



## **Territorial Tax Study Report**

Prepared for the National Foreign Trade Council  
Territorial Study Group

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## EXECUTIVE SUMMARY

There has been growing interest in some academic circles, on Capitol Hill, and within the Treasury Department for serious consideration of U.S. international tax reform in the form of a territorial tax exemption system. The specific concept of reforming the U.S. international tax system by shifting to a territorial tax regime has arisen recently in the context of the unfavorable World Trade Organization ("WTO") decisions regarding the U.S. Foreign Sales Corporation ("FSC") and the Extra-Territorial Income ("ETI") regimes. The WTO's decisions that both the FSC and the ETI regimes provided illegal export subsidies have caused substantial concern among U.S. taxpayers. This concern is firmly rooted in the common perception that the territorial tax systems as maintained by several European countries do, in fact, provide effective export tax incentives, yet survive or circumvent WTO constraints. The decisions, in turn, have sparked significant interest in a territorial exemption regime as a possible mechanism for complying with international trade obligations while improving U.S. competitiveness in a global economy. The recent publicity given to so-called inversion transactions has also increased interest in a territorial exemption regime. Finally, serious consideration has been given as to whether a territorial exemption regime could address the historically perceived need for U.S. tax simplification.

In light of these considerations, the NFTC decided to undertake a study to evaluate the efficacy of implementing some form of a territorial tax exemption system in the United States. In so doing, 32 member companies<sup>1</sup> formed a study group (the "Territorial Study Group") to review the basic features of the "traditional" territorial systems, as well as the features of one or more possible alternative exemption systems, and to evaluate each variation in terms of future U.S. competitiveness, effect on current WTO issues, tax simplification and administration, and long term stability. The Study Group then considered whether a switch to either model of territorial exemption system would be more likely to address these considerations than simply reforming the current U.S. tax system.

Traditional territorial exemption systems are founded on the philosophy that income should be subject to net income tax only in the jurisdiction where it makes most sense to tax it on a source basis, *i.e.*, in the jurisdiction in which the taxpayer undertakes the economic processes and activities necessary to generate income. Once a foreign person has established a significant economic presence in a country, the business income attributable to that presence – and only that income – becomes taxable by that country. The source country generally has the right to tax such income however it desires; the residence country (*i.e.*, the jurisdiction in which the foreign

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<sup>1</sup> For a list of member companies in the Territorial Study Group, *see* Appendix A.

person is formed, incorporated, or otherwise resident) accepts that source country right and exempts the income for its own tax purposes.

The territorial exemption systems of three major European countries provide a basis for identifying the general features of a U.S. territorial system were it to be proposed. First, the exemption would likely cover active foreign source income, both in the form of branch profits and of dividends attributable to the active business income of foreign subsidiaries. Income eligible for exemption could be limited to all active business income, to active business income subject to some minimum level of foreign income tax, or to active business income earned in a jurisdiction having an income tax treaty with the United States. Non-exempt active foreign income and income subject to foreign withholding tax would likely be eligible for a foreign tax credit, under rules substantially similar to the existing foreign tax credit rules. Furthermore, a U.S. territorial system would likely provide for some form of allocation of indirect expenses and a disallowance of deductions allocable to exempt income. Alternatively, the system could allow for a 95 percent exemption, as opposed to a 100 percent exemption.

In addition to a traditional territorial exemption, the Territorial Study Group also evaluated an alternative exemption proposal, a "foreign source" proposal that is based on traditional U.S. rules for sourcing income. Under this proposal, all foreign source income – as determined under current U.S. concepts – would be exempt from U.S. federal income tax. The foreign source proposal would also disallow deductions for all foreign source expenses, again as determined under existing U.S. rules. Thus, the disallowance would include not only expenses directly allocable to foreign source income, but also interest, R&D, and general and administrative expenses treated as foreign source under formulary allocation mechanisms. A foreign source exemption system would disallow foreign tax credits in respect of the exempted income. Indeed, because a taxpayer's income would be effectively divided into two categories – U.S. source taxable income and foreign source exempt income – this system would eliminate any ongoing need for foreign tax credit rules, and could eliminate or substantially scale back reliance on subpart F.

Based on its evaluation, the Territorial Study Group concluded that a broad based traditional territorial exemption system would improve the competitiveness of those U.S. companies that have substantial foreign active business income taxed at source country rates that are significantly less than U.S. tax rates. On the other hand, companies that can utilize foreign tax credits from high taxed countries could be worse off from a competitiveness viewpoint. However, to improve the competitiveness of any substantial group of U.S. companies would require favorably resolving many of the same issues that make our current rules anti-competitive: the overly broad scope of subpart F with respect to active business income, the over allocation of expenses to foreign income, and the restrictive aspects of the foreign tax credit. If not resolved, a traditional territorial exemption system would not only fail to improve competitiveness significantly, but would also result in increased complexity and long term instability of the U.S. tax system. In terms of current WTO issues, whereas a traditional territorial exemption system could be WTO-compliant, it would not provide significant export tax benefits for many U.S. companies with direct exports. Finally, a traditional territorial exemption system could pose substantial transition issues, potentially including the significant expansion of the U.S. income tax treaty network.

The foreign source exemption proposal could significantly improve the global competitiveness of U.S. companies and of the United States as a source country, provided that the expense allocation rules avoid the over-allocation and disallowance of interest expense.

Furthermore, the foreign source exemption proposal appears relatively simple to enact and presents the possibility of a short and effective transition from the current foreign tax credit rules. However, the proposal has other substantial drawbacks. The foreign source exemption proposal would likely fail to resolve the United States' current WTO issues, in that the proposal would likely be WTO non-compliant. Further, the proposal would cost substantial revenues. Any attempt to mitigate the cost or modify the allocation rules – even if successful – would detract substantially from the simplicity, stability, and administrability of the proposal. Finally, the proposal would result in some taxpayers having significant income that is not taxed in any country, and other taxpayers with significant expenses not deductible in any country. The long run stability of such a system is questionable.

Taking these factors into account, the Territorial Study Group concludes that, on balance, legislative efforts to improve current international tax rules are better spent on reform of our current deferral and foreign tax credit system and on finding a WTO-compatible replacement for FSC/ETI than on adopting a territorial exemption system. Most of the improvements generated by a competitively desirable exemption system would not be rooted in the exemption provisions themselves, but instead in other modifications to the current tax system, particularly to the overly broad subpart F rules, the restrictive expense allocation rules, and other foreign tax credit provisions. The Group believes these issues can and should be directly addressed by adopting specific reforms outside the context of an exemption proposal. These reforms would not specifically address the international competitiveness of U.S. exporters that benefit principally from the FSC/ETI regime. The adoption of these reforms will, however, improve the competitiveness of U.S. companies with substantial operations outside the United States.

## INTRODUCTION

There has been growing interest in some academic circles, on Capitol Hill, and within the Treasury Department for serious consideration of U.S. international tax reform in the form of a territorial tax exemption system. In recent years, international tax reform proposals generally<sup>2</sup> and, in particular, ways to improve competitiveness<sup>3</sup> and promote simplification,<sup>4</sup> have been discussed at length. On March 20, 2002, for example, House Ways and Means Committee member Amo Houghton (R-NY) introduced the "International Tax Simplification and Fairness for American Competitiveness Act of 2002," a bill to simplify taxation rules for U.S. businesses operating abroad.<sup>5</sup> Also this year, congressional focus on corporate inversion transactions and the resulting introduction of bills to curtail "corporate expatriations,"<sup>6</sup> have highlighted the issue of whether flaws in the U.S. international tax rules undermine an American company's ability to compete in the global marketplace.<sup>7</sup> Last year, the Joint Committee on Taxation released a

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<sup>2</sup> See, e.g., J.C. Fleming et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 937 (2000); R.J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975 (1997); H.J. Aaron and W.G. Gale, Brookings Institution, *Fundamental Tax Reform: Miracle or Mirage*, SETTING NATIONAL PRIORITIES 253-62 (1997); J.R. Hines, Jr., *Fundamental Tax Reform in an International Setting*, ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, H.J. AARON AND W.G. GALE, eds., Brookings Institution, 465-502 (1996).

