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Gauging the Relative Winners and Losers of Trump's Move to a Territorial System of International Taxation

President Trump released the outline of his tax reform plan on April 26. It was the first time his administration explicitly proposed moving to a territorial system of taxing business income so that, going forward, the foreign profits of U.S. multinationals could come back to the United States free of U.S. tax.[1]

While "territorial" sounds great for businesses competing in a worldwide economy, Trump was silent on a critical aspect of such a reform. A move to territoriality requires rules to prevent the now smaller tax base from further erosion. Those rules have historically been highly controversial—with the various options profoundly affecting some industries much more than others. Such rules are inevitable, and Treasury Secretary Steven Mnuchin acknowledged as much to a *Wall Street Journal* reporter.[2]

There are three primary ways in which Trump could fortify a territorial tax base:

- **implement a feature like Option C from Dave Camp's Tax Reform Act of 2014**
- **impose a minimum tax (similar to President Obama's) or a blacklist**
- **institute a border adjustment and move to a destination-based cash flow tax.**

Each of these will have very different sets of winners and losers. However, keep in mind that, if the Trump administration is able to achieve a business tax rate closer to 15 percent—something that will require significant offsets[3] if it plans to pass the legislation with only a majority vote in the Senate—most businesses will be winners. So, the following identifications of winners and losers are very much relative:

1) OPTION C IN CAMP'S TERRITORIAL

Trump's territorial proposal would make the United States' tax system more like those of its trading partners by reducing the size of the business tax net. However, without rules to shore up some of the biggest holes, such a move would cause a significant loss of revenue for the federal government, since it would amplify profit shifting that would enable highly mobile intangible income to escape the tax net.

No country has a pure territorial system,[4] but, if the United States were to stop taxing the dividends from active earnings that a foreign subsidiary makes to its U.S. parent company, it could reduce the so-

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[1] https://www.whitehouse.gov/the-press-office/2017/04/26/briefing-secretary-treasury-steven-mnuchin-and-director-national.

[2] https://twitter.com/RichardRubinDC?ref_src=twsrc%5Egoogle%7Ctwcamp%5Eserp%7Ctwgr%5Eauthor.

[3] On April 25, 2017, the Joint Committee on Taxation wrote that cutting the corporate tax rate from 35 percent to 20 percent for only three years would create a "nonnegligible revenue loss" in the second decade, meaning that a rate cut could pose a challenge to passing the bill using reconciliation (http://www.politico.com/f/?id=0000015b-a645-d0b0-afdb-b7c7e71d0001).

[4] Altshuler, Rosanne; Stephen Shay and Eric Toder, January 21, 2015, "Lessons the United States Can Learn From Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," *Tax Policy Center.*

called lockout effect, which has caused so much foreign-source cash to accumulate offshore. When tax experts talk about a territorial system, they often mean dividend exemption (or participation exemption).

Camp's comprehensive tax reform bill called for a move to territorial by way of a dividend-exemption system. Camp would have lowered the top corporate income tax rate to 25 percent (phased in over a period of five years) and would have exempted from U.S. tax 95 percent of all (largely active) foreign-source income of U.S. multinationals (designed as a deduction equal to 95 percent of foreign-source dividends). The 5 percent that remained taxed was "intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income."[5]

To address base-erosion concerns, Camp proposed a feature that tax wonks refer to as Option C, because that is how it was identified in the tax reform discussion draft released in 2011.[6] Option C would tax foreign-affiliate intangible income at higher rates immediately, whether or not it is repatriated. Camp's proposal added a new category of income to the Subpart F rules, which disallow deferral for certain passive income. So-called foreign base company intangible income would effectively be subject to a minimum tax rate of 15 percent on intangible income earned by the U.S. parent from exports and a rate of 25 percent on intangible income earned by the foreign affiliate from imports while providing an exemption for the normal returns on investments in tangible property.

OPTION C BASE EROSION MEASURE	
Relative Winners	**Relative Losers**
The formulary approach used to calculate the tax due under Option C benefits foreign affiliates that own tangible property with a high adjusted basis.	Companies with a lot of foreign-affiliate intangible income taxed currently at rates under 25 percent, especially manufacturing,[7] pharma, tech and services firms[8]

Camp also proposed a thin-cap rule to address concerns that companies would locate debt in the United States, using interest expense deductions to lower their U.S. tax bills. If the debt-level of the U.S. parent

(http://www.taxpolicycenter.org/publications/lessons-united-states-can-learn-other-countries-territorial-systems-taxing-income/full).

[5] July 2015, "The International Tax Bipartisan Tax Working Group Report," *United States Senate Committee on Finance* (https://www.finance.senate.gov/download/the-international-tax-bipartisan-tax-working-group-report) page 56.

