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PEER PRESSURE: WHY AMERICA SHOULD SUCCUMB TO THE TERRITORIAL TAX TEMPTATION

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ABSTRACT

This Note argues that the United States should adopt a territorial tax system. Currently, the United States is one of a small group of nations that employs a worldwide system of taxation. Under a worldwide system, income is taxed both in the country where it is earned and in the country where the taxpayer resides. Alternatively, under a territorial system, income is taxed only in the country where it is earned. By adopting a territorial system, the United States would jettison the duplicative taxation inherent in the worldwide system. Additionally, the presence of anti-inversion rules, controlled foreign corporation rules, and the rise of service-based economies will enable the United States to adopt a territorial system without fear of large scale capital flight.

I. INTRODUCTION

Johnny Depp has had a long and successful film career. A versatile actor, Depp has lent his talents to a variety of roles in dozens of films spanning a multitude of genres.¹ It was Depp's turn as a swashbuckling bandit for the Walt Disney Corporation, though, that paved the way for him to spend time atop the list of Hollywood's highest-paid actors.² Disney's *The Pirates of the Caribbean* franchise has grossed more than \$3.7 billion over the last decade with domestic audiences contributing one-third of the total.³

Johnny Depp owes a lot to American consumers, but that has not stopped Depp, an American, from acquiring a reputation as a Europhile and even going so far as to describe his native land as "a dumb puppy."⁴ So fans and non-fans alike were surprised when Depp revealed in an interview two years ago that he had given up his expatriate existence in France and returned to the incompetent canine.⁵ The reason for Depp's departure was less shocking. Like the fictional Jack Sparrow, Depp balked when it came to parting with his treasure.⁶

The French government wanted to classify Depp as a permanent resident, which would have subjected him to France's high marginal income tax rates.⁷ Additionally, Depp would have been subject to the United States' income tax rates regardless of where he earned his income.⁸ If Depp wanted to keep his American citizenship, he would have to be willing, as Depp put it, to "work for free."⁹

The United States is one of a small group of nations and an even smaller group of industrialized nations that employs a worldwide system of taxation.¹⁰ Under a worldwide tax system, income is taxed both in the country where it is earned and in the country where the taxpayer resides.¹¹ Most other countries employ a territorial tax system.¹² Under a territorial tax system, income is taxed only at the source.¹³ In other words, income earned in one country is

not taxed anywhere else.¹⁴ The United States should jettison the duplicative taxation inherent in the worldwide system and adopt a territorial tax system.

Foreign tax credits that help offset the portion of a taxpayer's foreign income that is taxed by foreign governments may make Johnny Depp's remark about working for free somewhat of an exaggeration. However, the credit's limits make it likely that Depp would have been subjected to at least some double taxation.¹⁵ This outcome illustrates the need for the United States to adopt a territorial tax system.

Section II of this note discusses the current state of international tax law both in the United States and abroad and the deleterious effects of the worldwide system. Section III outlines proposed legislation to shift the United States from a worldwide system of taxation to a territorial system. Section IV discusses why anti-inversion rules, the inclusion of controlled foreign corporation rules in the proposed legislation, and the rise of service-based economies will prevent capital flight from accompanying a shift to a territorial system of taxation. It also details how the United States would uniquely benefit from such a shift.

II. THE PAST AND PRESENT OF INTERNATIONAL TAXATION

A. *Contrasting Theories*

The economics of international taxation has long been dominated by two theories.¹⁶ One theory, capital export neutrality (CEN), postulates that tax rates on marginal investment should be identical regardless of whether an investor is investing at home or abroad.¹⁷ According to CEN, international tax considerations should be removed from investment decisions by applying both domestic and foreign income tax rates to foreign earnings and subsequently leveling the difference between the rates through the use of tax credits.¹⁸ In other words, if an American corporation were to make an investment in a foreign country with a 40% corporate tax rate, the

investment would be subject to both the United States' 35% corporate tax rate and the 40% foreign rate.¹⁹ The investment would then be eligible for a 35% foreign tax credit in the U.S., the maximum amount that may be credited under U.S. law.²⁰ CEN is the operative theory of worldwide tax systems.²¹

The alternate theory, capital import neutrality (CIN), represents the principle that tax rates on marginal investment in a given country should be identical regardless of where the investor is domiciled.²² For example, an American corporation investing in a hypothetical foreign country would pay income tax on that investment to the foreign country and nothing to the Internal Revenue Service (IRS).²³ CIN provides the theoretical basis for territorial taxation.²⁴

B. A Brief History of International Taxation

1. International Taxation in American Law

United States policy has always subscribed to the premise of worldwide taxation.²⁵ After the income tax was enacted in 1913, Congress made foreign taxes deductible to mitigate the double taxation on foreign income.²⁶ Low taxes were a casualty of World War I as governments at home and abroad increased taxes to pay for the expensive global conflict.²⁷ In response, Congress established the foreign tax credit to further ameliorate the problem of double taxation.²⁸ The foreign tax credit may be utilized in one of two ways.²⁹ The taxpayer may simply deduct foreign taxes from their U.S. income taxes or the taxpayer may credit foreign taxes against their U.S. tax liability on a dollar for dollar basis.³⁰ A panoply of additional deductions, credits, deferrals, and exclusions have been added to the U.S. tax code in the ensuing nine decades.