<sup>3</sup> See, e.g., H.D. Rosenbloom, U.S. Multinational and International Competitiveness: From the Bottom Up – Taxing the Income of Foreign Controlled Corporations, 26 BROOKLYN J. INT'L L. 1525 (2001); K. Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 U. TEX. L. REV. 1525 (2001).

<sup>4</sup> See, e.g., *NYSBA Tax Section Send Tax Simplification Report*, 2002 TAX NOTES TODAY 54-48 (March 20, 2002); *O'Neill Claims Simplification, Stimulus Top Priorities*, 2002 TAX NOTES TODAY 36-1 (February 22, 2002); W.G. Gale, Brookings Institution, *Tax Simplification: Issues and Options*, 2001 TAX NOTES TODAY 175-76 (September 10, 2001); *Neal Release on his Introduction of a Tax Simplification Bill*, 2001 TAX NOTES TODAY 138-23 (July 18, 2001) (Individual Tax Simplification Act of 2001, proposing to repeal the AMT, repeal personal exemption and itemized deduction phase-outs, simplify capital gains taxes, and create a single phase-out for personal credits); J.A. Snoe, *Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform*, 60 ALBANY L. REV. 61 (1996); E.J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267 (1990).

<sup>5</sup> H.R. 4047.

<sup>6</sup> See S. 2119 ("Reversing the Expatriation of Profits Offshore Act") introduced by Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Republican Charles Grassley (R-IA) on April 11, 2002. A memorandum announcing the bill's introduction includes the statements that "Senators Grassley and Baucus are committed to halting corporate inversions. Nonetheless, the Senators also recognize that the rising tide of corporate expatriations demonstrates that our international tax rules are deeply flawed." See also H.R. 3884 ("Corporate Patriot Enforcement Act of 2002"); H.R. 4756 ("Uncle Sam Wants You Act of 2002"); H.R. 3922 ("Save America's Jobs Act of 2002"); H.R. 3857 (proposing to treat nominally foreign corporations created through inversion transactions as domestic corporations); S. 2050 (same).

<sup>7</sup> See also U.S. TREASURY DEPARTMENT, PRELIMINARY REPORT ON INVERSION TRANSACTIONS (May 17, 2002) ("Inversion Report"). In its report, the Treasury observed, "Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses

report on U.S. tax simplification, which stated the Committee's cumulative findings for an 18-month simplification study (the "JCT Report").<sup>8</sup> In the last Congress, Rep. Houghton and Sander Levin (D-MI) introduced a bipartisan international tax simplification bill.<sup>9</sup> A companion bill was introduced in the Senate Finance Committee by Senators Orrin Hatch (R-UT) and (now chairman) Max Baucus (D-MT).<sup>10</sup>

The specific concept of reforming the U.S. international tax system by shifting to a territorial tax regime has arisen most recently in the context of the unfavorable WTO decision regarding the FSC regime, and was further catalyzed by a similarly unfavorable decision regarding the ETI, or FSC-replacement, legislation. The WTO's decisions that both the FSC and the ETI regimes provided illegal export subsidies have caused substantial concern among U.S. taxpayers. This concern is firmly rooted in the common perception that the territorial tax systems as maintained by several European countries do, in fact, provide effective export tax incentives, yet survive or circumvent WTO constraints. The decisions, in turn, have sparked significant interest in a territorial exemption regime as a possible mechanism for complying with international trade obligations while improving U.S. competitiveness in a global economy.

The concept of a territorial regime has also been discussed in the context of so-called corporate inversion transactions. Many companies reportedly are considering reincorporating in a tax haven jurisdiction to avoid the application of various U.S. international tax rules.<sup>11</sup> Concerns over the spread of these transactions have led to calls for adopting a territorial system to discourage companies from considering inversions.<sup>12</sup>

In addition, certain proponents believe that territorial exemption systems improve "tax competition" between countries seeking to attract foreign investment. Such competition, they believe, will ultimately drive down income tax rates in such countries, and improve the global economy overall.<sup>13</sup>

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and the U.S. economy. A comprehensive reexamination of the U.S. international tax rules and the economic assumptions underlying them is needed. As we consider appropriate reformulation of these rules we should not underestimate the benefits to be gained from reducing the complexity of the current rules. Our system of international tax rules should not be allowed to disadvantage U.S.-based companies competing in the global marketplace." Inversion Report at 2-3.

<sup>8</sup> See STAFF OF THE JOINT COMMITTEE ON TAXATION, STUDY ON SIMPLIFICATION OF THE U.S. TAX SYSTEM (April 25, 2001).

<sup>9</sup> H.R. 2018 (the "International Tax Simplification For America Competitiveness Act of 1999").

<sup>10</sup> S. 1164

<sup>11</sup> Editorial, *The Flight to Bermuda*, THE WALL STREET JOURNAL A18 (May 16, 2002).

<sup>12</sup> See Inversion Report at pp. 27-30.

<sup>13</sup> See, e.g., THE HERITAGE FOUNDATION, *How the Johnson-Neal Bill Would Harm Competition and Tax Reform* (September 5, 2001).

Finally, serious consideration has been given as to whether a territorial exemption regime could address the historically perceived need for U.S. tax simplification.<sup>14</sup>

In light of these considerations, the NFTC decided to undertake a study to evaluate the efficacy of implementing some form of a territorial tax exemption system in the United States. In so doing, 32 member companies<sup>15</sup> formed a study group (the "Territorial Study Group") to review the basic features of the "traditional" territorial systems, as well as the features of one or more possible alternative exemption systems, and to evaluate each variation in terms of future U.S. competitiveness, effect on current WTO issues, tax simplification and long term stability.<sup>16</sup> The Group then considered whether a switch to any model of territorial exemption system would be more likely to address these considerations than simply adopting specific reforms to the current U.S. tax system.

This paper describes the specific issues considered by the Territorial Study Group, and presents the Group's findings and recommendations.

## **"TRADITIONAL" TERRITORIAL EXEMPTION SYSTEMS**

As noted above, several major European countries, including the Netherlands, Germany, and France, employ a territorial exemption system. These "traditional" systems have common primary features, albeit with significant variations. These primary features, as well as highlights of the Dutch, German, and French territorial systems, are discussed below.

### **1. Basic Features of a Traditional Territorial Exemption System.**

First and foremost, the traditional territorial exemption systems share a basic philosophy – income should be subject to net income tax only in the jurisdiction where it makes most sense to tax it on a source basis, *i.e.*, in the jurisdiction in which a taxpayer undertakes the economic processes and activities necessary to generate income. Once a foreign person has established a significant economic presence in a country, the business income attributable to that presence (and only that income) becomes taxable by that (the "source") country. The source country generally has the right to tax such income however it desires; the residence country (*i.e.*, the jurisdiction in which the foreign person is formed, incorporated, or otherwise resident) accepts that source country right and exempts the income for its own tax purposes.

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<sup>14</sup> See G. Lubkin, *The End of Extraterritorial Income Exclusion? The W.T.O. Appellate Decision and its Consequences*, 31 TAX MGMT. INTL. J. 254 (2002) (noting that Ways and Means Committee Chairman, Rep. Bill Thomas, the Administration, and the Brookings Institution have all considered or espoused a territorial system); *International Taxes: U.S. Should Move to Territorial Taxation of Global Companies*, Treasury Official Says, 20 TAX MGMT. WEEKLY REP. 2084 (2001) (reporting remarks by Treasury Department's international tax counsel, Barbara Angus, at the IRS-George Washington University Institute on Current Issues in International Taxation); *Brookings Institution Examines Territorial Tax System*, 2001 TAX NOTES TODAY 86-10 (May 3, 2001).

