

Would Territoriality Require a Special Tax Haven Regime?

Rosanne Altshuler
Rutgers University

December 11, 2006
ITPF – AEI Seminar on Tax Havens and
Foreign Direct Investment

Understanding the question

- Would territoriality require a special tax haven regime?

2

Understanding the question

- Would territoriality require a special tax haven regime?
- Territoriality
 - Dividend exemption?
 - Distinction between foreign business income and mobile income
 - Anti-deferral rules?
 - Expense allocation rules?

3

Understanding the question

- Would territoriality require a special tax haven regime?
- Tax havens
 - Countries with low-tax rates?
 - OECD definition?

4

Understanding the question

- Would territoriality require a special tax haven regime?
- Special tax haven regime
 - Subpart F?
 - A special regime in addition to anti-deferral rules?
 - Treaty requirement?
 - Subject to tax requirement?
 - Minimum level of foreign tax?
 - Black list / white list?
 - Rosenbloom idea?

5

Attempting to answer the question

- How is the incentive to invest in low-tax countries affected by territoriality?
- Altshuler and Grubert (*National Tax Journal*, Dec. 2001)
- Builds on work by Grubert and Mutti (*AEI*, 2001)
- Dividend exemption system with expense allocations

6

Dividend exemption system modeled (briefly)

- Active foreign income would be exempt from U.S. taxation
- Royalties and interest paid to the U.S. parent company, which are deductible expenses in the host country, would be taxed
 - Royalties and interest payments from abroad would no longer be shielded by excess credits originating with dividends.
- Passive income would continue to be taxed on a current basis
- Expense allocations
 - The parent company's overhead expenses, such as interest, would be allocated to exempt income and to the extent allocated disallowed as deductions from U.S. taxable income.
 - R&D expenses, however, would be fully deductible since royalties are taxed.

7

ETR for a hypothetical investment abroad in a low-tax country

	Investment comprised of:		
	All tangible assets	All intangible assets	85% tangible assets
Dividend exemption	4.8%	35.0%	9.3%
Current system (25% in excess credits)	1.7	26.3	5.4
Excess limitation firms	0.7	35.0	5.8
Excess credit firms	4.8	0.0	4.1

- Host country statutory rate = local ETR net equity income from tangible capital = 7%

8

Taking behavior of government and taxpayers into account*

	Effective tax rate
Base case (15% intangible and 85% tangible assets)	9.3%
Different expense allocation assumptions (government behavior)	
No expense allocation rules	3.2
Taxpayer behavior	
Substitute dividends for royalties	8.0

*Estimates assume that firms respond to allocation rules and deduct interest and other overhead expenses at the local rate. See Altshuler and Grubert (2001) for details.

9

Concluding notes

- JCT and Advisory Panel proposals both retain Subpart F
- Could use adoption of dividend exemption to revisit Subpart F but not necessary
- Need to continue to think carefully about behavioral responses to dividend exemption
- Need to think about whether we need a special tax haven regime in the current system

10