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Back to the Future? The Potential Revival of Territoriality

Since 1994, the trend in the United States and other developed countries appears to be to reduce the scope of residence jurisdiction and increase the emphasis on source jurisdiction. If this trend continues, these countries are likely to move toward territoriality and decrease the emphasis on their CFC rules. In the author's opinion, the reason for this trend is political and economic, not legal. It is part of tax competition, specifically the competition to be the headquarters jurisdiction for multinationals. The author also thinks, however, that it is not necessary to go down this road because the solution to the competitiveness issue is collaboration, not more competition.

1. Introduction

Until 1993, the United States led the rest of the developed world in strengthening residence-based worldwide corporate and individual income taxation. Already in 1937, the US adopted its first regime aimed at "incorporated pocketbooks", or foreign corporations controlled by five or fewer US individual taxpayers, and designed to achieve deferral of US tax on foreign-source passive income.[1] This was followed in 1962 by the enactment of Subpart F, which sharply curtailed deferral for controlled subsidiaries of US multinationals (CFCs).[2] Between 1962 and 1993, the US expanded the scope of Subpart F to include both passive income and other types of income that were likely subject to low or no source-based taxation (e.g. shipping and insurance income).

The rest of the world followed. Germany was first in 1972, followed by Canada (1975), Japan (1978), France (1980) and the United Kingdom (1984). By 2008, 26 countries had CFC rules, including developing countries like Indonesia, Mexico, South Korea, Argentina and Brazil. Moreover, many countries that traditionally had only territorial taxation (e.g. Israel and most of Latin America) moved to worldwide taxation of their residents. As a result, the traditional dividing line between global and territorial jurisdictions became blurred so that it could be said that most countries tax the foreign-source passive income of their residents, but do not tax currently their foreign-source active income (which was entitled to deferral or exemption).[3]

2. Trend to Restrict CFC rules

Since 1994, this trend seems to have been reversed, at least in part. In the United States, the ascension of the Republicans in Congress from 1994 to 2006 meant a steady stream of enactments cutting back on the scope of Subpart F. The first step was to repeal IRC Sec. 956A in 1994. It was enacted in 1993 and added an asset test to the income test in Subpart F in order to prevent multinational enterprises (MNEs) from reinvesting their active earnings in passive assets overseas instead of repatriating them as dividends to the US. Second, the passive foreign investment company rules, which were enacted in 1986 to tax the passive income of residents from foreign corporations whether or not they were CFCs, were made inapplicable to CFCs.[4] Third, Congress enacted over President Clinton's veto the banking and insurance exceptions to Subpart F, which meant that most of the income of banks and insurance companies was exempt because it is active, even though it can easily be earned in low-tax jurisdictions.[5] Finally and most recently, all payments from one CFC to another were exempted, even when they are deductible and result in shifting income from a high-tax to a low-tax jurisdiction.[6]

Similar developments were taking place overseas. In Europe, the driving force was the European Court of Justice, which held in *Cadbury Schweppes* that the United Kingdom may tax the profits of EU subsidiaries under its CFC rules only if they are wholly artificial arrangements intended to escape the national tax normally payable.[7] In addition, the Supreme Administrative Court of France held in 2002 that France's CFC rules were incompatible with the France–Switzerland tax treaty.[8] As a result, France revised its CFC rules in 2005 to overcome the decision, resulting in a higher threshold for their application.[9]

The United Kingdom reacted to *Cadbury Schweppes* in 2007 by unveiling a consultation document which revealed that it was considering a significant narrowing

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1. The foreign personal holding company regime; see US Internal Revenue Code (IRC) Secs. 551-558, repealed in 2004.
2. IRC Secs. 951-960.
3. Avi-Yonah, Reuven S., *International Tax as International Law* (Cambridge University Press, 2007).
4. IRC Sec. 1297(d) (1997).
5. IRC Secs. 954(h) and (i) (1997).
6. IRC Sec. 954(c)(6) (2006).
7. *Cadbury Schweppes* (Case C-196/04), ECJ Doc. 2004-14844, 2004 WTD 141-7.
8. Supreme Administrative Court, 28 June 2002, No. 232276, *Société Schneider Electric*, *RJF* 10/02, No. 1080. See Mbwa-Mboma, Marcelin, "Treaty with Switzerland Overrides French CFC Legislation, French High Tax Court Confirms", 2002 WTD 127-1.
9. Goulard, Guillaume and Guillaume Jolly, "French Lawmakers Revisit CFC Rules", 2005 WTD 13-4.

of its CFC rules as well as, for the first time, exempting actual dividends paid out of the active income of UK CFCs.[10] This reform was recently put on hold because of its cost, but it is likely to be enacted eventually.[11]

In the United States, the most recent development has been the unveiling of a similar plan to exempt dividends paid out of non-Subpart F income (i.e. active income). The President's Advisory Panel on Federal Tax Reform proposed in 2005 that the United States should permanently switch from taxing the parent corporation of US multinationals on worldwide income to a modified territorial regime under which dividends paid out of active business income were exempt from US tax.[12] The Joint Committee on Taxation made a similar recommendation.[13] These recommendations follow the enactment in 2004 of a one-year reduced (5.25%) tax rate for such dividends, which resulted in the repatriation of over USD 300 billion in active earnings from CFCs of US MNEs.