Currently, the United States persists in adhering to a worldwide system despite recent repeated recommendations from various blue-ribbon panels such as the President’s Advisory Panel on Tax Reform and the recent Simpson-Bowles Commission to adopt a territorial system.³¹

2. The Evolution of International Taxation Abroad

a. Origins

The debate over international taxation has its roots in the League of Nations (the League), an international body established in the wake of World War I of which the United States was never a part.³² Article 24 of the Covenant of the League of Nations tasked the League with disseminating information and assistance relating to matters international in scope.³³ League economists quickly began taking steps to address the question of international taxation.³⁴

In April 1923, the League issued its first report on the matter of international taxation.³⁵ The League proposed avoiding the problem of double taxation by bestowing the right of taxation on the country with which the taxpayer owed an economic allegiance.³⁶ The report posited four factors for the determination of such an allegiance: “(1) origin of wealth, (2) situs of wealth, (3) place of enforcement rights to wealth, and (4) where wealth was consumed.”³⁷

The 1923 report also identified four possible systems of international taxation.³⁸ The first option called for vesting all taxing rights with the jurisdiction in which the income was earned, or simply, the “source country.”³⁹ This approach is a territorial system. The second option vested taxing rights with the country “of residence.”⁴⁰ This approach is a worldwide system. The third option proposed income to be proportionally allocated between the source country and country of residence.⁴¹ Lastly, the fourth option called for income to be classified into

different categories with the right to tax some categories of income belonging to the source country and the right to tax other categories of income belonging to the country of residence.⁴² This was known as the “classification-and-assignment” option.⁴³

The League economists favored the second option (the worldwide system).⁴⁴ However, the economists recognized that this approach would not go over well with the countries that were not industrial powers.⁴⁵ They understood that multinational corporations (MNCs) headquartered in an industrialized country but with operations in a developing country would pay taxes solely to the industrialized country. This deprived the developing country of any tax revenue from the MNCs’ operations within their borders. Naturally, developing countries would not be fond of this proposal.

Worried about the practical difficulties in persuading developing countries to adopt a worldwide system of international taxation, the League economists put forward the classification-and-assignment system for countries at unequal levels of development.⁴⁶ Income was divided into categories based on the principle that corporate parents provided the capital and intellectual property to conduct business in foreign locales.⁴⁷ Therefore, the right to tax income that derived from tangible assets such as land, commercial establishments, minerals, and agriculture was given to the source country.⁴⁸ Income that derived from less tangible sources was given to the country of residence.⁴⁹

While the classification-and-assignment approach was more palatable to developing countries, it presented problems of its own.⁵⁰ Foremost among these was the problem of “homeless income.”⁵¹ Homeless income is income that avoids taxation in both the source country and the country of residence.⁵² This is accomplished through the creation of holding companies and establishing them as residents in countries with no income tax.⁵³ Thus, when

operating under a worldwide or classification-and-assignment system, an MNC could potentially escape all or most of its tax liability.⁵⁴ The recommendations in the 1923 League of Nations report did not address the problem of homeless income.⁵⁵

b. Cui bono?

The recommendations of the 1923 report revealed a strong bias against territorial taxation.⁵⁶ The economists who wrote the 1923 report believed that territorial systems were based on “antiquated theories of taxation and predicted that source-based taxation would diminish in importance as semi-developed nations became more industrialized.”⁵⁷ These views reveal a strong desire on the part of the League economists to orient policy towards the needs of imperial powers at the expense of colonies and other developing countries.⁵⁸

Foremost among the imperial powers at the time was Great Britain.⁵⁹ Like most if not all imperial powers, Great Britain exported far more capital than it imported.⁶⁰ Naturally, Great Britain recognized that worldwide taxation was in its national interest.⁶¹ As the world’s primary superpower at that time, Great Britain’s policy preferences greatly influenced the debate.⁶²

Despite support for the League economists from powerful interests, the findings contained in the 1923 report were not without critics.⁶³ Georg Schanz, a German legal scholar, held that depriving a developed country the right to tax the activities of MNCs within its borders “was outrageous and contradicted principles held by all countries.”⁶⁴ Schanz also dismissed the classification-and-assignment system as “arbitrary and incapable of being justified on any reasoned basis.”⁶⁵ Schanz proposed the adoption of the proportional allocation approach where the great bulk of the income from operations in a source country would be taxed by the source country.⁶⁶ However, Schanz’s argument was not nearly enough to dissuade the League from expressing a preference for worldwide taxation.⁶⁷

