

***BACK TO THE DRAWING BOARD: THE STRUCTURAL AND ACCOUNTING
CONSEQUENCES OF A SWITCH TO A TERRITORIAL SYSTEM***

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ABSTRACT

We review the basics of international tax planning by U.S. multinational corporations and the organizational structures that facilitate such planning. We then discuss the potential impacts that adopting a territorial tax system along the lines proposed by Representative Camp would have on a U.S. MNC's worldwide supply chain structure and financing arrangements. We compare the change in a corporation's effective tax rate on its foreign source income under the current worldwide tax system and four territorial tax options proposed by Representative Camp: a 95% participation exemption system with no base erosion option and three base erosion options. Finally, we provide a preliminary analysis of the change in the effective tax rates of U.K.-headquartered companies since the United Kingdom transitioned to a territorial system in 2009.

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I. INTRODUCTION

The call for international tax reform has gained traction in the past two years, with the chairs of both tax writing committees pledging to craft comprehensive tax reform that will make U.S. businesses more competitive abroad and encourage the creation of jobs in the United States. The felt urgency to reform the U.S. international tax system has accelerated because of the increased globalization of U.S. businesses and the decline in corporate tax rates abroad. When Japan recently lowered its corporate tax rate below the U.S. rate, it left the United States with the highest statutory corporate tax rate among developed nations.

Ways and Means Committee Chairman Dave Camp (R-MI) endorses a plan that would lower the corporate tax rate to 25 percent and transition the United States from a worldwide system of taxation to a territorial tax system. His stated goal is to place “worldwide American companies on an equal footing to their foreign competitors when conducting business in a foreign country,” “to be more competitive,” and to “enjoy the benefits of a simpler tax system.” (press release dated October 26, 2011).

His counterpart on the Senate Finance Committee, Senator Max Baucus (D-MT), recently announced that his “end goal” was a comprehensive tax reform plan – crafted through regular order with input from all members of the committee – that will help businesses create jobs, simplify the system for families, and give the nation a long-term economic boost” (press release dated March 14, 2013). Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, is on record as endorsing a lower corporate tax rate and a transition to a territorial tax system.

Corporate America has endorsed comprehensive tax reform individually and collectively. For example, the U.S. Chamber of Commerce stated that:

The Chamber believes that the U.S.'s current worldwide tax system, developed more than 50 years ago in an age where global competition was less intense, should be replaced with a territorial system for the taxation of foreign source income to help American worldwide companies compete globally and to promote economic growth domestically. A territorial tax system will help allow American worldwide companies to build their global franchises while continuing to strengthen American operations.

The RATE coalition (“Reforming America’s Taxes Equitably”) supports a reduction in the corporate tax rate, but it is not on record as supporting a territorial tax system. The LIFT (“Let’s Invest for Tomorrow”) American Coalition endorses a “modernized” territorial tax system, emphasizing that the current worldwide system locks out \$1.7 trillion of unrepatriated foreign earnings. Although LIFT endorses a reduction in the corporate tax rate, it does not recommend a specific rate.

Individual corporations have endorsed various proposals, ranging from supporting a territorial tax system (Naatjes, 2011) to a reduction in the corporate tax rate while retaining existing manufacturing and research incentives (Dossin, 2012).

In this paper, we discuss the potential impacts of adopting a territorial tax system along the lines proposed by Rep. Camp in his discussion draft issued October 26, 2011. In particular, we focus on how a U.S. multinational corporation might alter its worldwide organizational structure and financing structures in reaction to a transition to a territorial system. We compare the worldwide effective tax rates of a hypothetical U.S. multinational company under the current worldwide system and four territorial tax regimes along the lines proposed by Representative Camp. We then analyze potential tax planning responses by a U.S. multinational corporation to Representative Camp’s three base erosion options. Finally, we provide a preliminary analysis of the change in the effective tax rates of U.K.-headquartered companies since the U.K. transitioned

to territorial system in 2009. Such analyses could provide insights as to whether a transition to a territorial tax system leads to more incentive to shift income to low-tax jurisdictions.

Serious debate over whether the United States should transition to a territorial tax system is relatively new, dating back to the beginning of the 21st century (see Altshuler and Grubert (2001) and Graetz and Oosterhuis (2001)). The landmark discussion of comprehensive tax reform issued by the U.S. Treasury (1984) prior to the Tax Reform Act of 1986 did not mention a territorial tax system, focusing instead on the implementation of a value added tax.

Numerous papers have been written on the merits and demerits of a territorial tax system (see Angus *et al.* (2010), Congressional Budget Office (2013), Fleming *et al.* (2012), Graetz and Doud (2013), Gravelle (2013), Grubert and Altshuler (2013), Kleinbard (2011), Merrill *et al.* (2006), Tuerff *et al.* (2010), and U.S. Department of the Treasury (2007)). The three most recent commissions on tax reform (National Commission on Fiscal Responsibility (2010), President's Economic Recovery Advisory Board (2010), and the President's Advisory Panel on Tax Reform (2005)) all discussed the potential benefits and caveats of transitioning to a territorial tax system.

Advantages cited are a decrease in the incentive to forgo U.S. investment opportunities to avoid U.S. tax on repatriated foreign earnings (Graham *et al.* (2010) and the need to engage in complex and costly tax planning to restrict such dividend repatriations. Concerns cited include providing a stronger incentive to shift income and assets to low-tax jurisdictions, engaging in tax planning to reduce allocations of expenses to foreign source income, and the continuing need for monitoring transfer pricing arrangements.

II. BASICS OF INTERNATIONAL TAX PLANNING

The alignment of a U.S. multinational corporation's worldwide organizational structure with tax considerations largely began in the late 1990s. This transformation was driven

principally by the confluence of several phenomena: 1) the issuance of the “check-the-box” regulations in 1997, which added “hybrid entities” (disregarded entities) to international tax planning, 2) the reduction in OECD country corporate tax rates below the U.S. rate (Gravelle 2012, 19), and 3) the increased expansion of U.S. companies into emerging markets. U.S. multinational corporations were able to reduce dramatically their global effective tax rates, both cash and accounting, by restructuring their global operations to locate each function in the supply chain in strategic tax jurisdictions. In this section we discuss the goals that underlie current international tax planning, how the goals are achieved, and how a shift to a territorial tax system might impact such planning.

A. Goals that underlie international tax planning in the 21st century

The goals that underlie international tax planning for most U.S. multinational corporations (MNC) can be summarized as follows: 1) minimize (“optimize”) the company’s worldwide effective tax rate; 2) reduce overall funding costs (i.e., facilitate the free flow of cash from investments that are cash generating to investments that are cash absorbing); 3) manage tax risks (e.g., transfer pricing), and 4) minimize compliance burdens.¹

Strategies and structures that follow from these goals must align (“rationalize”) with the company’s business strategies, planning, and operations. At the same time, tax planning needs to be flexible enough to accommodate the company’s projections of future results within and without the United States, and be consistent with the company’s risk tolerance. Risk tolerance will be a function of whether the tax department functions as a profit center (i.e., to enhance shareholder value) or as a cost center (i.e., to comply with the tax laws within budget). Most

¹ For example, General Electric Corporation reported in its 2012 Form 10-K that the company filed more than 5,900 tax returns in over 250 global taxing jurisdictions in 2012.

forward-thinking U.S. multinational corporations incorporate both objectives into their mission statement.

We focus on the first two basic goals (“pillars”) of international tax planning (optimizing the worldwide tax rate and facilitating the free flow of cash) in detail below and speculate how a switch to a territorial tax system could affect the achievement of these goals.

B. Minimize (“optimize”) the company’s worldwide effective tax rate (ETR)

Corporations manage two effective tax rate metrics: the accounting effective tax rate and the cash tax rate (see Donohoe, *et al.*, 2012 for a more in-depth discussion of these metrics). A goal of international tax planning is to create a structure that produces a global effective tax rate that is sustainable over the long-run (e.g., ITW’s “sustainable annuities”) rather than “one-off” short-term strategies that can lead to Enron-like consequences. Such a sustainable ETR becomes the company’s “optimal” ETR.

