MOVING TO A TERRITORIAL TAX: ISSUES AND DESIGN

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INTRODUCTION

After many years of general proposals to move to a territorial tax that would exempt income earned by foreign operations of U.S. multinational corporations, Congress has now provided a much more detailed blueprint of how such a provision might be designed. The National Commission on Fiscal Reform (2010) proposed a territorial tax in general terms. The proposals by Ways and Means Chairman Camp (Ways and Means Committee, 2011) and the bill by Senator Enzi (S. 2091) are much more specific. Their proposals appear much more generous to multinationals than the proposal that had been circulating for some time, the Grubert and Mutti (2001) plan. The latter proposal would actually raise revenue because loss of the foreign tax credit would eliminate the use of excess credits to shield royalty income and the proposal would allocate overhead deductions, including interest, between taxable and tax exempt sources.

The newer proposals aim for revenue neutrality in the budget horizon financed by a small tax on existing accumulated earnings, which would lose revenue in the longer run. These recent proposals do not include general allocation rules and propose, or may propose, to provide replacement tax benefits for royalties. The proposals also consider the problem of excessive profit shifting and propose anti-base-erosion provisions whose effectiveness is unclear.

Of course, there is far from unanimous agreement that going to a territorial tax is appropriate. Historically, most reform proposals, such as the Kennedy proposal in 1962, the Burke-Hartke proposals, and the Treasury Department version of the Tax Reform Act of 1986 proposed to move towards a fuller worldwide system. Similarly the Wyden-Gregg, now Wyden-Coats, bill (S. 727) would increase the taxation of foreign source income. President Obama has discussed imposing a minimum tax on foreign source income and, while the details have not been developed, such a tax would likely raise revenue. President Obama's budget proposals have consistently included provisions to limit the principal elements that cause little tax to be imposed on foreign source income: deferral and foreign tax credits.

The current system, at least in its outcome—negligible tax on income of U.S. foreign subsidiaries, as shown in Gravelle (2012b)— resembles a territorial tax. This outcome is due two features of the tax code: deferral of tax on foreign source income which, except for certain passive income, is not taxed until paid as a dividend to the U.S. parent; and the overall limit on the foreign tax credit which, while limiting credits for foreign taxes to U.S. tax due allows excess credits from high tax jurisdictions and investments to shield income in earned in low tax jurisdictions or from lightly taxed activities from U.S. tax.

The discussion of territorial taxes has also increased the focus on an additional consequence of the current system: the ability to use excess credits to offset the U.S. tax on royalties, which are current flow income and are generally deductible in foreign countries. While eliminating those tax shields via a move to a territorial tax may be thought of as desirable, since this income is not taxed in any jurisdiction, it may nevertheless induce some unwelcome behavior, by encouraging more developing of intangibles abroad and greater attempts to transform royalty income into income earned in low tax countries.

This analysis addresses the principal issues surrounding the move to a territorial tax considering first the arguments generally advanced to justify the move: elimination of incentives to repatriate and so called "competitiveness." Following that discussion, the issues of profit shifting and shifting of headquarters is addressed. The final section briefly discusses compliance and administration, transition, and revenue.

REMOVING REPATRIATION INCENTIVES: IS IT AN ADEQUATE JUSTIFICATION?

A criticism of the current system is that while collecting very little revenue from foreign subsidiaries, it nevertheless discourages repatriations. This effect on repatriations is a major rationale cited by the Ways and Means Committee (2011). The argument also ties the lower repatriation rates to less investment and fewer jobs in the United States. Accumulated deferred earnings abroad was estimated at $1.4 trillion in the Spring of 2011 (Tyson, 2011) and has undoubtedly grown since then.

A territorial tax is not necessary to eliminate the repatriation tax. The tax effect on repatriation could be eliminated by ending deferral where taxes would apply regardless of repatriation, or by a variety of hybrid approaches such as taxing a fixed share of profits currently and exempting the remainder, or allowing an exemption combined with a minimum tax.

