A Worldwide Territorial System

by Kyle Rose

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This article was selected as a winning entry in *Tax Notes'* annual student writing competition.

In this article, the author discusses the basic rules for foreign taxation, including two new methods introduced by the Tax Cuts and Jobs Act: global intangible low-taxed income and the base erosion and antiabuse tax.

"We didn't think about it. Nobody thought about it. We just knew a lot of good things were going to happen."

So said President Trump about H.R. 1. That was his triumphant response when AT&T gave a one-time bonus to their employees, citing the beneficial effects of the Tax Cuts and Jobs Act (P.L. 115-97) as the reason.[1]

Over the 10-year budget window, the Joint Committee on Taxation has forecast (JCX-69-17) annual increases of 0.7 percent in GDP, 0.9 percent in capital available for production, 0.6 percent in the national employment rate, and 0.7 percent in consumption. It also predicted a reduction of net $385 billion for the conventional estimate of the $1.456 trillion budgetary loss by using Laffer curve assumptions arising from prior economic growth projections.

Interestingly, the JCT was no more reflective than the president regarding the expected results of the TCJA's changes to taxation of foreign-source income, saying it projected "an increase in investment in the United States" — but did not elaborate. That is all the more curious because the TCJA's international provisions are its most revolutionary elements. They tried to turn a worldwide system into a territorial system without clearly accomplishing that. The full effect will not be measured for some time, but the impact of repatriating offshore profits could yield strong indicators within a year through dividends.

The TCJA was meant to create and improve jobs. But if corporate dividends surge, then corporations are not using the repatriated money to invest in themselves but to reward investors.[2] While the world awaits answers, it is worthwhile to study and compare the United States with other countries — New Zealand stands in particularly strong contrast.

The basic rule for foreign taxation has been switched. Before, all income worldwide would be taxable unless subject to an exception; now, foreign income is generally not taxable but is still being policed for abuse. The TCJA added two major tools to the tax code to ensure that multinational corporations are taxed fairly: global intangible low-taxed income and the base erosion and antiabuse tax. Although recent in design, those measures are ties to the old worldwide system.

The Birth of a Territorial System?

The TCJA changed the U.S. income tax regime from a modified worldwide system to a modified

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[1]Critics say employee bonuses like that may have had ulterior motives, ranging from tax arbitrage to settling a monumental antitrust investigation by executing a publicity-ridden political favor. *See* Scott Moritz, "AT&T Will Give Workers $1,000 Bonuses to Celebrate the Tax Bill," Bloomberg (Dec. 20, 2017).

[2]Danny Vinik, "Is the GOP Tax Law Already Working?" Politico (Jan. 15, 2018).

territorial system.[3] At the beginning of the 20th century, only two countries (New Zealand and the Netherlands) had territorial tax systems.[4] The trend toward that kind of system has been driven by the need to attract capital and company headquarters.[5] Although the U.S. tax system is now considered territorial, it might tax more foreign-source income than it did when it was a worldwide system.[6] That estimate does not even count the first effect of the TCJA, repatriation.

The metamorphosis into a territorial system involved a major violation: a drastic temporary modification of subpart F, which generally taxes controlled foreign corporations only on income from related-party transactions.[7] Apart from amending section 965 (the one-time repatriation tax), the TCJA left subpart F rules largely intact.

The repatriation tax is one of the most contested features of the TCJA. Few of its features seem to better exemplify the TCJA's supposed inherent biases than "a windfall of over $400 billion for a handful of corporations."[8] Section 965 taxes all untaxed foreign-source income earned between 1986 and 2018, and it is unique because the tax is on a corporation's net worth rather than its income. There are two rates: 15.5 percent for cash and cash equivalents and 8 percent on all other earnings ("accumulated foreign earnings that have been reinvested in the foreign subsidiary's business").[9] These rates, however, are misleading. The tax payment may be made in eight yearly installments in rising proportions. This installment plan does not bear interest. Also, a small portion of the foreign tax credit is still available.[10] Therefore, the actual rates are significantly lower than advertised, mostly through an effectively interest-free government loan.

Section 965 is necessary for section 245A, which is the keystone for the new territorial system because it allows for 100 percent deductions of partially controlled foreign corporations. While that deduction seems monumental, it is somewhat reduced when put in context with other TCJA provisions.