Managing a company’s global ETR involves a discussion of what components of the ETR are manageable (structural ETR) and benchmarking with competitors in the same industry (i.e., what should the ETR be).² As one international tax planner put it, “*The effective tax rate is, and will continue to be, the metric that is used to judge your performance*” (Drucker, 2010b). Both accounting and tax considerations go into the achievement and maintenance of an optimal global effective tax rate.

² The structural ETR excludes discrete (non-recurring) tax rate adjustments such as audit settlements, valuation allowances, and prior period adjustments such as changes in tax rates.

1. Accounting considerations in achieving and maintaining an optimal global effective tax rate

Under ASC 740, *Accounting for Income Taxes*, a corporation's assertion that its low-taxed foreign earnings are indefinitely (permanently) reinvested allows the corporation to lower its accounting effective tax rate by the rate differential between the U.S. statutory rate and the rate at which the earnings are taxed by the foreign jurisdiction (see Donohoe, *et al.*, 2012 for an in-depth discussion of the accounting rules that apply to unrepatriated foreign earnings).³ In addition, a corporation's accounting effective tax rate benefits from the future tax benefits associated with excess foreign tax credits and foreign losses provided the company does not have to offset the benefits with a valuation allowance (i.e., management can assert that it is more-likely-than not that the company will receive the benefit in the foreseeable future).

2. Tax considerations in achieving and maintaining an optimal global effective tax rate

Tax strategies that contribute to an optimal global effective tax rate involve 1) maximizing the deferral of U.S. tax on (low-taxed) non-U.S. earnings, 2) maximizing the use of foreign tax credits on the U.S. tax return, and 3) eliminating or mitigating the "double taxation" of non-U.S. earnings using income tax treaties. Currently, such strategies involve the identification of "profit drivers" and risks and the "migration" of functions (e.g., manufacturing, marketing, distribution, research and development), risks, and intellectual property to lower-tax jurisdictions (most often referred to as tax-aligning the company's supply chain).

These strategies require an organizational structure that ensures deferral of low-taxed foreign source income from U.S. taxation and the avoidance of the U.S. anti-deferral rules (subpart F) on intercompany transactions between the non-U.S. entities in the group. A tax-

³ For example, Microsoft Corporation reduced its 2012 accounting effective tax rate by 21.1 percentage points by earning income in low tax jurisdictions (primarily Puerto Rico, Ireland, and Singapore) and asserting the earnings were permanently reinvested outside the U.S.

effective organizational chart will include tax-favored holding companies and the use of “check-the-box” (hybrid) entities. The key component of these ETR strategies involves the shifting of income from high-tax (e.g., the United States) to low-tax jurisdictions using foreign intangibles migration, contract manufacturing, inter-company sales, and deductible payments (e.g., interest, royalties, and management fees). To capture this “profit alignment” with a company’s functional alignment, these cross-border transactions must satisfy the transfer pricing rules imposed by the United States and the foreign taxing jurisdictions.

International tax service providers have been instrumental in helping U.S. multinational corporations to implement tax-aligned supply chains. The TESCM[®] group within Ernst & Young LLP⁴ lists its role as “*identifying and reallocating functions, risks and people in the most tax-efficient manner, within the context of a businesses’ overall operational goals and restructuring plans...TESCM optimizes the global tax impact of current and prospective changes in business processes, product flows and assets to increase the profitability and working and fixed capital efficiency of supply chains.*”⁵ The group defines TESCM[®] as the

process of integrating tax planning into the overall management of your company’s supply chain, factoring in where to locate functions and assets of your business, centralized management and control over the risks, and which entity will legally and economically assume the risks. It is an operationally driven approach to tax planning, putting in place a flexible international structure fully aligned with the new business processes and designed to deliver sustainable, long-term reductions in effective tax rate.

The Deloitte LLP international tax services group (Deloitte LLP 2007) applies a methodology it calls “Global ST²EPS” (Global Sustainable Tax/Treasury Earnings Per Share).⁶ The methodology provides a template designed to 1) minimize global ETR on a sustainable basis

⁴ TESCM[®] as used by Ernst & Young stands for “tax effective supply chain management.” KPMG uses a similar methodology that it refers to as “tax efficient supply chain management.”

⁵ Lee Oster, Ernst & Young, “How to Benefit When the Supply Chain Meets Tax,” September 18, 2009.

⁶ Deloitte LLP, “Stay on Top. Global ST²EPS, 2007.

by minimizing U.S. and local country taxes (through global earnings mobility and tax-effective financing) and optimizing foreign tax credit (FTC) utilization (by maximizing the FTC limitation, maximizing creditable taxes, and accelerating creditable taxes), while 2) optimizing cash utilization and repatriation, 3) within global business strategy.

The PricewaterhouseCoopers (PwC) international tax services group has a Value Chain Transformation team that focuses on integrated global structuring that aligns a client's *“operational, tax and legal structures to achieve sustainable financial and operational benefits.”*⁷ The goal is to align profits (through business and supply chain planning) with the treasury function (cash management and deployment) and tax attributes (foreign tax credit and loss utilization).

3. Tax-aligned supply chain structures

The basic goal of a tax-aligned supply chain structure (TASC) is to separate a company's global profits into components by business process. In particular, the overall profit of an enterprise consists of 1) the normal profit associated with each of the functions and risks associated with the creation and sale of the product and 2) the residual profit reflecting entrepreneurial remuneration. A basic principle is that profit follows risk. As Grubert (2012) discovered, profit margins (as opposed to sales) explain a U.S. corporation's ability to shift income to low-tax jurisdictions. The higher a company's profit margin, the more residual profit there is to shift to a low-tax jurisdiction. This phenomenon explains why U.S. high-tech and pharmaceutical companies with high profit margins are able to drive their global effective tax rates much lower than a U.S. manufacturer or retailer with low profit margins. Strategies

⁷ <http://www.pwc.com/us/en/tax-services-multinationals/value-chain-transformation.jhtml>

designed to shift entrepreneurial profits to low-tax jurisdictions have been referred to as “profit portability potential” and “mobile income reengineering.”

Figure 1 provides an organizational chart of a typical TASC for a manufacturer with an allocation of profits between each function. This organizational chart reflects the basic characteristics of a TASC and is a composite of examples (case studies) provided in the Joint Committee on Taxation (JCT) report of income shifting and transfer pricing by U.S. multinational corporations (Joint Committee on Taxation, 2010).⁸ In the report, the JCT summarizes the characteristics of a TASC as follows:

Taxpayers may reduce their U.S. tax base by organizing their worldwide business to concentrate a significant portion of their more profitable functions offshore in jurisdictions where the average tax rate is low and a significant portion of their more routine and less profitable functions in jurisdictions where the tax rate may be higher. Ownership and responsibility for continued development of intellectual property rights may be centralized in a foreign jurisdiction where the average corporate income tax rate is relatively low as a result of either the jurisdiction having a low statutory corporate income tax rate or the local entity receiving a favorable tax ruling or entering into an advanced pricing agreement with the local tax authorities. Similarly, the responsibilities of the foreign principal (the legal entity that is designated as the multinational corporation’s risk taker, either on a global or regional basis) may be located in a jurisdiction that also has a low average corporate income tax rate. In contrast, the taxpayer may organize its worldwide operations such that more routine and less profitable functions such as serving in the capacity of a contract manufacturer or serving as a limited risk buy-sell distributor are located in jurisdictions where the average tax rate may be higher. This results in a lower tax base being subject to higher tax rates. (Joint Committee on Taxation, 2010, pp. 9-10)

The components of a TASC template are discussed in more detail below.

Central to a TASC is a Principal (“Hub”) Company (PC) located in a low-tax jurisdiction (e.g., Netherlands, Ireland, Switzerland, Luxembourg, Singapore, and Bermuda). The PC

⁸ The composite organizational charts we present also reflect the findings of Lewellen and Robinson (2013) and numerous presentations by international tax accountants and lawyers, including Paul Oosterhuis (Oosterhuis and Spinowitz, 2013) at the International Tax Policy Forum / The Urban-Brookings Tax Policy Center Seminar on *Tax Policy and U.S. Manufacturing in a Global Economy* held in Washington, D.C. on March 15, 2013. The OECD (2013) report on base erosion and Graetz and Doud (2013) provide additional discussions on TASC.

exercises direction, supervision, and control over the supply chain and bears all significant risks of the supply chain. Such risks could include contractor evaluation, selection, and supervision, entering into contract manufacturing arrangements, product quality control, product development and sourcing, project management, buying and negotiations, and logistics and delivery (Joint Committee on Taxation, 2010, 55-56). The PC can either own the intellectual property (IP) or license it from an IP Holding Company. It is important that the PC have substance, such as some level of senior management and decision-making functions. As a result, the PC earns the residual (entrepreneurial) profit associated with the group's profit-making activities.