c. Permanent Establishments

Several years later, the League tasked a group of technical experts, including experts from the United States, with the creation of a model convention relating to international taxation.⁶⁸ At the suggestion of the American experts, the group reached a compromise that allowed source countries to impose withholding taxes on certain income.⁶⁹ To prevent double taxation, the residence country would provide a foreign tax credit to offset any taxes paid to the source country.⁷⁰ In addition, source country taxation would only apply if the MNC had a permanent establishment in the source country.⁷¹ These recommendations were included in the 1927 Draft Model Convention.⁷²

d. Insurrection and Suppression

Utilizing the template of the 1927 Draft Model Convention, the Polish and Hungarian governments executed a bilateral tax treaty in 1928.⁷³ However, the Poland-Hungary treaty differed from the 1927 Draft Model Convention by expanding the definition of a permanent establishment to include “all permanent representatives of a business entity whether or not the representative had the authority to bind the foreign company.”⁷⁴ This skewed the treaty towards territoriality.⁷⁵

Concerned that Poland and Hungary had used the 1927 Draft Model Convention to establish a system that had territorial characteristics, the Fiscal Committee of the League of Nations took action to prevent further perversions of the model convention.⁷⁶ The Fiscal Committee sought to accomplish this through narrowing the definition of a permanent

establishment.⁷⁷ By 1930, the Fiscal Committee would adopt a permanent establishment definition that excluded both foreign subsidiaries and representatives that had no authority to bind the corporate parent.⁷⁸ A subsequent report by the Fiscal Committee confirmed this definition of permanent establishment in 1933.⁷⁹

In 1935, the League promulgated a revised Draft Model Treaty that further entrenched the principles of worldwide taxation.⁸⁰ The 1935 Draft Model Treaty was a confluence of three principles.⁸¹ First, it reaffirmed the definition of permanent establishment as excluding subsidiaries and independent agents.⁸² Second, when allocating profits between source countries and countries of residence, the source country may reach only profits from the operations within its country and not profits from the entire corporate structure.⁸³ Third, withholding taxes on source-based royalties were eliminated.⁸⁴ Together, these principles removed nearly all vestiges of territoriality from mainstream international taxation theory.⁸⁵ The exploitative practices employed by MNCs in developing countries had received ratification by the League of Nations.⁸⁶

e. Territorial Gains

With worldwide taxation at the height of its popularity, the problem of homeless income continued unabated.⁸⁷ Realizing that the laudable goal of preventing double taxation was being usurped by MNCs to create homeless income, the Assembly of the League of Nations charged the Fiscal Committee to address what the Assembly referred to as “fiscal fraud.”⁸⁸ In response, the Fiscal Committee admitted that eliminating homeless income had never previously been a high priority in their international tax analyses.⁸⁹ Nonetheless, the Fiscal Committee offered no solutions to the problem of homeless income other than suggesting that individual countries take independent action to combat “fiscal fraud.”⁹⁰ Although it was clear that without action the

problem of homeless income would continue unabated, the independent action recommended by the Fiscal Committee was met with nothing more than a lukewarm response from the members of the League of Nations.⁹¹

Change often only occurs out of necessity and this was no exception. The problem of homeless provoked a tectonic shift in the prevailing attitude towards territorial taxation. As World War II raged, the Fiscal Committee of the League of Nations permitted a subcommittee to explore possible changes to the 1935 Revised Draft Model Treaty.⁹² This subcommittee contained representatives from the developing countries of Latin America.⁹³ Tired of suffering under the bias against developing countries inherent in a worldwide system of taxation, the subcommittee firmly endorsed the concept of source-based taxation.⁹⁴ This endorsement directly contradicted the multi-decade policy of the League favoring worldwide taxation.⁹⁵

The subcommittee's findings became known as the 1943 Mexico Model Treaty after the country in which the bulk of the subcommittee's meetings took place.⁹⁶ The subcommittee argued that territorial taxation was the sole method of effectively dealing with the problem of homeless income.⁹⁷ Territoriality would be achieved through the adoption of two provisions: "(1) [p]rimary taxing authority over interest, dividends, royalties, and annuities was given to the source country, not the country of residence" and "(2) [a] nonresident entity's business profits that are not attributable to a PE [permanent establishment] were subject to source country taxation if the activities in the source country were more than isolated or occasional."⁹⁸

Unsurprisingly, the revolutionary proposals contained in the 1943 Mexico Model Treaty were not embraced by the Fiscal Committee.⁹⁹ But the subcommittee's work did prompt the Fiscal Committee to develop their own revised convention known as the 1946 London Model Convention.¹⁰⁰ Like the 1946 Mexico Model Treaty, the 1946 London Model Convention was

based on two principles.¹⁰¹ First, the taxation of interest, dividends, annuities, and royalties derived from commercial, scientific, and industrial property would remain the prerogative of the country of residence.¹⁰² Second, an MNC's profits were only subject to source-based taxation if it had a permanent establishment.¹⁰³ The 1946 London Model Convention defined a permanent establishment only as a fixed place of business or an agent that was authorized to make binding decisions on behalf of the parent corporation.¹⁰⁴

