business decisions. Subject to each income class, the foreign tax credit limit

> Defines whether income is treated as domestic or foreign and the extent to which overhead expenses (interest, R&D expenditures, general and administrative expenses) of the home corporation that support both domestic and foreign investment are deductible against domestic income.[5]

All in all, the income deferral and foreign credit aspects of the worldwide system in the US intend to alleviate the tax burden of multinational corporations.

However, in spite of its intentions and advantages, the worldwide system also poses risks to multinational corporations and the US as a whole. Although it strengthens the use of a worldwide approach, deferring income also serves as the major disadvantage to a worldwide system. More specifically, corporations can defer their subsidiaries' foreign income indefinitely. Even though corporations could profit from this timing strategy, problems arise from the motives, opportunities, and results of an indefinite deferral of income. First, many motives surround a corporation's decision to defer income. Each corporation may have reasons pertinent to its unique position, but the high corporate tax rate in the US motivates the majority. Compared to the rest of the world, the US has the third largest top marginal corporate tax rate at 38.92%, consisting of the 35% federal and 3.92% average state tax rates.[6] Out of 188 countries with a worldwide average of 22.5% and a worldwide GDP-weighted average of 29.5%, the US trails behind the United Arab Emirate' 55% and Puerto Rico's 39%.[7] Of course, the fluctuating, tiered-bracket structure of the US corporate income tax rates does not subject every corporation

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[5] Ibid.

[6] Kyle Pomerleau and Emily Potosky, "Corporate Income Tax Rates around the World, 2016," Tax Foundation, last modified August 18, 2016, https://taxfoundation.org/corporate-income-tax-rates-around-world-2016/.

[7] Ibid.

to the almost 39% marginal rate, but considering the size of most multinational corporations, their taxable income would still tax them at a minimum rate of 34%. Nevertheless, because a higher tax rate means more taxes paid and less after-tax income retained, corporations want to defer repatriating their income back to the US for as long as possible, especially when they can use the allocated tax money for more important business resources.

Next, looking at the opportunities available, corporations have both international and domestic incentives to defer taxable income. As mentioned earlier, as long as they reinvest their subsidiaries' income earned abroad in ongoing business activities, corporations can defer their taxable income. Since the US ranked third in the highest corporate tax rate, corporations have several other countries as viable options to pair paying international taxes at a low rate with deferring US taxes as a high rate. Even if "countries that have no corporate income tax or a very low corporate tax – such as Bermuda, the Cayman Islands, and the Bahamas – provide very little real business [reinvestment] opportunities for American corporations," US financial accounting and reporting standards further incentivize deferring income.[8] Under Accounting Standards Codification (ASC) 740, corporations do not have to report the otherwise required accrued tax liability or income tax expense on their financial statements if they meet certain criteria that designate their deferred income as Permanently Reinvested Earnings (PRE). Furthermore, these inadequate reporting standards allows public "companies to avoid disclosing [the US tax they would pay upon repatriation of their offshore profits] by asserting that calculating this tax liability is 'not practicable.'"[9]

[8] "Fortune 500 Companies Hold a Record $2.4 Trillion Offshore," Citizens for Tax Justice, last modified March 4, 2016, http://ctj.org/ctjreports/2016/03/fortune_500_companies_hold_a_record_24_trillion_offshore.php#.WQvV0Ma1uM9.

[9] Ibid.

The combination of wanting to mitigate high corporate tax rates with being able to take advantage of other countries' lower rates and the tax and financial reporting incentives in the US creates substantial results for multinational corporations and the entire US. Even though corporate income taxes and therefore, taxes on foreign-earned income account for very little of the federal tax revenue in the US, the worldwide approach greatly reduces the likelihood of the US increasing the current collection of the subsequent taxes because of its reinforcement over corporations' decisions to defer income. Although alternative methods to compensate for this lost tax revenue may exist, foreign-earned income staying abroad also discourages domestic investment and overall competition. In fact, analysts estimate that US multinational corporations possess over $2.5 trillion in "unremitted foreign earnings, a substantial portion of which is in cash … that cannot be reinvested in the US business or given to shareholders."[10] These trapped earnings become not only a lost tax revenue but also a potential lost domestic investment in tangible and intangible assets such as equipment, jobs, and wages because corporations must invest these PRE into their foreign subsidiaries. Moreover, these PRE yield the most efficient yet ineffective way for corporations to compete with their foreign competitors. To explain its monetary efficiency, under a worldwide system, deferring income indefinitely minimizes taxes paid while maximizing after-tax income that corporations can allocate towards increasing and strengthening their competitive advantage. However, this efficiency does not correlate with effective market location and control. In other words,