While the policy choice should not turn on the repatriations tax issue alone, it is also likely that the effect of the movement to a territorial tax would not have a significant effect on repatriations.

Estimates by Gravelle (2012b) suggest that about a third of foreign subsidiaries' earnings was repatriated, with discretionary distributions net of Subpart F income around 23%. Does that imply that the 77% of income net of Subpart F distributions would be repatriated under a territorial tax? It is unlikely that much of an increase would occur, and even more unlikely that it those repatriations would be translated into investment.

Several considerations suggest that the increase in repatriations would be limited. First, regardless of taxes, much of foreign source earnings would be retained abroad to be reinvested in the enterprises there. Historical evidence on corporate rates of return and growth rates in the United States suggest that about 60% of nominal income is typically retained to maintain the real capital stock and allow it to grow normally at a steady state. This share is consistent with a 10% nominal return and a 4% dividend rate. The remainder, 40%, would be distributed. Thus we might expect, at the most, to see an increase of 17% of earnings net of Subpart F income. The presence of a large amount of unrepatriated earnings is meaningless in itself.

Second, these repatriation rates are currently at an unusually low level. They followed the large one time repatriation (generally in 2005) from the temporary repatriation holiday enacted in 2004. This holiday probably reduced the need for repatriations before and after the holiday and encouraged more retentions due to anticipation of another holiday.

Historical data indicate that repatriation rates fell towards the end of the 1990s and continued to be low from 2000-2008. Data were provided every other year and did not include 2005, the year most repatriations occurred under the repatriation holiday. Over the period 1968-2008, the average repatriation rate was 40%; for 2000-2008 it was 20% (Internal Revenue Service, 2012; Hines, 1999). In addition to the repatriation holidays, the growth of high-tech and dot.com firms that were expanding rapidly and not initially paying dividends may also have affected these payout ratios. The evidence from tax data is also consistent with studies examining repatriation rates over an earlier period of time using financial data that found rates of around 40% (Desai, Foley and Hines, 2007). Since a 40% rate is about the rate that might be expected in a no-tax world, these results suggest that the repatriation tax has had relatively little effect on a permanent basis. If firms no longer anticipated another repatriation holiday or territorial tax, and the high-tech industries achieved a steady state growth, repatriation rates might rise to more normal levels.

Third, there is direct evidence that shifting to a territorial tax would not have large effects. Some initial evidence indicates that the Japanese shift to a territorial tax increased repatriations in the first year by about 20% (Thomas, 2011). Since a larger initial effect might be expected, as pent up earnings are returned, such an increase is quite modest. If U.S,. repatriations increased at the same rate, compared to the current realizations rate, it would increase realizations by about 4% of total earnings and compared to the 40% rate it would increase realizations by about 8% of earnings. Looking at further years for the Japanese experience, the dollar amount of repatriations fell the second year and were only 10% larger than before the change, while they rose the following year (Bank of Japan, 2012). As payout rates, the rate rose from 53% to 84% the first year and 86% the second year, but then fell back to 64% the third year. In addition to the increase being not that significant, and not appearing to be sustained, there could have been a reduction in repatriations immediately before the change in anticipation of the territorial tax. That appears to be the case as dividends declined in the year immediately preceding the change (2009), and the repatriations in 2010 were only 7% higher than those in 2008.

In addition to the Japanese evidence, preliminary results from a study of the UK territorial tax shift, while subject to revision, suggest an increase of 6% of earnings (Egger, et al., 2012). A statistical study of U.S. affiliates in different countries facing different taxes estimated that U.S. repatriations would increase by about 13%, which would be 2.5% to 5% of earnings (Desai, Foley and Hines, 2001).