Once again the Fiscal Commission failed to address the problem of homeless income other than reaffirming its belief that homeless income was a problem of tax administration and not a side effect of worldwide taxation.¹⁰⁵ The Fiscal Committee maintained that the problem would be solved only if individual countries took independent action to address the problem.¹⁰⁶

Despite the Fiscal Commission's ultimate rejection of the 1943 Mexico Model Treaty, the subcommittee's work left an indelible impression on the international taxation debate.¹⁰⁷ The Fiscal Committee was forced to acknowledge that there was a demand for territorial taxation among developing countries.¹⁰⁸ Even after reaffirming worldwide taxation in the 1946 London Model Convention, the Fiscal Committee understood that territoriality would persist as the preference for countries akin to those on the subcommittee.¹⁰⁹

f. Modern Developments

In 1951, the International Chamber of Commerce (ICC), an international business organization, examined the festering issue of homeless income.¹¹⁰ The ICC report advocated treating countries in which MNCs located holding companies as countries of residence even if those countries did not have income taxes.¹¹¹ Instead of trying to eliminate the problem of homeless income, the ICC report sought to perpetuate it.¹¹² This reflected the ICC's recognition that the international business community had come to rely on homeless income.¹¹³

By 1967, the United Nations (UN), the successor organization to the now-defunct League of Nations, sought to explore new ways of handling cross-border taxation.¹¹⁴ The UN's Economic and Social Council requested that the UN secretary-general appoint a working group of experts from both developed and developing countries to tackle the issue.¹¹⁵ Thus, the Ad Hoc Group of Experts on International Tax Cooperation in Tax Matters was born.¹¹⁶

The Ad Hoc Group would issue a number of reports between 1969 and 1980.¹¹⁷ At first, the Ad Hoc group was reluctant to make any major changes to the prevailing preference for worldwide taxation other than expanding the definition of permanent establishment to allow developing nations to enjoy more tax revenue from MNCs.¹¹⁸ This changed somewhat in the early 1970s when the Ad Hoc Group endorsed the idea of allowing source countries to apply a gross withholding tax on interest.¹¹⁹ This further chipped away at worldwide taxation.

Despite decades of pro-worldwide advocacy from the League of Nations and the UN, recent decades have seen a marked increase in the number of countries with a territorial tax system.¹²⁰ Among the highly industrialized economies that form the Organization for Economic Co-operation and Development (OECD), the number with territorial systems has doubled since the beginning of this century.¹²¹ In fact, the United States is among only six OECD countries that maintains a worldwide system.¹²² Moreover, of all the OECD members that have switched international tax systems since World War II, none currently use a worldwide system.¹²³

C. Competitive Disadvantage

U.S. policymakers are well aware that the foreign income of American citizens and corporations is subject to double taxation. To mitigate this problem, Congress has created a byzantine and labyrinthine system of deductions, credits, deferrals, and exclusions. The most important of these are the aforementioned foreign tax credit and the rules regarding deferral.

The foreign affiliates of U.S. corporations are generally structured as branches or subsidiaries.¹²⁴ Branches have no separate foreign incorporation and their income is immediately subject to U.S. taxes.¹²⁵ Subsidiaries are foreign affiliates that are separately incorporated in a foreign country.¹²⁶ Most subsidiaries are Controlled Foreign Corporations (CFCs), subsidiaries that are more than 50% owned by American shareholders.¹²⁷ U.S. taxes on CFCs are what is known as “deferred,” meaning CFC profits remain untaxed until they are repatriated back to the U.S.¹²⁸

The ability of American corporations to use the deferral process to their advantage is circumscribed by layers of anti-deferral rules known “subpart F” rules because they are enumerated in subpart F of subchapter N of the Internal Revenue Code (IRC).¹²⁹ For example, the passive income (dividends and interest) of CFCs and CFC income from transaction with third party countries is immediately subject to U.S. taxes.¹³⁰ These and other provisions greatly increase the tax compliance costs for citizens and corporations in worldwide tax systems. In fact, 46% of federal tax compliance costs for *Fortune* 500 companies emanated from such laws and regulations regarding foreign income.¹³¹

Despite contrary arguments from proponents of the worldwide system, worldwide taxation does not insulate American corporations from overseas competition. Under the current system, if American, Irish, and Dutch firms were all bidding for an investment opportunity in Ireland, the Irish and Dutch firms would only be subject to the 12.5% Irish corporate income tax. The American firm would owe the same 12.5% to the Irish government and an additional 22.5% to the American government to account for the difference between the 35% American rate and the 12.5% Irish rate which would be ineligible for the foreign tax credit.¹³² Perhaps other factors would allow the American firm to underbid the others regardless of the added tax liability, but it

certainly puts the other firms at a comparative advantage vis-à-vis tax considerations. With over 90% of non-American OECD-based *Forbes* 500 companies located in territorial tax jurisdictions, American corporations are engaging their competitors with one hand tied behind their backs.¹³³