> Merged entities are less likely to locate their parent company in a country with a worldwide tax regime and that the US international tax system leads to US companies being less competitive when trying to acquire other companies.[11]

[10] Michelle Hanlon, "Testimony of Michelle Hanlon and Howard W. Johnson, Professor, MIT Sloan School of Management, before the United States House Committee on Ways and Means," House Ways and Means, last modified February 24, 2016, https://waysandmeans.house.gov/UploadedFiles/HanlonTestimony78FC.pdf.

[11] Ibid.

Ignoring other factors, a corporation's choice not to locate its headquarters in a country practicing worldwide tactics saves it from paying or deferring the extra tax on its repatriated foreign income. Of course, the worldwide approach only pertains to US multinational corporations headquartered in the US. Thus, the US implemented strong anti-inversion policies to deter these corporations moving their headquarters to a different country, "but little prevents US businesses from selling themselves to foreign-owned businesses," especially when matched with less competitive acquisitions.[12] As a matter of fact,

> US companies with large amounts of cash held in their foreign subsidiaries are more likely to purchase foreign companies than domestic companies, and these acquisitions of foreign companies are less value enhancing than other acquisitions.[13]

To summarize, a worldwide system may not be the only and direct cause of lost tax revenue, domestic investment, and market competition for the US, but it significantly influences these results with its motivating high corporate tax rates and domestic and foreign opportunities. These disadvantages have led others to question whether the US should adopt a territorial tax system.

Unlike worldwide, a pure territorial system taxes income where earned, regardless of the location of a business' headquarters or the organization of its foreign entities as subsidiaries or branches. The majority of countries classified as territorial do not follow a pure territorial approach though. Instead, they enact an exemption system that exempts most or all foreign-earned income from domestic taxation. Thus, under an exemption system, a corporation would reduce its domestic tax base by its foreign branch's accrual-based income and/or its foreign

[12] Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," The Heritage Foundation, last modified September 12, 2013, http://www.heritage.org/taxes/report/territorial-tax-system-would-create-jobs-and-raise-wages-us-workers#_ftn17.

[13] Michelle Hanlon, "Testimony of Michelle Hanlon and Howard W. Johnson, Professor, MIT Sloan School of Management, before the United States House Committee on Ways and Means."

subsidiary's repatriated dividends. Generally, countries permit businesses to exempt 95% of their foreign earnings.[14] The purpose of taxing the remaining percentage protects a country's domestic corporate tax base. Using a similar ideology, countries usually do not grant foreign tax credits, and since they exempt most repatriated dividends, corporations usually have no need to defer and permanently reinvest their subsidiary's foreign-earned income. Even though a greater number of territorial countries deviate from pure territoriality in the form of an exemption system, additional modifications to the pure approach include inclusion of income categories, deductibility of foreign-generated expenses, changes to corporate tax rates, and preferential treatment of intellectual property.[15] Ultimately, each country adapts its territorial system to address its own specific needs, but popular trends emerge among these modifications. First, the tax base typically excludes or exempts active income while including or taxing narrowly defined passive and portfolio income. Furthermore, the tax base deducts expenses, like legitimate interest, incurred in creating foreign revenues. Next, because the tax base and tax rate calculate the tax revenue or liability, increasing or decreasing the tax rate increases or decreases, respectively and all else equal, the tax. Hence, countries tend to lower their corporate tax rates when transitioning to a territorial system. Likewise, countries frequently tax their income attributable to intellectual property at lower, preferential rates. Above all, these modifications along with the exemption system differ among countries but collectively show the flexibility of a territorial system. They also convey why every other Group of 7 (G7) country and 28 of the 33 Organisation for Economic Co-operation and Development (OECD) countries tax under a territorial system to enable multinational corporations to repatriate their active foreign earnings

[14] Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers."

[15] Philip Dittmer, "A Global Perspective on Territorial Taxation," Tax Foundation, last modified August 10, 2012, https://taxfoundation.org/global-perspective-territorial-taxation/.

with minimal domestic tax. Obviously, no matter the prevalence, "others' experiences do not necessarily dictate that the United States should follow the same path."[16] Accordingly, the US should carefully weigh the pros and cons of a territorial tax system before contemplating a switch from its current worldwide approach.

