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Will Congress Make Itself a Doormat for Corporations that Avoid U.S. Taxes?

Senate Should Reject Proposal to Allow "Repatriation" of Offshore Profits at Super-Low Tax Rate

"Congress can swear on two stacks of Bibles that it'll never do it again, but they've lost their virginity." H. David Rosenbloom, Director, NYU School of Law International Tax Program, commenting to the New York Times *on July 24, 2007 on the "repatriation" provision in the American Jobs Creation Act of 2004.*

In 2004, Congress did something that, it claimed, it would never do again. It allowed corporations that had shifted their profits offshore to "repatriate" those profits—that is, bring them back into the United States—and pay corporate income taxes on those profits at a almost nominal 5.25% rate instead of the normal 35% rate for corporate income.

In 2004, it was obvious to all that if we provided this sort of tax amnesty more than once, corporations would actually have an incentive to move their profits out of the United States. They would know to simply wait for the next amnesty, when they could bring those profits back and pay almost no taxes on them. So, lawmakers insisted that this wouldn't happen again, no matter how much corporate lobbyists begged.

Well, the corporate lobbyists are back. They argue that repeating the tax amnesty—which would surely encourage corporations to shift even more profits into offshore tax havens—will be an effective stimulus for the U.S. economy! When the Senate takes up its economic stimulus bill next week, some members will offer an amendment to include this second amnesty.

This proposal to reward tax-evading corporations should be rejected. If Congress believes that there is some economic benefit to getting offshore profits officially back into the U.S., there is a much better way to do so, one that will not drain the Treasury of hundreds of billions of dollars in taxes that corporate tax evaders should be required to pay.

How Corporations Use Offshore Tax Havens

First, some background. Many U.S.-based corporations currently engage in convoluted tax accounting schemes in order to pretend that they make their profits in tax-haven countries—thus avoiding U.S. taxes on those profits. For example, an American corporation might make sure that some asset, say a logo or a patent, is held by its foreign subsidiary in a country with low or no corporation taxes. The American parent company then "pays" an inflated price to the foreign subsidiary for the use of that asset, and tells the IRS that this expense (the payment for the use of the logo or patent or whatever) greatly reduced or wiped out its gross income, leaving it with no taxable income.

Meanwhile, the foreign subsidiary (which actually might only consist of a post office box) is the

alleged recipient of all or most of the profits. Thanks to the rule that lets corporations defer federal taxes on their foreign profits, the parent corporation generally gets to defer paying taxes indefinitely.

Of course, there are rules that are meant to prohibit companies from using accounting schemes and paper-only transaction to wipe out their U.S. taxes. For example, different divisions of a company are supposed to "buy" and "sell" services and goods from each other at a fair market price, to prevent the sort inflated payments for use of a logo or patent described above. And it's true that there are plenty transactions between U.S. parent companies and their offshore subsidiaries that are perfectly legitimate. But the number of IRS examiners devoted to making sure these rules are being followed is inadequate and there is no doubt that a great deal of illegal offshore tax evasion is taking place.

In fact, corporations engaged in questionable practices related to their offshore profits are apparently starting to worry that the IRS will catch up with them. The IRS under President Obama will (hopefully) be more attentive to offshore tax avoidance, so CEOs of companies using tax havens might be starting to fear that the party is over. If they believed they could really go on indefinitely without paying taxes on the profits they have shifted offshore, then they would prefer the zero tax rate they are now paying to a 5.25 percent tax rate.

Companies apparently hope that if they declare their tax haven profits on their tax returns, and pay the tiny 5.25 percent tax rate, the IRS will no longer go after them for their illegal profit-shifting schemes. In fact, this was almost certainly the companies' motive for pushing for the previous repatriation tax break in 2004. Since then, corporations have shifted hundreds of billions of dollars more in U.S. profits offshore, and they would like a "get out of jail free" card for those profits, too.