Moreover, some theory and research suggests the effects would be negligible on a permanent basis. Theoretical considerations indicate that the repatriation tax should not matter because firms will eventually have to repatriate earnings. This theory, referred to as the "new view" is related to a similar theory about why domestic firms pay dividends to their individual shareholders even though it triggers a dividend tax. In both cases, the idea is that eventually shareholders will want to receive their dividends in excess of amounts needed for steady state reinvestment and dividends will be paid either currently, or in the future with interest. In either case, the same present value of tax will occur. While this "new view" for dividends paid by a U.S. firm to its individual shareholders could be rejected on the grounds that firms can return cash to the economy by repurchasing shares, such an option is not available for dividend payments between a multinational affiliate and its parent.

If the theory correctly describes behavior, then one would expect that, regardless of the repatriation tax, a similar share of earnings would be paid in dividends with or without a repatriation tax. A large empirical literature has developed to study repatriation behavior in light of this theory, finding a variety of results (see review in Gravelle, 2012b).

Even if repatriations increase under a permanent territorial tax, those repatriations may not result in additional investment, but are likely to be paid out as dividends, or substitute for borrowing by the parent company. Job creation is not the primary focus here in any case, as in the long run the economy will tend to create jobs naturally. As an illustration, consider that in 1961 and in 1991 the unemployment rate was the same, 6.7%. Employment, however, rose from 66 million to 117 million, as the economy accommodated the baby boom and the entry of women into the labor force. Permanent provisions that encourage capital to move abroad can change the types of jobs and reduce wages, but not necessarily overall employment.

"COMPETITIVENESS," EFFICIENCY, AND THE LOCATION OF INVESTMENT

Another argument invoked for territorial taxes is to make U.S. multinationals "competitive." As a guide to making tax policy, however, international competitiveness as it is commonly perceived does not make sense. As ably pointed out by Paul Krugman (1994) in the context of trade policy, countries do not compete and are not rival in the sense of Pepsi and Coke. A country will not go out of business because it can't cover its costs with revenues, and competitiveness does not provide a guide to desirable policy. Krugman asks why economists, who should know better, use such a concept and concludes that they wish to harness popular ideas for a good cause; he concludes, however, that such a misguided standard leads to bad policy outcomes.

To illustrate the fruitlessness of a competitiveness objective consider a concrete example: lowering the U.S. corporate tax means the United States will be more "competitive" in attracting more capital from abroad. But how low should we set the tax rate? If 25% is better than 35%, why stop at 25%? Why stop at zero? Why not subsidize the import of capital? The competitiveness argument provides no guide to policy. Similarly, if firms foreign investments are taxed only in the country of location and all other countries have territorial taxes, they will be "competitive" in that they can sell for the same price and earn the same rate of return, but domestic investments will no longer be "competitive" with foreign investments. Which part of competitiveness should we seek?

However, if we forget about the inappropriate concept of competitiveness and consider instead the more standard notion of maximizing national welfare, this concept immediately produces a rule for achieving that effect. In a simple model, it says to set the tax rate at 1/(1+e), where e is the elasticity of capital inflow with respect to the tax rate. Given evidence that e is in the neighborhood of 3 (Jennifer Gravelle, 2010), the tax rate should be about 25%, approximately the level of the current effect tax rate, with an average effective tax rate of 27% and an average marginal effective rate of 22% (Gravelle 2013).

Similarly, if not taxing foreign source income makes our firms more competitive abroad, why not go farther and subsidize them? Again, optimality rules provide a concept for what is optimal: foreign investment income should be taxed with a deduction for foreign taxes.

Of course, it will immediately be argued that these notions depend on some simplifying assumptions that cannot be achieved in the real world. Fair enough, but the concept of "competitiveness" doesn't even produce a starting point.

With a proper starting point, then it is possible to consider how to accommodate any imperfections and caveats. For example most proposals to address international tax issues in the past have sought to move closer to a standard that maximized world welfare, and that standard calls for the same tax rate on foreign source income as on domestic income, based on the idea that firms' options are not being other country's firms. but its own alternative investments. It can readily be shown that, under certain circumstances, a tax system that taxes on a residence basis meets that standard, while a territorial tax does not: the economic logic is beyond questioning. A system that most closely approximates the efficient system is a worldwide tax with no deferral of income, and separate foreign tax credit limits by country and by type of income. This system achieves neutrality with respect to low tax countries and simply moves closer to U.S. rather than world optimality for high tax countries.