GILTI and BEAT

GILTI is one of two major taxes imposed by the TCJA.[11] Its name is misleading for two reasons: It taxes not intangible property but essentially all income, less the worth of specific tangible property,[12] and there is not a high-tax exception.[13] Therefore, the income eligible for or penalized under the GILTI rules can be taxed at extraordinarily high rates by foreign jurisdictions and still be subject to the GILTI tax. GILTI does take account of foreign income taxes — but only up to 80 percent of the amount paid, and it cannot be carried forward or back.

Also, a special deduction is available for GILTI's additional tax burdens. The deduction is equivalent to 37.5 percent of the foreign-derived intangible income (FDII), together with 50 percent of the GILTI amount. FDII is calculated by a lengthy series of formulas to record transactions of intellectual property sold (or leased or licensed) to foreign buyers. The GILTI and FDII deductions are both scheduled to be considerably reduced for tax years after 2025.[14]

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[3] Sen. John Thune, "Sen. John Thune: Why the GOP-Trump Tax Plan Works," *Time* (Oct. 23, 2017).

[4] Kyle Pomerleau, "Worldwide Taxation Is Very Rare," Tax Foundation (Feb. 5, 2015).

[5] *See* Pomerleau and Kari Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems," Tax Foundation, Fiscal Fact No. 554 (July 2017).

[6] Not necessarily that the average multinational corporation will have a greater total tax liability, but rather that more foreign income will likely be treated as taxable.

[7] Subpart F also taxes "bad" income, or that derived from bribery and other corruption, and "bad" CFCs, or those doing business with countries without diplomatic relations with the United States or that host international terrorism. It also contains a curious exception for insurance and investment companies that are taxed almost completely on their net income.

[8] AFL-CIO, "Statement on 'Tax Reform and Small Businesses: Growing Our Economy and Creating Jobs'" (May 23, 2018).

[9] Interestingly, the latest committee report (H.R. Rep. No. 115-466 at 620) obscured the incentive to reinvest oversees as made clear in its prior report (H.R. Rep. No. 115-409 at 375).

[10] This is calculated in a highly obtuse manner in section 965, but it can never amount to a quarter of the normal credit.

[11] Technically, GILTI is not an additional tax like the BEAT is, but by specially including some income, it acts like an extra tax paid for through an increased regular tax liability, much like subpart F.

[12] All business property eligible for a section 167 deduction (depreciation).

[13] Section 953(b)(4) exempts income from subpart F when taxed by foreign authorities at a rate greater than 90 percent of the maximum U.S. corporate tax. GILTI also lacks any de minimis protection (also found in subpart F section — providing relief from subpart F provisions when that income would be only the lesser of $1 million or 5 percent of gross income).

[14] To 21.875 percent for FDII and 37.5 percent for GILTI.

The term "base erosion" was introduced to the tax code last year. The BEAT seeks to ease the loss of tax revenue that occurs when deducting payments to foreign affiliates of corporations; it applies only to large multinational corporations that receive half a billion dollars in gross revenue for any year deemed to have proportionately high base-erosion deductions. The tax itself is calculated through highly technical formulas, but the liability is effectively a percentage of deductions and payments considered to erode the base.[15]

The BEAT reduces the taxpayer-friendly effect of some credits, a minor impairment at first. After 2025, however, the effect is drastic. Beginning in 2026, the research credit, as well as several alternative energy tax credits, will not reduce BEAT liability. That burden on the research credit is compounded by the TCJA's new requirement, beginning in 2022, for applicable expenses to be amortized over five years when domestically sourced and 15 years when foreign-sourced.

Depending perhaps on the necessary avalanche of coming regulations and guidelines, both GILTI and the BEAT could undermine the entire territorial system. It is unclear how much income those provisions would actually tax, but their effects could be broad. The tax liability stemming from the measures might be low. But that is not the purpose of a territorial system, which is intended to clearly designate between taxable and nontaxable income and eliminate double taxation. The TCJA's ability to remove the worldwide system to establish a territorial system is dulled on further review.

