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Territoriality: For and Against

by Reuven S. Avi-Yonah

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U.S.-based multinational enterprises currently have about \$1.7 trillion “permanently reinvested” offshore. Most of this immense pile of cash is located in low-tax jurisdictions so that under current law, repatriating it would result in a 35 percent tax on the dividend without an offsetting foreign tax credit.

There is no doubt that this “trapped income” phenomenon is a problem: The various ways in which MNEs have attempted to repatriate the funds without triggering a dividend tax (for example, by manipulating the short-term loan exception to IRC section 956, as documented in a recent Senate Permanent Subcommittee on Investigations hearing) show that there is a real desire to repatriate but that the dividend tax is a serious deterrent. Thus, the tax on dividends from the active income of controlled foreign corporations meets the criteria for a bad tax: It raises little revenue but significantly affects taxpayer behavior in undesirable ways.

There are two opposing solutions to this problem. The first, as envisaged by various congressional proposals (for example, by House Ways and Means Chair Dave Camp, R-Mich., and Sen. Michael B. Enzi, R-Wyo.) and also by a long series of commissions (for example, Bowles-Simpson), is to adopt territoriality — that is, not tax the dividend when it is repatriated (except perhaps for a small tax in lieu of disallowing deductions incurred to earn the exempt income). The second, as suggested by numerous administrations from Kennedy to Obama and by many other commentators, is to abolish deferral and levy a current tax on the active income of CFCs. Which one is better?

This article will survey the main arguments for and against territoriality and conclude that it is the wrong way to go in the short run but can perhaps be adopted in the medium to long run in conjunction with more fundamental international tax reform. The main reason

that territoriality should not be adopted now is that the OECD may be about to recommend worldwide consolidation for all its members as part of the base erosion and profit shifting (BEPS) project, and if the OECD does that, all of the standard arguments in favor of territoriality and against abolishing deferral disappear.

I. Why Do We Tax Corporations?

Before delving into the territoriality debate, I think it is helpful to step back and consider why we have a corporate tax to begin with. In a perfect world, I think it would be better to only subject individuals to taxation and not have a tax on legal entities. But there are two reasons to tax corporations:

- if we don't, rich individuals could park their income inside corporations and obtain deferral; and
- corporations are essential players in the economy, and Congress likes to use the corporate tax to regulate their behavior.

In theory we could subject individuals to mark-to-market on corporate shares and regulate corporate behavior by other means, but both steps seem politically unrealistic. Thus, the corporate tax is likely to survive as both an antideferral device and as a regulatory tax.

If those are the goals of corporate taxation, in my opinion they support worldwide taxation of U.S.-based MNEs and are inconsistent with territoriality because:

- if we adopt territoriality, rich individuals could invest in U.S.-based MNEs and know that their foreign earnings benefit from deferral; and
- if we adopt territoriality, we can only regulate the U.S. portion of the MNE, and the foreign portion often can have as much of an impact on the U.S. economy as the U.S. portion.

It can be argued that these reasons also support taxing foreign-based MNEs on worldwide income because U.S. individuals can invest in foreign-based MNEs, and foreign-based MNEs can affect the U.S. economy as well. But:

- we cannot tax foreign-based MNEs on foreign-source income under accepted jurisdictional norms;
- taxing U.S.-based MNEs is better than not taxing any MNEs on worldwide income from both an antideferral and a regulatory perspective; and
- it may be possible, as discussed below, to achieve both ends if other OECD members also tax their MNEs on worldwide income.

Let us now examine the arguments for and against territoriality in more detail.

II. Arguments for Territoriality

A. Everybody Does It

The first argument in favor of territoriality is that it has become the OECD norm. Since the U.K. and Japan adopted territoriality (narrowly defined as exempting dividends from active income upon repatriation), the U.S. is now left as the only major economy to tax its MNEs on a worldwide basis with deferral. This situation, it is said, violates capital ownership neutrality (CON) because it means that U.S.-based MNEs may face a higher tax burden on investments in a third country than MNEs based in another OECD jurisdiction. That, in turn, could lead to the less efficient foreign MNE making the investment rather than its U.S. counterpart.

B. Competitiveness

The main argument derived from the above is that U.S. MNEs are currently at a competitive disadvantage regarding MNEs from another OECD jurisdiction. Thus, it is said, we need to adopt territoriality in order to level the playing field. Implicit in this argument is the assertion that the U.S. should aid U.S. MNEs because they bring more benefits (for example, jobs) to the U.S. economy than do foreign MNEs.