Key tax factors that influence where the PC is located include a low effective tax rate, a favorable tax regime for foreign source income, a favorable tax treaty network, low withholding taxes on outbound payments, and a generous advance ruling regime (tax rate negotiation). Key non-tax factors include political and economic stability, favorable environment for expatriate personnel, infrastructure, and a dependable regulatory and legal environment.

The manufacturing component of the TASC can be an in-house full-fledged manufacturer, assuming significant manufacturing functions risks, or more likely, either a contract manufacturer (CM) or a toll (consignment) manufacturer (TM). Under a contract manufacturing arrangement, the CM manufactures goods for the PC under a guaranteed sale arrangement (e.g., cost plus a markup). The markup can range from 5 percent on sales to related parties (e.g., the U.S. parent) and 30 percent on sales to unrelated parties (Joint Committee on Taxation, 2010, 58). A TM converts raw materials supplied by the PC into finished goods. The TM does not take title to either the raw materials or the finished goods, bears insignificant risks, and performs minimal functions. If the CM or TM is located in a high-tax country (e.g., Germany), this arrangement minimizes the profit subject to a high(er) rate of tax.

The sales (distribution) component of the TASC could be a full-fledged in-house distributor, taking on significant sales and marketing functions, risks, and the marketing of intangibles. More likely, the distributor will be a “limited risk distributor” (LRD) or a Commissionaire. An LRD performs much the same functions as a full-fledged distributor but assumes significantly lower risks. A Commissionaire performs sales and marketing services for the PC. The Commissionaire enters into sales contracts on behalf of the PC, but does not assume title to the goods and does not bear any significant risks. As a result, little of the overall profit from the profit-making activity is assigned to the LRD or Commissionaire.

A typical breakdown of profit allocation to each function would be 65-80 percent to the entrepreneur (intangibles), 10 percent each to manufacturing and management, and 10-15 percent to sales and marketing. It should be noted that while the PC is treated as a corporation for U.S. tax purposes (to ensure deferral of income earned by the foreign operations), all of the entities below the PC are “check-the-box” (disregarded) entities, making them fiscally transparent to the United States. Such an arrangement allows intercompany payments to avoid being treated as subpart F income to the PC.

A final component of a TASC is the concentration of services and management activities in a shared services center (SCC). Administrative and support operations typically transferred to SSCs include a range of finance and personnel functions such as payroll, accounts receivable, accounts payable, tax compliance and other accounting related services.

The strategic component of a TASC is the development and sourcing of intellectual property (IP). The research and development (R&D) that creates the IP may be conducted substantially by U.S. employees located within the United States, but the funding is provided by the entity’s U.S. and foreign operations (Joint Committee on Taxation, 2010, 62). The

development of new IP often involves a cost sharing arrangement (CSA), under which the U.S. parent jointly develops the intangible and shares the costs of the project with a foreign subsidiary (located in a low-tax jurisdiction). If the U.S. parent makes pre-existing intangible property available to its foreign subsidiary for exploitation under a qualified CSA, the subsidiary must make buy-in payments to the parent. Buy-in payments are the arm's length charge for use of the intangible multiplied by the subsidiary's share of reasonably anticipated benefits. The buy-in payment provides a return to the developer for having invested its funds and engaged in other risky activities. Buy-in payments usually decline over time as the value of the intangible decreases (e.g., the IP is superseded by advances in technology). Under U.S. tax law (IRC section 367(d) and Treas. Reg. Sec. 1.482-7)), royalty payments to the U.S. parent under a licensing (CSA) agreement may be required to be adjusted annually to reflect the change in the composition of U.S. and international sales related to the products covered under the CSA (Joint Committee on Taxation, 2010, 64-65).⁹

The migration of existing intangibles can be a complex and costly undertaking, the details of which are beyond the scope of this paper.¹⁰ Needless to say, CSA and buy-in arrangements are the target of much IRS scrutiny and litigation.¹¹

The extent to which profits can be migrated to low-tax jurisdictions is illustrated in the much publicized description of Google's "Double Irish Dutch sandwich" to transfer significant

⁹ The JCT (2010, 65, 79) reported in the "Bravo Company" case study that average annual CSA payments back to the U.S. parent exceeded \$9 billion and in the "Delta Company" case study exceeded \$6 billion. The royalty income earned by the U.S. group was largely offset by the R&D expenses incurred to produce the IP, resulting in minimal net profit reported on the U.S. tax return from the CSA agreement.

¹⁰ See the testimony of William Sample before the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs, September 20, 2012 for a description of how Microsoft co-develops its IP with its regional operating centers in Singapore, Ireland, and Puerto Rico.

¹¹ *Veritas Software Corp., et al. v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) and *Xilinx, Inc. v. Commissioner* 125 T.C. 37 (2005), *aff'd* No. 06-74246(9th Cir. March 22, 2010). As a result of the appellate court decision, Cisco Systems reduced its income tax provision (uncertain tax position) by \$158 million in 2010.

profits to zero-tax jurisdictions (Drucker 2010a).¹² Under this arrangement, the details of which are provided in Kleinbard (2011), Sokatch (2011), and Loomis (2012), a U.S. corporation transfers intellectual property to an Irish subsidiary (Irish 1) under a buy-in arrangement. Irish 1 is treated as a resident of Bermuda under Irish law, but as an Irish corporation under U.S. law.¹³ Irish 1 licenses the technology to a Dutch company (BV), which in turn sub-licenses the technology to a second Irish subsidiary (Irish 2). Both BV and Irish 2 are treated as check-the-box entities. Irish 2 collects fees from international customers and subsequently pays royalties to BV, which in turn pays royalties to Irish 1. Ireland collects a 12.5 percent tax on the residual profit left in Irish 2, but does not collect any tax from Irish 1 because it is a non-resident. The Netherlands collects a small tax (negotiated in advance) on the residual profit it earns from Irish 2. Neither Ireland nor the Netherlands impose withholding tax on the payment of royalties from Irish 2 to BV and from BV to Irish 1 under the EU directive.

The Double Irish Dutch sandwich is employed by most Silicon Valley companies and can be quite powerful in reducing the corporation's global effective tax rate. As mentioned previously, Google reduced its financial accounting tax provision in 2012 by \$2.2 billion using this structure. This reduced the company's accounting effective tax rate by more than 16 percentage points. VMware, Inc. reduced its accounting effective tax rate by 22.4 percentage points in 2012 and 25.1 percentage points in 2011 through the use of this structure. (VMware is one of the few companies to disclose the existence of each of the components of its Double Irish Dutch sandwich in its Exhibit 21).

¹² Drucker (2010a) estimated that Google incurred an effective tax rate of 2.4 percent on its foreign earnings and reduced its worldwide tax liability by \$3.1 billion over 2007-2009 using this strategy.

¹³ Ireland uses a "mind and management" approach to determining residence rather than the U.S. country of incorporation approach.

4. The potential impact of a Camp-style territorial tax system on the organizational structure of U.S. multinational corporations

A transition to a territorial tax system is not likely to dramatically impact a U.S. multinational corporation's TASC. An efficient TASC is aligned with the business model of the company and is rationalized on other than tax motivation. Under each of the base erosion options, corporations using a Double Irish Dutch sandwich to transfer significant amounts of IP profits to a low (no) tax jurisdiction (e.g., Bermuda, Cayman Islands) likely will abandon the no-tax leg of the income transfer and locate profits in jurisdictions that impose a tax rate that meets the minimum effective tax rate threshold on such income to avoid the new categories of subpart F income (either 15 percent or 10 percent).