<sup>15</sup> For a list of member companies in the Territorial Study Group, see Appendix A.

<sup>16</sup> See D. Wessel, *Talking Tax Reform Is Easier Than Doing It*, THE WALL STREET JOURNAL A2 (May 16, 2002).

This philosophy adopts the principle of "capital import neutrality," *i.e.*, that income from investments made abroad should bear only the local income tax rate. It improves the source country competitiveness of multinational corporations resident in a territoriality country by permitting the companies to be taxed at the same rates as other local competitors in each source country.

The United States generally employs a deferral system that incorporates some aspects of, but does not embrace completely, capital import neutrality. Under this system, a taxpayer is taxed currently on its own foreign income (*e.g.*, branch earnings), but generally may avoid inclusion of income earned by foreign subsidiary corporations unless and until the income is distributed to the taxpayer. In some circumstances, deferral can permit a U.S. taxpayer that operates through foreign subsidiaries to elect capital import neutrality, because the income will be subject only to source country income tax so long as the taxpayer can leave the earnings abroad. If and when the income is distributed to the U.S. taxpayer, it is subject to U.S. tax, but is offset by a non-refundable credit for foreign income taxes paid. At that point the income is taxed at the U.S. rate to the extent that rate is higher than the local tax rate. Thus, the U.S. system can be seen as applying "capital export neutrality" for distributed earnings, *i.e.*, imposing the *residence* country tax rate on such earnings, but capital import neutrality for undistributed earnings.

To implement the capital import neutrality philosophy of traditional territorial systems, such systems typically exempt foreign active business income, whether in the form of branch profits or dividends received from foreign subsidiaries, as such income is "properly" taxed in the source country. The exemption may also apply to gains on the sale or exchange of active business assets and stock in foreign subsidiaries. Generally, though not in all cases, eligible dividends and capital gains must relate to non-portfolio stock holdings, which can be defined on the basis of a threshold level of voting power, value, or both. Depending on the jurisdiction, an exemption may apply to all business income or be limited to income earned in source countries having a tax treaty with the residence country, or income subject to a certain level of tax in the source country. In any case, territorial systems typically disallow credits for foreign taxes associated with the exempt income.

In addition, expenses associated with the exempt income as well as branch losses – all of which are "properly" deducted in the source country – are typically disallowed in the residence country. As an alternative to disallowing specific indirect expenses, countries may instead limit the level of the available exemption, for example, to a specified percent of the resident taxpayer's foreign active gross income.

It should be noted that countries employing a traditional territorial exemption system may continue to distinguish between foreign active and foreign non-active income. In such case, a taxpayer's taxable income can fall within three possible categories – domestic source taxable income, foreign source exempt income, and foreign source taxable income. Typically, such countries have less well developed foreign tax credit systems and often only permit a deduction to alleviate the double tax burden on non-exempt income at least with non-treaty countries.



## 2. Significant Features of Existing European Territorial Systems.

In evaluating territorial systems generally, the Territorial Study Group examined the territorial regimes employed by several major European countries. Highlights of these regimes are described below.<sup>17</sup>

### A. France.

French resident corporations carrying on a trade or business outside France through foreign branches are generally not taxed in France on the related profits, but may qualify for a 100 percent exclusion of such income. Capital and net operating losses of a foreign branch are disallowed, to the extent the losses are connected with exempt foreign activities.

In contrast, French resident corporations may exclude from gross income 95 percent of the dividends received from foreign subsidiaries. France offers a 95 percent "participation exemption," as opposed to a 100 percent exemption, in lieu of a disallowance of deductions for allocable expenses (*e.g.*, general and administrative expenses, etc.). Gain on the disposition of shares is taxable, but may enjoy a reduced corporate tax rate.

To qualify for the participation exemption, the French corporation must, at the time that the dividend is paid, own at least 5 percent of the share capital of the foreign subsidiary. This 5% minimum participation must entitle the French corporation to both voting and financial rights in the subsidiary. As a general matter, these shares must have been owned by the French corporation for at least 2 years. If the two-year holding requirement is not met, however, the French corporation may still qualify for the participation exemption if it commits itself to hold the shares for at least 2 years, or if the French corporation is the first registered owner of newly issued shares.

France does not require that income earned in another country be taxed at a minimum rate or be earned in a country with which France has a tax treaty in order to be eligible for exemption. However, France does have a "privileged tax regime," which is somewhat similar to the U.S. "subpart F." (*i.e.*, Article 209B of the French Tax Code). Under such regime, income earned by a foreign subsidiary is subject to current inclusion in its French parent's gross income if the subsidiary does not conduct significant commercial or industrial activities in the source country, and is not subject to a source country income effective tax rate that is 2/3 or more of the effective rate that would be payable were the income taxable in France.

In respect of income not exempt from French tax under the territoriality principle, France generally provides double tax relief in the form of a deduction for foreign income taxes. Under a relevant income tax treaty, however, foreign withholding taxes on dividends, royalties, and interest may be creditable against French income tax. France has a broad treaty network, with 115 income tax treaties in force.<sup>18</sup>

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<sup>17</sup> It should be noted that these descriptions are for illustrative purposes only and are not meant to constitute complete representations of the law currently in effect in these jurisdictions. The information contained herein was gathered from various published sources, as well as from internal Skadden, Arps and Ernst & Young tax personnel in various countries.

<sup>18</sup> In comparison, the United States only has 62 income tax treaties.

## **B. The Netherlands.**

Dutch resident companies may qualify for a 100 percent exclusion of foreign branch profits. Furthermore, under the Dutch "participation exemption," dividends received from foreign subsidiaries, and capital gains realized on the disposal of such shares, are exempt from Dutch corporate tax. Except for qualifying liquidation losses, capital losses are not deductible for Dutch tax purposes.

To qualify for the participation exemption, a Dutch company must own at least 5 percent of the paid-in capital (represented by shares) of the subsidiary. Moreover, the shares, or "participation," may not be held as inventory and the foreign subsidiary must be subject to a national foreign income tax. Even if the Dutch parent does not own the requisite percentage of a subsidiary's shares, the participation exemption will be available if the shareholding (i) is maintained for purposes connected with the parent's business, or (ii) was acquired for reasons "serving the public interest." In addition, the subsidiary generally must not be held as a portfolio investment.<sup>19</sup>

While income must be subject to tax in the source country to be exempt, the Netherlands neither imposes a minimum tax rate requirement, nor requires that the source country have an income tax treaty with the Netherlands. Thus, for example, a Dutch company with a subsidiary in a low tax jurisdiction may qualify for the participation exemption even though the subsidiary's earnings are taxed at a very low local rate. Furthermore, whether tax is actually paid by the specific subsidiary is irrelevant. Thus, dividends from a subsidiary may qualify for the exemption even if the subsidiary benefits from a temporary foreign tax holiday or if no tax is actually due because of available net operating loss carry forwards.

Expenses are generally disallowed to the extent that they relate to foreign income that is exempt from Dutch taxation. This includes, for example, expenses relating to a foreign subsidiary and certain expenses incurred with respect to the purchase and administration of shares constituting a participation (*e.g.*, acquisition expenses, interest related to acquisition financing, etc.). Expenses are deductible, however, to the extent that the taxpayer demonstrates that they relate to income of the subsidiary that is effectively subject to Dutch taxation.

Foreign dividends that are not exempt under the participation exemption are eligible for a Dutch tax credit in respect of foreign withholding taxes, so long as the subsidiary is resident in a treaty partner jurisdiction or certain developing countries, and is subject to net income tax there. If the subsidiary does not qualify under these requirements, withholding taxes incurred on non-exempt dividends may be deductible. Unlike France, the Netherlands does not employ a privileged tax, or subpart F-type regime. The Netherlands has 78 income tax treaties currently in force.<sup>20</sup>

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<sup>19</sup> Special rules apply for qualifying subsidiaries under the EU Parent-Subsidiary Directive as a result of which the participation exemption may apply for qualifying "passive" EU subsidiaries.

