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Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?

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PART I	286
PART II	289
<i>A. WWI/FTC System</i>	289
<i>B. Territorial System</i>	290
PART III	291
<i>A. Source of Income Rules</i>	291
<i>B. Source (or Allocation) of Deduction Rules</i>	292
<i>C. Outbound Transfers of Property</i>	292
<i>D. Transfer Pricing</i>	293
<i>E. Tax Havens</i>	294
<i>F. Look-Thru Rules</i>	294
<i>G. Foreign Losses</i>	295
<i>H. Tax Treaties</i>	295
<i>I. Transition Rules</i>	296
<i>J. Conclusion</i>	296
PART IV	297
PART V	299
PART VI	301

**TERRITORIAL VS WORLDWIDE INTERNATIONAL TAX SYSTEMS:
WHICH IS BETTER FOR THE U.S.?**

by

Paul R. McDaniel*

The Report of the President's Advisory Panel on Federal Tax Reform, entitled "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," was released in November 2005.¹ One of the issues addressed in the Panel Report was whether the U.S. should shift from its current international tax system (taxing the worldwide income of its nationals with a credit for foreign income taxes) to a territorial system (exemption of foreign branch business income and dividends from foreign subsidiaries out of business income). The Panel opted for the territorial system. The report devoted only about twelve pages to the subject, but its recommendation has reignited interest in a subject which has recurred with some regularity over the past decade.²

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1. Hereinafter "Panel Report." This paper generally will not consider the domestic aspects of the two major proposals in the Panel Report – the Simplified Income Tax Plan and the Growth and Investment Tax Plan. A helpful discussion by the Senior Counsel and the Senior Economist to the Panel can be found in Jonathan Z. Ackerman and Rosanne Altshuler, *Constrained Tax Reform: How Political and Economic Constraints Affect the Formation of Tax Policy Proposals*, LIX N.T.J. 59 Nat'l Tax J. 165 (2006).

2. See, e.g., Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. Rev. 753 (2006); J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 41 Tax Notes Int'l 217 (Jan. 16, 2006); Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 Nat'l Tax J. 771 (2001); Ernest R. Larkins, *Double Tax Relief for Foreign Income: A Comparative Study of Advanced Economies*, 21 Va. Tax Rev. 233 (2001); Ernest S. Christian, *The International Components of Tax Reform: Tax Policy that Serves the National Interest*, 14 J. of Int'l Tax. 48 (2003 [Part I]) and 15 J. of Int'l Tax. 36 (2004 [Part 2]); Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman & Martijn van Kessel, *U. S. Territorial Tax Proposals and the International Experience*, 42 Tax Notes Int'l 895 (Jun. 5, 2006).

In this paper, I explore whether the proposal of the Panel would represent a beneficial tax policy change for the U.S. In so doing, the territoriality recommendation and what I will term a “model” worldwide taxation of income coupled with a foreign tax credit (WWI/FTC) system will be examined from the perspectives of efficiency, equity, and simplicity.³

3. The approach in this paper in general was taken by the American Bar Association Section of Taxation Task Force on International Tax Reform, U.S. International Tax Reform: Objectives and Overview, 59 *Tax Law.* 649 (2006) (hereinafter “ABA Task Force”). The difference is that, because of disagreements among the Task Force members, neither system was endorsed over the other.

In adopting the approach described in the text, I reject competitiveness of U.S. companies as a tax policy criterion, although increased competitiveness by U.S. companies is often cited as a reason for adopting a territorial system. See, e.g., Panel Report, *supra* note 2, at 105; Staff of Joint Comm. on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, 55-56 (Comm. Print 2006) (discussing the various meanings of the term “competitiveness”) (hereinafter “JCT Staff Competitiveness Report”); Hearing on the Impact of International Tax Reform on U.S. Competitiveness, Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006) (Statement of R. Glenn Hubbard); David L. Brumbaugh, *Taxes and International Competitiveness*, CRS Report to Congress, RS 22445 (May 23, 2006).

I reject competitiveness as a criterion (1) because it has no substantive tax policy content (it seems largely to be a rhetorical slogan for U.S. multinationals that want tax cuts) and (2) I have found no empirical studies that show U.S. companies are at a competitive disadvantage vis-à-vis their foreign competitors. The World Economic Forum publishes an annual Global Competitiveness Report, the most recent being for 2006-2007. The report utilizes nine different factors to assess a country’s (not a company’s) competitiveness in global markets. Taxation – let alone a given international tax system – is not among the nine factors. The report can be found online at www.weforum.org.

Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 *Nat’l Tax J.* 937 (2004), advanced a new criterion, that of “ownership neutrality.” That concept was sharply critiqued by Harry Grubert as lacking any “conceptual basis” and as of no use in addressing “any relevant policy issue.” See Harry Grubert, *Comment on Desai and Hines, “Old Rules and New Realities: Corporate Tax Policy in a Global Setting,”* 58 *Nat’l Tax J.* 263 (2005). I find the Grubert analysis persuasive and will not employ the ownership neutrality concept in this paper. See also the critique of the concept by Fleming & Peroni, *supra* note 3, at 235-39.