This could cause some increases in a high tech company's global foreign effective tax rate. For example, if Google paid an average effective tax rate of 10 percent on its foreign earnings, its foreign provision on its \$8,075 of foreign profit before tax in 2012 would have increased by almost \$400 million, increasing its accounting effective tax rate from 19.4 percent to 22 percent. The governments of Ireland or The Netherlands undoubtedly would welcome the additional tax revenue.

As the recent OECD report (2013) on base erosion and *The Economist* (2013) Special Report on offshore finance indicate, corporations domiciled in jurisdictions with territorial tax systems are not immune from profit shifting to low-tax jurisdictions.

C. Reduce overall funding costs

A TASC focuses on a multinational corporation's worldwide income generated by profit drivers (IP, risks, and functions) that are strategically located in tax-favorable jurisdictions. A

key component of a TASC is to ensure that the transaction flows support U.S. tax deferral and other tax planning objectives.

Tax planning for a U.S. multinational corporation also takes into consideration the entity's financial supply chain. Typically, a financial supply chain (FSC) has three objectives: 1) enhancing the deployment of excess cash within the organization on a tax-efficient basis, 2) rationalizing intercompany payments, and 3) effectively managing the ability to remit earnings on an after-tax basis through maximizing foreign tax credit use.¹⁴ One common way to facilitate such objectives is through a finance company, which monitors and facilitates the deployment of cash within a group of companies. Such finance companies ideally are situated in low-tax jurisdictions that have a well-developed treaty network that allow distributions to avoid withholding tax on cross-border transfers. Attractive locations were jurisdictions that had treaties with the United States that did not include a "limitation on benefits" (anti-treaty shopping) provision. Currently, only the Hungary and Poland treaties lack such a provision, but new protocols awaiting ratification will add a limitation on benefits provision that will diminish their attractiveness as finance centers.

The basic components of a tax efficient FSC are summarized below.¹⁵

1. Tax-aligned financial supply chain structures

One component of a tax-efficient FSC is the alignment of tax attributes where they produce the optimal tax benefit. In its simplest form, deductible cross-border payments such as interest, royalties, rents, and management fees should be located in higher-tax jurisdictions. This

¹⁴ Deloitte LLP, *Five Ways a Conversion to International Financial Reporting Standards Could Impact a Global Tax Structure*, 2008.

¹⁵ Due to space limitations, only the basic goals of a tax-efficient FSC are discussed in this paper. A detailed discussion of repatriation strategies involving the corporate reorganizations provisions (sections 367 and 368) is beyond the scope and objectives of this paper.

can be accomplished through tax-advantaged leasing, debt-financing of intercompany sales, and intercompany debt. Not surprisingly, most OECD countries have enacted “thin capitalization” rules that limit that amount of interest that can be deducted on cross-border borrowings (e.g., section 163(j) limits interest paid or accrued by a U.S. corporation on indebtedness to related persons where the debt-equity ratio exceeds 150 percent). In his fiscal year 2014 budget, President Obama proposes to limit the tax benefits of interest deductions on U.S. tax returns even further by deferring the deduction of interest expense related to deferred income of foreign operations until such foreign income is repatriated to the United States (U.S. Department of the Treasury, 2013, 46).

Two key objectives in accomplishing the “rate shift” from a high-tax to a low-tax jurisdiction are minimizing withholding taxes on the payments and avoiding the U.S. anti-deferral (subpart F) rules. Ordinarily, payments of interest, rents, dividends, and royalties into a low-tax jurisdiction are characterized as foreign personal holding company income and treated as a deemed dividend on the U.S. parent company’s U.S. tax return. However, the advent of the check-the-box regulations in 1997 and the CFC “look-through” rules (section 956(c)(6)) in 2004 allow such payments to be disregarded for U.S. tax purposes while being respected for foreign tax purposes.

More exotic rate tax attribute tax planning involves the use of hybrid instruments that are treated as equity by the United States and debt in the foreign jurisdiction (e.g., PECs in Luxembourg). These cross-border payments reduce the tax base in the jurisdiction from which they are paid and receive the benefits of deemed paid foreign tax credits on the U.S. tax return.

Tax planning through financing structures has been under stress recently because of the decrease in worldwide interest rates, the temporary nature of the CFC look-through rules, the

static nature of interest deductions (i.e., the effect diminishes as income increases), and the tightening of thin capitalization rules worldwide (e.g., Canada reduced its safe harbor ratio from 2:1 to 1.5:1).

2. *Mitigating (eliminating) the residual U.S. tax on repatriations*

Under the current U.S. worldwide system of taxation, foreign income that is deferred from U.S. taxation when earned through a foreign subsidiary is subject to residual U.S. taxation when repatriated back to the United States. In the case of dividends, the United States taxes the income on a residual basis, giving the U.S. taxpayer a foreign tax credit for taxes paid on the income when earned and any withholding tax imposed by the host country. For example, assume USCo operates in Lo-Tax through a wholly-owned subsidiary. The subsidiary reports taxable income of \$100 and pays a tax of \$20. The subsidiary repatriates the remaining \$80 as a dividend, and Lo-Tax withholds an additional \$4 (5%) of tax on the distribution. USCo computes its residual U.S. tax as follows:

Dividend received (gross)	\$ 80.00
§78 gross-up for foreign taxes paid	+ <u>20.00</u>
Gross income	\$100.00
× U.S. tax rate	× <u>.35</u>
U.S. tax on dividend received	\$ 35.00
– FTC (\$20 + \$4)	<u>(24.00)</u>
Residual U.S. tax paid	<u>\$11.00</u>
 Effective tax rate on \$100 of foreign income	 35%

The imposition of this residual tax is at the heart of the arguments made by U.S. multinational corporations that their foreign earnings become “trapped cash” because of the “punitive” imposition of the residual U.S. tax on repatriations, a tax their competitors located in territorial systems do not face. As an example, Apple Inc. CEO Peter Oppenheimer, when asked

if the company intended to use any of its international cash to pay its newly announced \$10 billion per year dividend program, stated:

Today, we've got plenty of U.S. cash to invest in the business, to pay dividends, and to initiate our share repurchase program. Repatriating the cash from offshore would result in significant tax consequences under current U.S. law. We have expressed our views with Congress and the administration, we think the current tax laws provide a considerable economic disincentive to U.S. companies that might otherwise repatriate the substantial amount of foreign cash that they have; that's our view, and we've expressed it.¹⁶

International Business Machines (IBM) Corporation told its shareholders in its 2012 Form 10-K (115) that

The company has not provided deferred taxes on \$44.4 billion of undistributed earnings of non-U.S. subsidiaries at December 31, 2012, as it is the company's policy to indefinitely reinvest these earnings in non-U.S. operations. However, the company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability."

In a report issued in May 2012, J.P. Morgan (2012) listed 66 U.S. corporations that had \$5 billion or more of unrepatriated foreign earnings and estimated the total amount of unrepatriated earnings at \$1.7 trillion.

Mitigation (elimination) of the residual U.S. tax on repatriations can be accomplished through cross-crediting of high and low-taxed income. Kleinbard (2011) likens this blending to a tax distillery, where the company's tax director functions as a master distiller, dipping into the firm's casks of high-tax and low-tax foreign income. Efficient repatriation structures separate the high and low-tax entities such that distributions from the entities do not get blended at the foreign entity level, but rather at the U.S. parent-level. This structuring has been likened to the "hot" (high-tax) and "cold" (low-tax) spigots of a sink faucet. Such a structure emphasizes a lateral ("brother-sister") organizational chart as opposed to a vertical (chain) organizational chart

¹⁶ Transcript from the Apple Inc. conference call on March 19, 2012.

and comports with the finding by Lewellen and Robinson (2013) that the majority of U.S. multinational companies are structured laterally. In his fiscal year 2014 budget, President Obama proposes to limit these blending strategies by requiring that a U.S. corporation compute the foreign tax credit on repatriations on a pooling basis rather than on a company-by-company basis (U.S. Department of the Treasury, 2013, 48).