<sup>20</sup> See footnote 18.

### C. Germany.

As a general matter, German resident corporations are taxed on foreign source income. Foreign branch income is fully exempt from gross income. Foreign source dividend income, however, is eligible for a 95 percent participation exemption. As in France, a participation exemption of 95 percent, as opposed to 100 percent is allowed in lieu of a disallowance of deductions for allocable expenses. As a general matter, foreign branch losses are disallowed, unless the taxpayer can establish that the branch is engaged exclusively or virtually exclusively in the active conduct of certain types of business. However, the financing costs of acquiring or holding foreign shares are deductible in full.

By statute, Germany recently eliminated all minimum share requirements for the availability of the participation exemption. Thus, a German resident corporation may qualify for a participation exemption in respect of dividends paid by foreign subsidiaries, irrespective of the German corporation's level of ownership in the foreign corporation, the characteristics of such stock (*e.g.*, as voting or participating, or as held for a minimum ownership period), the location of the subsidiary, or the type of income earned by the subsidiary.

Prior to these statutory amendments, the participation exemption was only available in respect of dividends paid by subsidiaries resident in jurisdictions having a tax treaty with Germany. Germany currently has 86 income tax treaties in force.<sup>21</sup> The specific parameters of Germany's participation exemption were articulated under the provisions of the relevant income tax treaty. Thus, for example, Article 23 (Relief from Double Taxation) of the income tax treaty between the United States and Germany<sup>22</sup> (the "U.S.-German Income Tax Treaty") generally provides for a participation exemption for any item of U.S. source income or any item of capital situated within the United States. In accordance with the U.S. Treasury Department's Technical Explanation in respect of the treaty, the principal types of U.S. source income covered by the exemption are (i) income derived by a German enterprise that is attributable to a U.S. permanent establishment, (ii) many kinds of capital gains, (iii) most classes of personal services income, and (iv) certain dividends from direct investments in the United States by U.S. subsidiaries of German corporations.<sup>23</sup>

In order to be eligible for the participation exemption, the U.S.-Germany Income Tax Treaty required a German corporation to own directly stock representing at least 10 percent of the voting power of a U.S. subsidiary, and for dividends to represent a distribution of profits that are otherwise subject to tax under U.S. law.<sup>24</sup> The treaty also provided for a German tax credit in

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<sup>21</sup> See footnote 18.

<sup>22</sup> CONVENTION BETWEEN THE FEDERAL REPUBLIC OF GERMANY AND THE UNITED STATES OF AMERICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND TO CERTAIN OTHER TAXES, effective January 1, 1990.

<sup>23</sup> UNITED STATES DEPARTMENT OF THE TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE FEDERAL REPUBLIC OF GERMANY FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND TO CERTAIN OTHER TAXES, Explanation Regarding Article 23 (Relief from Double Taxation) (June 14, 1990).

<sup>24</sup> Article 23(a), U.S.-Germany Income Tax Treaty.

respect of U.S. taxes imposed on certain U.S. source income that is designated as not otherwise eligible for the participation exemption.<sup>25</sup> Credits for foreign taxes levied in respect of non-exempt foreign income are also provided under German statutory law.

Finally, Germany employs a controlled foreign corporation ("CFC") regime, under which a controlling shareholder resident in Germany must currently include a pro rata share of a CFC's non-active foreign income that is subject to a source country tax rate of less than 25 percent.

### **3. Possible Features of a Comparable U.S. Territorial System.**

The above description of the common underlying philosophy of territorial systems and the implementation of that philosophy in three home countries for major competitors of U.S.-based companies provides a basis for identifying the general outline of the features of a U.S. territorial system were it to be proposed. First, the exemption would likely cover active foreign source income, both in the form of branch profits and of dividends attributable to the active business income of foreign subsidiaries. Income eligible for exemption could be all active business income, active business income subject to some minimum level of foreign income tax, or active business income earned in a jurisdiction having an income tax treaty with the United States. If the treaty limitation were adopted, the U.S. treaty network, which currently includes 62 income tax treaties in force, would need to be expanded significantly.<sup>26</sup> In comparison, as noted above, France and Germany have 115 and 86 income tax treaties in force, respectively.

Non-exempt active foreign income and other income subject to foreign withholding tax would likely be eligible for a foreign tax credit, under rules substantially similar to the existing foreign tax credit rules. Furthermore, a comparable territorial system would likely provide for some form of allocation of indirect expenses and a disallowance of deductions allocable to exempt income. Alternatively, the system could allow for a 95 percent exemption, as opposed to a 100 percent exemption.

Finally, a U.S. territorial exemption system would no doubt involve some continued dependence on the principles of the existing subpart F rules. At a minimum, such rules would provide a mechanism for identification and current taxation of "passive" foreign source income.

### **AN ALTERNATIVE "FOREIGN SOURCE" EXEMPTION PROPOSAL**

Because the United States has traditionally employed a foreign tax credit system rather than an exemption system, the principles used to identify foreign income for U.S. federal income tax purposes are quite different from those used in traditional exemption countries. Most importantly, these principles do not distinguish between income that is "foreign" because it is

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<sup>25</sup> Article 23(b), U.S.-Germany Income Tax Treaty.

<sup>26</sup> Moreover, it is possible that U.S. treaty partners could view the shift to a territorial exemption system as an opportunity to renegotiate provisions of existing tax treaties, *e.g.*, to capture a share of U.S. companies' overall tax savings by way of increased source country withholding taxes. Although arguably remote, this possibility is not entirely unprecedented. For example, Indonesia requested a renegotiation of its treaty with the Netherlands, to raise the branch profit tax rate for oil and gas sectors. Unsuccessful negotiations culminated in Indonesia moving to terminate the treaty in July, 2000. *See Indonesia Terminates Income and Capital Tax Treaty with Netherlands*, 2000 WTD 134-4 (July 12, 2000).

properly subject to foreign withholding tax and income that is subject to foreign net income tax. All such income is properly treated as "foreign source" income eligible for a foreign tax credit in the United States.

Consequently, in addition to a traditional territorial exemption, the Territorial Study Group also evaluated an alternative exemption proposal, a "foreign source" proposal, that is more consistent with traditional U.S. rules for sourcing income. Under this proposal, all foreign source income – as determined under current U.S. concepts – would be exempt from U.S. (*i.e.*, residence country) federal income tax. The scope of this alternative proposal, although arguably related to that of the traditional exemption system, is clearly more expansive than the traditional approach.

In particular, under this alternative, items that are otherwise normally deductible in a source country (including, for example, interest paid by a foreign payor) and that, as a result, would not be subject to source country income tax, would be exempt in the United States. As a result, if such income is not subject to withholding tax – either by reason of the source country's internal withholding tax rules or under the provisions of its income tax treaty with the United States – it could go untaxed in the United States and the source country. Subject to tax treaties, the choice to impose a withholding tax on such items would be left entirely to the source country.

The foreign source proposal would also disallow deductions for all foreign source expenses. As with exempt income items, disallowed foreign source expenses would be identified under the existing U.S. sourcing concepts. Thus, the disallowance would include not only expenses directly allocable to foreign source income, but also interest, R&D, and general and administrative expenses treated as foreign source, perhaps under formulary allocation mechanisms similar to those in effect today. Because these rules operate irrespective of whether the expenses are "more properly deducted" elsewhere, certain foreign source expense items could go completely unrecovered, either in the United States or in any other jurisdiction.

Like the traditional territorial exemption system, a foreign source exemption system disallows foreign tax credits in respect of the exempted income. Indeed, because a taxpayer's income would be effectively divided into two categories – U.S. source taxable income and foreign source exempt income – this system would eliminate any ongoing need for foreign tax credit rules.

A foreign source exemption system would also substantially scale back, if not eliminate, subpart F. Under such a system, any need for continuing subpart F rules would be limited to the current taxation of U.S. source income earned by CFCs.