Thus, there seems to be a trend to reduce the scope of residence jurisdiction while increasing the emphasis on source jurisdiction.[14] If this trend continues, it seems likely that both traditional territorial countries like France and traditional worldwide countries like the United Kingdom and the United States will move toward territoriality and decrease the emphasis on their CFC rules.

3. Reasons for the Trend to Source Jurisdiction

What is driving this trend? In Europe, the obvious answer is the European Court of Justice. But this cannot be the whole story because *Cadbury Schweppes* does not require the EU Member States to eliminate CFC rules, and it certainly does not force them to exempt foreign-source active dividends. Moreover, the trend seems to extend beyond Europe.

The argument that CFC rules are incompatible with Arts. 7 and 10 of the OECD Model Tax Convention has broader application, but in my opinion (and the OECD's opinion), it is clearly wrong. The argument is that CFC rules tax a foreign corporation on its foreign-source earnings without its having a permanent establishment in the residence jurisdiction, which arguably violates Art. 7 (requiring no tax on business profits absent a permanent establishment) and tax a foreign corporation on its undistributed dividends, which arguably violates Art. 10 (requiring that dividends be paid). But Art. 7 was clearly written as a limitation on source jurisdiction, not on residence jurisdiction. In my opinion, what CFC rules do is redefine the residence of a CFC (i.e. make it a resident of its parent's residence country), and this is permissible under Art. 4.[15] Once the CFC is a resident, there is no treaty limit on the residence-based taxation of all its income.

In my opinion, therefore, the reason for the trend to restrict CFC rules is political and economic, not legal. It is part of tax competition, specifically the competition to be the headquarters jurisdiction for MNEs.

When Daimler bought Chrysler in 1998 to form Daimler/Chrysler AG, Juergen Schrempf, the CEO of Daimler/Chrysler, testified before the US Senate Finance Committee that Subpart F was a major reason that the combined company was German and not American. I do not think he was correct. The German government and the German unions would not have tolerated a takeover of Daimler by Chrysler, and German shareholders were subject to tax on capital gains (if Daimler/Chrysler were a US company), while US shareholders were not (if it were German). In addition, Germany's CFC rules are as tough as Subpart F. However, Schrempf addressed a broader phenomenon, which is that lawmakers are reasonably concerned about the impact of CFC rules on the decision where to incorporate MNEs. In the US, this can be shown by the trend of inversion transactions, in which US MNEs reincorporated in Bermuda in part to avoid Subpart F.[16] The trend was stopped by legislation in 2004, but the competitiveness issue continues.

When deciding where to establish the headquarters of a new MNE, or of a newly merged combination of two MNEs, it makes sense to take tax into consideration. Why establish the parent in a jurisdiction with tough CFC rules and a tax on dividend repatriations when the parent can just as easily be established in a jurisdiction with no or lax CFC rules and an exemption for dividends?

In a world in which MNEs are mobile and can shift their headquarters (see e.g. the recent migration of Halliburton and others to Dubai) and where headquarters bring positive externalities, it makes sense for lawmakers to respond by relaxing CFC rules and enacting exemption regimes.

In addition, the dividend exemption proposal makes economic sense. The basic rationale for exempting dividends is based on Joel Slemrod's observation that the efficiency of a tax should be measured by the ratio between the revenue it generates and the behavioural change it induces in taxpayers.[17] In the case of the tax on dividends, it can be demonstrated that the revenue generated is small because, as James Hines et al. have shown, US multinationals repatriate only a small fraction of their overseas earnings.[18] On the other hand, the behavioural impact is