Because of its sufficiency, convenience, efficiency, and fairness, a territorial system presents the US with a more superior way to enforce it tax policy and administration on foreign-earned income. The first standard of a good tax, sufficiency, deals with the ability of a tax to raise adequate revenue for government purposes. Thus, a sufficient tax balances a government's budget. The over $19.8 trillion US budget deficit communicates not only excess federal spending but also insufficient tax collection, both of which lead the US to rely on other sources of funds like borrowing.[17] The worldwide system is not solely responsible for this budget deficit, especially since foreign-earned income represents a small portion of the US federal tax revenue, but it has contributed to over $2.5 trillion trapped earnings abroad or lost tax revenue to the US. On the other hand, a territorial approach removes the incentives for corporations to keep foreign-earned income oversees, especially when paired with lowering the US corporate tax rate. Certainly, a territorial system will not cause all corporations to invest their foreign earnings domestically and subject that income to US taxes, but it offers a more effective impact on reducing the amount of trapped earnings abroad and on converting them into US tax revenue. The second standard of a good tax evaluates the convenience for a government to administer it and the convenience for a taxpayer to pay it. To be more specific, convenience minimizes the time and money spent in complying with relevant tax laws. As the most expensive provision of

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[16] Rosanne Altshuler, Stephen Shay, and Eric Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations."

[17] US Debt Clock, accessed May 4, 2017, http://www.usdebtclock.org/.

the Internal Revenue Code (IRC), the US Corporation Income Tax Return "accounts for 36 percent of the total cost of the entire tax code, at $147 billion,"[18] with "a disproportionate share associated with the international requirements of the tax code."[19] Two of these international components include dividends and distributions and the foreign tax credit, which combined, consume over 59 billion total annual hours.[20] Although the complexity and fluctuation of the IRC and other tax laws will continue to require the average taxpayer or tax-paying entity to hire a tax accountant or firm to complete his tax return, a territorial reform offers a simpler approach to decreasing compliance costs for both the government and taxpayers. For instance, implementing a dividend exemption system along with removing the foreign tax credit would simplify the code, and corporations could divert the saved compliance costs to more productive uses.

As the third standard of a good tax, efficiency describes either a tax that does not influence a taxpayer's decisions or a tax that changes taxpayers' reactions to a desired behavior. The worldwide system does not fit either definition. First, the worldwide approach interferes with corporations' economic decisions, including which country to place headquarters, which countries to locate subsidiaries, and whether to permanently reinvest their foreign earnings or repatriate them back to the US. Moreover, regardless of the deferral option and foreign tax credit, which policymakers designed to relieve unnecessary tax burdens, a worldwide approach wants corporations to pay US federal income taxes on their foreign-earned income. Instead, corporations utilize the shortcomings of the system to avoid paying US taxes through legal

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[18] Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation, last modified June 15, 2016, https://taxfoundation.org/compliance-costs-irs-regulations/.

[19] Philip Dittmer, "A Global Perspective on Territorial Taxation."

[20] Scott A. Hodge, "The Compliance Costs of IRS Regulations."

indefinite deferral of Permanently Reinvested Earnings. On the other hand, a territorial system reinforces efficiency not only with its disincentives on business location and income deferral but also with its neutral tax policy and administration on both foreign and domestic investment. Because corporations should not have to base their decisions merely on taxes, a truly neutral tax system should not affect the pre-tax return on an investment. Under the current worldwide approach, in order for a corporation to repatriate its income or dividends back to the US for investment purposes, "the expected return must be higher than the foreign return on investment plus the US tax on the repatriated money."[21] Naturally, this system "does not prevent all foreign [and domestic] investment, [but] the extra tax it applies stops the marginal investments that do not meet the higher rate of return."[22] In contrast, a territorial approach eliminates that extra US tax, giving those corporations, who originally fell short from the required return, a chance to make a new, feasible investment decision without the conflict of the extra tax, all else being equal. Furthermore, a territorial system creates a stronger correlation between the relationship of foreign and domestic investment and between the relationship of foreign and domestic employee wages. Statistically, a

> 10 percent greater foreign investment is associated with a 2.6 percent greater domestic investment, and a 10 percent greater foreign employee compensation is associated with a 3.7 percent greater domestic employee compensation."[23]

Many factors attribute to these percentages, but the underlying idea contradicts the popular opinion that investment abroad results in a lost investment opportunity domestically. The percentages suggest that "the level of total production might not be fixed but, instead, responsive

[21] John Barrasso, "Territorial vs. Worldwide Taxation," Senate Republican Policy Committee, last modified September 19, 2012, https://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation.