The TCJA's Policies

Section 245A dividends and GILTI help by reducing the BEAT liability.[16] However, BEAT liability does not reduce GILTI. Subchapter F income also does not add to GILTI. Moreover, GILTI seems to have been constructed independently from section 245A;[17] only dividends that are not from related parties increase GILTI.

Related parties are business entities under the control of the taxpayer by 50 percent of value or votes. That is a far greater threshold than the 10 percent required for qualifying dividends under section 245A. As a result, most of the dividends deducted under section 245A would still probably be taxed as GILTI. That appears counterintuitive not only to section 245A but also to the overall purpose of the TCJA, which is to stimulate the U.S. economy by keeping "companies from leaving [its] shores and opening up in other countries."[18]

Considering its purpose, the TCJA made some curious changes. It repealed the prized section 199 domestic production activities deduction, probably to increase tax revenue.[19] It seems unlikely that Trump used that measure to resolve a decades-long trade dispute between the United States and the WTO and EU, or to zealously comply with the anti-subsidy rules in the General Agreement on Tariffs and Trade.[20]

Indeed, Trump was elected under a campaign hostile to the WTO, which he has called "a disaster," rallying against both its values and existence.[21] Those sentiments are reflected in the section 250 FDII deduction and its blatant rewards for exportation. Under Trump's mercantilist theory, the more income sent to the United States, the more its economy will prosper. That philosophy has already produced tensions in foreign relations — allies or otherwise. The TCJA may be the first step in Trump's long-promised trade war with China,[22] and it threatens to

[15] The percentage starts at 5 percent for tax year 2018 and rises to 10 percent until tax year 2026, when it becomes 12.5 percent.

[16] Section 59A(b)(1)(B) uses the taxpayer's regular tax liability in inverse correlation to the BEAT owed. The term "regular tax liability" is a reference to section 26(b), which does not include the section 245A dividend reductions or GILTI.

[17] Neither section 951 nor the applicable committee report mentions the section 245A 100 percent deduction.

[18] Trump's remarks on signing legislation on tax reform and on funding for the departments of Homeland Security, Defense, and Health and Human Services and an exchange with reporters, DCPD201700925 (Dec. 22, 2017), at 3.

[19] The committee reports do not provide an answer.

[20] U.S. Chamber of Commerce, "The U.S. Chamber Opposes Repeal of the Section 199 Manufacturing Deduction" (undated).

[21] Tim Worstall, "Donald Trump's Ludicrous Idea of Pulling the US From the World Trade Organisation" (July 25, 2016).

[22] See Keith Bradsher and Sui-Lee Wee, "U.S. Tariffs, Aimed at China and South Korea, to Hit Targets Worldwide," *The New York Times*, Jan. 23, 2018, describing new punitive tariffs with China in mind.

destabilize economic relations with long-standing partners amid allegations of treaty violations.[23]

The TCJA missed a splendid opportunity to achieve its makers' goal. Rather than tax the foreign-source income regardless of repatriation, the act could have exempted repatriated profits by expanding the new section 245A dividend deductions for GILTI and BEAT as it does for subpart F income. If that income was imported only to be spent outside the United States, that practice could be curbed using existing transfer pricing rules and by taxing the exported income to the extent the exemption was used.

The incentive to invest outside the United States would thus be balanced and fair because taxes lost by profits incorporated into the United States would be gained by taxes on investments outside the United States, and because the tax liability for the exported funds for each year would be nonexistent (rather than deferred) until the year the profits are imported into the United States. That would treat entering and existing multinational corporations equally. Unless tax rates become egregious, it is unlikely that a business would take profits only without foreign investment one year and give foreign investment only without profits for the next year simply for tax purposes. Even if businesses would engage in that kind of gaming, there could perhaps be limited carryovers or carrybacks for both the income exemption and the investment liability.

The TCJA penalizes income derived from intangible property (GILTI), and it is unclear why that is so.[24] Although ulterior motives might be suspected, they are misdirected.[25] GILTI does not apply to intangible property income as such but to all income minus the adjusted basis of all depreciable property.[26] That harms not just technology companies, but also all service-centered business — and indeed all businesses that are not based on depreciable property.