Finally, I do not employ the criterion of “international norms,” as was done, for example, by the Treasury Department in its study of subpart F. See United States Department of the Treasury Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (2000). The problem is that supposed “norms” change. For example, prior to the issuance of the first set of regulations under IRC § 482 in 1968, there was no international consensus and hence no norm about the comparable uncontrolled price method to be used in the arm’s length

Part I of the paper describes the Panel's proposal and the arguments it advanced in favor of the proposed change. Part II sets forth a model by which the Panel proposal will be evaluated. Part III compares the simplicity arguments for each of the two international tax regimes. In Part IV, the efficiency arguments advanced for each system are considered. Part V analyzes the equity issues under each system. Part VI sets forth my own conclusions on the issues.

PART I

The Panel recommended that the current U.S. international tax regime be replaced with a two-part system:

1. Foreign active business income, as well as dividends from foreign subsidiaries out of such income, would be exempt from U.S. income tax.
2. Current U.S. income tax would be imposed on passive income and so-called mobile income (including, for example, financial services business income); a foreign tax credit would be allowed against the U.S. tax, with all such income being placed in a single basket.⁴

The Report provides a few of the technical details that would be required to implement the basic rules. Thus, allocation of expense rules between U.S. and foreign source income would be required. The Report asserts, without explanation, that these rules could be simpler than the current U.S. allocation rules.⁵ The Panel goes on to recommend that interest expense allocation rules like those adopted in the 2004 Act be employed.⁶

pricing methodology. Some 25 years later, when the Treasury issued proposed regulations, setting forth the largely formulary profit split and comparable profits methods, there was an outcry from many OECD countries that the international norm of arm's length transfer pricing was being violated by the new rules.

4. Panel Report, *supra* note 1, at 240. The Panel Report closely parallels a report prepared by the Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 186-98 (Comm. Print 2005) (hereinafter JCT Staff Report). This discussion will include references to that study and notes any differences between the Panel Report and the JCS approach. The JCT Staff adopts the same two-pronged approach. *Id.* at 189. That Report also observed that current subpart F and PFIC rules would have to be retained, including retaining the foreign tax credit for such income. *Id.* at 191-92.

5. Panel Report, *supra* note 1, at 241.

6. *Id.* The 2004 Act changed the mandatory "water's edge" interest allocation rule to provide certain corporations with an election to adopt a worldwide allocation method beginning in 2009. IRC § 864(f).

General and administrative expenses provided free of charge by one member of a (presumably controlled) group of corporations to another member would be required to be allocated first between U.S. and foreign income and then the expenses allocated to foreign income would have to be allocated between exempt and currently taxable income.⁷ Research and experimentation expenditures, however, would be allocated only between U.S. and foreign mobile income.⁸

As to the exempt income group, the Report stated that gain on the sale of assets generating exempt foreign income likewise would be exempt from U.S. tax, but losses realized on such assets could not be deducted against U.S. income.⁹ The Panel also noted that special rules would be needed for dividends from foreign corporations in which a U.S. company owned between 10 and 50% of the stock.¹⁰ While dividends out of foreign active business income would be exempt, royalty and interest payments would be subject to U.S. tax if those payments were deductible in the source country.¹¹

As to other issues, the Report noted that transfer pricing rules would become even more important under the proposed exemption system than under current law,¹² and recommended that increased resources be devoted to enforcing transfer pricing rules.¹³

The Report contains no recommendations with respect to transition rules that would be required if the Panel's recommendation were adopted.¹⁴

The Panel offered several reasons for its proposed changes. They will simply be listed here and discussed in succeeding parts of this paper. The reasons included:

7. Panel Report, *supra* note 1, at 241. The JCT Staff Report makes the same points with respect to expense allocation rules. JCT Staff Report, *supra* note 4, at 190.

8. Panel Report, *supra* note 1, at 240.

9. *Id.*

10. *Id.* Presumably, look-thru rules like those contained in IRC § 904 would be required.

11. *Id.* at 134.

12. *Id.*

13. *Id.* at 240. The Panel also recommended that increased disclosure requirements be adopted for foreign income. *Id.* The JCT Staff Report observed that adoption of an exemption system by the U.S. would require it to renegotiate all of its income tax treaties. JCT Staff Report, *supra* note 4, at 192.

14. Apparently, the Panel exemption system would apply to all post-enactment dividends, including those paid out of pre-enactment earnings on which U.S. tax had been deferred. The JCT Staff Report, at 191, proposed a transition rule under which the new exemption system would apply only to qualifying foreign income generated after the effective date of the enacting legislation. Present law would continue to apply to pre-effective date foreign earnings.