III. POSSIBLE SOLUTIONS

A. *The Camp Proposal*

In the last decade, the “adoption of a territorial tax system has been recommended by the President’s Advisory Panel on Federal Tax Reform (2005), the co-chairs of the National Commission on Fiscal Responsibility and Reform (“Bowles-Simpson” Commission, 2010), the President’s Export Council (2010), . . . [and] the President’s Council on Science and Technology (2011).”¹³⁴ In response to such recommendations, Congressman Dave Camp (R-MI), Chairman of the House Ways and Means Committee, released a proposal for the adoption of a territorial system in October 2011.¹³⁵ A companion, though not quite identical, proposal was released by Senator Mike Enzi (R-WY) of the Senate Finance Committee in February 2012.¹³⁶

Chairman Camp’s proposal would exempt 95% of foreign corporate profits from U.S. taxation.¹³⁷ Additionally, a transition tax of 5.25% would be immediately applied to the \$1.4 trillion of existing deferred foreign income.¹³⁸ Branches would be treated as CFCs, as would subsidiaries with Americans owning at least 10% of shares under certain circumstances.¹³⁹ Other provisions are designed to prevent base erosion and profit shifting (BEPS) by limiting or eliminating the exemption from U.S. taxes for interest and certain highly-mobile intangible assets.¹⁴⁰

Chairman Camp’s proposal bars credits and deductions for foreign taxes for any dividend that is already eligible for the dividends received deduction.¹⁴¹ The dividends received deduction merely allows corporate shareholders to deduct dividends on shares the corporation

owns in another corporation.¹⁴² Included in this are withholding taxes levied by foreign governments on dividend distributions previously taxed under subpart F.¹⁴³ This is a component of Chairman Camp's overall reform of the foreign tax credit apparatus.¹⁴⁴

Gains realized by American shareholders from sales of stock in a qualified foreign corporation would also be eligible for the 95% exemption if certain requirements are met.¹⁴⁵ However, if American shareholders realize losses from such a sale, those losses cannot be deducted from U.S. taxes.¹⁴⁶ A qualified foreign corporation is defined as a foreign corporation with dividend distributions that are eligible for the dividends received deduction.¹⁴⁷ Additionally, a qualified foreign corporation must also meet an active asset standard requiring 70 percent of corporate assets to be active over the previous three years.¹⁴⁸

Chairman Camp's proposal makes only minor changes to subpart F, indicating his proposed base-erosion rules would not replace subpart F but co-exist with subpart F.¹⁴⁹ One base erosion option creates a new category of subpart F income for sales that entail moving intangible income from the U.S. to a foreign country.¹⁵⁰ Income derived "from the use, consumption, or disposition of property in the CFC's country of incorporation or income from services performed in that country" would not be included.¹⁵¹

Alternatively, the Camp proposal contains a standard CFC rule.¹⁵² This applies U.S. taxation to "income earned by a CFC that is not derived from the conduct of an active trade or business in the home country of the CFC and is not subject to a 10 percent effective rate of foreign tax."¹⁵³ Such CFC rules are common among nations with territorial tax systems.¹⁵⁴

A third base-erosion option presented by the Camp proposal involves the creation of a foreign income called "foreign base company intangible income."¹⁵⁵ Foreign base company intangible income is simply a CFC's intangible income.¹⁵⁶ Intangible income is defined in the

Chairman Camp proposal as anything that has substantial value “independent of the services of any individual” such as copyrights, trademarks, and patents.¹⁵⁷

Under the Camp proposal, foreign base company intangible income is excluded from subpart F only if it is subject to a foreign effective tax rate less than or equal to 13.5 percent.¹⁵⁸ This limits the ability of American MNCs to elude U.S. taxes. Additionally, interest deductions would be limited to curb the practice of using debt to generate tax-exempt income.¹⁵⁹

B. The Enzi Proposal

Senator Enzi’s proposal modifies Chairman Camp’s proposal in ways friendlier to American MNCs.¹⁶⁰ Included among these are a 95 percent dividends received deduction for “qualified foreign-source dividends from a CFC.”¹⁶¹ Qualified foreign income is defined as income that is “not effectively connected with a U.S. business or received from an 80-percent-owned U.S. corporation.”¹⁶² These dividends would be subject to an effective tax rate of no more than 1.75 percent.¹⁶³

Additionally, the Enzi proposal differs from the Camp proposal in that it does not exempt income from the foreign branches of an American corporation.¹⁶⁴ Instead, each American corporation is provided a deduction amounting to 50 percent of its yearly qualified foreign income.¹⁶⁵ Qualified foreign income is “all intangible income derived . . . through U.S. business activity in connection with property sold, leased, licensed, or transferred in any way for use, consumption, or disposition outside the United States, or through U.S. business activity in connection with services provided for persons or property located outside the United States.”¹⁶⁶ This provision subsidizes the foreign use of domestically-developed intangibles by American MNCs.¹⁶⁷

Senator Enzi's draft calls for the replacement of subpart F anti-deferral rules with a "low-taxed-income test."¹⁶⁸ If any non-qualified business income is not subject to an effective foreign tax rate above half the U.S. corporate tax rate it would be subject to taxation under subpart F.¹⁶⁹ Qualified business income is defined as income from business operations in a foreign country where the business has a fixed permanent residence that is substantially related to business operations in that country.¹⁷⁰ Both the low-taxed-income test and determinations regarding qualified business income would be conducted on a country-by-country basis.¹⁷¹