When a dividend does not produce a favorable tax (or financial accounting) result, U.S. multinational corporations have devised other strategies to bring cash back to the United States without creating income on the U.S. tax return and avoiding a foreign withholding tax. One such strategy is the payment of alternating short-term loans to the parent company. The loans must be structured to avoid the deemed dividend rules of section 956 (“investments in U.S. property”). The mechanics of this “alternating loans” strategy are detailed in the testimony of Lester D. Ezrati before the U.S. Senate Homeland Security and Governmental Affairs Committee Permanent Subcommittee on Investigations on September 20, 2012¹⁷. For fiscal years 2011 and 2012, Hewlett-Packard had an average of \$1.6 billion of alternating short-term (45-day) loans from their foreign affiliates, which enabled the company to avoid U.S. residual tax or foreign withholding tax on the cash transfers.

U.S. multinational corporations have used corporate restructurings to repatriate cash to the United States without incurring a residual income tax or withholding tax. Such strategies, the complexities of which are beyond the scope of this paper, have acquired such names as the “killer B” transaction (now shut down by IRS Notice 2006-85 and Treas. Reg. Sec. 1.367(b)-4(b)), the “deadly D,” “Shanghai Lady” (section 304 intergroup stock sales), and the “outbound F” (see Toce (2011)). Restructuring transactions that attempt to shift stock basis to a newly

¹⁷ <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>

created foreign subsidiary without shifting earnings and profits allow repatriations from the newly created entity to be treated as tax-free returns of capital to the U.S. parent that also avoid foreign withholding tax.

Needless to say, the current U.S. worldwide tax system engenders complex, creative, and costly uses of the tax code to avoid repatriation taxes (U.S. and foreign) on cash payments back to the United States.

3. The potential impact of a Camp-style territorial system on the repatriation strategies of U.S. multinational corporations

The transition to a territorial tax system likely would have its most dramatic effect on the repatriation strategies of U.S. multinational corporations. In a recent study, Arena and Kutner (2013) found that after the United Kingdom and Japan switched to a territorial system in 2009, firms domiciled in those two countries accumulated less cash abroad, paid out larger amounts to shareholders through dividends and stock repurchases, and invested less abroad.

How much of the estimated \$1.7 trillion of unrepatriated earnings currently on the books of U.S. multinational corporations would be repatriated remains an open question. Under the tax repatriation holiday in 2005, which provided an 85 percent dividends received deduction on certain dividends repatriated to the United States, U.S. multinational corporations repatriated \$312 billion in “excess” dividends, or approximately 40 percent of the total that could have been repatriated (Redmiles, 2008). Not surprisingly, most of the qualifying dividends were repatriated from low-tax jurisdictions (Netherlands, Switzerland, Bermuda, Ireland, Luxembourg, and the Cayman Islands). Regardless of whether actual cash would be repatriated as a result of a switch

to a territorial system, under the Camp transition rule, the U.S. Treasury would collect upwards of \$90 billion over eight years on the deemed repatriation of such income (taxed at 5.25 percent).

The means by which cash could be repatriated to the United States would be simplified in cases in which the distribution did not attract foreign withholding taxes. When Delphi Corporation reemerged from bankruptcy in 2009, the company reincorporated in the United Kingdom (from Delaware) because of its territorial tax system. In its 2012 Annual Report, the company informed shareholders that

The Company is a U.K. resident taxpayer and as such is not generally subject to U.K. tax on remitted foreign earnings. As a result, the Company does not anticipate foreign earnings would be subject to a 35% tax rate upon repatriation to the U.K., as is the case when U.S. based companies repatriate earnings to the U.S.

The assumption that all repatriations back to the United States will take the form of dividends may be misplaced, however. The fact that all foreign taxes imposed on dividend repatriations will no longer be creditable under the Camp proposal will make withholding taxes a deadweight cost. As a result, there will be increased lobbying efforts to negotiate a zero percent withholding tax rate on dividends from foreign subsidiaries in U.S. treaties and incentives to structure cash transfers to avoid their designation as a dividend (the foreign withholding tax and the U.S. 1.25 percent tax $\{5\% \times 25\%$ is avoided).

III. IMPACT OF THE CAMP TERRITORIAL TAX PROPOSALS ON THE TAXATION OF A U.S. MNC'S FOREIGN SOURCE INCOME

In this section we present alternative tax outcomes related to Representative David Camp's territorial tax proposals outlined in his Discussion Draft of October 26, 2011. Under the Camp proposals, the top U.S. corporate tax rate would be reduced to 25 percent and a 95 percent dividend received deduction would be applied to dividends received from foreign subsidiaries

(controlled foreign corporations) and joint ventures (“10/50 companies”). No foreign tax credits would be allowed for withholding taxes and deemed paid taxes related to dividend distributions. In addition, Representative Camp offered three “base erosion” options that focus on intangibles (Technical Explanation, 2011). The three base erosion options can be summarized as follows:

Option A: Intangible income attributable to use or exploitation of intangibles transferred from a U.S. corporation to a related CFC that has not been subject to a specified minimum foreign effective tax rate (more than 10 percent) is included in U.S. income to the extent that such income exceeds 150 percent of costs attributable to such income. To completely escape subpart F designation, the foreign effective tax rate imposed on the income must exceed 15 percent. This new category of subpart F income is referred to as foreign base company excess intangible income.

Option B: Foreign source income earned by a CFC that is neither derived from the conduct of an active trade or business in the home country of the CFC (“the home-country exception”) nor subject to an effective rate of foreign tax of more than 10 percent is included in subpart F income as low-taxed cross-border income.

Option C: Creates a new category of subpart F income for worldwide income derived by CFCs from intangibles developed in the United States and provides a deduction for the U.S. corporation of 40% of its income from foreign exploitation of intangibles. Income taxed at greater than 60 percent of 90 percent of the U.S. rate (13.5 percent if the U.S. rate is 25 percent) escapes designation at subpart F income.

The facts for the analysis come from the TASC depicted in **Figure 1**. For each option, it is assumed that the income earned by Principal is treated as excess intangible income under Option A and subpart F intangible income under Options B and C. We assume the intangible income profits earned by Principal (P) result from the transfer of IP from the U.S. Parent (USP) under a cost sharing arrangement. We also assume the income from the contract manufacturer (CM) is subpart F foreign base company sales income and included in USP’s income currently. The comparative tax results under the current U.S. tax system and four options under the Camp territorial tax proposals are summarized in **Table 1**.

A. Accounting Effective Tax Rates under the Current System and Camp Proposals

Under the current U.S. worldwide tax system, USP receives foreign source income from three sources: a CSA payment of \$150 from Principal, a dividend of \$90 from Principal that brings with it a foreign tax credit (FTC) of \$8, and subpart F income of \$21 from CM that brings with it a FTC of \$9. We also assume USP has U.S. source income approximating 50 percent of its worldwide income. The net U.S. and foreign taxes paid under the current system are summarized in Table 1, Panel A. USP reports \$278 of foreign source income, which generates a precredit U.S. tax of \$97 (at 35 percent). The precredit U.S. tax is reduced by \$17 of FTCs related to the P dividend and CM subpart F income, resulting in a net U.S. tax on the foreign source income of \$80. After eliminating the intercompany foreign source income, the global accounting effective tax rate is 34.5 percent.

Under the 95 percent participation exemption proposal without any base erosion provisions (Table 1, Panel B), the \$90 dividend from Principal is reduced by \$86, but no foreign taxes paid on the dividend are allowed as a credit. The 95 percent dividends received deduction, coupled with the reduction in the corporate tax rate to 25 percent, results in a reduction in the net U.S. tax on the foreign source income to \$37. After eliminating the intercompany foreign source income, the global accounting effective tax rate is reduced to 23.7 percent.

Under Base Erosion Option A (Table 1, Panel C), Principal is deemed to have foreign base company excess intangible income because the tax rate imposed on the income is not greater than 10 percent and gross income exceeds 150 percent of the related expenses. As a result, \$150 of excess intangible profit from Principal would be treated as subpart F income (\$137 of after-tax earnings plus a \$13 deemed paid credit) and included in USP's gross income currently. The net U.S. tax on foreign source income under Option A increases to \$61. After

eliminating the intercompany foreign source income, the global accounting effective tax rate is 26.4 percent. To date, Option A has received very little corporate or Congressional support.