1. The availability of deferral of U.S. tax on income earned by a foreign subsidiary creates an incentive to retain those earnings in the subsidiary for as long as possible and distorts other business and investment decisions.¹⁵
2. The current system distorts business decisions, treats different U.S. multinational corporations (MNCs) differently, and encourages wasteful tax planning.¹⁶
3. Changing to an exemption system would make U.S. businesses more competitive in their foreign operations.¹⁷

The benefits of changing to an exemption system, according to the Panel, include:

1. It would allow U.S. companies to compete abroad more effectively.
2. It would reduce the degree of tax-induced distortions on business decisions.
3. It would produce simplification gains.¹⁸

The Report also stated, without discussion, that there is no definitive evidence that investment location decisions would be significantly changed from the present situation.¹⁹

15. Panel Report at 103. The Panel also asserted that U.S. tax on repatriated dividends distorts the repatriation decision. *Id.* at supra note 1, at 133. The JCT Staff Report added that basing U.S. taxation on repatriation makes the U.S. tax on foreign source income substantially elective. It also noted that maintaining deferral indefinitely is the equivalent of exemption of the income so deferred. JCT Staff Report, supra note 4, at 188.

16. Panel Report, supra note 1, at 104. The Panel apparently had in mind tax planning that aims at averaging down overall foreign tax rates to avoid falling into an excess credit position for foreign tax credit purposes. The JCT Staff Report also asserts without any authority that U.S. corporations engage in a greater degree of tax-induced business planning than do corporations in exemption countries. JCT Staff Report, supra note 4, at 189.

17. Panel Report, supra note 1, at 104.

18. *Id.* at 134. The JCT Staff Report, however, notes that the need to retain subpart F rules, and transfer pricing rules, and to provide transition rules would create significant complexities. JCT Staff Report, supra note 4, at 195.

19. Panel Report, supra note 1, at 135. The JCT Staff Report, however, warned that there would need to be rules to prevent shifting of income to low-tax jurisdictions. It did observe that disallowance of deductions attributable to exempt foreign income should serve as a brake on incentives to move more activity to low-tax jurisdictions. JCT Staff Report, supra note 4, at 194-95.

PART II

In this part, I will set forth the model I propose to use in assessing whether a worldwide taxation of income with a foreign tax credit system (WWI/FTC) or a territorial system is better for the U.S. And by “better,” I mean which maximizes the welfare of U.S. citizens and residents.

In so doing, I reject the approach of the Panel and the JCT staff in which they compared an ideal (or near ideal) territorial system with the current imperfect WWI/FTC system in effect in the U.S.²⁰ This approach, it seems to me, does a real disservice to policymakers (unless, of course, they have predetermined that they desire the adoption of a territorial system).

Instead, I believe the appropriate policy comparison is between a (near) ideal WWI/FTC system and a (near) ideal exemption system. Only then can policymakers assess each in terms of equity, efficiency, and simplicity. Accordingly, this part sets forth a model of a WWI/FTC system and a model of a territorial system.

A. WWI/FTC System

In very brief form, the following basic elements constitute a (near) ideal WWI/FTC system.

1. All foreign income, whether from business operations or passive investments, would be taxed currently, on an accrual basis, by the U.S. No deferral of tax on foreign source income would be permitted.²¹ As a result, U.S. income tax

20. See Panel Report, *supra* note 1, at 104-105. This same approach was taken in Harry Grubert & John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System* (American Enterprise Institute, 2001); see also, Rosanne Altschuler & Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 *Nat'l Tax J.* 787 (2001).

At various points in the following discussion, I do compare aspects of the proposed exemption system to current law.

21. For extensive discussions of a proposal to end deferral, see Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 *SMU L. Rev.* 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 *Tax Notes Int'l* 547 (Jan. 31, 2000).

Senator John Kerry has introduced legislation to require current taxation of the income of controlled foreign corporations, coupled with a reduction in the corporate tax rates. The Export Products Not Jobs Act, S. 3777, 109th Cong., 2d Sess. (2006).

considerations would not affect the decision whether to operate in branch or subsidiary form, a situation that does not currently exist, e.g., the branch form is preferred if foreign losses are expected that can offset U.S. source income whereas if profits are expected, the use of a subsidiary provides the opportunity to defer U.S. tax on those profits.

2. An FTC would be allowed for all foreign income taxes paid by the U.S. taxpayer on its foreign source income.
 - a. The allowable credit would be limited to the U.S. tax on the foreign source income.
 - b. Two baskets – active business income and passive investment income – would be retained.
 - c. Because worldwide averaging of business income presents too much opportunity for eliminating U.S. tax on foreign source income, a per-country limitation (with two baskets in each country) should be employed.²²
 - d. As discussed in further detail in following parts of this paper, a number of elements of the current U.S. FTC system would continue, e.g., look-through rules and allocation of deduction rules.