## **EVALUATIVE FACTORS**

The Territorial Study Group pursued its study of territorial exemption proposals described above with several specific considerations in mind.<sup>27</sup> These considerations, which are

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<sup>27</sup> These considerations are similar to those commonly highlighted by Treasury officials in the context of tax reform. *See, e.g.*, DEPT. OF THE TREASURY, OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED CORPORATIONS: A POLICY STUDY (December 2000); F. Goldberg, Then-Assistant Secretary (Tax Policy), Department of the Treasury, Testimony Before the Ways and Means Committee Regarding H.R. 5270 (May 1992).

described further below, were used to evaluate the merits of adopting either of the territorial exemption proposals, as compared to reforming specific aspects of the current U.S. tax system.

## **1. Effect on the Global Competitiveness of U.S. Companies.**

Each alternative was first evaluated on the basis of whether it is likely to improve substantially the competitiveness of U.S. businesses. In particular, consideration was given to whether the alternatives would alleviate specific competitive disadvantages that our present system imposes on U.S. business.

First, the foreign tax credit rules of our current system are not fully effective in avoiding double taxation. For example, the current rules allocating and apportioning deductions to U.S. and foreign sources, particularly in respect of interest expenses and general and administrative expenses, over-allocate expenses to foreign sources. Thus, a consolidated group's interest expense is allocated to U.S. and foreign sources based on the group's U.S. gross assets but, in effect, the net assets of foreign subsidiaries. By failing to take into account foreign subsidiary debt and the assets financed with this debt, these rules can result in a double allocation of interest expense to foreign source income, artificially restricting a U.S. company's ability to utilize foreign tax credits. Furthermore, the foreign tax credit system lacks domestic loss recapture rules (*i.e.*, rules similar to the Section 904(f) foreign loss recapture rules). As a result, a domestic operating loss will reduce a taxpayer's foreign tax credit limitation permanently, with no restoration of the reduced limitation amount when the taxpayer subsequently generates domestic profits. These restrictions are exacerbated by the limited carryover rules that apply to foreign tax credits. Other problems limit the effectiveness of the foreign tax credit as well.<sup>28</sup>

In addition, the existing subpart F rules are much broader in scope than analogous "privileged tax" regimes employed by other countries. Most significantly, the subpart F rules tax various types of active income, such as foreign base company sales and services income, and payments between related parties that fall outside the narrow scope of the various "same country" exceptions. In contrast, analogous foreign regimes generally apply only to passive investment income earned by foreign subsidiaries.<sup>29</sup>

The rules governing the treatment of non-subpart F income, *i.e.*, allowing deferral but ultimate taxation subject to foreign tax credits upon distribution of the income, can also be problematic from a competitiveness standpoint. As noted above, although deferral can permit a company to elect into capital import neutrality, and remain subject only to the local tax rate for at least a substantial period of time, any ultimate distribution of earnings to a U.S. taxpayer can come at a significant tax cost, because the distributed income may be subject to a U.S. tax rate that is greater than the local income tax rate. In other cases involving the distribution of earnings subject to relatively high foreign tax rates, however, the earnings are not subject to incremental

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<sup>28</sup> For a detailed discussion of the anti-competitive features of the U.S. foreign tax credit rules, see NATIONAL FOREIGN TRADE COUNCIL, INC., INTERNATIONAL TAX POLICY FOR THE 21<sup>ST</sup> CENTURY, PART TWO: RELIEF OF INTERNATIONAL DOUBLE TAXATION (December 15, 2001).

<sup>29</sup> For a detailed discussion of the anti-competitive features of the subpart F rules, as well as a summary description of several other CFC regimes, see NATIONAL FOREIGN TRADE COUNCIL, INC., INTERNATIONAL TAX POLICY FOR THE 21<sup>ST</sup> CENTURY, PART ONE: A RECONSIDERATION OF SUBPART F (December 15, 2001).

U.S. tax and indeed any excess credits accompanying the earnings may offset other foreign source income. The ability to minimize distribution tax costs by distributing only relatively high taxed earnings, however, varies from company to company.

## **2. Effect on Current WTO Issues.**

Of more immediate consequence, the Territorial Study Group's evaluation included the specific consideration of whether either exemption proposal could alleviate or avoid current WTO problems. In light of the WTO Appellate Body decision, which is discussed further below, one of the major considerations of the Territorial Study Group was whether any proposal not only could replace foregone FSC/ETI benefits but could otherwise present U.S. businesses with a realistic opportunity to obtain any export incentives. To accomplish this, the Territorial Study Group reviewed in detail the history of the WTO dispute and the basis for the various WTO decisions treating U.S. tax provisions as illegal export subsidies.

### **A. The Dispute Between the United States and the European Commission Over the Legality of Export Tax Incentives.**

By way of background, the WTO ETI case can be traced back to 1972 when the European Community challenged the 1971 enactment of the Domestic International Sales Corporation ("DISC") provisions under GATT 1947, and the United States counter-claimed that the tax exemptions for foreign-source income provided by Belgium, France, and the Netherlands were export subsidies. A 1976 GATT panel issued reports finding that the DISC had some characteristics of an illegal export subsidy and that the three European territorial tax systems provided impermissible export subsidies. The GATT panel's reports were not adopted until 1981, when the GATT Council adopted an "Understanding" that a country is not required to tax income from foreign economic processes. No further explanation of the "1981 Understanding" was memorialized. However, contemporaneous reports by U.S. participants indicated that there was a tacit agreement that the European systems in question met the foreign economic processes standard and that the United States would be able to amend its DISC regime to come into compliance.

The 1981 Understanding provided the blueprint that was used to develop the Foreign Sale Corporation ("FSC") as a replacement for the DISC. The FSC provided a limited tax exemption for certain income earned from defined economic activities occurring outside the United States. The issue was dormant for more than 15 years until the European Commission ("Commission") challenged the FSC in late 1997. After the WTO Appellate Body determined that the FSC conferred a prohibited export subsidy, the United States replaced the FSC regime with ETI in November 2000.

ETI excludes income derived from a broad range of overseas transactions from the definition of gross income. Unlike the FSC, this regime applies whether the goods are manufactured in the United States or abroad. A taxpayer is treated as generating income eligible for exclusion under ETI only if prescribed "economic processes" take place outside the United States. The Commission brought a WTO challenge immediately following enactment of the ETI regime, which challenge ultimately resulted in a WTO Appellate Body decision that ETI constituted an illegal export subsidy. The matter is now before an arbitration panel where the Commission is seeking authorization to impose more than \$4 billion in trade sanctions on U.S.

exports. The arbitration process likely will be completed by mid-June 2002, at which time the Commission would be free to retaliate.

## **B. The Application of the WTO Agreements to Tax Measures.**

The two principal issues presented by export tax incentives under the Agreement on Subsidies and Countervailing Measures (the “SCM Agreement”) and the Agreement on Agriculture are: (1) whether a tax provision confers a subsidy, and if so, (2) whether the subsidy is contingent on export performance.<sup>30</sup> Article 1.1(a)(1)(ii) of the SCM Agreement provides that a “subsidy” exists if “government revenue that is otherwise due is forgone or not collected.” In turn, Article 3.1(a) prohibits “subsidies contingent in law or in fact, whether solely or as one of several conditions, upon export performance, including those illustrated in Annex I” (the Illustrative List of Export Subsidies that appears at the end of the SCM Agreement).