[22] Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers."

[23] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," University of Michigan Law School Scholarship Repository, last modified 2009, http://repository.law.umich.edu/cgi/viewcontent.cgi?article=2452&context=articles.

to profit opportunities that are influenced by economic growth rates;" therefore, foreign investment may increase "the return to domestic production, stimulating domestic factor demand and domestic output."[24] For example, foreign branches or subsidiaries may be able to produce products at a lower cost than their domestic counterparts may, but they can also be a viable buyer of tangible and intangible assets produced in the US. Because many corporations follow a common trend of transferring or outsourcing their lower value-added work to their foreign affiliates, their domestic capacities tend to have higher-skilled jobs and products, especially in areas of management positions, research and development, and intellectual property. These higher-skilled jobs and products may have higher costs, but they also have higher sales prices and employee compensation. Overall, the territorial system taxes corporations more efficiently; it does not conflict with corporations' investment decisions on where to achieve the highest return, which allows not only growth abroad but growth at home in terms of a better flow of capital, higher employee compensation, and higher quality employment opportunities.

The last criteria of a good tax evaluates fairness based on horizontal and vertical equity. Both equities revolve around a taxpayer's ability to pay taxes with the economic resources under his or her control. Horizontal equity says those taxpayers "with the same ability to pay (as measured by the tax base) owe the same amount of tax," while vertical equity says taxpayers "with a greater ability to pay owe more tax than persons with a lesser ability to pay."[25] Hence, horizontal equity relates to a tax base, while vertical equity relates to a tax rate. Because the corporate income tax rate schedule ultimately determines the US federal income tax rate applied to corporations' taxable income, a territorial system would not change the tax rates extensively,

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[24] Ibid.

[25] Shelley C. Rhoades-Catanach and Sally M. Jones, "Taxes Should Be Fair," in *Principles of Taxation for Business and Investment Planning: 2009 Edition*, (New York: McGraw-Hill/Irwin, 2009), 32-33.

unless it included an additional provision to lower the current corporate rate. The bigger concern for a territorial approach pertains to the tax base. Because the territorial system does not subject foreign-earned income to domestic taxation, it shrinks a corporation's domestic taxable income relative to the worldwide system. In other words, corporations have a higher after-tax income, other things held constant, or more income saved from paying taxes that they can spend on other things like investing. This higher after-tax income equates to domestic and international fairness not only in ability to pay but also in competition. Corporations can better compete with their comparable domestic and foreign rivals because they do not have to pay the extra tax imposed under a worldwide system. Corporations can use that saved income to enhance their competitive advantage. Even if they decide not to allocate in that way, a territorial approach gives them greater flexibility to make that decision. Furthermore, increasing the competition of US corporations helps to increase the competition of the US from a global standpoint. For businesses and the economy, healthy competition aids in innovation, customer service, and many other benefits. All in all, a territorial system's sufficiency, convenience, efficiency, and fairness would be a practical and reasonable solution to the current worldwide problems of excessive foreign-trapped earnings and compliance costs. More satisfactory, it would provide an advantageous opportunity for investment and competition throughout the world.

Although a territorial system has many valuable aspects, it does pose some potential side effects that the US needs to take into consideration. Because a territorial approach removes the incentives for corporations to permanently reinvest foreign-earned income oversees, corporations have the power to invest or spend their income how and where they want to. One ramification of this freedom of choice "allows the shifting of profits to no or low-tax locations where the business has little or no economic activity; these activities are referred to as base erosion and