The implications of these basic elements and additional needed rules are detailed further in subsequent parts of this paper.

B. Territorial System

In very brief terms, the following sets forth the basic elements of a (near) ideal territorial system.

1. The residence country could include foreign source income in its tax base but exempt foreign source business income. Exempt income includes both branch income and dividends from foreign subsidiaries paid out of foreign business income.
2. Typically, countries adopting such a system do not extend the exemption to foreign investment income. As per the

Note that this element of the model eliminates the concerns expressed in the Panel Report, that the current system discourages repatriation of dividends from foreign subsidiaries. Panel Report, *supra* note 1, at 133.

22. See ABA Task Force, *supra* note 3, at 672, for a discussion of a similar proposal.

Panel Report, such income may be taxed currently, with a foreign tax credit allowed.

3. Foreign source losses are not permitted to offset domestic source income.

Implications of the foregoing and the rules necessary to implement a territorial system are discussed in subsequent parts of this paper.

PART III

Supporters of a territorial system frequently assert that such a system is more simple than a WWI/FTC system.²³ Typically, little analysis accompanies this assertion. And, indeed, there is no basis for such a statement. In fact, virtually all the elements that add up to complexity in a WWI/FTC system are, or should be, present in a territorial system. And, when additional elements of the Panel proposal are factored in, the U.S. international tax system would be made more, rather than less, complex.

The following discussion identifies the elements that can create complexity, or in any event are necessary, in a model WWI/FTC system. As each rule is identified, its role in a territorial system is considered, including an assessment whether there is greater or less pressure on the rule in one system versus the other.²⁴

A. Source of Income Rules

Source of income rules play a critical role in the current U.S. international tax system and would continue to do so in a model WWI/FTC system. Such rules are equally necessary in a territorial system. Since in that system complete exemption is provided for specified foreign source income, there would be greater pressure on the source of income rules than is the case even under present law. Under present law, deferral of tax but not complete exemption turns on classifying income as foreign source. A territorial system is no more simple (or complex) when compared to a model WWI/FTC system insofar as source of income rules are concerned.²⁵

23. See, e.g., Panel Report, *supra* note 1, at 132-34; Christian, *supra* note 3, at 40 (territoriality is simplest system “[w]ithout question”); Larkins, *supra* note 3, at 250.

24. The best analysis of why an exemption system is not more simple than a WWI/FTC system is in Hugh J. Ault, U.S. Exemption/Territorial System vs. Credit-Based System, 32 *Tax Notes Int’l* 725 (Nov. 24, 2003).

25. In accord with the text discussion are Ault, *supra* note 24, at 727; Merrill et al., *supra* note 2, at 905; Graetz & Oosterhuis, *supra* note 2, at 782.

B. Source (or Allocation) of Deduction Rules

Under current law, source of deduction rules play a crucial role in the operation of the FTC system. Deductions allocated to foreign source income reduce the allowable foreign tax credit (and for a taxpayer in an excess credit position, the allocation is equivalent to denying the deduction altogether). Such rules would continue to be necessary in a model WWI/FTC system. But it is also true that such rules play an equally important role in a territorial system. Failure to allocate appropriately deductions to foreign source income that is exempt from domestic tax means that the taxpayer would be able to deduct against domestic taxable income items that are costs of producing tax-exempt income (from the perspective of the residence country). This result, of course, would violate a long-accepted principle in U.S. tax policy. For these reasons, as compared to present law, pressure on the source of deduction rules would be at least as great in a territorial system. And, as with the source of income rules, in this respect, a territorial system is no more simple than a model WWI/FTC system or, indeed, even the present rules.²⁶

C. Outbound Transfers of Property

Currently, IRC section 367(a) may impose a toll charge on outbound transfers of property that has appreciated in value while subject to U.S. domestic taxation. Exceptions to this rule and exceptions to the exceptions are also to be found. In turn, IRC section 367(b) and the regulations thereunder provide rules for the treatment of certain inbound and foreign-to-foreign transactions.

In a model WWI/FTC system, there would be no need for IRC section 367. Gain on appreciated property transferred to a CFC would be taxed currently by the U.S. whenever realized. Similarly, the concerns of IRC section 367(b) would appear to decline significantly.

Under a territorial system, however, IRC section 367(a) would be of greater importance than under current law and would be necessary to protect the U.S. tax base.²⁷ Currently, the IRC section 367(a) toll charge is the price paid to transfer property into a world of deferral. But under a territorial system the appreciation in value would be completely exempt from U.S. tax if the gain is not taxed at the time of transfer. It thus appears that some of the exceptions in IRC section 367(a) that are tolerable in a world of deferral

26. In accord with the text discussion are Ault, *supra* note 2, at 728; Panel Report, *supra* note 1, at 134; Merrill et al., *supra* note 2, at 905; Graetz & Oosterhuis, *supra* note 2, at 782.