A plethora of arguments have been advanced to nevertheless claim that a territorial system is, despite this compelling reasoning, actually a better system. Without reprising in detail a discussion that has appeared in other works (Gravelle 2012a, 2013), most of these arguments can be rejected. Arguments that worldwide taxation along the lines suggested will create disadvantages for U.S. firms because other countries have territorial systems can be rejected by the same reasoning that identities the efficient system: even in the worst case a territorial tax will gain no benefits and in most cases it will be less optimal. The argument that foreign investment does not displace domestic investment of firms not only largely defies logic, but the empirical evidence used to support it (showing foreign investment is correlated with more, not less, domestic investment) not only does not address the overall capital in the United States but cannot be demonstrated to show a causal relationship. The so-called "capital ownership neutrality" argument that taxing foreign source income undermines the ability of U.S. firms to exploit intangibles and excess profits not only is not supported by evidence but ignores the numerous ways that firms can exploit these assets without investing in production facilities (e.g. contract manufacturing, leasing assets, franchises, etc.). The argument that neutrality in U.S. investments cannot be achieved because of portfolio investment in foreign firms by individuals (so that capital available to U.S. multinationals does not match capital of U.S. citizens) is true enough, but does not relate to rules taxing foreign source income, but rather to the overall corporate tax burden on U.S. firms. That is, individual investors care about returns, not about the specific features of the tax law that affect those returns. In any case, evidence indicates that individuals continue to have a strong home bias and that U.S. individuals tend to invest in high-tax, not low-tax, countries, suggesting that the major objective is portfolio diversification.

One issue that is important is whether U.S. firms can change their nationality and become foreign firms. If that behavior were widespread then the neutrality claims for a world wide system that does not allow deferral and limits cross-crediting would no longer be true. This issue is an important one, discussed below.

Setting aside this issue for the moment, although both the current system and a territorial system create inefficiencies, the economic importance of these inefficiencies is likely to be small. First, most of the countries where real economic activity takes place (as opposed to artificial profit shifting) have tax rates that are similar to those in the United States (Gravelle 2013). While statutory U.S. tax rates tend to be higher than the GDP weighted OECD or other large countries, average effective tax rates are about the same, so the distortions cannot be that significant. Moreover, Gravelle (2013) shows that the effects of a much larger revision than the effects of moving to a territorial tax or to a more effective world wide tax, a ten percentage point rate reduction, nevertheless would be expected to have a very small effect on U.S. output (less than 2/10 of one percent) and an even smaller effect on U.S. income (less than 2/100 of 1 percent). The smaller effect on national income occurs because the profits from additional capital are not increases in U.S. income (for inbound investment they are received by foreigners and for reductions in outbound investment they are simply changing location). The gains are thus the taxes on induced investment offset by the losses from lower rates from inbound investment already in the country. Since this change is about 29% of corporate revenues, while eliminating all taxes on foreign income is about a quarter of this magnitude and moving to a more effective worldwide tax is about a half, these effects are unlikely to be significant.

SHIFTING PROFITS; SHIFTING HEADQUARTERS

If the real allocation of investment does not matter that much, and repatriation policy is not affected very much either, what is the central policy issue? I suggest that it is artificial activities to avoid taxation: profit shifting and headquarters shifting. Although there are limited data to guide us, the insights of the previous discussion suggest strongly that moving to a territorial tax will greatly increase the incentive to shift profits, but it is unlikely to make much difference in shifting headquarters.

There are two additional issues: effects on administration and compliance costs and transition effects, that will be discussed subsequently.

