Switching to a “Territorial” Corporate Tax System Would Encourage Offshore Tax Dodging

America does best when companies succeed through efficiency and innovation, not through tax avoidance strategies. Unfortunately, however, America’s corporate tax system is riddled with loopholes and exemptions that enable many large multinational corporations to pay much less than the statutory tax rate.

Federal policy allows corporations to postpone indefinitely paying U.S. taxes on profits earned overseas, as long as corporations keep those profits abroad. Many corporations take advantage of the system by artificially shifting earnings on paper to offshore tax havens—countries with very low or nonexistent taxes—to avoid paying taxes in the United States. In 2008, American companies reported 43 percent of their profits from just five tax haven countries—Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland. These same companies hired only 4 percent of their foreign workers from these countries, and made only 7 percent of their foreign investments there.

Profit shifting activity has increased over the past decade. (See Figure 1.) For example, the amount of profits reported by American companies in Bermuda grew from 260 percent of Bermuda’s overall economy in 1999 to 1,100 percent in 2010—more than a four-fold increase. American multinational corporations currently hold on the order of $1.9 trillion in earnings abroad.

Proposals to shift America’s corporate tax policy to a “territorial” system would further promote tax haven abuse, which already costs the federal treasury about $90 billion in lost revenue every year.

A pure “territorial” tax system would give multinational corporations an open invitation to park their profits in offshore tax havens. The policy would effectively act as a permanent “get out of taxes free” card.

Under a territorial tax system, corporations would never have to pay taxes on earnings they declare to be earned abroad, instead of merely being able to defer tax payments until they bring the money back to the United States.
States. Such a move would open offshore tax loopholes even wider—increasing existing incentives for corporations to disguise profits as “foreign” to avoid paying U.S. taxes, while also encouraging companies to move jobs and factories out of the country.

Shifting to a Territorial Tax System Would Encourage Companies to Shift More Profits Offshore
The United States already loses approximately $150 billion in federal tax revenues every year due to corporations and wealthy individuals sending their money to offshore tax havens. Tax haven abusers benefit from our markets, infrastructure, workforce and security, but they pay next to nothing for these benefits. Ordinary taxpayers end up picking up the tab through higher taxes, higher national debt, or budget cuts to public programs.

Shifting to a territorial corporate tax system, without changing other rules, would cost $130 billion in tax revenue over a decade.

Shifting to a Territorial Tax System Would Put Small Businesses and Larger Domestic Companies at a Competitive Disadvantage
When large multinational corporations exploit offshore tax loopholes to lower, or even eliminate, their tax bills, they force small American businesses and larger domestic companies to compete on a tilted playing field. Shifting to a territorial tax system would increase this competitive disadvantage. A March 2013 poll revealed that more than four out of five small business owners nationwide oppose shifting to a territorial tax system, with opposition spanning both political parties.

Countries with Territorial Tax Systems Suffer from Tax Haven Abuse
No major U.S. trading partner has adopted a pure territorial tax system. Nations that have adopted territorial tax systems all tax a portion of foreign income. For example, Japan applies taxes to income generated in other countries when that country’s tax rate is less than 20 percent, and the United Kingdom charges taxes when income generated elsewhere is taxed at less than three-quarters of the domestic rate.

However, despite rules intended to prevent tax haven abuses, countries with territorial tax policies remain vulnerable. For example, Starbucks paid no corporate tax in the United Kingdom from 2009 through 2012. Starbucks reported paying premiums for coffee beans and roasting to subsidiaries based in other countries to make it appear as if the company was operating at a loss in the United Kingdom. Because the U.K. levies corporate tax on domestic profits, this income shifting eliminated Starbucks’ U.K. corporate tax bill. Other multinational companies such as Amazon and Google engage in similar practices.

Territorial Tax Systems Do Not Create Jobs at Home
Experience with tax repatriation holidays suggests that adopting a territorial tax system would not promote job creation at home. During the temporary tax repatriation holiday created by Congress in 2004, which is similar to what would happen under a shift to a territorial tax system, U.S. corporations paid only minimal taxes on profits they had been storing offshore. Evidence shows that companies used the extra cash to enrich shareholders or pay down corporate debt rather than to create jobs. After Japan and the United Kingdom adopted partial territorial tax systems, Japanese and U.K. firms behaved similarly. The companies brought more foreign cash back to their home countries because of the newfound tax advantage. However, rather than investing in domestic jobs or infrastructure, the companies used their extra cash to increase payouts to shareholders.

Multinational Corporations Should Pay U.S. Taxes
U.S. tax policy should ensure that corporations pay their taxes, not encourage them to avoid responsibility by storing profits in offshore tax haven nations. Businesses should prosper based on their efficiency and innovation, not on their ability to exploit tax loopholes.

Instead of adopting a territorial tax system, America should reform corporate tax rules to end the practice of deferring taxes on income generated abroad. In addition, incremental steps to curb offshore tax avoidance include treating the profits of publically traded ‘foreign’ corporations that are managed and controlled in the U.S. as domestic companies for tax purposes, and limiting the shifting of income to offshore subsidiaries through the transfer of intellectual property.
Notes


4 Ibid.


7 This figure shows trends in net income reported by majority-owned foreign affiliates of U.S. multinational companies in two different country groups. The tax haven nation group includes Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland. The regular nation group includes Canada, Germany, the United Kingdom, Mexico, and Australia. Each data point represents the average of the amount of net income reported in each of these countries, per (U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment and Multinational Companies*, available at www.bea.gov/iTable/index_MNC.cfm), relative to the size of the economy of the country the income was reported in, per (World Bank, GDP, current U.S. Dollars, available at data.worldbank.org/indicator/NY.GDP.MKTP.CD). Data are for years 1999 through 2010. The Bureau of Economic Analysis changed its data reporting in the middle of this time series. Data from 1999 through 2008 are for non-bank companies. Data for 2009 and 2010 are for all industries, minus finance and insurance, which was the closest analogous grouping available. The average was weighted by the size of the economy of the country in question—in other words, the Netherlands represents about 50 percent of the tax haven country data series, because it is the largest economy among the tax haven nation group.

8 See note 6.


13 According to the Joint Committee on Taxation, “existing territorial systems exempt foreign income only if the income satisfies certain requirements. For example, exemption may be available only for income attributable to the conduct of a foreign business. Foreign business income may be eligible for exemption only if it is subject to meaningful tax in the foreign jurisdiction or is derived in a jurisdiction that has in force an income tax treaty with the taxpayer’s country of residence.” Staff of the Joint Committee on Taxation, Scheduled for a Public Hearing Before the Committee on Ways and Means on May 24, 2011, U.S. Congress, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income*, 20 May 2011.


15 Ibid.