10. "Taxation of the foreign profits of companies", Doc. 2007-15183, 2007 WTD 124-8.
11. "UK Government to Rethink Foreign Profit Plans", *International Tax Review*, 22 July 2008.
12. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, D.C.: US Government Printing Office, 2005), at 102-105.
13. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (2005), at 186-197.
14. See Sheppard, Lee, "Revenge of the Source Countries", 2006 TNT 200-3 (17 October 2006).
15. The OECD agrees with this view, as shown by the Commentary on Art 7. See also Honda, Mitsuhiro and Hugh J. Ault, "Japanese CFC Rules Consistent with Treaty, Court Holds", 2008 WTD 50-9 (13 March 2008).
16. See Avi-Yonah, Reuven S., "For Haven's Sake: Reflections on Inversion Transactions, 95 *Tax Notes* 1793 (17 June 2002).
17. Slemrod, Joel, "A General Model of the Behavioral Response to Taxation", 8 *International Tax and Public Finance*, No. 2 (March 2001), at 119-128.
18. Hines, Jr., James R., M.A. Desai and C.F. Foley, "Dividend Policy Inside the Multinational Firm", 36 *Financial Management*, No. 1 (2007), at 5-26.

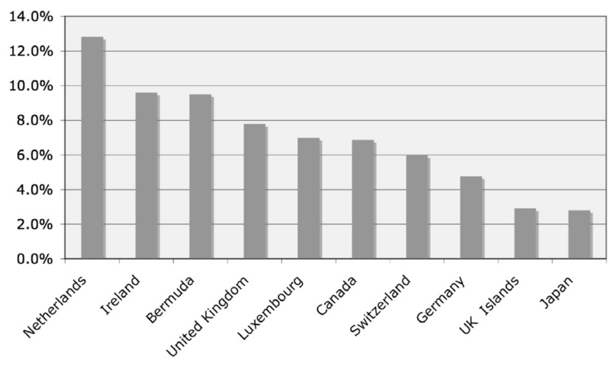
large, as can be seen from the data of Hines et al. (presumably, a major reason why US multinationals do not repatriate earnings is the tax on dividends) and even more vividly from the behavioural response to the one-year partial amnesty of the dividend repatriation tax enacted in 2004, which (as noted above) resulted in over USD 300 billion in income being repatriated.

4. Problems with the Trend to Source Jurisdiction

This trend has its attendant problems as well. The main argument against the US dividend exemption proposal is that, like any move in the direction of territoriality, it puts more pressure on the source rules and on transfer pricing. Currently, US multinationals are constrained in their willingness to shift income from the US to foreign jurisdictions by the knowledge that to get it back into the US a price will have to be paid in the form of the dividend tax. The same data cited above show that this constraint is real and that the phenomenon of "trapped income" is significant. If the US now abolishes the tax on repatriation, it should be expected that US multinationals will have every incentive to shift even more income overseas.

This issue would not be so problematic if the US transfer pricing regime worked adequately to prevent income shifting. But as Kim Clausing and I have shown, the current system is woefully inadequate to prevent income shifting.[19] This can be shown, for example, by considering Table 2 in George Yin's article, which shows high concentrations of earnings and profits (E&P) in the Netherlands, Ireland, Switzerland and Luxembourg.[20] Or consider the data in Figure 1, which shows the top ten locations of profits of US multinationals in 2003.[21]

Figure 1: Where were the profits in 2003?
(profits as a percentage of the worldwide total)



Country	Effective tax rate (%)
Netherlands	5.3
Ireland	6.1
Bermuda	1.7
United Kingdom	20.1
Luxembourg	– 1.8
Canada	23.5
Switzerland	4.5
Germany	8.2
UK Islands	1.3
Japan	36.9

In a world in which a third of the foreign profits of US-based multinationals are in countries with an effective tax rate of less than 10%, it seems dangerous to increase the incentive to shift profits by removing the one real disincentive to do so – the knowledge that repatriation will bear tax.

Yin recognized that this is a real problem and stated that "one modification Congress should consider is to require exempt income to be subject to tax somewhere".[22] The question is how to achieve this goal, which I fully support as being consistent with what I call the "single tax principle".[23] Yin proposed that a good proxy would be to apply the dividend exemption only with respect to countries with which the US has a tax treaty. However, this would include many jurisdictions with very low effective tax rates (see Yin's Table 2, which includes Austria, Barbados, Cyprus, Ireland, Luxembourg, the Netherlands and Switzerland). Of the top ten destinations in Figure 1, only two (Bermuda and the UK Islands) would not qualify for an exemption under this modification.

Therefore, I believe that if we are to adopt the exemption proposal, we must condition it on the actual effective tax rate in the source jurisdiction being high enough (e.g. 90% of the US rate). This is consistent with what the United States' trading partners do, as well as with the original intent of Subpart F.[24] In my opinion, this condition does not pose insuperable administrability obstacles since US multinationals already have to report both their current E&P and the actual tax paid by each CFC (see Yin's Table 2). It is similar to the "franking" mechanism employed by countries with dividend imputation systems which requires that it be shown that exempt dividends are paid out of income that was in fact subject to a corporate-level tax.