27. In accord are Ault, *supra* note 24, at 728; ABA Task Force, *supra* note 3, at 665-66; Graetz & Oosterhuis, *supra* note 2, at 783.

would not be acceptable in a world of exemption. The IRC section 367(b) rules would need to be examined in a shift to a territorial system to see if it would still be necessary to deal with some of the inbound situations.²⁸

In this set of rules, a territorial system produces more, not less, complexity than does a WWI/FTC system.

D. Transfer Pricing

Transfer pricing rules play two important roles. First, they seek to assure that each entity in a controlled group is assigned the income that is appropriate to its role in cross-border transactions. Second, transfer pricing rules operate to allocate revenues between the governments of the countries that are involved in particular cross-border transactions.

As the Panel Report recognized, a territorial system would place greater pressure on transfer pricing rules than is true under present law.²⁹ Again, the reason is that profit that can be isolated in a low- or no-tax country is totally exempt from U.S. tax; in today's world, deferral of U.S. tax is at stake. The Panel also noted that in fact a territorial system would require a much higher degree of enforcement of transfer pricing than is currently the case.

By contrast, I argue that a WWI/FTC system could actually reduce the pressure on transfer pricing rules. In general, there would be no benefit from isolating profit in the Cayman Islands since the U.S. would tax that profit currently and would have to give little or no FTC. The argument needs to be modified if a per-country limitation is adopted. There would be an incentive, for example, to shift profits from a high-tax country in which the taxpayer is in an excess credit position to a low-tax country in which the taxpayer is in an excess limit position. This result could be most easily accomplished by making interest or royalty payments that are deductible in the payer's country. Of course, the high-tax country would have an interest in applying its own transfer pricing rules to such transactions. Effective exchange of information procedures would help protect the tax bases of both the U.S. and the high-tax country.

28. Ault, *supra* note 24, at 728, observes that the issues to which the current regulations under IRC § 367(b) are directed also would arise in an exemption system.

29. In accord are Ault, *supra* note 24, at 728; Panel Report, *supra* note 1, at 134, 240; JCT Staff Competitiveness Report, *supra* note 3, at 30; Merrill et al., *supra* note 3, at 905; Graetz & Oosterhuis, *supra* note 2, at 782.

E. Tax Havens

The U.S. seeks to protect its tax base through the application of its transfer pricing rules and the rules of subpart F (requiring current taxation of specified base company income and passive investment income).

Countries with exemption systems have found that some rule is necessary to deal with efforts by their taxpayers to isolate income in low- or no-tax countries. Some countries require that the source country impose a specified minimum rate of tax, others that the income be subject to tax, and still others maintain lists of “good” countries, the income earned in which would qualify for exemption. The point is that shifting to an exemption system does not eliminate the need for subpart F-type rules.³⁰ As a result, no simplification gains from such a change should be expected as compared to the present U.S. approach.

On the other hand, such regimes are unnecessary in a WWI/FTC system. All foreign income would be taxed currently by the U.S. even if earned in a low- or no-tax country. Thus, purely on simplification grounds, in this area the model WWI/FTC system has the edge over a territorial system.³¹

F. Look-Thru Rules

For purposes of applying the indirect FTC under IRC section 902, the U.S. uses look-thru rules to determine the proper basket into which to place dividends received either from a CFC or a so-called 10/50 corporation.³²

Under the model WWI/FTC system, these look-thru rules would continue to be needed as it includes a two-basket (business income and passive investment income) system on a per-country basis.

An exemption system in theory would not require baskets. However, in practice countries with territorial systems typically do not exempt foreign source passive investment income. Instead, they tax such income earned by their residents on a worldwide basis and provide a FTC for foreign taxes (typically withholding taxes) paid.

The Panel Report adopts this approach. It would tax so-called “mobile” income on a current basis and allow a FTC for foreign taxes incurred, if any. Two observations may be made. First, in effect a two-basket system is retained because it is necessary to distinguish business income from mobile income. Second, each basket of income is subject to a different

30. See Ault, *supra* note 24, at 727-28.

31. Astonishingly, the Panel Report contained no mention of the tax haven problem. Presumably, under the Panel approach even if foreign business income incurred no tax at source, the income would still be exempt from U.S. tax.

32. IRC § 904(d)(3), (4).

international tax regime, i.e., an exemption system for business income and a worldwide system for mobile income. In contrast, under the model WWI/FTC system, while two baskets are employed, the same international tax system would apply to each basket. The Panel Report approach inevitably will be more, not less, complex than either the model WWI/FTC system or current law, as it requires the complete implementation of an exemption and an FTC system for each of the two different classes of income.

