



October 19, 2011

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## **Why Congress Should Reject A “Territorial” System and a “Repatriation” Amnesty: Both Proposals Would Remove Taxes on Corporations’ Offshore Profits<sup>1</sup>**

■ Corporations are lobbying Congress to exempt their offshore profits from U.S. corporate income taxes, either permanently (by enacting a “territorial” tax system) or temporarily (by enacting a “repatriation” amnesty).

■ Instead, Congress should end the tax break that caused many of those corporate profits to be shifted overseas in the first place — the rule allowing U.S. corporations to “defer” U.S. taxes on their offshore profits (often just called “deferral”).<sup>2</sup>

■ “Deferral” means that U.S. corporations may pay lower taxes indefinitely if they move operations and jobs to a low-tax country or just make their U.S. profits appear to be generated in a low-tax country. In other words, deferral can encourage job offshoring and profit shifting to tax havens.<sup>3</sup>

■ The tax incentives for job offshoring and profit shifting would increase if Congress adopted a “territorial” tax system. If *deferring* U.S. taxes on foreign profits has already encouraged U.S. multinational corporations to favor shifting profits and jobs offshore, then *eliminating* U.S. taxes on foreign profits would logically increase that incentive.<sup>4</sup>

■ The problem is not that all other countries have lower corporate taxes than the U.S., but that certain countries apply no tax, or a low tax, to corporate profits. Most major U.S. corporations with foreign profits actually pay taxes at higher effective rates to foreign governments on foreign profits than they pay on their U.S. profits to the U.S.<sup>5</sup> The problem is that deferral provides a tax incentive to shift jobs or profits to the low-tax countries, and a territorial system would make this problem worse.

■ The tax bias in favor of workers in low-tax countries over U.S. workers, which is caused by deferral (and which would increase under a territorial system), is not remedied by “complementary” job creation for U.S. workers. U.S. corporations claim that they will be able to operate in other countries more easily if the U.S. does not tax any of the profits they claim to earn abroad. But there is no evidence that their offshore operations help American workers. In fact, between 1999 and 2008, U.S. multinational corporations created 2.4 million foreign jobs while reducing their U.S. workforce by 1.9 million positions.<sup>6</sup>

■ The incentive to shift profits to tax havens caused by deferral (which would increase under a territorial system) cannot be remedied by better “transfer pricing” rules. U.S. corporations often claim deductions for inflated fees and royalties paid to their subsidiaries in offshore tax havens, effectively wiping out their U.S. profits. Transfer pricing rules are supposed to make U.S. corporations and their subsidiaries conduct business at “arm’s length,” meaning fees and royalties would be charged as if they were unrelated companies, thus removing the possibility of such manipulation. But tax lawyers recognize that the IRS often cannot enforce this system very well because it often cannot define a reasonable price for such transfers, particularly for intellectual property.<sup>7</sup>

■ **The countries with territorial tax systems have serious problems with profit shifting now.** These governments are having tremendous problems particularly with enforcing transfer pricing rules.<sup>8</sup> In fact, the European Union is considering moving away from the territorial system for determining how corporate profits are allocated among its member states.<sup>9</sup>

■ **Another temporary tax amnesty for repatriated offshore corporate profits would increase incentives for job offshoring and offshore profit shifting in similar ways.** One reason why the Joint Committee on Taxation concluded that a repeat of the 2004 “repatriation holiday” would cost \$79 billion over ten years is the likelihood that many U.S. corporations would respond by shifting even more investments offshore in the belief that Congress will call off most of the U.S. taxes on those profits again in the future by enacting more “holidays.”<sup>10</sup>

■ **The Congressional Research Service concluded that the offshore profits repatriated under the 2004 tax amnesty went to corporate shareholders and not towards job creation.** In fact, many of the companies that benefited the most actually reduced their U.S. workforces.<sup>11</sup>

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<sup>1</sup> The points made here are explained in greater detail in Citizens for Tax Justice, “Congress Should End ‘Deferral’ Rather than Adopt a ‘Territorial’ Tax System,” March 23, 2011. <http://www.ctj.org/pdf/internationalcorptax2011.pdf>

<sup>2</sup> A bill before Congress that would repeal deferral is the Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Senators Ron Wyden (D-OR) and Dan Coats (R-IN). This bill could use significant improvements (for example, it does not generate sufficient revenue) but it would create a system in which U.S. corporations would receive no tax advantage from shifting jobs or profits offshore.

<sup>3</sup> Several tax experts have concluded that a pure worldwide system in the U.S. (repeal of deferral) would be superior to either our current system or a territorial system. For example, see Samuel C. Thompson Jr., “An Imputation System for Taxing Foreign-Source Income,” *Tax Notes*, January 31, 2011; J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, “Perspectives on the Worldwide vs. Territorial Taxation Debate,” *Journal of the Australasian Tax Teachers Association* 2008 Vol.3 No.2.

<sup>4</sup> Many tax scholars have concluded that these problems would worsen under a territorial tax system, even if these experts do not agree among themselves on the best alternative. See Amy S. Elliott, “Territorial System Largely Rejected by Corporate Tax Panel,” *Tax Notes*, December 6, 2010. Some emphasize the increased problems with offshore profit shifting that would result from a territorial system. See Edward D. Kleinbard, “Throw Territorial Taxation from the Train,” *Tax Notes*, February 5, 2007. Others warn about the impact on jobs of a territorial system. See James R. Repetti, “Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President’s Advisory Panel on Tax Reform,” Boston College Law School Legal Studies Research Paper Series, April 12, 2007.

<sup>5</sup> Statement of Robert S. McIntyre Director, Citizens for Tax Justice, Before the Senate Budget Committee Regarding Business Tax Subsidies Administered by the Internal Revenue Service, March 9, 2011, p. 4-6, <http://www.ctj.org/pdf/mcintyretestimony03092011.pdf>. Figures in CTJ’s forthcoming report on corporate income taxes will show that this is still the case.

<sup>6</sup> Testimony of Martin A. Sullivan before the Committee on Ways and Means, U.S. House of Representatives, January 20, 2011.

<sup>7</sup> A recent study estimated that the U.S. Treasury lost \$90 billion in 2008 because of transfer pricing abuses. Kimberly A. Clausing, “The Revenue Effects of Multinational Firm Income Shifting,” *Tax Notes*, March 28, 2011.

<sup>8</sup> Michael C. Durst, “It’s Not Just Academic: The OECD Should Reevaluate Transfer Pricing Law,” *Tax Notes*, January 18, 2010.

<sup>9</sup> The EU is considering an apportionment system similar to the one used by U.S. states to allocate corporate profits among themselves. Stephen Castle, “Europeans Introduce Corporate Tax Plan,” *New York Times*, March 16, 2011. For an explanation of the proposal, see European Commission, “Common Consolidated Corporate Tax Base: Questions and Answers,” March 16, 2011.

<sup>10</sup> Letter from the Thomas A. Barthold, Joint Committee on Taxation to Congressman Lloyd Doggett, April 15, 2011. [http://www.ctj.org/pdf/jct\\_repatriationholiday.pdf](http://www.ctj.org/pdf/jct_repatriationholiday.pdf). The top 20 corporations that took advantage of the previous holiday now have three times as much in foreign profits parked offshore. <http://www.ctj.org/pdf/ndnreport.pdf>

<sup>11</sup> Donald J. Maples, Jane G. Gravelle, Congressional Research Service, “Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis,” May 27, 2011. [http://www.ctj.org/pdf/crs\\_repatriationholiday.pdf](http://www.ctj.org/pdf/crs_repatriationholiday.pdf)