Another question, however, is whether the US and other jurisdictions need to go down this road at all. The answer, I believe, is no. The solution to the competitiveness issue is collaboration, not more competition.

5. Overcoming the Competitiveness Issue

This year marks the tenth anniversary of the OECD report on curbing harmful tax competition, in which the OECD Member countries bound themselves to "ensure that [CFC rules] apply in a fashion consistent with the desirability of curbing harmful tax practices".[25] Harmful

19. Avi-Yonah, Reuven and Kimberly Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (The Hamilton Project, Brookings Institution, 2007); also in 2007 TNT 114-38 (13 June 2007).
20. Yin, George K., "Reforming the Taxation of Foreign Direct Investment by US Taxpayers", 2008 TNT 5-22 (8 January 2008).
21. Avi-Yonah and Clausing, supra note 19, Figure 2.
22. Yin, supra note 20.
23. Avi-Yonah, Reuven S., "Tax Competition, Tax Arbitrage and the International Tax Regime", *Bulletin for International Taxation* 4 (2007), at 130.
24. Avi-Yonah, Reuven, "U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective", *Tax Notes International* (8 June 1998).
25. OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), at 40-41.

tax practices are defined to include tax holidays targeted at foreign investors.[26]

If this recommendation is taken seriously, it means that it should be possible to combat deferral in a coordinated fashion, thus overcoming the competitiveness issue. The United States was the traditional leader in restricting deferral and, as noted above, other countries have followed. The OECD report makes it very likely that if the United States were to move now to restrict or even repeal deferral, other OECD countries would also tighten their anti-deferral rules, just as they did in the 1970s in response to Subpart F. Since 85% of all multinationals are based in OECD countries, such a coordinated move by the OECD would effectively solve the competitiveness issue (because all the competitors of a US-based MNE would be subject to the same anti-deferral rules as the US-based MNE).

On the other hand, if the United States were to adopt an exemption regime now, as the President's Advisory Panel recommended, this would in all likelihood lead other OECD countries to expand deferral as well, despite the OECD report. We are thus in a classic prisoners' dilemma situation, but one that can be successfully resolved because of the availability of the OECD as a coordinating institution through which countries can credibly commit to limit their deferral or exemption regimes.

Advocates of deferral may doubt that the OECD would actually be able to achieve the coordinated action needed to curtail deferral and support the single tax principle. There is, however, a well-known example in which the OECD was successfully used to overcome such a prisoners' dilemma. In 1977, the United States unilaterally enacted a draconian set of rules applicable to US-based MNEs, which drastically limited their ability to obtain projects abroad by bribing local officials. The US Foreign Corrupt Practices Act made such behaviour subject to criminal prosecution as well as to tax penalties. This predictably led to an outcry by US-based MNEs that their competitive position would become untenable because of their inability to follow local corrupt practices, while their foreign-based competitors faced no such impediments (Germany, in fact, allowed a tax deduction for documented bribes). The result was a prolonged drive by the United States to get other OECD countries to commit to enact similar tough laws. This drive finally culminated in the 1990s in the OECD anti-corruption treaty, which anecdotal evidence suggests has already had a major impact in removing the competitive disadvantage facing US-based MNEs.

Of course, there is an important difference between bribes and taxes: both are costs from an MNE's perspective, but from the government's perspective (and this applies even to governments in countries plagued by corruption), bribes are to be prohibited while taxes are to be collected. Thus, MNEs themselves supported the OECD anti-corruption effort, which enabled them to avoid paying bribes for fear of competition, while they were less supportive of the anti-tax competition initiative, which would curtail their ability to avoid taxation. However, the basic prisoners' dilemma is the same, and there is therefore no reason why the OECD should not enable countries to advance the global goal of eliminating double non-taxation by limiting or even eliminating deferral without impairing the competitiveness of "their" MNEs. Thus, the right answer to the competitiveness issue is for the new US administration to push its allies in the OECD Forum on Harmful Tax Practices to act in a coordinated fashion to tighten their anti-deferral rules. The anti-corruption example shows that such a push has a good chance of succeeding under current conditions.

Even if all the OECD countries adopted strict anti-deferral rules, this would still leave the door open to reincorporating in non-OECD countries and to forming new companies in them. At the present time, few corporations are willing to reincorporate in non-OECD countries because of the likely loss of some shareholder protections and other reputational concerns. If, however, reincorporating or forming new MNEs in non-OECD countries becomes a significant trend, this may require further action by the OECD to protect the corporate tax base.[27]

26. Id. at 27.
27. See IRC Sec. 7874, enacted in 2004 to stop US-based MNEs from moving to Bermuda.

