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SUITABILITY OF TERRITORIAL TAX SYSTEM WITH MODERATE ANTI ABUSE RULE TO A
GLOBALISED ECONOMY.

In the event that globalization has to affect to both the public and private sectors it is quite evident that the tax policies of any country have to be affected. However, the degree of the effects caused by these tax systems depends on the rules and regulations affecting them. These tax systems can be categorized into two categories which include; worldwide tax systems and territorial tax systems.

These tax systems refer two different tax systems in that worldwide tax refers to tax policies that affect all the countries in the world. On the other hand territorial tax system is a tax system whereby the tax policies involved only affect specific jurisdiction area for example a country, a district or even a province.

According to Tanzi, V. and P. Shome (1992), globalization, greatly affects technological changes which affect national tax systems. On a lighter note it is quite evident that the change of tax policies due to globalization is very vital for continuous a process that keeps on taking place each and every day.

Therefore, it is very important for countries to be consistent in creating the best level of consultation and awareness so as to eliminate redundancy in their tax policies that would lead to a loss financially¹. This paper is therefore is geared towards analyzing suitability of territorial tax systems with moderate anti abuse rules and its corresponding processes in the determination of tax policies to adopt.

According to Shah, A. and J. Slemrod (1991), in principle, it is quite evident that in a globalized economy a tax system with moderate deferral from complete anti abuse would lead to more efficiency and would yield more revenue as compared to one with complete anti-abuse rule². Globalization has been referred by many economists as the process of creation and nurturing corporate giants from all the spheres of the

¹ Tanzi, V. and P. Shome (1992). Redundancy of tax policies. It is quite evident that the worldwide tax system is highly tax redundant as compared to the territorial tax system and the mixed tax system

² Shah, A. and J. Slemrod (1991). 76 percent of world economies have failed to create territorial tax systems that have a pure anti abuse rule. Others have adopted mixed systems such as Netherlands and France.....others use only worldwide systems but cannot fail to bear with their shortcomings.

world. Though seen as a process it encompasses with itself a rather technical nature of business processes as it involves their integration into one whole system that is comprised of subsystems. This paper seeks to analyze the territorial tax system with moderate anti abuse rule and its overall suitability in a globalized economy.

A pure territorial tax system calls for payment of tax by individuals for income that is derived from within the borders of a specific country says Tanzi, V. and P. Shome (1992). Therefore income outside the borders or from abroad does not apply to this criterion³.

On the other hand worldwide tax system calls for taxation of individuals of all the income they receive regardless whether it is derived internally without a country's border or whether it is derived from abroad. In this case this is a pure worldwide tax system.

According to Mansfield, E. (1988), economically the worldwide tax system is not so much revenue yielding as compared to the territorial one⁴. This is because of determent of taxation of foreign income that is active, very liberal cross crediting capabilities and opportunities and other forthcoming shortcomings.

Globalization has greater effects on tax as mentioned earlier. This is because different territorial states have different tax laws and regulations regarding different types of products. In this regard globalization has been considered to impact greatly on both direct and indirect tax due to the presence of high factor

³ Tanzi, V. and P. Shome (1992). Definition of tax systems and their unique characteristics.

⁴ Mansfield, E. (1988). Economic settings and systems demand crosscutting features to be incorporated in the tax systems to avoid forth coming shortcomings.

mobility. In real sense a factor of production like capital is typically more mobile than labor⁵. Territorial tax burdens will therefore impact greatly on this factor of production as individuals will be taxed differently in different countries⁶. To evade these burdens in order to enhance business process abuse of territorial system is quite evident in developing countries. The major problem in this discussion is the extent to which anti abuse rule will hold for these two tax systems.