Again, the blatant preference for brick-and-mortar industry remains unexplained. Perhaps it is compensation for the anecdotal bonanza for tech companies following the TCJA or the perception of the tech industry as among the worst tax abusers pre-reform.[27] In that case, the overbreadth of GILTI would be intentional to catch all possible income from intangible property that has a history of notoriously difficult valuation.[28] If true, that belies a great lack of confidence in the tax code's transfer pricing rules seen elsewhere with BEAT's measures to combat base erosion.

The tax code's new bias against intellectual property and the rest of the world is made manifest in the watering down of the research credit. To triple the amortization period of expenses simply because they are foreign-sourced is a clear indicator of protectionist intent. The FDII deduction is of similar spirit even though it goes against the apparent trend against intangible property. Even here, a drastic redirection is pointed on the technology industry when combined with the GILTI disadvantages. Overall, GILTI falls into a remarkable pattern of the TCJA having seemingly arbitrary provisions.[29]

One English-speaking nation has a tax system acclaimed by the OECD as "one of the most efficient within the OECD" and further improved by recent reform.[30] That country is New Zealand, not the United States.

The United States is expected to increase in rank in the International Tax Competitiveness Index to 25th of the 35 OECD countries. New Zealand is ranked second.

[23] Anne-Sylvaine Chassany and Chris Giles, "Europeans Issue Warning to Trump on Tax Overhaul," *Financial Times*, Dec. 11, 2017.

[24] Neither the committee report for section 951A nor the presidential remarks on signing yield insight into that matter.

[25] The leaders of Silicon Valley have long had problems with Trump's immigration policies. *See* Tory Newmyer, "President Trump's Feud With Tech CEOs Has Been Brewing for a While," Fortune (Feb. 7, 2017).

[26] The newly strengthened tax preference for depreciable property is most loudly echoed by section 199A. That 20 percent deduction takes pains to apply the real estate investment sector but places severe restrictions on a range of industries.

[27] See Ryan Knutson, "Tax Law Saves Verizon $17 Billion in Deferred Taxes," *The Wall Street Journal*, Jan. 17, 2018; and Vanessa Barford and Gerry Holt, "Google, Amazon, Starbucks: The Rise of 'Tax Shaming,'" BBC (May 21, 2013), describing a trend of public indignation against otherwise popular businesses.

[28] *See generally*, Jody C. Bishop, "The Challenge of Valuing Intellectual Property Assets," 1 *Nw. J. Tech & Intell. Prop.* 1 (2003).

[29] See Reuven S. Avi-Yonah et al., "The Games They Will Play: An Update on the Conference Committee Tax Bill," 103 *Minn. L. Rev.* (Dec. 22, 2017), observing inexplicable differential tax treatment among professions.

[30] Johan Christensen, *The Power of Economists Within the State, New Zealand Plotting a Market-Oriented Revolution* (2017).

'New Zealanders Have a Right to Be Smug'

Taxation of CFCs in New Zealand is an exception that does not eat the territorial rule.[31] The basic definition of a New Zealander CFC is similar to the U.S. one. CFC rules apply only to residents holding an interest of at least 10 percent, in contrast to the U.S. inclusion of all resident stockholders.[32] Income from a CFC, however, can be taxable (attributable) only if the CFC is not an active business.[33]

New Zealand generally taxed dividends from foreign companies upon receipt by the resident.[34] That policy was changed by the Income Tax Act of 2007 to promote savings by middle-income taxpayers and remedy rules that arbitrarily resulted in overtaxation for some taxpayers and unduly favored some countries over others.

New Zealander ownership of a foreign company that falls short of the CFC threshold is categorized as a foreign investment fund (FIF).[35] Natural persons holding no more than NZD 50,000 (about $34,100) (at cost basis) are taxed under regular rules, and holders may elect to calculate FIF taxable income using one of five methods.[36] The primary method is the fair dividend rate method,[37] which is 5 percent of the opening market value of the stock together with quick sale adjustments. A quick sale adjustment takes account of stock both bought and sold in the same year. The adjustment incorporates the lower of the actual gains or 5 percent of the stock's cost basis. Any losses from the quick adjustment cannot lower the fair dividend amount, and the amount itself cannot be a loss (zero is the lowest possible amount). The resulting amount from the fair dividend method is the taxable income from the FIF rather than the tax liability itself.