G. Foreign Losses

Under present U.S. law, a special set of rules applies to deal with foreign losses incurred by U.S. companies. The rules play two different roles. The first role is to account for the fact that, in the case of operation through a foreign branch, any losses incurred by the branch reduce U.S. taxable income. If the branch subsequently earns a profit, then special rules insure that the U.S. in effect recaptures those previously deducted losses into income.³³ The second set of rules operates within the FTC basket system and mandates how foreign losses in one basket of income are to offset income in other baskets of income.³⁴ Again, the objective is to ensure that foreign losses in one basket offset foreign income in other baskets before offsetting U.S. income for FTC purposes.

Similar foreign loss rules would be necessary in a model WWI/FTC system, although their FTC role would be significantly diminished in a two-basket system.

Foreign losses must also be dealt with in an exemption system. The basic rule needs to be that, since foreign source business income is exempt from domestic tax, foreign source losses cannot be taken against domestic source income. That is the approach recommended by the Panel Report. It should be noted, however, that exemption systems are not impervious to deviations from the norm. In a number of exemption countries, foreign losses are allowed as a deduction against domestic source income. Such a rule constitutes a tax expenditure or tax subsidy in an exemption system.

H. Tax Treaties

All current U.S. bilateral tax treaties guarantee U.S. taxpayers the availability of a foreign tax credit.³⁵ If the Panel proposal were adopted, all

33. IRC §§ 367(a)(3)(C), 904(f)(1).

34. IRC § 904(f)(5).

35. See, e.g., Article 23 of the 2006 United States Model Income Tax Convention.

these treaties would have to be renegotiated, a prescription for complexity and uncertainty for the government and taxpayers alike.³⁶

I. Transition Rules

Another element of complexity involved in a change to an exemption system would arise from transition rules from the current system to an exemption system. Remarkably, the Panel Report contains no such rules. Apparently, dividends repatriated out of pre-effective date tax-deferred business earnings would be wholly exempt from tax.

More realistically, as noted above, the JCT Staff Report did include transition rules to ensure that distributions out of previously untaxed foreign earnings would be subject to tax. Presumably, some sort of ordering rule would be required to determine whether a post-effective date dividend was made out of pre-effective date or post-effective date earnings (or some combination thereof), the latter qualifying for exemption. As the JCT Staff Report recognizes, however, the necessity of such a transition rule introduces an additional layer of complexity.

If the U.S. were to adopt the model WWI/FTC system, transition rules would also seem to be required. That is, post-effective date income would be taxed currently, but tax on pre-effective date earnings would be taxed only when repatriated. Again, additional complexity is introduced by the necessity for transition rules.³⁷

J. Conclusion

The assertion that an exemption system is less complex than a model WWI/FTC system simply will not stand up to analysis. Indeed, it does not even hold true as compared to the current U.S. rules. As noted above, in several important areas, the model WWI/FTC system actually achieves greater simplification than does an exemption system. Moreover, the Panel approach involving the use of an exemption system for business income and a WWI/FTC system for other income necessarily is inherently more complex than either current law or the model WWI/FTC system proposed here, as taxpayers have to comply with two different systems of taxing foreign income.

36. See JCT Staff Competitiveness Report, *supra* note 3, at 12-13; Merrill et al, *supra* note 2, at 905. It could be argued that a domestic law exemption system would apply to U.S. taxpayers without regard to the treaty in any event so no treaty change is required. However, some U.S. multinationals will pay a higher tax under an exemption system than they do under current law. Such taxpayers might assert that they are entitled to a treaty-based FTC.

37. See JCT Staff Report, *supra* note 3, at 10; Graetz & Oosterhuis, *supra* note 2, at 783-84.

PART IV

The next issue to be addressed is whether efficiency gains would be realized by changing from the present system to a territorial system or, alternatively, by changing from the present system to a model WWI/FTC system. There may be a number of different ways in which the term efficiency is used. For definitional purposes in this paper, the term shall refer to a tax system that affects as little as possible the nature and location of business and investment activities.

There are a number of problems with the current U.S. international tax rules that violate this efficiency criterion. In no particular order, these include, but are not limited to, (1) use of the check-the-box rules for foreign subsidiaries;³⁸ (2) the ability of a parent company to borrow in the U.S. to fund foreign subsidiaries the tax on whose income is deferred but the interest on the loan is fully deductible against U.S. taxable income; (3) the deferral regime itself; (4) the ability to treat as foreign source 50% of export sales income even though that income is unlikely to be taxed in the importing country; (5) to this observer, at least, insufficient resources devoted to curbing aggressive transfer pricing structures; and (6) the ability to average down foreign taxes by cross-crediting low and high tax country taxes. The result has been very low effective rates of U.S. tax on the foreign income of U.S. companies.

Two competing notions of neutrality have been employed in assessing international tax systems: capital export neutrality (CEN) and capital import (or competitive) neutrality (CIN). The former is associated with a foreign tax credit mechanism and the latter with an exemption system. The issue is whether both of these asserted neutralities satisfy the efficiency criterion set forth above.