[6] A technical explanation of the original Option C starts on page 34 of http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_--_Ways_and_Means_Participation_Exemption_Discussion_Draft.pdf; for the final version, which involves a "significant refinement" from the 2011 version, see section 4211 starting on page 149 of the section-by-section summary, https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf.

[7] The National Association of Manufacturers wrote that "the use of intangible property in the conduct of a global business, and the derivation of income necessarily attributable, in part, to such property, represents one of the key exports of the U.S. economy. Rather than taxing current income from intellectual property used outside the United States for the conduct of active business operations, U.S. tax policy should promote the U.S.-based development of intellectual property and the use of that property outside the United States". (http://www.nam.org/Issues/Tax-and-Budget/NAM-Comments-on-Rep_-Camp-s-Internaitonal-Tax-Reform-Discussion-Draft/).

[8] https://www.finance.senate.gov/imo/media/doc/Tax%20Innovation%20Equality%20Coalition%20(TIE%20Coalition).pdf.

is more than 110 percent of its worldwide affiliated group or the parent's net interest expense is more than 40 percent of its adjusted taxable income, then interest expense will be disallowed.

It is important to remember that, because so little foreign-source income is taxed today,[9] and because a move to territoriality will require anti-base-erosion rules, Camp's international reforms did not lose much revenue. The 95 percent deduction for dividends stemming from foreign-source income was estimated to cost $212 billion over 10 years. However, the anti-base-erosion protections for passive and mobile income somewhat offset the cost of the participation exemption system by raising $121 billion.[10]

2) MINIMUM TAX OR BLACKLIST

Because Option C would not require multinationals to identify what portion of their income is attributable to intangibles, but is applied using a rough justice formula approach, the Trump administration may decide that a better way to prevent firms from engaging in tax-motivated planning, given the smaller tax net, would be to institute a minimum tax or a blacklist.

A minimum tax is a middle ground between repealing deferral, which would tax all foreign-source earnings currently by the United States at 35 percent, and going pure territorial, which would exempt all foreign-source earnings, whether active or passive, from any U.S. tax. In his fiscal 2016 budget, Obama basically proposed taxing all foreign earnings at 19 percent, whether they were repatriated or not.

However, the fine print of Obama's proposal would actually impose a minimum tax at a rate that is usually less than 19 percent, because it allowed a reduction to take into account a portion (85 percent) of the effective foreign tax rate of the company over the past 60 months. If a firm had a 12.5 percent effective tax rate in the foreign jurisdiction in the past (in Ireland, for example), then it would owe only 8.375 percent U.S. tax on its Irish income (because 19 percent - (85 percent of 12.5 percent) = 8.375 percent). For a jurisdiction with a 0 rate of tax (Bermuda, for example), the firm would owe the full 19 percent.

Obama's minimum tax proposal contains an added feature—the allowance for corporate equity (ACE)—which essentially exempts from the minimum tax an amount equal to the "risk-free return on equity invested in active assets" in a foreign country. It was provided in response to the increasingly generous benefits offered by other countries to attract businesses.

On the other hand, a blacklist would effectively repeal deferral (requiring the current taxation of foreign earnings) for only income earned in particular jurisdictions (generally in tax havens like Bermuda).

[9] In 2013, researchers estimated that U.S. multinationals paid U.S. tax on less than 4 percent of their foreign-source income. (See Rosanne Altshuler, Stephen Shay and Eric Toder, January 21, 2015, "Lessons the United States Can Learn From Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," *Tax Policy Center* at http://www.taxpolicycenter.org/publications/lessons-united-states-can-learn-other-countries-territorial-systems-taxing-income/full, page 21).

[10] November 18, 2014, "Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code (JCS-1-14)," *Joint Committee on Taxation*, (https://www.jct.gov/publications.html?func=startdown&id=4674) pages 650-651.

MINIMUM TAX BASE EROSION MEASURE	
Relative Winners	**Relative Losers**
Purely domestic firms that compete with U.S. multinationals that generate profits in low-tax countries	Multinationals that generate profits (by way of production or intellectual property payments) in jurisdictions with a tax rate lower than the minimum, especially manufacturers like pharma and electronics[11]

While both a minimum tax and a blacklist would serve to protect the U.S. tax base in their own ways, depending on the various designs of each, the minimum tax has the potential to raise significant revenue in the process. In his 1998 *Tax Notes* article "Deferred Gratification: A More Rational Approach for Taxing Multinationals," Stuart Leblang explained that a minimum tax would "allow both U.S. multinationals and the U.S. Treasury to derive substantial benefit from a reduction in foreign taxes."[12]

To understand why, consider that under Obama's per-country minimum tax proposal, the 85 percent foreign effective tax rate allowance gives U.S. multinationals an incentive to engage in planning opportunities to reduce their foreign taxes below the 19 percent rate. A blacklist would offer no similar incentive. Leblang noted that Obama's minimum tax (or minimum distribution) proposal would explicitly repeal the portion of the Subpart F rules that relate to active foreign income, meaning that "U.S.-owned businesses could therefore shift income and activities among foreign jurisdictions without being influenced by a potential loss of U.S. tax deferral benefits."