Congressional proponents of repeating the 2004 repatriation tax break, led by Senators Barbara Boxer (D-CA) and John Ensign (R-NV), claim that getting tax-cheating companies to pay 5.25 percent on their tax-sheltered offshore profits will raise as much as $40 billion for the U.S. Treasury. But that's highly misleading. If, as expected, the IRS and Obama Treasury Department crack down on these offshore tax scams, then hundreds of billions of dollars will be raised at the 35 percent regular corporate tax rate. Almost all of those likely tax receipts will be lost, however, if companies can get a "tax amnesty" by paying a mere 5.25 percent.

How We Know the Last "Repatriation" Was a Fiasco

Under the amnesty provision enacted as part of the so-called American Jobs Creation Act of 2004, profits were repatriated typically through a dividend made to a U.S. company from its offshore subsidiary, and the U.S. parent company then paid a tax of 5.25 percent on that dividend. About $312 billion of overseas profits were repatriated this way, but this did not have the stimulative effect that lawmakers promised.

1. Only a small number of companies actually benefitted. Of the estimated 9,700 companies with controlled foreign corporations, only 843 took advantage of the repatriation tax break.

2. Congress utterly failed to ensure that this select group of companies used their repatriated profits to create jobs. The statute required that the repatriated funds be used for "the reinvestment of such dividend in the United States (other than as payment for executive

compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation."

A 2008 study found that there was no positive correlation between a company's repatriated earnings and an increase in the permitted uses, but did find a positive correlation between the repatriation and increased repurchases of stock (effectively putting the money in the hands of the shareholders) which was NOT a permitted use under the bill.

CTJ director Robert McIntyre said back then, "Money is fungible. You take it from one pot, you put it in another. Congress says you can't use repatriated profits for a prohibited purpose but of course you can free up some other money and use that for the prohibited purpose."

3. Many companies that took advantage of the repatriation provision continued to layoff workers and close factories in the following year. That was the path taken by Pfizer, Ford Motor Co., Merck, Motorola, Proctor & Gamble, PepsiCo, and Honeywell International after they saved billions from this "one-time" tax amnesty.

4. The predicted economic benefits of the 2004 provision did not materialize. Advocates of the tax amnesty promised it would usher in a large increase in capital spending, a decline in the unemployment rate, and a significant increase in GDP. None of this happened.

"Repatriation" of Offshore Profits Is Unlikely to Stimulate the U.S. Economy

The corporate lobbyists claim that the repatriation proposal is needed now more than ever because companies are facing the one-two punch of slackening consumer demand and a credit crunch. But the repatriation proposal is in no way targeted to companies that actually have those problems.

If Congress wants to boost demand for goods and services, it can do so through the sort of government spending projects that make up most of the stimulus bill. If Congress wants to help companies that are unable to invest because of the unavailability of credit, it can enact aid targeted to companies actually facing liquidity problems and could place strenuous conditions on that aid. (Think of the bailout for automobile manufacturers that was debated in December).

But calling off almost all taxes on profits that any corporation shifted offshore—which they would be encouraged to do again—is simply not a way to stimulate the economy.

A Much Better Solution

Even if there would be some modest benefit from getting offshore tax-avoidance money officially back into the United States, the approach that Corporate America is pushing is totally backwards. The right answer, from a fairness and economic efficiency perspective, is to impose a one-time 35 percent tax on the entire amount of the tax-sheltered offshore profits.

Taxing those profits and then allowing them to be repatriated without further tax is certainly a fair result — it would put the tax avoiders in the same position as U.S. companies that dutifully paid their fair share of taxes over the years. Perhaps more important in these troubled

economic times, the move would also get high grades on efficiency grounds. A one-time levy on corporate tax-avoidance funds not only would have no undesirable effects on corporate behavior, it also might discourage companies from shifting profits offshore in the first place.

The suggested tax on offshore tax-avoidance money would raise considerable revenue, perhaps as much as $350 billion. That revenue could be used, for example, for domestic public works projects, which could stimulate the domestic economy without the undesirable effects of unbridled deficit spending.