Senator Enzi proposes a separate limitation of foreign tax credits for foreign taxes on intangible foreign earnings.¹⁷² Additionally, export sales would be treated as U.S.-source income for the purposes of the foreign tax credit limitation.¹⁷³ Subpart F would also be tweaked by making permanent the exceptions for active finance and active insurance.¹⁷⁴

Contrary to Chairman Camp's proposal, Senator Enzi's proposal would allow, but not require, a one-time election regarding the accumulated deferred foreign earnings of a CFC.¹⁷⁵ This income would be subject to an effective tax rate of no more than 10.5 percent.¹⁷⁶ While each CFC is allowed to make a separate election, the taxable portion may not be reduced by foreign tax credits, which is also a provision that is not included in Chairman Camp's proposal.¹⁷⁷ The Enzi proposal would allow taxes on increased subpart F income to be paid in no more than eight annual installments.¹⁷⁸

In order to avoid untaxed pre-effective-date earnings ineligible for the Enzi proposal's 95 percent dividends received deduction, a corporation must make the election for accumulated foreign income during the first year the corporation receives CFC treatment.¹⁷⁹ As a result, a rule for post-effective-date distributions is a necessity.¹⁸⁰ These dividend distributions will be

eligible for foreign tax credits only if American corporations pay the dividends to American shareholders.¹⁸¹

B. 2005 Repatriation Tax Holiday

Until the United States adopts a territorial tax system, the benefits such a system would yield remain in the realm of conjecture no matter how informed the prognostications. However, the results of a recent experiment are encouraging.

In 2004, Congressman Phil English (R-PA) successfully persuaded Congress to insert a provision into the American Jobs Creation Act that allowed American corporations to repatriate their foreign income subject to a super low 5.25% income tax rate for one year (2005).¹⁸² This yielded in excess of \$275 billion in foreign repatriations.¹⁸³ The Treasury's cut amounted to \$17 billion in additional corporate taxes for fiscal years (FY) 2005-06.¹⁸⁴ This represented an increase of \$16.4 billion in two years over what the Joint Committee on Taxation (JCT) estimated for the same period and a \$20.2 billion increase over JCT's predicted \$3.2 billion loss in corporate tax revenue over 10 years.¹⁸⁵ These numbers also fail to account for the increase in other federal taxes that accompanied \$275 billion in new investment.¹⁸⁶

The effect that the tax holiday had on encouraging repatriation was even greater than the effect on the exchequer. For the first time since the records began in 1952, foreign earnings retained abroad were negative during the latter half of FY2005.¹⁸⁷ The amount of foreign income held overseas declined by a combined \$142.9 billion during the third and fourth quarters of FY2005.¹⁸⁸

It is important to note that these were the results of a one-time tax holiday that reduced the corporate income tax rate from 35% to 5.25%. It goes to reason that the increase in repatriations would increase substantially if all or nearly all foreign earnings were permanently exempt from U.S. taxes as is characteristic of a territorial tax system.

IV. DISCOURAGING CAPITAL FLIGHT

Proponents of maintaining the current worldwide system insist that shifting to a territorial system will exacerbate BEPS.¹⁸⁹ While discouraging such behavior will always remain a concern for policymakers, there are reasons to believe that adopting a territorial system will not result in any large scale hemorrhaging of capital.

A. Anti-Inversion Rules

An inversion occurs when a corporate parent moves from one country to another.¹⁹⁰ Most inversions entail a two-step process of corporate reorganization.¹⁹¹ First, the shareholders of the parent corporation exchange their stock for stock in newly incorporated foreign subsidiary.¹⁹² This step removes corporate parenthood from the American corporation and places it in the foreign subsidiary.¹⁹³ However, the corporate entity as a whole remains subject to subpart F anti-deferral rules if the American corporation remains a part of the corporate structure.¹⁹⁴ Therefore, the second step of an inversion is liquidating the American corporation.¹⁹⁵ Corporate inversions are often used as a strategy to lessen the corporation's tax burden.¹⁹⁶

Corporate inversions are taxed by the federal government.¹⁹⁷ This is justified on equitable grounds.¹⁹⁸ American multinational corporations have benefitted from their U.S. residence through the enjoyment of property rights, limited liability, and other amenities.¹⁹⁹

Therefore, IRC § 367(a) makes gains from stock transfers to related foreign corporations immediately taxable unless stringent regulations are met.²⁰⁰ This serves to make corporate inversions costly.

