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Territorial Tax Regime – What Does It Mean?

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Overview

- “Worldwide” versus “territorial” tax regimes
  - In a pure “worldwide” tax system, resident corporations are immediately taxable on all worldwide income, regardless of source
  - In a pure “territorial” tax system, only income derived within a country’s borders are subject to tax by that country
- In reality, tax regimes tend to fall somewhere in the middle
  - U.S. tax system imposes tax on worldwide income but allows for indefinite deferral of CFC profits and cross-crediting of foreign taxes
  - Most territorial tax regimes impose tax on at least some foreign-source income, such as mobile income and/or tax haven income of CFCs
    - These rules are conceptually similar to the U.S.’s “Subpart F” rules, IRC §§ 951-965, which eliminate the benefit of deferral for certain CFC income

Some Critiques of U.S. Worldwide Regime

- “Lock-out effect” created by our deferral rules traps substantial amounts of income earned by U.S. MNCs overseas
  - Proponents argue that eliminating the lock-out effect would free up capital of U.S. MNCs to invest more in the U.S.
  - Ending deferral without adopting a territorial regime would end “lock-out effect” but would increase the incentive for U.S. MNCs to move their tax residence outside the U.S.
- The current U.S. regime disadvantages U.S. MNCs relative to foreign MNCs
  - The U.S. currently only taxes foreign MNCs on U.S.-sourced income
  - Adopting a territorial system would treat U.S. MNCs similar to foreign MNCs
- Foreign tax credit (FTC) system is complicated

Defenses of U.S. Worldwide Tax Regime

- Others do not believe the U.S. needs to adopt a territorial tax regime
  – Senator Ron Wyden, ranking member of U.S. Senate Committee on Finance, has introduced a bipartisan tax reform bill keeping worldwide taxation (“Wyden-Coats”)
  – Commentator and professor Stephen Shay has repeatedly defended the U.S.’s worldwide tax regime in testimony before Congress
- Ending deferral and adopting a lower corporate rate would end the lock-out effect without incentivizing U.S. MNCs to move their tax residence
  – The existing FTC regime coupled with a substantially lower U.S. corporate tax rate would effectively eliminate worldwide tax for many U.S. MNCs
  – A worldwide tax regime with a lower corporate rate would not necessarily be more complicated than a territorial tax regime with robust base erosion rules
- Adoption of a territorial tax regime does not in-of-itself eliminate inversion incentives
  – As long as there are opportunities for foreign MNCs to strip U.S. income, U.S. MNCs will have incentives to move their tax residence out of the U.S.

Major Features of a Territorial Tax Regime

- There are two major components of territorial tax regimes:

  1. Some “participation exemption,” which allows resident MNCs to exclude or deduct foreign profits from domestic taxable income; and

  2. Base erosion rules, which are designed to prevent resident MNCs from reducing domestic taxable income through interest stripping or moving mobile income like royalties to low tax jurisdictions

- Base erosion rules are a necessary compliment to a territorial regime because exempting foreign source income may give resident MNCs an even greater incentive to shift profits to low tax jurisdictions

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