Shifting Profits

Profit shifting is largely achieved by two methods: borrowing in high tax countries, and transferring intangibles to low tax subsidiaries at below market prices. Grubert (2003) estimates these to each be responsible for about half of profit-shifting. The revenue loss from profit shifting under current law is generally estimated at between 14% and 20% of revenue (Gravelle 2013).

A crucial issue is the extent to which a territorial tax would lead to increased profit shifting. Judging merely by the similarity of the current system to a territorial tax, some might argue that this profit shifting might not change very much, since firms pay little tax currently. Of course, that means profit shifting could be eliminated by reform as well, in that case, eliminating deferral.

However, if repatriation taxes don't matter very much (as discussed above) the corollary is that profit shifting will be enormously more attractive. If firms expect that sooner or later profits in excess of investment will need to be repatriated and taxed, then the advantage to shifting profits to low tax countries is limited. Unless a firm has extra excess foreign tax credits, taxes (with interest) must ultimately be paid, and there is powerful theoretical evidence as well as empirical evidence to believe this (including the large repatriation that occurred in 2005). Some profit shifting may be by firms that have excess foreign tax credits they wish to use. However, some profit shifting in the current system could be in part due to new high-tech firms that are not yet in a steady state or firms that have hopes for periodic repatriation holidays or a shift to territorial tax that would involve a lower rate for accumulated deferred income. Certainly the granting of a holiday in 2004, the reconsideration of it in 2009 and more recently, and the continued discussion of moving to a territorial tax, would encourage firms to delay repatriation as long as possible. However, if it became clear that there were to be no more holidays and no shift to a territorial tax, the degree of profit shifting could be reduced especially as high tech firms settle down to a steady state. In a territorial system, however, profits can be shifted and repatriated immediately, permanently escaping tax.

Moving to a territorial tax compared to retaining the current system, therefore, would lead to a much greater incentive to shift profits abroad, as there would never be a concern about paying U.S. tax. It might cause the current level of profit shifting, which might otherwise diminish, to be maintained and to grow. Firms would be free under a territorial tax to shift profits abroad, and then quickly repatriate them, with no real change in investment retained abroad and a lower U.S. tax. Repatriations might appear to increase, but would only reflect the increase in profit shifting.

The designers of various proposals for a territorial tax appear to recognize concerns about profit shifting and all have some provisions directed at profit shifting.

It is a relatively simple matter, comparatively speaking, to deal with leveraging (challenges are more political than technical): limit the debt share in the U.S. to the overall worldwide debt share of the firm and its foreign subsidiaries, or alternatively, allow deductions only for the share of worldwide interest paid that corresponds to the share of worldwide income being reported. Probably the only issue is how to define included subsidiaries, but it could be the same rule that permits a dividend exclusion under the territorial proposal (an issue that presents some complexities in and of itself). These types of strict restrictions on leveraging have already been used in other countries.

Whether the political will exists to accompany a move to a territorial tax with strict leveraging is, however, still uncertain. The more academic proposal by Grubert and Mutti (2001) would disallow deductions (all overhead, not just interest) to the extent income is not taxed, effectively limiting shifting through leverage. The Ways and Means draft proposal has limits on interest deductions by parents, but discusses a potential alternative safe harbor with unspecified parameters that could undermine this approach, depending on where the values are set. It also has a haircut (taxes 5% of dividends). This provision is about a fifth the size of the deduction restriction in the Grubert-Mutti proposal (Gravelle, 2012b). Senator Enzi's bill has no provision addressing leveraging although does have the 5% haircut.

Dealing with intangibles is much more difficult. If the IRS were able to determine the proper pricing of intangibles there would be no profit shifting, but the evidence clearly suggests it exists. Various approaches include a measure of excess profits based on profits relative to costs or simply taxing all intangible income (or all income) located in tax havens or low tax countries.