Tax systems impact greatly on foreign tax credits. Debate on effect of globalization would be incomplete without the mention of double taxation if the same tax exists in the same countries. Foreign tax credit is granted between two countries to avoid the impact and incidence of the presence of double taxation if the same kind of tax is charged between two countries.⁷

In the United States one clause used in tax determination is the subpart F. taxation income derived from foreign subsidiaries of companies incorporated in America which is under subpart F is deemed subject to taxation even if it is not repatriated to the United States. One interesting thing about subpart F is that it includes even income that is paid as bribes to foreign officials⁸.

A good and elaborate example is the United States whereby the internal revenue service is able to grant an individual taxpayer if this taxpayer pays taxes such as income tax on revenue from goods produced in another country. In the long run deferral of subpart F and its corresponding clauses means attraction of capital. This creates another reason to accept the argument that a territorial system with moderate anti abuse rule would be appropriate for a globalised economy.

⁵Tanzi (2000): the presence of indirect tax burden. A modern approach to tax systems and their deficiencies.

⁷Rodrik, D. (1998). Double taxation of companies can have adverse effects on the company's performance as a whole.

⁸ There is nothing wrong with U.S. companies seeking to reduce their tax rate, but if tax reduction is the goal, it is not clear why, as a matter of macroeconomic policy, it should be focused on offshore earnings reinvested offshore

A major disparity comes in the wake of the fact that in the United States gross revenue tax is not counted as part of the double taxation and therefore a foreign tax credit would not be granted as a result. This can be explained by the subsequent adoption of the worldwide system as opposed to the territorial system.

According to Tanzi, V. (2000)⁹ operation of this kind of concept is in such a way that the only primary role as regard globalization is the eventual elimination of the process of double taxation between countries, therefore to eliminate this each country calculates the tax payable to it from the revenue generated with a clear elimination or assumption that the other country is taxing it and then the primary country takes the priority and after tax has been paid to it, the other country will take a tax credit⁵.

In this debate of suitability of a territorial tax system with moderate anti abuse rule it is quite evident that the presence of double taxation exists as a common characteristic of the pure territorial tax system thereby a defect. According to Shah, A. and J. Slemrod (1991), this defect can be cured by creation of a territorial system that creates an appropriate exemption regime.

A clear crosscutting feature of the name transfer pricing is just how the name describes itself.¹⁰ In a contemporary view transfer pricing is the transfer of good between the various departments of an organization. Due to increased division of labor and specialization in the whole world many components of production are continuously developed in different parts of the world. For instance, in 1994, 36 percent of US exports and 43 percent of US imports were of the intra-firm nature (Clausing, 1998). In the United States, international tax laws demand that American or foreign owned multinationals are supposed to pay taxes for profits earned in the United States.

⁹ Tanzi, V. (2000). Double taxation policies and measurements procedures.

¹⁰ Tanzi, V. (1998). Transfer pricing and its effect on multinationals. The direct impact in double taxation mitigation.

In this regard IRS data reveals that this is however abused. With a 35% tax rate and the fact that this is a worldwide tax system evidence of plenty of room by multinational to maneuver is so much. A hypothetical example in this is the case of IBM whereby in 1987, it reported that 1/3 of its global profits were earned in US. However on its tax return statement, IBM treated most of its expenses as US related and therefore its federal taxes for 1987 were eliminated.

According to (Harris, et al., 1993), it is quite evident that most of the multinational enterprises in US are able to reduce their tax burdens by between 3% and 22% by shifting incomes from high tax countries to low tax areas. These flagrant tax violations or abuse means increased revenue for US firms and hence their increased reduction in taxation costs.

Knowledge of tax reporting and tax implications due to aspects such as transfer pricing helps to ensure that integration of business processes remains intact. In relation to globalization, transfer pricing are the cross-border transactions that relate to the transfer of asset in multinationals.

As noted in the US, the use of a predetermined tax base or formula for all its operations abroad is not sustainable for operations in a globalized economy since it would lead to consequences such as double taxation and international in competitiveness. Therefore the adoption of a territorial system with moderate anti abuse deferral would be ideal for any globalized economy.