New Zealand does not seem to have an equivalent for the U.S. branch profit tax, BEAT, GILTI, or subpart F (as additional taxes to normal liability). There are other considerable differences between the two countries. For instance, New Zealand has an FTC that credits the taxpayer for taxes paid on foreign income but only up to the amount of New Zealand tax liability had the foreign income been taxed under New Zealand law. There is not a baskets limitation as there is in IRC section 904.

Perhaps the greatest similarity in the two tax codes is transfer pricing. New Zealand transfer pricing is based on OECD standards that the United States largely adheres to, albeit on a more independent basis.[38]

Thin capitalization rules, however, are quite dissimilar — but instructively so. The rules are far stricter in New Zealand than in the United States.

Before the TCJA, U.S. related-party companies were subject to scrutiny if their debt-to-asset ratio exceeded 1.5 to 1. Net interest payments over 50 percent of the adjusted taxable income plus past disallowed interest payments would be denied a deduction for the tax year. Now, the limit is up to the amount of business interest payments over 30 percent of the company's adjusted taxable income regardless of the entity's debt-to-equity ratio.

In both versions, however, the disallowed income is deferred only to the next year rather than truly prohibited. New Zealand distinguishes between outbound thin capitalization and other thin cap situations, with the first covering residents who have an income interest in a CFC. That limit is the greater of 75 percent of the assets of the New Zealand group or 110 percent of the worldwide group. If the entity is a foreign controlled company in New Zealand, the limit is the greater of 60 percent of the New Zealand group and 110 percent of the worldwide group.

The countries' de minimis provisions are also different. Whereas U.S. rules exempt small businesses with average gross receipts of less than NZD 25 million, New Zealand judges by the weight of the debt financing: less than NZD 2 million, but only for outbound entities. New Zealand also exempts outbound entities if the

[31] "New Zealand's Identity: Clashing With the Sunset," *The Economist* (Nov. 1, 2014).

[32] The Income Tax Act (ITA) of 2007 DN 2l; and IRC section 951(a)(1).

[33] An active business is a business with passive income of less than 5 percent of the business's total income. ITA EX 21B.

[34] Inland Revenue, "A Guide to Foreign Investment Funds and the Fair Dividend Rate" (May 2016), at 7.

[35] There are also tax benefits for Australian FIF holdings.

[36] That choice is limited under some circumstances.

[37] Inland Revenue, *supra* note 34, at 17.

[38] OECD, "New Zealand Transfer Pricing Country Profile" (Oct. 2017). U.S. transfer pricing rules do not mention the OECD but are consistent with its guidelines. *See* OECD, "United States Transfer Pricing Country Profile" (Oct. 2017).

New Zealand group constitutes more than 90 percent of the worldwide group, as judged by assets, and has total interest deductions of NZD 250,000 or less.

Conclusion

Jeremy Bentham once wrote "every law is an evil, for every law is an infraction of liberty."[39] More importantly, every tax law is an infliction of an economic distortion far beyond the simple extraction of money from the economy for the government's use.

It takes a U.S. corporation an average of 175 hours to ensure it's complying with its tax obligations, about half of which concern the corporate income tax.[40] New Zealand companies spend an average of 140 hours ensuring compliance with their tax obligations, 34 hours of which are devoted to the corporate income tax — less than half that of their U.S. counterparts.[41]

Complexity comes at a cost, and misnomers may be the most expensive. To transform a deferral-ridden worldwide system into a GILTI-infested territorial system muddies waters that should be transparent. The inability to distinguish between an exception and a rule results in neither. Every change to the tax code and every departure from a straight line should be less burdensome to the economy (or even society) than the obstacle it avoids.

That is a far from easy task, but the law should at least appear to be trying to achieve it. It seems as though New Zealand tax law tries to accomplish that, but that is not necessarily so for U.S. tax law. As former U.S. Treasury Secretary William E. Simon said, the United States "should have a tax system that looks like someone designed it on purpose."[42] ■

[39] *Theory of Legislation* 48 (1908).

[40] World Bank Group, *Paying Taxes 2018*, at 81.

[41] *Id.* at 68.

[42] Jane Frecknall-Hughes, *The Theory, Principles and Management of Taxation: An Introduction* 49 (2015).