**Existence of a “Subsidy.”** As interpreted by the WTO Appellate Body, any elective tax regime that departs from an otherwise applicable rule is likely to be viewed as granting a subsidy. Under this standard, the Appellate Body compared the treatment of income excluded under ETI with the taxation of other foreign-source income, and determined that the United States “foregoes revenue that is otherwise due” and thus grants a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.<sup>31</sup>

**Export Contingency Determination.** To avoid a finding of export contingency, it would be necessary to devise an operative rule that applies without regard to whether property is produced within or without the United States. Under ETI, property produced within the United States must be exported to satisfy the condition of use outside the United States. Thus, notwithstanding the existence of a single operative rule, the Appellate Body bifurcated the ETI provisions, on the grounds that the “conditions for the grant of subsidy with respect to property produced *outside* the United States are distinct from those governing the grant of subsidy in respect of property produced *within* the United States.”<sup>32</sup>

**Exception for Double Tax Avoidance Measures.** Paragraph (e) of Annex I (the Illustrative List of Export Subsidies) lists as an export subsidy “the full or partial exemption remission, or deferral specifically related to exports, of direct taxes... paid or payable by industrial or commercial enterprises.” Importantly, however, the fifth sentence of “Footnote 59” to Paragraph (e) provides that “Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.” It is this language on which European countries rely in maintaining territorial exemption systems.

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<sup>30</sup> Because the Appellate Body’s treatment of the principal issues under the SCM Agreement also determined the outcome under the Agreement on Agriculture, the following discussion focuses on the SCM Agreement.

<sup>31</sup> UNITED STATES – TAX TREATMENT FOR “FOREIGN SALES CORPORATIONS” – RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES, adopted January 14, 2002 (“AB Report”) at ¶106.

<sup>32</sup> AB Report at ¶114-115.



In light of Footnote 59, the Appellate Body ruled that a WTO member could provide an export subsidy in the form of a tax exemption if it is a measure to avoid double taxation of foreign-source income. ETI, however, fell short of adequately identifying “foreign-source income” (primarily because the ETI allocation rules apply fixed percentages to amounts that may include domestic-source income, with the result that taxpayers can obtain a tax exemption for income that is domestic-source income).<sup>33</sup> Similarly, as explained below, the ability of the United States to provide export tax benefits under a territorial system would be circumscribed by the Appellate Body’s definition of “foreign-source income” (and the related requirement that arm’s length pricing be used to allocate income between foreign and domestic sources).

**WTO Definition of “Foreign Source” Income.** “[U]nder footnote 59. . .the ‘foreign-source income’ . . . is only that portion of the total income which is generated by and properly attributable to activities that do occur in a ‘foreign state.’”<sup>34</sup> The term cannot be interpreted solely by reference to the rules of the Member taking the measure to avoid double taxation of foreign-source income.<sup>35</sup> Rather, the WTO Appellate Body deemed it appropriate to refer to “widely recognized principles” derived from bilateral tax treaties and multilaterally developed model tax conventions dealing with double taxation, noting that the majority of bilateral treaties adopt the principles of the OECD and U.N. Model tax treaties.<sup>36</sup>

**Treatment of Exports.** In the case of an export transaction, sales income will not be regarded as “foreign-source income” for the sole reason that the property is exported to another country for use there.<sup>37</sup> Rather, an allocation between domestic and foreign sources would be required. In the case of a sale of goods, for example, the Appellate Body suggested that arm’s length pricing rules would be an acceptable basis for distinguishing between domestic and foreign-source income.<sup>38</sup> In other words, some portion of export income may be treated as foreign source where the exporter’s activities in the country of export (or another foreign country) are sufficient that the foreign country might reasonably tax a portion of the export income. Moreover, in such a case the portion of the export income properly treated as foreign source should be determined by the amount the exporter would pay a third party for those activities.

### 3. Simplicity, Administrability, and Long Term Stability.

Furthermore, the Territorial Study Group evaluated whether any proposal would successfully promote the simplification and administrability of the U.S. tax system. To some extent, both the traditional exemption system and the foreign source exemption proposal are

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<sup>33</sup> AB Report at ¶¶183, 186.

<sup>34</sup> AB Report at ¶154.

<sup>35</sup> See AB Report at ¶140.

<sup>36</sup> AB Report at ¶141.

<sup>37</sup> AB Report at ¶176.

<sup>38</sup> See AB Report, n. 133.

dependent on the continued operation of some of the existing U.S. tax rules, such as sourcing. At the same time, both alternatives would change the immediate implications of those rules for U.S. taxpayers, at certain times putting enormous pressure on an already complex set of rules and at other times eliminating the need for some of those rules entirely. The Territorial Study Group considered the ease and speed of the anticipated reform and transition (including modifications to the U.S. technical rules as well as possible expansion of the United States' bilateral income tax treaty network), as well as the ultimate complexity of each alternative. These factors are important not only from the standpoint of U.S. taxpayers, who need comprehensive and reliable guidelines as to the identification, treatment, and computation of tax items, but also from the perspective of the tax administrators, who must be able to articulate clear rules and enforce those rules consistently.

Closely related to the issues of simplicity and administrability is the long term stability of any proposal. Consideration of this factor includes specific evaluation of whether the policies underlying either territorial exemption proposal would be sufficiently clear and compelling to provide U.S. taxpayers with a reliable long term tax regime.

## **TERRITORIAL STUDY GROUP OBSERVATIONS**

### **1. The Traditional Territorial Exemption System.**

#### **A. Scope of the Exemption.**

As noted above, if the United States were to adopt a traditional territorial exemption system, the exempt income under such a system could generally include all "active" business foreign income. Alternatively, exempt income might include all foreign, non-passive income that is subject to some minimum effective rate of foreign income tax. Finally, exempt income could include all active foreign income specified under U.S. income tax treaties.

From a competitiveness standpoint, only the first variation would make sense for several reasons. Either of the other alternatives would carve out a significant amount of active business foreign income, and would thus remain dependent on a broadly applicable foreign tax credit system. Such dependence would only increase the complexity of the U.S. tax rules without a correlative increase in U.S. competitiveness. As discussed above, the existing foreign tax credit rules present significant problems in terms of U.S. competitiveness. To the extent those rules are preserved, their anti-competitive effect would continue under a new system. In contrast, a broad exemption that provides capital import neutrality for virtually all active foreign income would provide a potential increase in competitiveness wherever U.S. companies do business abroad. Such an exemption would improve the competitiveness of those U.S. companies that have significant earnings subject to tax rates lower than U.S. rates and that desire to distribute the earnings back to the United States.

In particular, a system based on a minimum effective rate of tax in a foreign jurisdiction would be fundamentally flawed.<sup>39</sup> Effective tax rates vary substantially from year to year based

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<sup>39</sup> See *International Tax Policy Conference in New York Focuses on "Flawed Miracle,"* 2000 WTD 221-3 (November 12, 2000) (citing D. Rosenbloom as advocating reform of subpart F that would allow deferral for income earned in certain countries, based on a Treasury-level determination that such countries had "real tax systems" at rates comparable to those in the United States, as opposed to relying on the current high-tax exception to subpart F, which is based on effective tax rates).

largely on differing rules in different countries affecting the timing of income and expenses. Accelerated depreciation and the deduction of various liability reserves are but two examples of how foreign effective tax rates can be substantially lower in some years and substantially higher in other years than comparable U.S. rates on income as measured for U.S. tax purposes. A minimum effective tax rate requirement set at higher than a *de minimis* level would inevitably result in situations where income from the same country, including countries with relatively high statutory rates, would be exempt in some years but taxable in others. The uncertainty and complexity of such a rule for both taxpayers and tax administrators make it clearly anti-competitive.

In addition, if the benefits of the exemption system were limited to tax treaty countries, the U.S. treaty network would have to be expanded substantially. It may also be desirable to update certain provisions of existing U.S. tax treaties, *e.g.*, transfer pricing and competent authority provisions, to tighten correlative adjustment measures and to prevent inconsistent source determinations by the treaty countries (both of which could lead either to double exemption or double inclusion of cross-border income), respectively. All these activities could only be implemented over a period of several years during which companies would face a complicated and uncertain transition.

