Tax Systems: Territorial vs. Worldwide

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Introduction

Tax reform is widely supported across both political and corporate landscapes.

The 2016 Elections resulted in not only a GOP controlled Senate and House of Representatives, but also a GOP White House. While both Democrats and Republicans are highly interested in tax reform, such was not the priority of the Obama Administration or Democratic leadership in Congress. As a result, social issues were more actively pursued prior to 2016.

The likelihood of tax reform occurring has increased dramatically as of 2017. The United States has not undergone a tax overhaul since 1986 under the Reagan Administration, and the nature of our economy has vastly changed since that time, with less emphasis on domestic manufacturing and more high tech research and development.

Several approaches to tax reform are been suggested, including border adjustment taxes, corporate integration, healthcare/estate/death taxes, full expensing, etc.

One key point on tax reform is the debate on whether the United States should move from a worldwide some-deferral tax system to either a worldwide no-deferral or territorial tax system.

Arguments have been made for all of these options; these arguments will be broadly outlined below. Whatever the outcome, this question will be addressed in the ongoing discussions on tax reform.
Territorial Taxation

A territorial tax system is primarily applied towards residents within a given territory earning income within that territory.

Traditionally, income earned by a company/individual from outside a territorial system is not taxed, regardless of whether or not the company/individual is a resident of the nation with the territorial system.

For example, if I were a citizen of Australia, and I had foreign income from a company in Canada, I would not be taxed on that income. The money would be considered taxed, having likely been taxed in Canada by the Canadian Government due to either myself or the Canadian company being a resident of Canada, and thus subject to Canadian taxes.

Additionally, if I were to bring that income back to Australia from Canada, typically in this system, there would be no tax on that repatriation.

This system is widely used and accepted in the western world. Japan and the United Kingdom are among the most recent adopters.

Often times, primarily in Europe, this system is paired with a Value-Added Tax (VAT). The VAT is a consumption based tax, with a tax levied on a product with each stage of production, the value of the product increasing with each stage from start to finish.

This includes the final stage of production being a product’s shipment from seller to buyer. This is often seen as a replacement for official tariffs on international trade.
Worldwide Taxation

A worldwide tax system is primarily applied to citizens of a given nation, regardless of their place of residence or the source of their income.

Traditionally, all citizens under this system must file tax returns and report all income to the federal government. Residents of the country usually also pay a federal income tax.

For example, if I were a citizen of the United States, but moved to Mexico when I was two years old, and remained in Mexico until I was working and receiving income, I would still need to pay U.S. income taxes on all my earnings, despite my lack of residence in the United States.

Deferral & Repatriation

Within a worldwide taxation system, all income made by citizens, regardless of residence, must be taxed. Domestic income is always taxed immediately; however, foreign income can be taxed on a delayed basis, also known as a deferral.

In a no-deferral system, the foreign income is treated the same as domestic income; it is immediately subject to tax.

In a deferral system, foreign income is not subject to taxes immediately, but rather is delayed somewhat either through a time limit or repatriation.

Repatriation, or the return of foreign income to its domestic owner, is often the mechanism by which deferral systems implement taxes.

For example, if I am a U.S. citizen with a foreign company, I can either bring my money back to the U.S. for my own use, thus subjecting it to taxes, or I can keep the money abroad and reinvest it elsewhere, thus protecting it from U.S. taxes.

Many companies with foreign income use this deferral to avoid paying costly income tax rates, often the highest in the world, opting rather to keep money abroad to reinvest into foreign costs.

The United States uses repatriation as its deferral method on taxing foreign income.

As of 2016, the Joint Committee on Taxation estimates untaxed earnings held overseas are around $2.6 trillion.
Comparison

These two taxation systems each come with their own benefits and challenges. Keep in mind the two systems are not always inherently supported by party lines, and an argument can be made for both.

Additionally, most countries use hybrids of these systems to best fit their economic situation. Using a pure territorial or worldwide system is extremely uncommon and unadvisable.

**Territorial:**

**Pros:**

- Standard tax system for developed 1st world nations
- Fast repatriation of foreign income into domestic economy
- Less complex taxation
- Growth in “intangibles” (services, intellectual property)

**Cons:**

- Often paired with consumer tax
- Less revenue generated for gov’t operations
- Incentive to freely move income out of the U.S. into foreign markets with lower tax rates
- Risks to domestic businesses from large foreign entities

**Worldwide:**

**Pros:**

- Stability in gov’t revenue stream
- Keeps income taxation
- Protects smaller domestic businesses
- Incentive to keep investments domestic

**Cons:**

- Complex taxation system
- Not widely used in global economy
- Less growth in higher salary employment
- No incentive to repatriate existing foreign cash
Stances

Political

Territorial

- Common Republican Support
- Sen. Orrin Hatch
- Speaker Paul Ryan
- Gov. Mitt Romney
- Chairman of President Obama’s Export Council Jim McNerney

Worldwide

- Common Democratic Support
- President Barack Obama
- President Donald Trump
- Vice President Joe Biden
- Sen. Ron Wyden

International

Territorial

- Hong Kong
- France
- Belgium
- Netherlands
- United Kingdom
- Japan
- Australia
- Austria
- Canada
- New Zealand
- Luxemburg
- Portugal

Worldwide

- Spain
- Sweden
- Iceland
- +

Source: OECD Tax Data from the Manhattan Institute.
Summary

“A great wind is blowing, and that gives you either imagination or a headache.”

-Catherine the Great

The United States is desperate for an updated tax system. The struggle comes with the transition from one tax system to another, the ability of Congress to move legislation that will last beyond a single term, and the actual creation of a tax system that will benefit the U.S. economy and its residents.

This task requires the perfect storm of economic ideas, legislative text, executive support, and a staying power to allow the economy to break in the new tax system and realize fiscal success.

The worldwide tax system presents a stale but sure option, a continuation of a well-known factor.

The territorial tax system offers high risk, high reward, with the appeal of updated policy and the opportunity for new growth and increase.

With the potential for tax reform in the United States, confidence is high among businesses and taxpayers. The desire for tax reform alone could bring with it a growth and fulfillment from even minor legislation passed. Additionally, failure to pass tax reform could result in its own economic downturn and a lack of trust in domestic investments.

Whatever the decision between worldwide and territorial, the need for reform is too great to let an opportunity pass, and the rewards of doing so seem to heavily outweigh the risks.

If a territorial tax reform could be passed, it may be in the country’s best interest to do so.
Additional Resources

2011 Year-End Report: “Road Map to Renewal” – President’s Council on Jobs


Center on Budget and Policy Priorities: The Fiscal and Economic Risks of Territorial Taxation

ABC News: That Horrible Territorial Tax System Biden Railed Against

Heritage Foundation: A Territorial Tax System Would Create Jobs, Raise Wages

Forbes: A Look at the Territorial Tax Systems in Four Countries Finds No Magic Bullets

Manhattan Institute: The Merits of a Territorial Tax System

Tax Foundation: A Global Perspective on Territorial Taxation
    https://taxfoundation.org/global-perspective-territorial-taxation/
IMF Working Paper: Territorial vs. Worldwide Corporate Taxation


RPC: Territorial vs. Worldwide Taxation

https://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation

Foreign Policy: Beware Territorial Tax Proposals