To avoid the high cost of inversion, corporate planners have sought ways to circumnavigate the rules.²⁰¹ Federal regulators were alarmed when the publicly-traded American personal care products manufacturer Helen of Troy, Ltd. inverted to Bermuda in 1994.²⁰² Helen of Troy's clever use of a Bermuda-based holding company to skirt U.S. tax liability for both the corporation and its shareholders particularly troubled policymakers.²⁰³ In response, the U.S. Treasury Department adopted regulations between 1994-96 bringing Helen-of-Troy-style reorganizations under the U.S. tax net.²⁰⁴ These regulations expanded the definition of a taxable stock transfer and curtailed the acquisition of American corporations by small or asset-less "shell" corporations abroad.²⁰⁵ This has further limited the ability of corporations to expatriate without experiencing significant financial pain.²⁰⁶

B. CFC Rules

Capital flight is furthered discouraged by the proliferation of CFC rules in countries with territorial systems.²⁰⁷ Generally, CFC rules exclude from the general foreign income exemption income that is both highly mobile and not subject to taxation in the foreign country.²⁰⁸ In other words, only income that has real presence in a foreign country, a discernible purpose (other than tax avoidance) for being there, and a substantial tax burden enjoys the benefits of territoriality.²⁰⁹ This greatly limits the abuses of the territorial system without eliminating the benefits of such a system.²¹⁰

Such barriers to tax avoidance are included in the Camp-Enzi proposal.²¹¹ Specifically, Camp-Enzi calls for the exclusion of CFC income that is not tethered to a foreign location and

subject to an effective tax rate under 10% from the general territorial exemption.²¹² This provision is analogous to CFC provisions in dozens of other countries.²¹³

C. Service-Based Economy

As economies advance and populations become wealthier, the demand for various services increases.²¹⁴ Naturally, the service sector comes to account for a greater and greater share of total output.²¹⁵ Today, services account for 70% of total output in OECD countries.²¹⁶ This development places intrinsic limits on BEPS.

If the U.S. were to adopt a territorial tax system, income earned in the U.S. would still be subject to U.S. taxation. The markets for services are relatively immobile as most services require service providers to have some contact with whom they serve.²¹⁷ Therefore, most service industry MNCs require some permanent establishment in the markets that they serve.²¹⁸ As the United States remains the world's largest consumer market, it goes to reason that a shift to a territorial system will not deter service industry MNCs from seeking American customers.

It is also important to consider the remarkable reversal that has occurred since the end of World War II regarding the developed and the developing worlds. For decades, developed countries advocated for worldwide taxation because they were net capital exporters.²¹⁹ This allowed developed to reap the tax benefit from the foreign operations of MNCs headquartered in their country.²²⁰ Naturally, developing countries objected to this as it deprived them of tax revenue from operations within their borders.²²¹

During the last half of the twentieth century, the United States shifted from a net capital exporter to a net capital importer.²²² The irony is completed by the companion shift of many developing countries to net capital exporters over the same period.²²³ The result of this reversal of fortune is that MNCs headquartered in developing countries are now coming to the United

States and other developed countries in search of investment opportunities.²²⁴ Therefore, the same worldwide system that used to disadvantage developing countries now disadvantages the United States.²²⁵ Most other developed countries, including Great Britain, the great imperial power of the past, have adapted to this phenomenon by shifting to a territorial system of taxation.²²⁶

V. CONCLUSION

Macroeconomic events over the last half century have made the worldwide system of international taxation increasingly untenable.²²⁷ The theory of capital export neutrality has seen its time come and go.²²⁸ Consequently, the number of nations that employ worldwide systems of taxation has fallen precipitously since its mid-century apogee.²²⁹ After decades of rejection, the age of territoriality has arrived.

In light of these developments, the United States should adopt a territorial system of international taxation. The United States of America is an exceptional nation and Americans have traditionally prided themselves on their outlier status. However, there is no need to inflict unnecessary hardship on American individuals and businesses for sole purpose of maintaining national pride. Uniqueness for its own sake is not a virtue. And conformity out of self-interest is not a vice.

The fact that American citizens and corporations are subject to double taxation under the current worldwide system is not disputed.²³⁰ In fact, the array of deductions, credits, deferrals, and exclusions exists to remedy this very problem. Like most solutions that mitigate the symptoms of a problem rather than attack the cause, this remedy causes problems of its own. Instead of diverting resources that would have gone to Uncle Sam through the double taxation of foreign earning into productive activities, it merely forces an inordinate amount of resources into

the unproductivity activity of tax compliance. Johnny Depp may not have described this phenomena using terms of art but he undoubtedly understood it.²³¹

Nor does adhering to a worldwide system improve American economic competitiveness.²³² In recent decades, the number of America's competitors located in territorial tax systems has increased dramatically.²³³ However, corporate tax revenue has remained remarkably stable throughout the OECD in the face of such a pronounced and one-sided shift.²³⁴ This betrays the presence of incentives discouraging capital flight. Similar or greater incentives either exist or could one day exist in the United States. In economics, there are no benefits without costs, but a shift to a territorial tax system would maximize the former and minimize the latter.

END NOTES

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⁵ Decca Aitkenhead, *Johnny Depp: 'I'm not ready to give up my American citizenship,'* THE GUARDIAN, Nov. 6, 2011, <http://www.theguardian.com/film/2011/nov/06/johnny-depp-interview-rum-diary>.