The Panel Report, following earlier studies, asserts that shifting from the present U.S. system to an exemption system would have little impact in terms of the decisions by U.S. companies to locate in low- or no-tax countries. Even if one accepts that view, it does not lead to the conclusion that adopting an exemption system is a desirable policy for the U.S. All these studies tell us is that the U.S. WWI/FTC system is deeply flawed.

One can gain perspective on the efficiency issue only if the comparison is made between an exemption system and the model WWI/FTC system outlined earlier in this paper. The model WWI/FTC system generally achieves CEN while the exemption system generally would achieve CIN. I

38. For a discussion of the impact of these rules in the international context, see Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 Fla. Tax Rev. 186 (2005). See also ABA Task Force, *supra* note 3, at 668; Lokken, *supra* note 2, at 759-64; Paul W. Oosterhuis, *The Evolution of U.S. International Tax Policy – What Would Larry Say?* 42 Tax Notes Int'l 1119, 1124 (Jun. 21, 2006).

have defined efficiency as including minimization of the tax impact on business location decisions. The model WWI/FTC system comes closer to achieving efficiency than the proposed exemption system. That is, the decision whether to carry on business or invest in the U.S. or another country generally would be unaffected by U.S. income tax rules in the model WWI/FTC system. There would be no incentive to invest or do business in a low- or no-tax country because, regardless of location, the U.S. tax would be imposed. This result would be reinforced by adopting a per country limitation for FTC purposes.

There is one deviation from a pure CEN approach that is accepted in the model WWI/FTC system proposed here. A completely implemented CEN policy would require that the U.S. refund all foreign taxes in excess of the U.S. tax on foreign source income. Such a rule, of course, would put U.S. revenues completely at the mercy of foreign countries' tax rates. Neither the U.S. nor any other FTC country will accept or has accepted this result. Accordingly, the model WWI/FTC system does accept that the U.S. will limit the allowable FTC to the U.S. tax on foreign source income, albeit imposed on a per country basis to prevent averaging between high- and low- or no-tax countries.

As compared to the CEN model, CIN does not satisfy the efficiency criterion as I have defined it. There is an inherent bias in favor of investing or carrying on business in countries with a tax rate lower than that of the residence country. In addition, it is unlikely that an exemption system can achieve its stated goal of insuring that a residence company can do business in another country and face the same tax rate as its local or third country competitors operating in the source country. This failure is due to the fact that an exemption system will "work" only if all countries employ an exemption system and have identical tax rates, conditions obviously not now met or ever likely to be met.³⁹

To a non-economist, it is puzzling why a territorial system would be seen as preferable to a model WWI/FTC system. It seems clear that whereas the model system would not favor locating business or investment abroad at the expense of U.S. workers, an exemption system would create just such an incentive in a world where there are a substantial number of low- and no-tax countries.⁴⁰ As a Treasury study concluded, CEN maximizes global (including the U.S.) welfare, whereas CIN does not.⁴¹

The Panel Report advances as a reason in support of its territorial recommendation its assertion that the sophisticated (wasteful) tax planning that is carried out under current U.S. rules would be greatly curtailed. The

39. See Dan R. Mastromarco, U.S. International Tax Reform? Define 'Reform' for Me, 43 *Tax Notes Int'l* 481, 487 (Aug. 7, 2006).

40. See ABA Task Force, *supra* note 3, at 665.

41. See United States Department of Treasury, *supra* note 3, at 23.

JCT staff went further and asserted that U.S. corporations engage in a greater degree of tax-induced planning than do corporations in exemption countries. These, I assume, are efficiency concerns. Unfortunately, neither report provides any basis for these assertions. And, indeed, there is no such basis.

The assertion that tax planning is less complex in an exemption country would be astonishing to a Dutch tax advisor, for example. Tax planning for Dutch multinational companies is at least as sophisticated as that carried on in the U.S. On the other hand, my own experience in dealing with tax advisors in Japan (an FTC country) is that less emphasis is placed on tax planning. Thus, the presence of complex tax planning has nothing to do with whether a country employs a WWI/FTC or a territorial regime.

I believe that the degree of sophisticated tax planning is affected far more by what I would term the “tax culture” of a country. In the U.S., that culture includes the general rule that lawyers are to advance the interests of their clients as vigorously as is permitted by law. In addition, in the tax context, this approach is reinforced by the view that no taxpayer is obligated to pay a dollar more in taxes than the law requires. These elements of the U.S. “tax culture” result in legal (and accounting) tax advisors aggressively advancing the tax interests of their clients to produce the lowest tax possible. Nothing in this tax culture would change just because the U.S. adopted a territorial system. Nor would it change if the U.S. adopted the model WWI/FTC system. Sophisticated and complex tax planning, and equally sophisticated legislative and regulatory responses thereto, are here to stay.