C. Inversions

Another argument in favor of territoriality is that if we deviate too much from the international norm, current U.S.-based MNEs will have an incentive to migrate to other jurisdictions. While the enactment of IRC section 7874 in 2004 stopped the first wave of migrations, a new wave is occurring now (Aon PLC and five others since early 2012) because of the desire to avoid the U.S. worldwide taxing jurisdiction. Avoiding IRC section 7874 requires a real presence in a foreign jurisdiction, but arguably U.S.-based MNEs are willing to undergo real migrations and even have top management relocate overseas. If we go further and abolish deferral, those migrations will become even more common and new corporations will not be founded in the

U.S. In general, corporate residence is not a very meaningful basis for our international tax system and we should not base the tax consequences entirely on whether the parent is incorporated in the U.S. or elsewhere.

III. Arguments Against Territoriality

A. Profit Shifting

The main argument against territoriality is that it will encourage even more profit shifting to offshore jurisdictions. Currently, the main deterrents against profit shifting are that it is impossible to bring the funds back without incurring the tax and that it is necessary for financial reporting purposes to convince an auditor that the funds are in fact permanently reinvested offshore to avoid a reserve for the future tax on the dividend. These deterrents disappear once territoriality is adopted.

The various congressional proposals all contain various antishifting provisions. My favorite is Camp's option B, which ties exemption to the effective tax rate in the foreign jurisdiction, which is what most other OECD countries do. But it is unclear whether those provisions will be enacted and whether they are tough enough to deter shifting (Camp's proposal only kicks in if the foreign effective rate is below 10 percent, and it contains a significant exception for real presence in the foreign jurisdiction).

Such incentives to shift profits offshore reduce the U.S. corporate tax base and violate corporate export neutrality (CEN), and there is no consensus in the economics literature that CON is clearly more important than CEN.

B. Competitiveness

The counterargument to the competitiveness issue is that the empirical evidence suggests that U.S.-based MNEs do not bear a higher effective worldwide tax burden than their European counterparts, even though EU-based MNEs benefit from territoriality and U.S.-based MNEs do not. The reason is presumably because EU-based MNEs are subject to CFC rules that are tougher than the increasingly porous subpart F, which has become relatively toothless following the adoption of check-the-box and the subsequent enactment of IRC section 954(c)(6) (the CFC-to-CFC payment exception to subpart F).

While it may be true that abolishing deferral would put U.S.-based MNEs at a competitive disadvantage, this by itself is an argument for keeping the current rules in place, not for adopting a version of territoriality that gives U.S.-based MNEs a competitive advantage over both EU-based MNEs and U.S. domestic corporations.

C. Cooperation

While inversions may be a serious concern, I believe that it may be possible to stop them by adopting a corporate exit tax at the corporate level (as opposed to the

IRC section 367 shareholder-level tax, which proved ineffective, or the loophole-ridden IRC section 7874). Also, I would adopt a “managed and controlled” standard for corporate residency so that an inversion would require a real move by the CEO and top management team. The combination of these two measures will raise the bar for inversions quite high.

More importantly, the OECD BEPS study indicates that the OECD may be on the verge of doing something significant about profit shifting, such as recommending abolition of both deferral and exemption for all OECD-based MNEs. If that were to happen, all the arguments in favor of territoriality disappear because:

- we will be following OECD practice in abolishing deferral, so that CON is not an issue;
- there will be no competitive disadvantage if we abolish deferral, because everyone else will too; and
- inversions to other OECD countries will be fruitless.

IV. Conclusion

I support worldwide taxation of U.S.-based MNEs because it seems to me congruent with the reasons we

tax corporations, as explained above. However, I have also been dubious that a regime that depends so crucially on whether a given MNE is U.S.-based or foreign-based can survive in a globalized world.

This ambivalence leads me to different conclusions in the short and long runs. I believe that adopting territoriality now would be a mistake because I want to see where the OECD BEPS project leads. If it can lead to all OECD members taxing their MNEs currently on a worldwide basis, then all of the standard arguments in favor of territoriality disappear because they all depend crucially on the assumption that our major trading partners have adopted territoriality.

On the other hand, in the longer term I would be supportive of a different sort of territoriality: real territoriality, in which each country only taxes the corporate income that belongs to it. In my opinion, this is congruent with the reality that corporate residence is not very meaningful in a globalized world and therefore source-based taxation of a corporation is better than residence-based taxation. But that kind of territoriality requires allocation of profits by formula, which is a much more radical departure from current norms as embodied in the tax treaties and therefore cannot be done in the short term. ◆