Grubert and Mutti have no provision to address shifting through intangibles, perhaps because that method was not as important when they were preparing their research. The Ways and Means proposal, in addition to the haircut, presents three options. Option A would treat intangible income in excess of 150% of costs as U.S. income for countries with tax rates below 15% (phased out between 10% and 15%). Option B would tax income as U.S. income in countries with tax rates below 10%, although there would be exceptions whose reach is uncertain. Option C would tax intangible income at a minimum rate of 15% and also apply this rate to royalties. This extension to royalties addresses a concern that a territorial tax will increase the tax on royalties which can no longer be shielded by excess foreign tax credits. S. 2091 would tax as U.S. income amounts in countries with less than half the U.S. rate (17.5%) and also apply this rate to royalties.

There are a number of problems with all of these approaches. Options A and C in the Ways and Means plan and the approach in S. 2091 apply only in countries with a specified tax rate, creating a cliff and an incentive to move profits to a locale with taxes. that are just above the minimum that triggers the tax. These cliffs and incentives, however, could be eliminated by imposing a minimum tax on all foreign source income (although that would no longer be a territorial tax). Some provisions have tax levels so low they would exclude a major tax haven such as Ireland. Some options appear to leave a great deal of room for justifying an exclusion based on the firms' activities in the country. All would lead to some complications (such as measuring effective tax rates and measuring intangible income). Provisions that partially eliminate the benefit by imposing a minimum tax would still leave firms with the ability to shift profits, although limiting the ability to reduce taxes.

Some of these proposals could also induce some other undesirable effects. For example, by triggering current taxation of intangibles when the return exceeds 150% of costs, the first Ways and Means option provides an incentive to push deductible development and marketing costs into the CFC. Once a firm falls into the excess profit class a dollar of cost moved to the CFC will decrease income subject to U.S. taxation by $1.50, while increasing taxable income in the United States by $1.00 (although if the tax code retained the production activities deduction and income were eligible for it, this additional dollar would increase taxable income by $0.91).

It is not clear that a territorial system could be designed that would work efficiently and effectively in preventing a surge in profit shifting activity, in the case of intangibles. However, moving in the other direction, by ending deferral, should effectively close off the opportunities for profit shifting to low tax countries.

Shifting Headquarters

Moving to a territorial tax should reduce and perhaps eliminate the incentive to move headquarters abroad by one of three methods: moving an existing firm's headquarters abroad (inverting), merging with a foreign firm that becomes the parent (international mergers), or originally incorporating abroad. (These incentives would increase substantially with an end to deferral).

Anti-inversion rules adopted in 2004 have prevented large-scale shifting of headquarters of existing firms. Of course, with tax planners in action, these rules might need to be revised from time to time. For example, a report in the Wall Street Journal (McKinnon and Thurm, 2012) highlighted some recent moves abroad despite the

2004 legislation. This report claimed ten companies had inverted, with six within the last year or so.

Was this a sign of the failure of anti-inversion rules, as the article seemed to imply? Aside from the fact that ten is a quite small number of companies, it is instructive to look at some of them specifically. McKinnon and Thurm identified by name five of the ten companies, and these were ones that moved abroad recently—Aon, Ensco, Rowan, Eaton, and DE Master Blenders 1763— as among the recent companies to move abroad. (The article also referred to Transocean and Weatherford International, but these were firms that had inverted prior to the legislation: Transocean first to the Cayman Islands and then Switzerland, and Weatherford first to Bermuda, and then Switzerland).

The first three of these firms used what Wells (2012) refers to as a "naked inversion," (where the only objective is tax savings) which used an exception in the anti-inversion rules for firms that had substantial business activities. All three moved to the United Kingdom, where recent changes had made their tax system more attractive. Two were oil drilling firms and one might speculate that drilling in the North Sea might have affected their ability to use this exemption; Aon is an insurance firm. In response, IRS regulations issued in June, 2012 increased the substantial business activities test requirement from 10% to 25% of activity, apparently closing of this avenue in the future (Wells, 2012; Parillo, 2012). Wells also mentions another firm, Tim Hortons, that used a naked inversion in 2009 to relocate to Canada. In doing so, the firm was returning to its origins as it was founded in Canada. It was acquired by Wendy's in 1995 but spun off in 2006 (Tim Hortons, 2012). DE Master Blenders 1763, like Tim Hortons, was returning to its origins as well (a Netherlands firm), as it was spun off from Sara Lee who had acquired it in 1978 (DE Master Blenders 1763, 2012).