profit shifting (BEPS)."[26] Of course, corporations are able to exploit these activities legally due to gaps and disparities in the tax code, but the seriousness of the consequences of BEPS are what have led to a global movement by the OECD countries to collectively work towards closing these gaps. In order to address the BEPS issues adequately, countries must understand the components of BEPS. Even though the acronym combines them together, base erosion and profit shifting constitute two different activities. In fact, they share a causal relationship, in which the shifting of profits erodes the tax base. As one of the causes of base erosion, profit shifting can take on many forms, but earnings stripping tends to be the most common. Earnings stripping "artificially shifts earnings on paper to offshore tax havens – countries with very low or nonexistent taxes" – to minimize overall taxes paid.[27] Two frequent methods used to accomplish this minimization objective include transfer pricing and thin capitalization. First, under transfer pricing, corporations transfer intangible assets at the lowest price possible to their branches or subsidiaries located in lower-tax jurisdictions. Because the transfer represents a transfer of ownership, the corporation must make royalty payments to the branch or subsidiary in exchange for the right to use the intangible asset in the future. Under a territorial approach, the branch or subsidiary benefits from the corporation's royalty payments, often paid at the highest price possible, because the payments equate to income only taxable at the affiliate's lower rate. The corporation could benefit from the transfer as well if it "is able to deduct the inflated royalty payments, thereby reducing the amount of its" taxable income subject to its higher rate. [28]

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[26] "OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports, Information Brief," OECD, accessed May 4, 2017, https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf.

[27] "Switching to a 'Territorial' Corporate Tax System Would Encourage Offshore Tax Dodging," U.S. PIRG Education Fund, accessed May 4, 2017, http://www.frontiergroup.org/sites/default/files/U.S.%20PIRG%20Ed%20Fund%20territorial%20tax%20factsheet%20(web).pdf.

[28] Joel Friedman, Chye-Ching Huang, and Chuck Marr, "The Fiscal and Economic Risks of Territorial Taxation," Center on Budget and Policy Priorities, last modified January 31, 2013, http://www.cbpp.org/research/the-fiscal-and-economic-risks-of-territorial-taxation.

Corporations can transfer tangible assets also, but the difficulty in valuing intangible assets limits tax authorities' ability to challenge a corporation's intercompany transfer price. Particularly, since corporations do not typically trade intangible assets in open markets, establishing a fair market value requires speculative judgments and estimates. This difficulty in accounting for intangibles helps explain why the intangible-heavy pharmaceutical and technology industries favor transfer pricing business strategies for their intellectual property. While corporations can manipulate transfer pricing under a worldwide and territorial system, a territorial system gives corporations a permanent legal avoidance of domestic taxes on foreign-earned income if they transfer their intangibles to their foreign entities. The net effect of lower foreign and domestic taxes paid contradict the neutral policy of a territorial approach and could cause a base erosion for any domestic tax rate higher than the foreign affiliates' rate. The other technique of earnings stripping, thin capitalization, deals with intercompany interest and borrowing. Thin capitalization occurs when a parent corporation leverages as much of the entire corporation's debt, and the lighter-leveraged branches and subsidiaries in lower-tax jurisdictions make loans to the parent corporation. The affiliates treat the interest payments received as income, while the parent corporation treats the interest payments on the debt borrowed as deductions. Similar to transfer pricing, the income to the affiliates is taxed at the lower rate, whereas the deduction to the parent reduces the taxable base at the higher rate. This pairing generates a tax savings to the corporation, but under a territorial system, the tax savings would be bigger because like transfer pricing, the affiliates, if foreign, would never pay domestic taxes on their earned income. This encouragement to borrow within the company could erode the domestic taxable base if corporations choose to continue borrowing in this way.

In spite of the fact that transfer pricing and thin capitalization present risks to most territorial systems, especially to pure territorial ones, the US faces more stringent repercussions with its third largest corporate tax rate. The high corporate tax rate further encourages US corporations to transfer their intangibles to and borrow from their lower-rate foreign entities, so they can use the subsequent deductions to lessen the amount of their income taxed at that high rate. Even if corporations intend for this reasoning to be a valid business strategy, it could disadvantage other domestic corporations or the US as a whole. In other words, because the corporations who shift assets and income oversees still

> Benefit from US markets, infrastructure, and workforce and security by paying next to nothing for these benefits, ordinary taxpayers end up picking up the tab through higher taxes, higher national debt, or budget cuts to public programs.[29]