PART V

Finally, I turn to the question whether an exemption system or the model WWI/FTC system is more equitable. Of course, the traditional notions of horizontal and vertical equity apply only to individuals. At the corporate level, as discussed in Part IV, the primary concern is efficiency, and that is the level at which most cross border investment and business is carried out. But this does not mean that there are no fairness issues raised by an international tax regime, particularly when coupled with a country’s corporate/shareholder tax regime.⁴²

It is not always appreciated that there is an equity as well as neutrality principle embedded in a WWI/FTC system. The horizontal equity principle can be stated as requiring that a U.S. taxpayer pays the same amount of U.S. and foreign taxes as does a taxpayer realizing the same amount of income solely from a U.S. source. Likewise, vertical equity

42. For an extensive analysis of fairness issues in the international context, see J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 Fla. Tax Rev. 299 (2001).

requires that a taxpayer with greater income from U.S. and foreign sources should pay relatively more tax than does a U.S. taxpayer with lower income, whether from U.S. or foreign sources.

The equity issue may be more readily seen if a model WWI/FTC system were employed by a country that had a fully integrated shareholder/corporate tax regime. By fully integrated, I mean that all income and tax attributes flow through the corporation and are taken into account only at the shareholder level. (A withholding obligation might be imposed on the corporation.) This would mean that in a model WWI/FTC system all foreign income taxes incurred by a corporation would flow through and be creditable by individual shareholders. In such a system, both horizontal and vertical equity would be satisfied.

The Panel Report did propose an integration system. Under its proposal all foreign income would be exempt at the corporate level but domestic income would be taxed. At the shareholder level, dividends paid out of domestic income would be exempt but dividends out of foreign (exempt) income would be fully taxable. This pair of proposals has several perverse effects. I shall describe three. First, depending on the tax rate in the foreign country, an individual U.S. shareholder could well experience a tax reduction on corporate-earned domestic income but a tax increase on dividends paid out of corporate-earned foreign income. Indeed, if there is any positive rate imposed on foreign source income, a dividend out of that income will bear a higher tax rate than a dividend paid out of domestic income.⁴³ Thus, the repatriation tax, much decried by exemption proponents, is retained; it is imposed at the shareholder level rather than at the corporate level. Perversely, only if the foreign income is not subject to any tax would dividends out of foreign and domestic source income bear the same tax. The inherent incentive in a territorial system to earn income in no-tax countries would thus be aggravated. Second, the Panel proposal replaces the asserted lock-in effect under current law for income earned abroad with a lock-in

43. Suppose that U.S. Corporation A has 100 of foreign source income on which it pays 30 of tax. U.S. Corporation B has 100 of domestic source income on which it pays 35 of tax. Corporation B distributes a 65 dividend which, under the Panel proposal, is exempt from tax at the shareholder level. Corporation A distributes a dividend of 70 and a tax of 24.50 (35% x 70) is imposed at the shareholder level because the dividend is not tax exempt. The shareholder of Corporation A has thus borne a total tax of 54.50, leaving only 45.50 in after-tax income, compared to the 65 that the shareholder of Corporation B realizes. This result will occur at any time the foreign source income is subject to a positive rate of tax. See also Merrill et al., *supra* note 3, at 907, for a further example of the phenomenon described here.

The Panel's integration proposal also raises complexity concerns as some type of ordering rules would be required for corporations that have both domestic and foreign income in order to determine the portion of a dividend that is subject to shareholder tax and the portion that is exempt. The Panel suggests a *pro rata* approach.

effect on distributing dividends out of foreign earnings. Thus, the only way to avoid the shareholder level repatriation tax is the same as that used to avoid the current corporate-level repatriation tax: do not distribute dividends to a U.S. parent corporation out of business income earned by a foreign subsidiary. Third, and following from the first two points, is that the sophisticated tax planning that currently takes place to avoid the corporate-level repatriation tax will shift to be carried out to avoid the shareholder-level repatriation tax.

It is thus clear that, under the Panel proposal, both horizontal and vertical equity principles would be violated. Shareholders with the same amount of dividend and other income generally would not pay the same amount of tax. Nor would there be any guarantee that higher income shareholders would bear a relatively greater tax than lower income counterparts, at least not in the manner specified in IRC §1.

PART VI

The Panel Report missed an opportunity to assist U.S. tax policy makers and the American public by comparing its proposed exemption system only to the current flawed FTC system. In my view, it would have performed its stated mission far better if it had also compared its exemption proposal with a model WWI/FTC system so that taxpayers and tax policymakers could have formed a better judgment as to which direction the U.S. should move in reforming its international tax system. Of course, had the Panel done so, it might well have concluded, as did this examination of the issues, that a model WWI/FTC system is superior to a territorial system, on simplicity, efficiency, and equity grounds.