Under Option B (Table 1, Panel D), all of Principal's intangible income is treated as subpart F income because the tax rate imposed on the income is not greater than 10 percent and we assume the products are sold outside of Luxembourg. The subpart F inclusion is \$300 (\$275 of after-tax earnings plus a deemed paid credit of \$25). The net U.S. tax on foreign source income under Option B increases to \$87. After eliminating the intercompany foreign source income, the global accounting effective tax rate is 29.5 percent. Option B has some support from the corporate community, primarily from U.S. manufacturers that are likely not to have significant amounts of low-taxed intangible-related income because of their low profit margins (Dossin, 2012).

Under Option C (Table 1, Panel E), we assume all of Principal's intangible income is treated as subpart F income because it is taxed at a foreign effective tax rate not greater than 13.5 percent (60% x 90% x 25%). In addition, the CSA payment from Principal also is considered foreign intangible income on USP's tax return. Option C would give USP a 40 percent deduction for the intangible income because it derives from a U.S.-created intangible and a full foreign tax credit. The subpart F inclusion is \$300 (\$275 of after-tax earnings plus a deemed paid credit of \$25). The net U.S. tax on foreign source income under Option C equals \$41. After eliminating the intercompany foreign source income, the global accounting effective tax rate is reduced to 24.1 percent. Option C is rumored to be Representative Camp's preferred alternative and has support from the corporate community, primarily from U.S. high tech and pharma companies that are likely to have significant amounts of low-taxed intangible-related

income that would be eligible for the 40 percent deduction (i.e., from U.S.-developed intellectual property).

The comparative effective tax rate consequences of the current system and four Camp proposal alternatives are summarized in Table 3, Panel A. The tax consequences of each option depend on the types of income earned by the components of the TASC, the U.S. parent's repatriation intentions, and the tax rate imposed on the income earned by each component of the TASC. Assuming Option A is off the table, the lobbying efforts of the U.S. corporate community likely will be directed at Option B and Option C.

B. Accounting Effective Tax Rates under Potential Planning for the Camp Proposals

Under Option A, one of the goals likely will be to keep the effective tax rate imposed on intangible income above 15 percent. By negotiating a LUX tax above 15 percent USP avoids a subpart F inclusion for excess foreign intangible income (see Table 2, Panel A). The net U.S. tax on USP's foreign source income is reduced from \$61 to \$37, but Luxembourg's tax revenue increases from \$25 to \$45. After eliminating the intercompany foreign source income, the global accounting effective tax rate is reduced to 26 percent, a 0.5 percentage point decrease compared to no planning.

Under Option B, USP avoids subpart F income by negotiating a tax rate on its foreign income to exceed 10 percent (see Table 2, Panel B). If the Luxembourg tax rate was negotiated to 10.1 percent, the LUX intangible income no longer is subpart F income, and the net U.S. tax on USP's foreign income is reduced from \$87 to \$37. Luxembourg's tax revenue increases from \$25 to \$30. After eliminating the intercompany foreign source income, the global accounting effective tax rate is reduced to 24.3 percent, a 5.2 percentage point decrease compared to no tax

planning. As currently proposed, Option B would determine the effective tax rate using U.S. tax accounting principles on a separate country basis. Countries with zero corporate tax rates such as Bermuda would no longer be an attractive location for housing intellectual property income.

Under Option C, USP avoids subpart F income by negotiating a tax rate on its foreign income to exceed 13.5 percent (Table 2, Panel C). If the Luxembourg tax rate was negotiated to 13.6 percent, the LUX intangible income no longer is subpart F income and USP loses the 40 percent deduction on the inclusion. The net U.S. tax on USP's foreign income is reduced from \$41 to \$22. Luxembourg's tax revenue increases from \$25 to \$41. After eliminating the intercompany foreign source income, the global accounting effective tax rate is 23.7 percent, a decrease of 0.5 percentage points compared to no planning.

The concern with Option C is whether the 40 percent deduction for foreign intangible income will be viewed as an illegal trade subsidy by the World Trade Organization, similar to the extraterritorial income exclusion and foreign sales corporation incentives (Sullivan, 2013). U.S. multinational corporations supporting Option C likely will lobby for a safe harbor option, allowing them to reduce intangible income by a percentage of SG&A costs.

A comparison of the global effective tax rates under differences in foreign tax planning using negotiated higher tax rates is found in Table 3, Panel B.¹⁸

IV. A FIRST LOOK AT THE IMPACT OF THE U.K. TERRITORIAL SYSTEM ON THE ETRS OF U.K.-HEADQUARTERED COMPANIES

In this section, we present empirical data on the United Kingdom's switch to a territorial tax system in 2009. Our goal is to provide a snapshot of the potential effects of a territorial tax

¹⁸ Negotiating higher tax rates is but one of many different responses a U.S. multinational corporation could make to the Camp proposals. Restructuring to take advantage of the same country rules is another option.

system on ETRs rather than perform rigorous statistical analyses. Specifically, we examine the change in companies' ETRs relative to average statutory tax rates across the two tax system regimes with the following equation:

$$ETRA = [ETR_POST - ASTR_POST] - [ETR_PRE - ASTR_PRE], \quad (1)$$

where ETR_POST is the two-year sum of total tax expense for 2010 and 2011 divided by the two-year sum of pre-tax book income less special items over the same period, and ETR_PRE is the three-year sum of total tax expense for 2006 through 2008 divided by the three-year sum of pre-tax book income less special items.¹⁹ The United Kingdom reduced its top statutory corporate tax rate from 30 percent to 28 percent in 2008 and to 26 percent in 2011 (effective in April of each year). To account for these changes, we compute the weighted monthly average statutory tax rate (ASTR) for each period and subtract it from each company's ETR (ASTR_POST is 27.25 percent; ASTR_PRE is 29.50 percent). As a result, negative (positive) values for ETRA indicate whether a company's ETR decreased (increased) after the switch to a territorial tax system.

We focus our analyses on the FTSE 100 Index (as of December 2012), a widely used stock index comprised of the largest 100 companies listed on the London Stock Exchange. We obtain financial statement data for these companies from the Compustat Global database for fiscal years 2006 to 2011. We then drop companies without the necessary data to calculate Equation (1), resulting in observations for 75 of the 100 FTSE companies.

Table 4 reports components of Equation (1) for companies in the top and bottom quintiles of the overall change in ETRs following the switch to a territorial tax system (ETRA).

¹⁹ Following prior studies, ETRs are reset to 1 (0) if greater (less) than 1 (0).

Figure 2 illustrates ETR Δ by overall SIC industry sector. ETRs for companies in the Construction (SIC Codes 2000-2999) and Manufacturing (SIC Codes 3000-3999) industries increase following the switch to a territorial tax system (0.022 and 0.035, respectively). ETRs for all other industry sectors decline, with the largest ETR reductions occurring in the Agriculture (SIC Codes 1000-1999), Retail (SIC Codes 5000-5999), and Healthcare (SIC Codes 8000-8999) industries (-0.041, -0.047, and -0.017, respectively).

Figure 3 illustrates ETR Δ by specialized industry sector, namely Pharmaceuticals (SIC Code 2834), Software (SIC Codes 7300-7399), and Manufacturing (SIC Codes 3000-3999). Consistent with a high proportion of intangible assets (i.e., intellectual property) providing opportunities to transfer profit across the supply chain, firms in the Pharmaceutical and Software industries realize reductions in ETRs following the switch to a territorial tax system (-0.039). In contrast, ETRs for firms in the capital intensive Manufacturing sector increase (0.035) over the same time period.