Through these highlight it is quite evident that a worldwide system has deficiencies when compared with a territorial system that has all the best designs and features of a good tax system. However on the other hand it is very evident that a worldwide system with a proper design can be viable over time if it is only structurally fine and can be even superior to a territorial system in the long run.

Aggressive transfer pricing is one of the distortions experienced in determination of the deficiencies involved in a particular tax system. This because it leads to income shifting in the various countries that multinationals are placed.

A territorial system clearly advocates for an undercharge of the goods and services by the parent company to the subsidiary if in the subsidiaries country taxes are lower¹¹. This actually transfers income shift to the foreign subsidiary from the parent. This problem can only be eliminated through enactment of stringent transfer pricing rules so as to avoid foreign tax credits limitations¹².

In the quest for attainment of a territorial system one major component derived is foreign tax credit. This is similar to foreign tax deduction and is only claimed for exact taxes paid in a particular country.

However, foreign tax credit cannot be claimed on income that has been excluded from US taxation through use of foreign earned income exclusion.

In statistical terms a foreign tax credit reduces ones US tax liability on a dollar for dollar basis, therefore the overall percentage deduction is better than that of foreign tax deduction. Multinationals in a globalized economy therefore aim at maximizing their dollar for dollar exchange in their operations. The territorial tax system is best suited for this as it aims at ensuring that this dollar for dollar exchange will be taxed accordingly according to the available tax rules.

On a lighter note in determination of the Foreign tax credit it must be known that the FTC cannot exceed the US tax liability multiplied by a percentage. Any Foreign tax credit amount that exceeds the maximum amount must therefore be carried back to the previous tax year or carried forward to the next tax years. However, tax credit for interest or due penalties from operations such as foreign mineral income, allowable income, international boycott operations and foreign partnerships among others cannot be granted.

¹¹ Tanzi, V. (1999). Impact of globalization on tax systems goes beyond the real essence of the needs of a particular country.

¹² Developed countries are at the verge of fighting out presence of very high foreign direct credits.

More benefit is derived when the tax credit is multiplied by the available territorial tax rates.

Multinationals however try as much as possible to flaw this process and hence end up generating more profits. (The World bank, 1998, Table 3.2b, pp. 95-96) illustrates that 23% of foreign tax credits are not remitted accordingly in the US. This means that the US government loses much of these credits according to their current system.

Various distortions caused by the abuse of the territorial systems illustrates that there are more efficiency gains which outweigh losses as a result of remittance of foreign n direct credits.

In the quest for pure territorial systems to attain maximum revenue collection it is quite evident that products are taxed on the value added.

Value added tax is international tax that is taxed on the value added on a good or service. However the question of the value added on a good or service remains difficult at each stage of production. Therefore the issue of non adherence of anti abuse rule is derived from the difficulty obtained of clearly distinguishing for each of the transactions where actual consumption is deemed to take place and where it should be taxed.

Businesses can therefore incur double taxation. According to Rajan, R. (2000), unlike the worldwide tax system adopted by countries such as the US, the territorial system has established refund schemes if there are different jurisdiction between where goods are located and where the recipient is located.

In international tax practices sales tax works a bit more differently than the value added tax mentioned above. Sales tax systems have stipulated a certain amount of tax on consumption of goods within a certain territorial boundary¹³.

¹³ Shah, A. and J. Slemrod (1991). Sales tax in developing countries contributes to major budget funding and therefore it increases as consumption of goods and services increases.

The implementation of sales tax under the territorial system aims at engaging at fair play when carrying out international trade transactions. However sales tax is still abused in the pure territorial system of tax as most businesses do incur sales tax that is irrecoverable when they subsequently export various goods and services, there is an element of this sales tax that is carried upon by this goods. This is especially the case with multinationals. In this regard these multinationals are able to generate more revenue and incur lower costs of operations. Therefore, this proves that it is easier to generate more revenue in a globalised economy with anti abuse rule.

According to Rajan, R. (2000), globalization demands integration of business services and other concepts adopted by multinationals. A common demand of the pure territorial system of taxation with no abuse is the exemption of exports and taxation of imports.