Other domestic corporations, especially smaller businesses, may then have a harder time competing since they would not receive the same tax benefits, such as the deductible royalty and interest payments. Moreover, the high US corporate tax rate under a territorial system could motivate multinational corporations to locate their headquarters in lower tax rate countries to avoid altogether the high US rate. Finally, history may not always repeat itself, but it can be a good indicator of future responses. In 2004, Congress decided to test the shift to a territorial system by deeming a temporary tax repatriation holiday for US-based multinational corporations. The holiday gave corporations a chance to repatriate their foreign-earned income back to the US and only pay a 5.25 percent tax rate on the income. Corporations reacted in the opposite that Congress had sought for initially. They mostly "cut jobs in 2005-06 – despite overall economy-wide job growth in those years – and many used the repatriated funds simply to repurchase stock

[29] "Switching to a 'Territorial' Corporate Tax System Would Encourage Offshore Tax Dodging."

or pay dividends."[30] In fact, share repurchases accounted for 20 percent of all repatriated foreign earnings.[31] The corporations who acted in this way reaped billions of dollars but did not represent the majority. The holiday created an unequal distribution where "five firms got over one-quarter of the tax benefits of the repatriation holiday, and just 15 firms got more than 50 percent of the benefits."[32] As the example of the tax repatriation holiday shows, the territorial tax system may not always produce favorable outcomes. Its primary risk, profit-shifting techniques like transfer pricing and thin capitalization, can result in erosion of the taxable base. In terms of the US, the high corporate tax rate could increase the risks because as the third largest rate, corporations could shift resources or relocate to countries with lower rates. If the US adopted a territorial approach, it will need to create and implement modifications to address the shortcomings unique to its situation, especially those issues that emerged from the tax repatriation holiday.

A territorial system's cons may hinder a country's decision to convert to its methods of taxing foreign-earned income, but as the other G7 and the majority of the OECD countries demonstrate, more countries prefer its tax treatment. Even so, most of these countries do not have pure territorial systems, and instead, they deviate from it by enacting various policy adjustments like the dividend exemption system. Interestingly enough, many of these countries originally taxed under a worldwide system before adopting their current territorial system. One such country, Japan, switched from a worldwide to a territorial approach in 2009. Prior to 2009,

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[30] Michael Mundaca, "Just the Facts: The Costs of a Repatriation Tax Holiday," U.S. Department of the Treasury, last modified March 23, 2011, https://www.treasury.gov/connect/blog/Pages/Just-the-Facts-The-Costs-of-a-Repatriation-Tax-Holiday.aspx.

[31] M. Mendel Pinson, "Effects of 2004 Int'l Tax Holiday, Recommendations Going Forward," Tax Analysts, last modified August 31, 2011, http://www.taxhistory.org/www/features.nsf/Articles/E7A958612953C1EF852578FD00607975?OpenDocument.

[32] Michael Mundaca, "Just the Facts: The Costs of a Repatriation Tax Holiday."

Japan's worldwide system operated in much the same way as the current worldwide approach in the United States does.

> It taxed Japanese corporations' foreign-source income upon repatriation while allowing tax credits for corporate income taxes paid by Japanese-owned subsidiaries in foreign jurisdictions and other related taxes paid to foreign governments, including withholding taxes on dividend, royalty, and interest payments between foreign subsidiaries and their Japanese parents.[33]

However, leading up the switch in 2009, Japan began to question the consequences of its worldwide approach. Similar to the US, Japan estimated that multinational corporations "held offshore approximately US $150 billion in foreign subsidiary earnings."[34] Paired with having complex tax codes and holding one of the highest corporate tax rates, much comparable to the US, Japan worried "that this pool of earnings represented foregone investment in Japan and that the barrier to repatriation increased the risk that R&D operations would be moved abroad."[35] Japan's overall competitiveness was a concern, especially with the internal social and the external economic environments. Internally, Japan had an aging population and shrinking labor pool. Externally, the impact of the 2007-2009 recession had provoked a global financial crisis and decreased investor confidence around the world. Therefore, the three primary objectives why legislators proposed a territorial change consisted of

> Replacing the indirect foreign tax credit for simplicity; enabling Japanese enterprise to repatriate foreign profits as they wish; and stimulating the Japanese economy for capital investment, research and development, and employment.[36]

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[33] Sebastien Bradley, Estelle Dauchy, and Makoto Hasegawa, "Investor Valuations of Japan's Adoption of a Territorial Tax Regime: Quantifying the Direct and Competitive Effects of International Tax Reform," Center for Economic and Financial Research at New Economic School, last modified September 2014, http://www.cefir.org/papers/WP201.pdf.