This analyses is preliminary and in need of more rigor. It does seem to indicate that U.K.-headquartered companies that have significant entrepreneurial profits (pharma and high-tech) have lowered their effective tax rates below what would be expected taking into account only the reduction in the U.K. tax rate

TABLE 1
Calculations of the U.S. tax imposed on the foreign source income of USP under the Camp Proposals

Panel 1A: Base Case – Current U.S. Tax System

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	35.0%	\$175	\$325.0	35.0%
	Foreign source	278		278	35.0%	97	180.7	35.0%
FTC						(17)		
Principal	Luxembourg	600	300	300	8.5%	25	275.0	8.3%
CM	Germany	130	100	30	30.0%	9	21.0	30.0%
LRD	U.K.	430	400	30	24.0%	7	22.8	24.0%
Less: Intercompany Income		(278)		(278)				
Worldwide		\$2,660	\$1,800	\$860		\$296	\$825	34.5%

U.S. Tax Return

	<u>Gross Income</u>	<u>\$78 Gross-Up</u>	<u>Total</u>
Royalty from P	\$150		\$150
Dividend from P	90	\$8	98
Subpart F from CM	21	9	30
Foreign Income			\$278
U.S. Tax Rate			35%
Pre-Credit U.S. Tax			\$97
Foreign Tax Credit		17	(17)
Net U.S. Tax Due			\$80

Panel 1B: Camp Territorial Tax with No Base Erosion

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	185		185	25.0%	46	138	25.0%
FTC						(9)		
Principal	Luxembourg	600	300	300	8.5%	25	275	8.3%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(185)		(185)				
Worldwide		\$2,660	\$1,800	\$860		\$203	\$832	23.7%

U.S. Tax Return

	<u>Gross Income</u>	<u>§78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
Dividend from P	90		(86)	5
Subpart F from CM	21	9		30
Foreign Income				\$185
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$46
Foreign Tax Credit		9		(9)
Net U.S. Tax Due				\$37

Assumption: The U.S. tax rate is reduced to 25%; a 95% dividends received deduction (DRD) is applied to the Principal dividend; no base erosion.

Panel 1C: Camp Territorial Tax – Option A

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	330		330	25.0%	83	238	25.0%
FTC						(22)		
Principal	Luxembourg	600	300	300	8.5%	25	275	8.3%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(330)		(330)				
Worldwide		\$2,660	\$1,800	\$860		\$227	\$941	26.4%

U.S. Tax Return

	<u>Gross Income</u>	<u>\$78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
Excess IP income ^{1,2}	137	13		150
Dividend from P (PTI)				-
Subpart F from CM	21	9		30
Foreign Income				\$330
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$83
Foreign Tax Credit		22		(22)
Net U.S. Tax Due				\$61

Assumption: Gross income from a covered intangible exceeds 150% of costs; FBCEII becomes subpart F income (less foreign tax) because LUX tax \leq 10%.

¹\$600 – 150%(\$300) = \$150 – 8.5%(\$150) = \$137

²\$150 / \$300 × \$25.5 = \$13

Panel 1D: Camp Territorial Tax – Option B

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	485		485	25.0%	121	364	25.0%
FTC						(34)		
Principal	Luxembourg	600	300	300	8.5%	25	275	8.3%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(485)		(485)				
Worldwide		\$2,660	\$1,800	\$860		\$253	\$1,058	29.5%

U.S. Tax Return

	<u>Gross Income</u>	<u>§78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
Subpart F from P	275	25		300
Dividend from P (PTI)				-
Subpart F from CM	21	9		30
Foreign Income				\$485
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$121
Foreign Tax Credit		34		(34)
Net U.S. Tax Due				\$87

Assumption: Principal income is low-taxed cross border foreign income because the foreign tax is $\leq 10\%$.

Panel 1E: Camp Territorial Tax – Option C

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	300		300	25.0%	75	225	25.0%
FTC						(34)		
Principal	Luxembourg	600	300	300	8.5%	25	275	8.3%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(300)		(300)				
Worldwide		\$2,660	\$1,800	\$860		\$207	\$919	24.1%

U.S. Tax Return

	<u>Gross Income</u>	<u>\$78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
P Intangible Income	275	25		300
∑ Intangible Income				\$450
Dividend from P (PTI)				-
Subpart F from CM	21	9		30
Foreign Income				\$480
40% Deduction for II ¹				(180)
Total Taxable Income				\$300
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$75
Foreign Tax Credit		34		(34)
Net U.S. Tax Due				\$41

Assumption: Principal income is foreign intangible income subject to taxation at a reduced rate (< 15%).

¹U.S. Parent receives a 40% deduction for the FBCII (40% × \$450).

TABLE 2
Tax Planning to Avoid the Base Erosion Subpart F Income

Panel 2A: Camp Territorial Tax – Option A: Negotiate a tax rate of at least 15% in Luxembourg

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	185		185	25.0%	46	138	25.0%
FTC						(9)		
Principal	Luxembourg	600	300	300	15.0%	45	255	15.0%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(185)		(185)				
Worldwide		\$2,660	\$1,800	\$860		\$223	\$812	26.0%

U.S. Tax Return

	<u>Gross Income</u>	<u>\$78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
Dividend from P	90		(86)	5
Subpart F from CM	21	9		30
Foreign Income				\$185
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$46
Foreign Tax Credit		9		(9)
Net U.S. Tax Due				\$37

Panel 2B: Camp Territorial Tax – Option B: Negotiate a tax rate of at least 10.1% in Luxembourg

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	185		185	25.0%	46	138	25.0%
FTC						(9)		
Principal	Luxembourg	600	300	300	10.1%	30	270	10.1%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(185)		(185)				
Worldwide		\$2,660	\$1,800	\$860		\$209	\$827	24.3%

U.S. Tax Return

	<u>Gross Income</u>	<u>§78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
Dividend from P	90		(86)	5
Subpart F from CM	21	9		30
Foreign Income				\$185
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$46
Foreign Tax Credit		9		(9)
Net U.S. Tax Due				\$37

Panel 2C: Camp Territorial Tax – Option C: Negotiate a tax rate of at least 13.6% in Luxembourg

<u>Entity</u>	<u>Country</u>	<u>Gross Income</u>	<u>Expenses</u>	<u>PBT</u>	<u>Tax Rate</u>	<u>Tax Paid</u>	<u>E&P (before dividends)</u>	<u>ETR</u>
U.S. Parent	U.S. source	\$1,500	\$1,000	\$500	25.0%	\$125	\$375	25.0%
	Foreign source	125		125	25.0%	31	93	25.0%
FTC						(9)		
Principal	Luxembourg	600	300	300	13.6%	41	259	13.6%
CM	Germany	130	100	30	30.0%	9	21	30.0%
LRD	U.K.	430	400	30	24.0%	7	23	24.0%
Less: Intercompany Income		(125)		(125)				
Worldwide		\$2,660	\$1,800	860		\$204	\$771	23.7%

U.S. Tax Return

	<u>Gross Income</u>	<u>§78 Gross-Up</u>	<u>95% DRD</u>	<u>Total</u>
Royalty from P	\$150			\$150
∑ Intangible Income				\$150
Dividend from P	90		(86)	5
Subpart F from CM	21	9		30
Foreign Income				\$185
40% Deduction for II ¹				(60)
Total Taxable Income				\$125
U.S. Tax Rate				25%
Pre-Credit U.S. Tax				\$31
Foreign Tax Credit		9		(9)
Net U.S. Tax Due				\$22

¹U.S. Parent receives a 40% deduction for the FBCII (40% × \$150).

TABLE 3
Effective Tax Rate Comparison

Panel 3A: Summary of ETRs under the Current U.S. Tax and Camp Proposals

	<u>U.S. Tax</u>	<u>Foreign Tax</u>	<u>Global ETR</u>
U.S. Worldwide Tax	\$255	\$41	34.5%
Camp Base Case	162	41	23.7%
Option A	186	41	26.4%
Option B	212	41	29.5%
Option C	166	41	24.1%

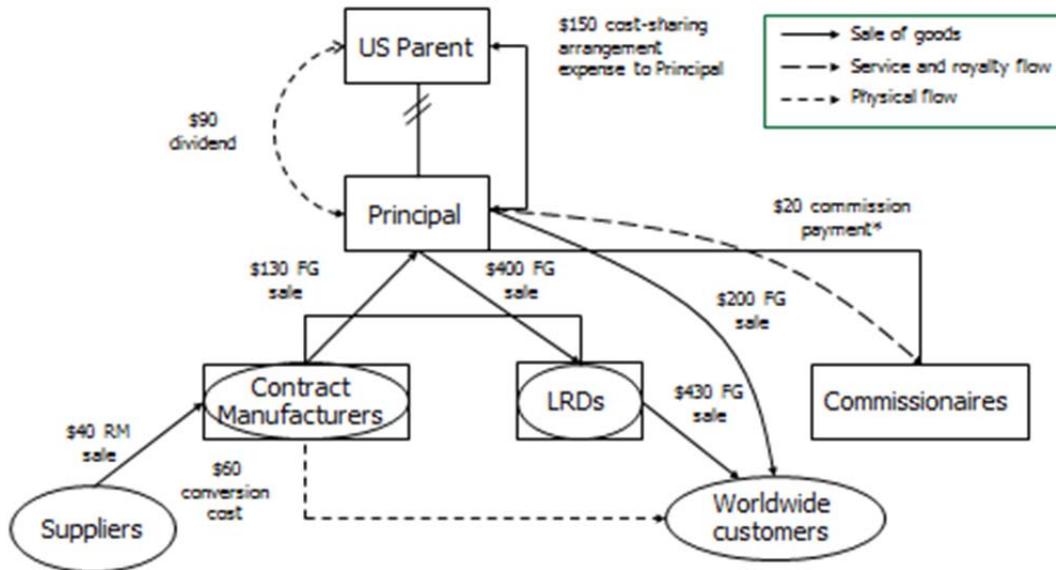
Panel 3B: Summary of ETRs with Tax Planning Under Camp Proposals