⁶ *Id.*

⁷ *Id.*

⁸ It is interesting to note that Depp did not opt to simply renounce his citizenship. This suggests that there are nontax incentives to remain a United States citizen. It goes to reason that the greater the nontax incentives for maintaining United States citizenship, the less tax considerations would determine a taxpayer's choice of citizenship or a corporation's decision as to where to incorporate.

⁹ *Id.*

¹⁰ Kevin D. Williamson, *The Helvetica Type*, NAT'L REV., Sept. 16, 2013, at 35.

¹¹ Michael S. Knoll, *Business Taxes and International Competitiveness*, U. PA. INST. FOR LAW & ECON. NO. 8-12, 8, (2008), http://scholarship.lw.upenn.edu/faculty_scholarship/212.

¹² *Id.*

¹³ *Id.*

¹⁴ Although Depp's story illustrates the impact a worldwide tax system has on individuals, it is not dissimilar from the economic pressures such a system places on corporations. To the extent that the discussion from this point forward leans toward corporate-centric issues is merely a

reflection of where the concerns of anti-territoriality critics lay and a recognition of the fact that territorial systems for individuals are far less numerous than territorial systems for corporations.

See The 2011 global executive, ERNST & YOUNG 1, 3-1360 (Aug. 2011),

[http://www.ey.com/Publication/vwLUAssets/Global_Executive_2011/\\$FILE/GE_2011_Global_Executive.pdf](http://www.ey.com/Publication/vwLUAssets/Global_Executive_2011/$FILE/GE_2011_Global_Executive.pdf).

¹⁵ *Id.* at note 33.

¹⁶ Chris Edwards & Veronique de Rugy, *International Tax Competition: A 21st-Century Restraint on Government*, CATO POL'Y ANALYSIS NO. 431 1, 14-15 (2002),

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¹⁷ *Id.* at 14.

¹⁸ *Id.* at 15.

¹⁹ *Id.* at 14-15.

²⁰ *Id.* at 16.

²¹ *Id.* at 15.

²² *Id.*

²³ *See* GROVER G. NORQUIST, LEAVE US ALONE 270 (2008).

²⁴ Edwards & de Rugy, *supra* note 14, at 15.

²⁵ Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535, 574 (2011),
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²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Evolution of Territorial Tax Systems in the OECD*, TECHCEOCOUNCIL.ORG E-2, (Apr. 2, 2013),
http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf.

³² Wells & Lowell, *supra* note 23, at 545.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at 545-46.

⁴¹ *Id.* at 546.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 547.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 548.

⁵¹ *Id.*

⁵² *Id.* 538.

⁵³ *Id.* at 548.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* at 548-49.

⁶³ *Id.* at 549.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* at 551.

⁶⁹ *Id.* at 552.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.* at 555.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* at 555-56.

⁷⁷ *Id.* at 556.

⁷⁸ *Id.*

⁷⁹ *Id.* at 557-58.

⁸⁰ *Id.* at 560.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* at 560-61.

⁸⁶ *Id.* at 561.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.* at 562.

⁹⁰ *Id.*

⁹¹ *Id.* at 562.

⁹² *Id.* at 563.

⁹³ *Id.* at 563-64.

⁹⁴ *Id.* at 564.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 564-65.

¹⁰³ *Id.* at 565.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 566.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at 567.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 569-73.

¹¹⁸ *Id.* at 568.

¹¹⁹ *Id.* at 571.

¹²⁰ *Evolution of Territorial Tax Systems in the OECD*, *supra* note 31, at 8.

¹²¹ *Id.* at E-1.

¹²² The others are Chile, Ireland, Israel, Mexico, and South Korea. *Id.* at E-3.

¹²³ *Id.*

¹²⁴ Edwards & de Ruyg, *supra* note 14, at 15.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* at 14-15.

¹²⁹ Elizabeth Chorvat, *You Can't Take It With You: Behavioral Finance and Corporate Expatriations*, 37 U.C. DAVIS L. REV. 453, 465-66 (2003-04),
http://lawreview.law.ucdavis.edu/issues/37/2/articles/DavisVol37No2_Chorvat.pdf.

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¹⁴² I.R.C. § 245.

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¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 4.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 5.

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 5-6.

¹⁷¹ *Id.* at 6.

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

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¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² Norquist, *supra* note 21, at 271.

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¹⁸⁴ *Id.* at 272.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 271

¹⁸⁸ *Id.*

¹⁸⁹ Sloan & Rubin, *supra* note 43.

¹⁹⁰ Chorvat, *supra* note 35, at 469.

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 471.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.* at 473-74.

²⁰¹ *Id.* at 474.

²⁰² *Id.*

²⁰³ *Id.* at 474-75.

²⁰⁴ *Id.* at 475.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 476.

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²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

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²¹⁸ *Id.*

²¹⁹ Wells & Lowell, *supra* note 23, at 548.

²²⁰ *Id.*

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²²² *Id.* at 603.

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

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²³⁴ Avi-Yonah, *supra* note 72.