[34] Rosanne Altshuler, Stephen Shay, and Eric Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations."

[35] Philip Dittmer, "A Global Perspective on Territorial Taxation."

[36] Toshio Miyatake, "Japan's Foreign Subsidiaries' Dividends Exclusion," Proceedings from the 2009 Sho Sato Conference on Tax Law, Social Policy, and the Economy, accessed May 4, 2017, https://www.law.berkeley.edu/files/sho_sato_tax_conf_web_paper--miyatake.pdf.

Today, Japan's territorial system reflects these three primary objectives. Preceded by reductions to its corporate tax rate, Japan transitioned to a 95-percent dividend exemption system with specific criteria regarding corporate stock ownership. As long as Japanese parent corporations own at least 25 percent of their foreign subsidiary's common or voting shares for at least six months as of the dividend declaration date, they can exempt 95-percent of their subsidiaries' repatriated dividends from domestic taxation. The existing five percent "of non-exempt dividends are regarded as expenses incurred by parent firms for earning foreign income and are added to the calculation of Japanese taxable income."[37] As a tradeoff for the dividend income exclusion, parent corporations cannot elect the indirect foreign tax credit against the five percent. Furthermore, the entire dividend exclusion does not apply to 10 percent Japanese shareholders of foreign subsidiaries, whose common or voting shares are at least 50 percent owned by Japanese residents and who pay an effective tax rate of less than 20 percent. Altogether, Japan designed a territorial system to not only allow greater repatriation of foreign-earned income but also protect the corporate taxable base against erosion.

Since its adoption in 2009, Japan's territorial system has had a net positive effect on Japan's economic measures, especially unemployment and corporate tax revenue. In spite of an increase in 2009, Japan's unemployment rate has been decreasing annually since 2010. In fact, in February 2017, Japan's unemployment fell to 2.8%, the lowest rate in 22 years.[38] Naturally, the territorial system is not solely responsible for the decline, but interestingly enough, the decline has remained consistent even with the aftermath of the 2007-2009 global recession and

[37] Sebastien Bradley, Estelle Dauchy, and Makoto Hasegawa, "Investor Valuations of Japan's Adoption of a Territorial Tax Regime: Quantifying the Direct and Competitive Effects of International Tax Reform."

[38] Kyodo, "Japan's unemployment rate falls to 22-year low of 2.8% in February," The Japan Times News, last modified March 31, 2017, http://www.japantimes.co.jp/news/2017/03/31/business/economy-business/joblessness-falls-22-year-low-2-8-february/#.WQwB5sa1uM8.

the 2011 earthquake and tsunami. One explanation for the 2011 earthquake and tsunami could be that Japanese corporations repatriated foreign earnings back to Japan to help fund the recovery process. Similar to the unemployment rate, corporate tax revenue decreased in 2009, but it has been increasing steadily since 2010, suggesting that the territorial system has not drastically eroded Japan's corporate taxable base. Even though Japan has experienced many advantages under the territorial approach, they have also seen some unexpected outcomes. The biggest of which did not meet Japan's initial expectations involved one of its primary objectives for transitioning to a territorial system. Specifically, "while the number of foreign affiliates paying dividends did not increase as a result of the legislation, dividend exemption increased dividend repatriations from foreign affiliates that had paid dividends under the worldwide tax system."[39] The more profitable subsidiaries repatriated both the higher number and the higher amount of these total dividend payments. However, as the consistency of the unemployment rate and corporate tax revenue suggests, these unexpected reactions have not negatively influenced the economy severely. In sum, to evaluate Japan's switch from a worldwide to a territorial approach fully, one must consider the unique aspects of Japan during those timeframes. Overall, though, Japan exemplifies the flexibility of policy creation and the economic effectiveness of a system who taxes under a territorial approach.