Further, under any of the alternatives, there is a significant likelihood that the current subpart F rules would be employed at least to address the identification and treatment of non-active foreign income. However, in light of the higher stakes presented by a territorial exemption (*e.g.*, the complete exclusion, as opposed to mere deferral, of income), even greater pressure would be placed on the issues of whether and to what extent types of active business income now subject to subpart F (*e.g.*, foreign base company sales and services income) would be eligible for exemption. Retention of anything like the current scope of subpart F as it applies beyond passive income would clearly make a territorial system less competitive.

In addition, a movement from a deferral and foreign tax credit system to a territorial exemption system would necessitate a high-level policy decision as to how to treat pre-adoption foreign earnings that had not been distributed to a U.S. taxpayer or taxed by the United States. One option would be to make the exemption rules retroactive, *i.e.*, to forgive any taxes that would have accrued had the earnings been distributed in prior years. This option would accomplish much in the way of simplicity and administrability, and would make the United States more competitive as a source country, but could be impractical from a revenue standpoint. A reduced rate of tax on the distribution of such earnings might be a reasonable compromise. Alternatively, Congress could adopt ordering rules for post-adoption distribution of such earnings, which would decrease any revenue loss but greatly increase the complexity of the new system. Any of these alternatives is highly contentious, and the initial choice of which approach to pursue (or the formulation of other alternatives) is likely to be anything but simple.<sup>40</sup>

Finally, a serious issue arises as to whether a shift from a deferral and foreign tax credit system to a traditional territorial exemption system represents too much of a change to enact and sustain over a long term period. In the world of politics, many have claimed over the years that even our current deferral system is a "giveaway" to U.S. multinationals, notwithstanding the

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<sup>40</sup> For further discussion of this issues, see M.J. Graetz and P.W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, NATIONAL TAX JOURNAL, vol. LIV, no. 4, p.771, at 783-84 (December 2001).

clear necessity of a true deferral system to avoid substantial double taxation of foreign earnings and serious competitive disadvantages to U.S. businesses.<sup>41</sup> A move to an exemption system, particularly one applicable to foreign business earnings subject to local tax rates substantially lower than U.S. tax rates, would invite even more heated debate. Assuming Congress could overcome such rhetoric and enact a broad exemption system in the first place, it is not clear that subsequent Congresses operating in different political climates would be equally temperate.

## **B. Potential Export Tax Benefits.**

It is unlikely that a traditional territorial exemption system will help to fully satisfy U.S. trade objectives while still resolving the current WTO issues. In analyzing the extent to which the United States could provide WTO-permissible export incentives via a territorial exemption system, it is important to distinguish between “indirect exports” and “direct exports.” “Indirect exports” refer to exports by corporations that manufacture in whole or in part in the United States but rely on foreign subsidiaries or other foreign operations to carry out distribution, marketing, or other export-related activities. As a result of the heavy involvement of foreign operations, these corporations or their foreign subsidiaries are typically subject to foreign tax on at least some of their export-related income. In contrast, “direct exports” involve U.S. taxpayers that sell to unrelated foreign businesses but whose activities are (for the most part) located in the United States. These domestic corporations are rarely subject to tax in any other jurisdiction. To the extent the European territorial exemption systems described above provide effective export incentives, they relate exclusively to the first category of transactions – indirect exports. In contrast, the United States had sought to provide export incentives for both indirect and direct exports through FSC/ETI.

It should be noted that, as a technical matter, the 1976 GATT panel which reported that three of the European territorial tax systems provided impermissible export subsidies has never been overruled. Rather, those systems are viewed as satisfying the requirements of the 1981 Understanding and its subsequent “codification” in Footnote 59. Indeed, the economic nexus principles underlying the traditional territorial exemption system are consistent with the requirements of Footnote 59.

Because a traditional territorial exemption system is premised on significant foreign economic activity, income from *indirect* exports could be exempted in a WTO-compliant manner, based on the conduct of export-related activities abroad and assuming the application of arm's length/transfer pricing principles (as is true, at least theoretically, of European systems). On the other hand, as noted above, income from *direct* exports is unlikely to be taxed elsewhere.

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<sup>41</sup> See Shay Testimony at *W&M Hearing on WTO Extraterritorial Income Decision*, reprinted in 2002 TAX NOTES TODAY 40-78 (February 28, 2002); J.C. Fleming, Jr., R.J. Peroni & S.E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 2000 TAX NOTES TODAY 25-66 (February 7, 2000); R.J. Peroni, J.C. Fleming, Jr. & S.E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); R. Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of IRS' Check-the-Box Regs.*, 97 TAX NOTES TODAY 8-88 (January 13, 1997); S.B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45 (1996); A. Bhansali, *Note: Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401 (1996); J. McDonald, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 J. INTL. L. BUS. 248 (1995); R.A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993); J. Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988).

Thus, it is not surprising that a traditional system based on significant foreign economic activity would not exempt income from direct exports. Therefore, whereas a traditional territorial exemption system could be WTO-compliant, it would not provide significant export tax benefits for many U.S. companies with direct exports and, consequently, would fail to increase the global competitiveness of those companies. The NFTC FSC/ETI Coalition has developed a four-point, unitary proposal, that it has shared with Congress and the Administration, which in a WTO-compliant fashion would help preserve the international competitiveness of companies that currently participate in FSC/ETI. That proposal includes a proposal to modify certain subpart F rules.<sup>42</sup>

### C. Disallowed Expenses.

As noted above, a significant feature of a traditional territorial exemption system is some form of disallowance of expenses related to exempt income. As also discussed above, however, the existing U.S. tax rules over-allocate expenses – particularly interest and general and administrative expenses – to foreign sources. Such over-allocation is already controversial in the existing system, where it is significant only for purposes of calculating a U.S. taxpayer's foreign tax credit limitation;<sup>43</sup> this issue would become critical in a regime that disallowed such expenses entirely.<sup>44</sup>

The disallowance of over-allocated expenses would clearly undercut the competitiveness of U.S. companies. Using 1996 Treasury data from a 2001 study performed by Harry Grubert, a senior economist at the U.S. Treasury Department (the "Grubert Study"),<sup>45</sup> the disallowance of allocated interest expense would have raised approximately \$3.5 billion in increased taxes in 1996.<sup>46</sup> The disallowance of general and administrative and other allocated expenses would have raised an additional \$4.5 billion in 1996, a year in which total taxes collected on aggregate foreign source taxable income (including only non-financial businesses) was \$5.2 billion.<sup>47</sup> To the extent that the exemption system continued to rely on the current interest allocation rules and allocated general and administrative-type expenses to exempt income, the disallowance of over-

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<sup>42</sup> See, NATIONAL FOREIGN TRADE COUNCIL, INC., FSC/ETI COALITION: DRAFTING SPECIFICATIONS FOR PROPOSED STATUTORY AMENDMENTS (April 30, 2002).

<sup>43</sup> See, e.g., H.R. 2488, § 901 (bill to amend the interest allocation rules to provide for an election to allocate interest on a worldwide basis, passed by Congress but vetoed by President Clinton in 1999); B. Wells, *Interest Allocation: A Regime Desperately in Need of Sound Policy*, 53 TAX LAW. 859 (2000).

<sup>44</sup> For further discussion of the worldwide approach to interest expense allocation, see Statement by National Foreign Trade Council, Inc. to the Committee on Finance, United States Senate (May 14, 2001), *reprinted in* 2001 WTD 106-37 (June 1, 2001). See also Grubert Study at 819-22.

<sup>45</sup> H. Grubert, *Enacting Dividend Exemption and Tax Revenue*, NATIONAL TAX JOURNAL, Vol. LIV, No. 4, p. 811 (December 2001).

<sup>46</sup> Grubert Study at 816.