Obama's proposal contains a number of base-erosion provisions, including disallowing deductions for interest expense allocable to foreign-source income that did not give rise to any U.S. tax and doing away with the ability of U.S. multinationals to use cross-crediting to reduce the taxes on royalty income (which is sourced based on where the related property is used), taxing those payments at the full corporate rate (now 35 percent). Obama's minimum tax with its ACE feature was scored at generating $350 billion over 10 years.[13] If all of the anti-base-erosion provisions are taken into account, Obama's international reforms were scored to generate a sizable $484 billion in revenue over 10 years.

3) DESTINATION-BASED BORDER ADJUSTMENT

House Republicans' destination-based cash flow tax (DBCFT) would be a more radical way to provide what amounts to pure territoriality for businesses. It would reduce the tax rate on all foreign-source income to zero, something no option above can claim. Because it transforms the United States' system of taxation from a source-based income tax (one that cares about the "citizenship" of the business

[11] http://www.law.uchicago.edu/files/file/minimum_tax_draft_paper_rev.pdf.

[12] Leblang, Stuart, December 14, 1998, "Deferred Gratification: A More Rational Approach for Taxing Multinationals," *Tax Notes*, Doc 98-36753.

[13] February 2016, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals" Department of the Treasury (https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf).

earning the income) to a destination-based consumption tax (one that cares about only where the business's goods and services are sold), it would be the simplest way to protect from base erosion.

Although most people do not think of the border adjustment, which is described as a tax on imports and a subsidy for exports, as a base erosion measure, that is exactly what it is. In reviewing different international reform options, the Tax Policy Center praised destination-based border adjustments for their ability to "eliminate incentives under the U.S. corporate income tax for firms to invest and report income overseas instead of at home and eliminate incentives for U.S. firms to 're-domicile' themselves as foreign-based firms."[14]

However, a border adjustment arguably could not be tacked onto our current system of taxation without a move to either a business cash flow tax or a value-added tax. Both are politically challenging, and the former would involve a move to full expensing and the denial of net interest expense deductions.

Economists who have studied what happens to trade and price levels when countries implement border-adjusted taxes have found empirical evidence[15] that the real exchange rate will adjust to fully offset the implementation of the tax on imports and exemption for exports (resulting in no net change to buying power or the trade balance).[16] Because of this, and because tax reform is expected to come with a significant reduction in the corporate tax rate from 35 percent to more like 15 or 20 percent, some of the industries that have been identified in the press[17] as major losers from a border adjustment—net importers such as retailers (especially of apparel and electronics)—should actually end up as winners.

BORDER ADJUSTMENT BASE EROSION MEASURE	
Relative Winners	**Relative Losers**
Nearly all businesses Possibly net exporters*	Companies that inverted or use aggressive transfer pricing techniques to reduce U.S. tax Possibly net importers*
*Absent a complete offset through nominal exchange rate adjustments, it is possible—especially in the short term—that importers will have to increase the prices of goods in order to account for the added tax, which, absent a corresponding wage increase, will result in losses, and importers will see a windfall.	

[14] http://www.taxpolicycenter.org/briefing-book/what-are-options-reforming-our-international-tax-system.

[15] Freund, Caroline and Joseph E. Gagnon, April 5, 2017, "Do Border Adjusted Taxes Affect Trade or the Exchange Rate?" *Peterson Institute for International Economics* (https://piie.com/blogs/trade-investment-policy-watch/do-border-adjusted-taxes-affect-trade-or-exchange-rate).

[16] Sullivan, Martin A., April 25, 2017, "Economic Analysis: Why Economists Believe the Blueprint Boosts the Dollar," *Tax Notes* (http://www.taxnotes.com/tax-reform/economic-analysis-why-economists-believe-blueprint-boosts-dollar).

[17] Jopson, Barney, December 14, 2016, "Republicans face corporate tax rebellion: Opponents from clothes makers to big retailers unite against a plan to penalise US importers," *The Financial Times* (https://www.ft.com/content/d80c483a-c18a-11e6-9bca-2b93a6856354).

Although Trump's tax reform outline did not mention a border adjustment feature, Mnuchin said at an event on April 26 that "there are many aspects of it we like. There are certain things that we're concerned about. . . . We don't think it works in its current form, and we're going to continue to have discussions . . . about revisions."[18] Border adjustments are estimated to increase government revenues from about $1.2 trillion in the first decade to about $1.7 trillion in the second decade.[19]

Transitioning to a New International Tax System

Trump is smart to propose a new system of international taxation,[20] but he will need to adopt anti-base-erosion rules like those outlined above to ensure that U.S. companies pay their fair share.