Japan's situation may not replicate the transition of the US to a territorial tax system, but it offers some guidance on strategy implementation. In other words, in order for the US to adopt a territorial approach, the US needs to consider adding policy changes to address US-specific as well as territorial risks. In terms of US-specific risks, lowering the US corporate tax rate would

[39] Hasegawa Makoto and Kiyota Kozo, "The Effect of Moving to a Territorial Tax System on Profit Repatriations: Evidence from Japan," RIETI Discussion Paper Series 13-E-047, last modified May 2013, http://www.rieti.go.jp/jp/publications/dp/13e047.pdf.

further enhance the competitiveness of the US. As a common trend among territorial countries, lowering the corporate tax rate would help to remove the US as an outlier among developed countries and to make the US a more viable country to bring foreign profits to and invest in domestically and internationally. Because decreasing the corporate tax rate may induce behaviors to exploit the inadequacies of a territorial approach, the US needs to actively search for these deficiencies. Looking at the territorial risks, the US should focus on policies that protect against profit shifting and base erosion. First, since transfer pricing and thin capitalization give incentives for corporations to shift profits into lower-tax jurisdictions, the US should address both. A patent box policy taxes income from intangible property at a lower rate. This preferential treatment would not only make keeping intangibles in the US as an attractive option but also encourage more innovative activities like research and development. Likewise, the US could limit the deductibility of the interest expense paid from a parent to its foreign subsidiary to only legitimate borrowing costs. One such way could deny, "US business interest deductions if [the parent's] indebtedness exceeds that of all of its combined foreign subsidiaries or if its debt exceeds a certain portion of its income."[40] Having this appropriate limitation guards against abusive profit shifting and earnings stripping. Next, to help prevent erosion of the corporate taxable base, the US could narrowly define passive income to exclude only legitimate ordinary and necessary business income. Increasing the income activities included in passive income maintains a higher level of income subject to tax. Lastly, implementing a 95 percent dividend exemption system would still permit foreign subsidiaries to repatriate 95 percent of their dividends back to the US, while only paying taxes on the remaining 5 percent to preserve the tax base more adequately. In summary, these policy recommendations do not constitute an

[40] Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers."

exhaustive list, but they help the US utilize the strengths and weaknesses of a territorial system to its own advantage.

To conclude, the worldwide and the territorial system both provide a means of taxing foreign-earned income. Currently, the worldwide system in the US taxes multinational businesses headquartered in the US on both foreign earnings from their foreign branches and repatriated dividends from their foreign subsidiaries' income earned abroad. Although the current policy allows subsidiaries to defer repatriating those dividends as long as they permanently reinvest them abroad and allows most corporations to mitigate double taxation with the election of the tax credit, the worldwide approach has created some negative consequences to the US. Corporations hold an estimated $2.5 trillion of income oversees that should otherwise be subject to US taxes, except the worldwide approach influences corporations to act oppositely, especially with a corporate tax rate that ranks third globally. An alternative approach, the territorial system, taxes income where earned, regardless of the location of a corporation's headquarters or the organization of the foreign entity as a branch or subsidiary. The territorial system not only exempts the repatriated dividends taxed under a worldwide approach, but it enforces a more neutral tax policy and administration on foreign-earned income. It removes the current incentives for the $2.5 trillion of income to remain abroad and removes the need for the foreign tax credit, one of the most costly code provisions. It supports more foreign and domestic investment and supports higher after-tax income for corporations, strengthening the competitive advantage of the US and a universally better flow of capital. However, like most anything, the territorial approach has risks that the US must consider in its decision-making. Transfer pricing and thin capitalization enable corporations to shift profits from the higher US tax rate to lower foreign tax rates, exposing the potential erosion of the US corporate taxable base. The US

should also consider other countries who presently have a territorial system, especially those countries who transitioned from a worldwide approach. Japan's switch in 2009 offers a comparable match to the situation of the US since Japan's prior worldwide system closely resembles the current one in the US. Japan's unique circumstances may have persuaded the results, but Japan's territorial system exemplifies the positive changes it has had on Japan's unemployment and corporate tax revenue. As Japan and the majority of OECD and all other G7 countries show, taxing foreign earnings on a territorial basis is the norm. Even though the US does not have to mimic this norm, the US should question the reasons for its popularity and its applicableness to the US. More importantly, the US should note the ability to mold the territorial approach to the most suitable design for the US. Adopting a territorial system, along with other modifications such as decreasing the corporate tax rate, incorporating a patent box, limiting the definition of deductible interest expense, broadening the definition of taxable passive income, and implementing a 95 percent dividend exemption system, would equip the US with policies to continuously monitor for problems and improvements. In conclusion, the US must remain future-oriented. Its tax regime should reflect a sufficient, convenient, efficient, and fair tax that maintains sustainable growth and competition. Because a territorial approach better aligns with these values, the US should adopt a territorial tax system.