<sup>47</sup> Grubert Study at 816.

allocated expenses would have the effect of seriously undercutting the competitiveness of U.S. companies.<sup>48</sup>

These problems could be substantially alleviated by changing the interest apportionment calculation from a “waters’ edge” mechanism to a “worldwide” mechanism. Under a worldwide approach, interest expense allocation would take into account the borrowings of foreign subsidiaries as well as the borrowings of the U.S. group. The Grubert Study estimates that such a shift would have reduced allocation of interest expenses by approximately two-thirds in 1996.<sup>49</sup> Moreover, a strong case can be made that no general and administrative expenses should be allocated to exempt income where the expenses are not properly deductible in the source country. However, whether these changes from current U.S. rules are sustainable over the long term is far from certain. If, instead, a territorial system were enacted using the current interest and general and administrative expense allocation rules, the resulting disallowance would constitute a serious competitive disadvantage for most U.S. companies.

#### **D. Conclusions on Traditional Territorial System.**

As described above, a traditional territorial system would not preserve the competitiveness of companies that are principally U.S. exporters. A traditional territorial exemption system applicable to active business income generally, without limitation, could improve the competitiveness of those U.S. companies that have substantial foreign active business income taxed at source country rates that are significantly less than U.S. tax rates. Other companies, which can utilize foreign tax credits from high taxed countries, could in fact be worse off from a competitiveness viewpoint. Equally importantly, however, to improve the competitiveness of any substantial group of U.S. companies would require favorably resolving many of the same issues that make our current rules anti-competitive: the overly broad scope of subpart F with respect to active business income, the over allocation of expenses to foreign income, and the restrictive aspects of the foreign tax credit.

### **2. The Foreign Source Exemption Proposal.**

#### **A. Scope of the Exemption.**

As noted above, the foreign source exemption proposal would apply the existing U.S. sourcing concepts to the income derived by a U.S. company, and exempt the company’s foreign source income as determined under those concepts.

Several of the concerns raised by the traditional territorial exemption system are alleviated in respect of the foreign source exemption proposal. The competitiveness of a much broader group of U.S.-based companies would be increased.<sup>50</sup> Moreover, from a simplicity and

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<sup>48</sup> Similarly, the disallowance would create a strong incentive to locate the enterprise’s headquarters outside of the United States. Allocated headquarters expenses are unlikely to be deductible in any other jurisdiction; shifting headquarters functions to another jurisdiction would ensure the enterprise’s ability to recover those expenses fully.

<sup>49</sup> Grubert Study at 817.

<sup>50</sup> In the long run, increases in source country withholding taxes could offset much of this benefit.

administrability viewpoint, the foreign source exemption proposal could be modeled closely after the current U.S. tax rules, with the principal change the zero tax rate applied to foreign source income and expense items. Furthermore, the creation of two baskets of income – U.S. source taxable income and foreign source exempt income – would eliminate any ongoing need for a foreign tax credit system. And, as discussed above, subpart F could be repealed or scaled back to apply only to passive U.S. source income earned by foreign subsidiaries. As a result, the foreign source exemption proposal would be much simpler to implement than the traditional territorial system.

Notwithstanding these comparative benefits, the foreign source exemption proposal is highly problematic because it may simply be too expensive for the United States to consider realistically, much less implement on a long-term basis. A foreign source exemption proposal would clearly cost a substantial amount in foregone tax revenues.<sup>51</sup> Whereas the significant tax savings would undoubtedly improve the competitiveness of U.S. companies, the cost represents a serious obstacle to enactment.

### **B. Potential Export Tax Benefits.**

Put simply, any territorial system that departs from the traditional territorial exemption system would likely be viewed as defective under WTO rules. The foreign source exemption system based on U.S. concepts would not allocate income between domestic and foreign sources based on arm's length principles. Rather, the foreign source exemption system would require only that title to the goods pass outside the United States and then automatically designate a portion of income from the direct and indirect exports as foreign-source income. Under the Appellate Body's ruling, this definition of "foreign source" would not be determinative for WTO purposes. Instead, the applicable WTO agreements would require a foreign source exemption system to include rules for allocating income from indirect exports between domestic and foreign sources based on arm's length principles.

### **C. Disallowed Expenses.**

As noted above, the foreign source exemption proposal is much broader in scope than the traditional territorial exemption system. As such, although the deduction disallowance feature of the proposal would have the same effect as that of the traditional system – decreased competitiveness of U.S. companies, increased pressure on the interpretation and enforcement of complex allocation rules, and the creation of a disincentive to place debt capital in the United States – the effect would be more pronounced due to the larger amount of deductions implicated. However, given the magnitude of the income exempted from tax, the disallowance of expenses under current U.S. concepts would be more tolerable, except for the disallowance of interest expense under the present law "water's edge" rules.

### **D. Conclusions on Foreign Source Exemption.**

The foreign source exemption proposal could significantly improve the global competitiveness of U.S. companies and of the United States as a source country, so long as the expense allocation rules avoid the over-allocation and disallowance of interest expense.

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<sup>51</sup> Under a static analysis, it would have cost \$5.2 billion per year, based on 1996 data. Under a dynamic analysis, however, the revenue cost would no doubt be much higher. *See* Grubert Study at 811.

Furthermore, the foreign source exemption proposal appears relatively simple to enact and presents the possibility of a short and effective transition from the current foreign tax credit rules. However, the proposal has other substantial drawbacks. The foreign source exemption proposal would likely fail to resolve the United States' current WTO issues, in that the proposal would likely be WTO non-compliant. Further, the proposal would cost substantial revenues, which, together with necessary modifications to the expense allocation rules, could be fatal to the proposal. Any attempt to mitigate the cost or modify the allocation rules – even if successful – would detract substantially from the simplicity, stability, and administrability of the proposal. Finally, the proposal would result in some taxpayers having significant income that is not taxed in any country, and other taxpayers with significant expenses not deductible in any country. The long run stability of such a system is questionable.

### **RECOMMENDATIONS OF THE GROUP**

Taking into account all of the observations noted above, the Territorial Study Group concludes that, on balance, legislative efforts to improve current international tax rules are better spent on reform of our current deferral and foreign tax credit system and on finding a WTO-compatible replacement for FSC/ETI than on adopting a territorial exemption system.

While it is true that a territorial system could improve competitiveness and simplicity for some U.S.-based companies with substantial operations abroad, the accompanying reduction in foreign tax credits attributable to exempt income could more than offset that benefit for other such companies. Moreover, the benefit for any significant group of companies would be dependent on the adoption of a broad exemption, a cut back on the existing subpart F rules, and reform of the current expense allocation rules.

As the above indicates, most of the improvements generated by a competitively desirable exemption system would not be rooted in the exemption provisions themselves, but instead in other modifications to the current tax system, particularly to the overly broad subpart F rules, the restrictive expense allocation rules, and other foreign tax credit provisions. The Group believes these issues can and should be directly addressed by adopting specific reforms outside the context of an exemption proposal. These reforms would not specifically address the international competitiveness of U.S. exporters that benefit principally from the FSC/ETI regime. The adoption of these reforms will, however, improve the competitiveness of U.S. companies with substantial operations outside the United States.



## **Appendix A**

The following companies participated in the study, although each company may or may not agree with every aspect of the report.

Agilent Technologies, Incorporated  
Air Products and Chemicals, Incorporated  
The Boeing Company  
Caterpillar Inc.  
ChevronTexaco Corporation  
Citigroup  
Coca-Cola Company  
Delphi Automotive Systems Corp  
Dow Chemical Company  
DuPont  
Eastman Kodak Company  
Electronic Data Systems Corporation  
Eli Lilly and Company  
Exxon Mobil Corporation  
General Electric Company  
General Motors Corporation  
Goodyear Tire & Rubber Company  
Hewlett-Packard Company  
Household International, Incorporated  
Ingersoll-Rand Company  
Intel Corporation  
Johnson & Johnson  
Lockheed Martin Corporation  
Mars, Incorporated  
Merck & Company  
Merrill Lynch & Company  
Microsoft Corporation  
Morgan Stanley  
Pfizer Inc  
Procter & Gamble Company  
Schering-Plough Corporation  
WorldCom, Incorporated