	<u>U.S. Tax</u>	<u>Foreign Tax</u>	<u>Global ETR</u>
Option A	\$162	\$61	26.0%
Option B	162	46	24.3%
Option C	147	57	23.7%

TABLE 4
Changes in ETRs Surrounding the United Kingdom's Switch to a Territorial Tax System

Company	POST 2010-2011 ETR-ASTR	PRE 2006-2008 ETR-ASTR	ETRA
<i>Most Negative Changes (Bottom Quintile)</i>			
SEVERN TRENT PLC	-0.273	0.085	-0.357
UNITED UTILITIES GROUP PLC	-0.273	0.054	-0.327
WHITBREAD PLC	-0.123	0.187	-0.310
RANDGOLD RESOURCES LTD	-0.152	0.029	-0.181
TULLOW OIL PLC	0.113	0.260	-0.146
KAZAKHMYS	-0.152	-0.006	-0.146
AMEC PLC	-0.129	0.014	-0.143
NATIONAL GRID	-0.103	-0.006	-0.097
MELROSE INDUSTRIES PLC	-0.273	-0.176	-0.096
BRITISH SKY BROADCASTING GRP	0.015	0.110	-0.095
SAINSBURY (J) PLC	-0.034	0.045	-0.079
AGGREKO PLC	-0.023	0.054	-0.077
BABCOCK INTERNATIONAL GROUP	-0.181	-0.114	-0.067
BAE SYSTEMS PLC	-0.096	-0.031	-0.065
SMITHS GROUP PLC	-0.053	0.009	-0.061
<i>Most Positive Changes (Top Quintile)</i>			
TUI TRAVEL PLC	0.718	0.379	0.339
ROLLS-ROYCE HLDGS PLC	-0.042	-0.295	0.253
INTERCONTINENTAL HOTELS GRP	-0.072	-0.277	0.205
BT GROUP PLC	-0.116	-0.295	0.179
ITV PLC	-0.125	-0.295	0.170
CENTRICA PLC	0.170	0.016	0.154
REED ELSEVIER GROUP	-0.100	-0.218	0.118
GKN PLC	-0.185	-0.295	0.110
BURBERRY GROUP PLC	0.000	-0.108	0.108
ARM HOLDINGS PLC	-0.019	-0.097	0.077
ANTOFAGASTA PLC	0.022	-0.049	0.071
BP PLC	0.140	0.070	0.070
MORRISON (WM) SUPERMARKETS	0.001	-0.061	0.063
RIO TINTO GROUP (GBP)	0.004	-0.057	0.062
SMITH & NEPHEW PLC	0.027	-0.030	0.058

Figure 1
Principal company with contract manufacturers, LRDs and commissionaires



*For direct sales by the principal

FIGURE 2
ETRA by Overall SIC Industry Sector

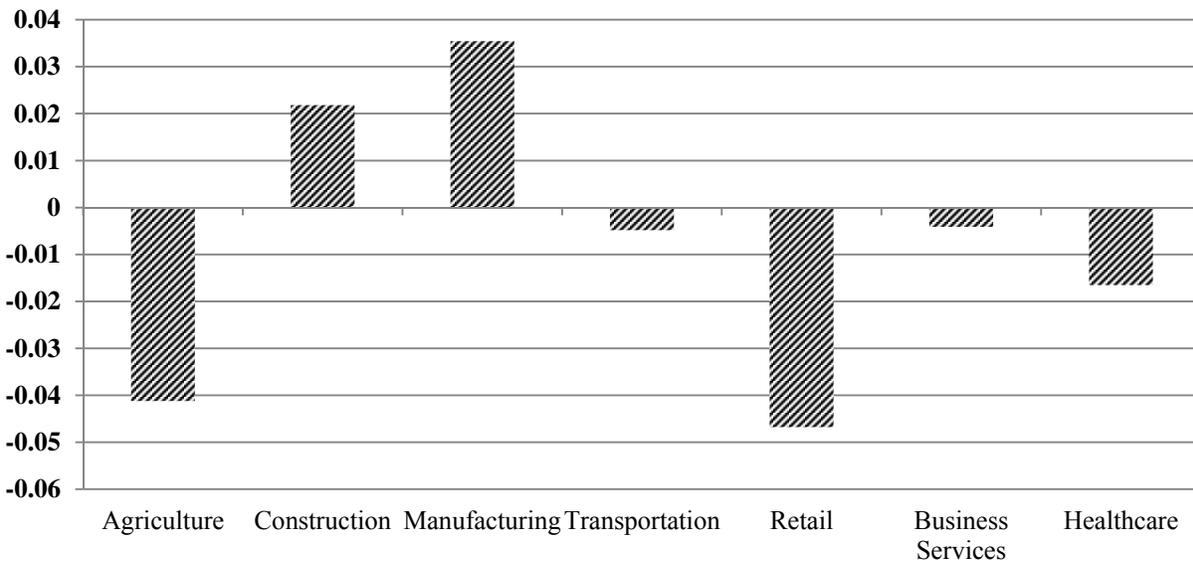
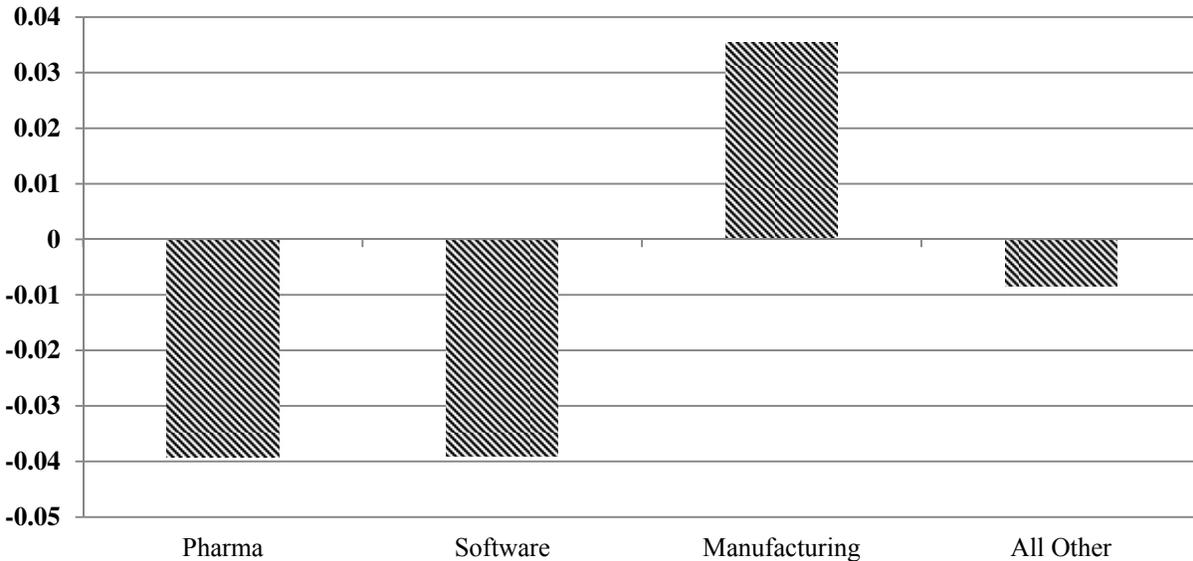


FIGURE 3
***ETRA* by Specialized Industry Sector**



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