The remaining firm mentioned in the Wall Street Journal article is Eaton. Eaton's move abroad was a merger; it merged with Coopers, a firm effectively operating its headquarters in the United States, but one that had inverted prior to the law change.

When looked at from this perspective the anti-inversion rules appear to be holding up well, and when evidence of a problem occurred, the IRS moved to contain it. The major firm that used a merger merged with a U.S. firm that had already inverted, not a foreign one. In general, mergers, and particularly mergers with foreign firms that become the parent, involve numerous other constraints and considerations that cause barriers to the use of this approach. As for original incorporation outside the United States, evidence suggests that very little incorporation of true U.S. firms occurs abroad (Morse and Allen, 2011). There would seem to be good reasons, since new firms are largely concerned about surviving and would likely consider these tax matters as secondary.

Moreover unlike countries in Europe, where rules of the European Union prevent anti-inversion laws from being enacted, the United States is free to enact provisions to strengthen these restrictions, by imposing toll taxes, or basing taxation on where effective management occurs.

On the whole, therefore, it appears that shifting profits is a relative easy option compared to shifting headquarters.

ADMINISTRATIVE, TRANSITIONAL, AND REVENUE ISSUES

One of Grubert and Mutti's arguments for moving to a territorial tax was to reduce the cost of tax planning that surrounds repatriations.

The development of a detailed plan by the Ways and Means and the commentary that it attracted, however, clearly showed that moving toward a territorial tax was by no means a simple matter (as discussed in more detail in Gravelle, 2012b). If all investments were through wholly owned subsidiaries, the definition of coverage would be straightforward, but firms operate in a variety of forms: branches, minority owned interests (either for a firm or for U.S. firms as a whole), and partnerships Whether and how the regime would apply to these operations is no easy matter. For example, if branches are not treated as foreign subsidies there would be considerable room for abuse, yet measuring income and transactions of an entity that does not exist is difficult. Firms where there is a large, but not majority, U.S. share might not be able to provide documentation to comply with transition rules and base erosion rules. If anti-abuse provisions are included, the identification of income that is and is not subject to tax and the measurement of effective tax rates on a country by country basis will add to complexity. Many features of the foreign tax credit are eliminated (such as separate basket, limits and allocation rules) even through foreign tax credits still exist for some purposes, creating additional problems and avenues for abuse.

The second issue is transition and revenue. One of the difficult problems facing a shift to territorial tax is what to do about accumulated profits abroad. One option would be to treat income as taxable until the accumulated earnings are paid out, which would greatly prolong the transition to the new system. Another is to mandate recognition of accumulated earnings and impose a tax, perhaps at a lower rate, and perhaps spread over time. Since a lot of the accumulated earnings would not likely have ever been subject to tax, a lower rate may be appropriate.

Grubert and Mutti do not discuss transition. The Ways and Means draft would require a deemed recognition (not necessarily actual repatriation) but at a lower rate (85% would be excluded, with foreign tax credits associated with the share taxed allowed). S. 2061 let firms to elect to repatriate, with a 70% exclusion and no foreign tax credits; dividend relief would be delayed otherwise under all the earnings are paid out.

The transition relief might reflect rough justice. However, the revenues are used to finance other potential beneficial features in both the Ways and Means draft and S. 2061. The Grubert and Mutti (2001) proposal would raise revenue. However, the Ways and Means proposal, while not completely designed, has proposed to be revenue neutral in the budget window in conjunction with other corporate tax changes, but includes transitional revenues, which means the proposal will lose revenue in the long run. S. 2091 has a similar plan. Given the future deficit and debt challenges that face the United States, this revenue loss is of some concern.

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