The complexity associated with globalization however creates a problem due to this. Different jurisdictions in their application of import and export taxes as part of consumption taxes in international trade, has led to a significant change in business activities.

Therefore imports are taxed higher in terms of import duty and excise so as to discourage the level of importation among nations¹⁴. In this regard the anti abuse rule under the territorial system is highly upheld since different jurisdictions can charge different import and export taxes.

Another major aspect of globalization that cannot go unmentioned is foreign direct investment (FDI). It is a concept in globalization that has a direct effect on economic growth of any given country¹⁵. In this regard countries would want to compete with each other to attract foreign direct investment. In this regard these countries offer tax incentives to these countries and thereby creating an effect on the tax burdens

¹⁴ Tanzi, V. (1996). Import duties imposition on developing countries.

¹⁵ Rajan, R. (2000). Effects of foreign direct investments on developing countries. The exact implications on revenue and costs.

according to Shah, A. and J. Slemrod (1991). In this regard the matters to be addressed here include key business processes such as international trade and mobility of capital as a factor of production and in general and the outcomes derived from various tax systems. In this regard an analysis of how territorial tax systems with moderate abuse have been used among various territorial boundaries to attract foreign direct investment (FDI), and the overall technical capability in these economies.

Developing countries and in particular those in Africa are in much need of foreign direct investments in order to gain foreign exchange for the infrastructural development needs. In this regard they tend to give fiscal incentives in order for them to gain from FDI. Fiscal incentives will only be very efficient if there are no substitutes available for them. Such substitutes include sound macroeconomic policies, infrastructure and presence of availability of necessary and sufficient social amenities.

Many African countries, such as Kenya and Uganda have made the best use of tax incentives in order to attract foreign direct investment through multinational enterprises. The multinational enterprises bring foreign exchange to these countries. To counter the effects of tax competition territorial tax systems are best suited for this. In the United States due to the presence of a global tax system it is difficult to have tax competition practices.

Different tax policies demand different modes of business reorganization especially in the management of multinationals. This involves the policies to adopt at any given time and their corresponding impact on business practices. According to Simons, H. (1938), the major factors involved here are things like personal taxes whereby multinationals employees are entitled to remit taxes in their country of operations¹⁶. Territorial tax with moderate anti abuse rules ensures flexibility different jurisdictions are confronted with various varying taxation needs.

¹⁶ Rodrik, D. (1992). Personal taxes and their effects on global revenue. Multinationals regard of business reorganization and taxation

Sovereignty is another key aspect of globalization. This is due to the fact that multinationals operate in different countries with different cultural and ethnic backgrounds. A larger approach to this clearly identifies that there exists a herd instinct and it is difficult to change people from their culture. Simons, H. (1938), illustrates developing countries old want to create a tax system that best suits their cultural standards and hence the adoption of the territorial system as opposed to the worldwide system.

In the eventual carrying out of tax practices different jurisdictions have stipulated various taxation treatment of the different taxable incomes in this countries. For example, tax on intangible property depends on where the property is used. In the US where a worldwide system is used anti abuse is likely to affect the sovereignty as this tax system is not customized to meet the best suitable tax practices rather, it is based on some predetermined standards.

As a matter of fact different aspects of globalization mentioned above create varying effects on the suitability of the tax system to be adopted at any time. In this regard, analysis and evaluation of various tax concepts such as application of transfer pricing, subpart F, foreign direct investments and foreign tax credits shows that the world wide tax system is quite deficient as compared to the territorial system.

According to Rajan, R. (2000), it is quite important that in a globalized economy due to factors such as double taxation and competition, a pure territorial system is not suitable¹⁷. Due to this, deficiencies the most suitable tax system would be a territorial tax system with moderate anti abuse rule.

¹⁷ Rajan, R. (2000). Are Multinational Sales to Affiliates in High Tax Countries Overpriced. How does double taxation contribute to this.

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