All of these alternatives, including moving to the DBCFT, would give lawmakers a chance to tax the foreign earnings that have accumulated untaxed offshore. Transitioning to a new international tax system effectively restarts the clock on how the United States treats foreign-source income and would give lawmakers the opportunity to apply a toll charge of sorts, deeming all previously untaxed earnings accumulated since 1986 as repatriated (whether or not companies actually want to bring them back) and taxing them at a discounted rate.

In repatriation, Camp would have taxed cash and cash equivalents at 8.75 percent and property, plant and equipment (which presumably would require liquidation in order to come up with the funds to pay for the tax) at 3.5 percent (which can be paid in installments over a period of eight years). This was scored at bringing in $170 billion in additional revenue over 10 years.[21] The DBCFT contemplates a similar deemed repatriation, which the Tax Foundation scored at bringing in $185 billion over 10 years, and the Tax Policy Center scored at bringing in $138 billion over 10 years.[22]

Obama, on the other hand, would have imposed a 14 percent tax on previously untaxed accumulated foreign earnings, generating an estimated $299 billion in additional revenue.[23]

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[18] https://www.c-span.org/video/?427555-3/treasury-secretary-mnuchin-promises-biggest-tax-cut-us-history.

[19] Pomerleau, Kyle, 2016, "Details and Analysis of the 2016 House Republican Tax Reform Plan," *Tax Foundation* (http://taxfoundation.org/article/details-and-analysis-2016-house-republican-tax-reform-plan); and James R. Nunns, Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, Benjamin R. Page, 2016, "An Analysis of the House GOP Tax Plan," *The Tax Policy Center* (http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full).

[20] Inversions are a sign that the competitiveness issues with the current system are real. The way the government has tried to stop inversions up until now has been by redefining what constitutes a U.S. corporation for tax purposes. Under current law, a corporation is considered to be a U.S. taxpayer if it is organized under the laws of a U.S. state or the District of Columbia. The United States taxes such corporations on their worldwide income, with exceptions including deferral. Foreign corporations are subject to U.S. corporate income tax on only the portion of their income that has a sufficient nexus to the United States. Congress enacted Section 7874 to address inversions (a U.S. parent corporation is acquired by, or merges into, a foreign corporation such that the resulting parent entity is no longer a U.S. taxpayer). To stop them, Section 7874 provides that, if the U.S. corporation's shareholders own 80 percent or more of the foreign corporation post-acquisition or merger, the foreign corporation will be deemed to be a U.S. corporation. Obama proposed reducing the ownership threshold to 50 percent.

[21] See Sections 4003 and 4201 of the Tax Reform Act of 2014.

[22] Pomerleau, Kyle, July 5, 2016, "Details and Analysis of the 2016 House Republican Tax Reform Plan, *The Tax Foundation* (https://taxfoundation.org/details-and-analysis-2016-house-republican-tax-reform-plan/) and James R. Nunns, Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, Benjamin R. Page, 2016, "An Analysis of the House GOP Tax Plan" (http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full).

[23] February 2016, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," Department of the Treasury (https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf).

Speaking at a press briefing April 26, Mnuchin declined to specify a tax rate for the deemed repatriation outlined in Trump's tax plan and declined to say whether the revenue would be spent on infrastructure (as was contemplated by both Camp and Obama) or tax cuts (reducing the corporate tax rate by about 2.5 percentage points).

As the administration and lawmakers spend the coming months sorting out the details of their tax plans, it is reassuring to know that there is consensus that the international tax system requires real reform. Action is needed as more U.S. multinationals are abandoning their U.S. citizenship, either of their own accord or as unwilling targets of foreign acquirers.[24]

Although lowering the corporate rate (Trump proposed a dramatic reduction from 35 percent to 15 percent) helps relieve some of the pressure to invert, the United States' more worldwide system of taxation is a major factor in a business's location decisions, resulting in "a significant loss of American jobs, business headquarters and tax revenues."[25] A move to territorial puts Trump in line with what Republican lawmakers have been working on for years. Comprehensive reform may be achievable.

[24] Foreign buyouts of U.S. firms had "the third year-over-year increase" in 2016. See Naso Chelsea, November 17, 2016, "Record U.S. Inbound M&A May Soon Face Headwinds," *Law360* (https://www.law360.com/articles/863135/record-us-inbound-m-a-may-soon-face-headwinds).

[25] https://www.hsgac.senate.gov/download/?id=2C48E3A3-AFBE-43CB-8F05-0996EAAFCDF7

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