CTJ
Citizens for Tax Justice
August 8, 2007

Senate Should Enact the Doggett Proposal to Close Loophole That Allows Foreign Corporations to Dodge Taxes on U.S. Profits

> *"We can just say they're raising taxes because people have such a low opinion of the Democratic Congress that they are certainly willing to believe that they are raising their taxes."*
> *—Congressman Tom Cole (R-Okla.) quoted in the* Washington Post, *Thursday, August 2, 2007*

The farm bill passed by the U.S. House of Representatives on July 27 includes a provision proposed by Congressman Lloyd Doggett of Texas to close a tax loophole that currently allows foreign companies doing business in the U.S. to dodge taxes on their U.S. profits — which gives these foreign companies an advantage that American firms don't have. Unfortunately, the chairmen of the relevant committees in the Senate have indicated to the press that they are unlikely to include this provision in their version of the farm bill. They should reconsider.

Existing Loophole Allows Foreign Companies to Avoid Taxes on U.S. Profits

When foreigners receive dividends, interest, royalties and other kinds of passive income in the U.S., they are nominally subject to a 30 percent withholding tax. We have reciprocal tax treaties with countries that are our major trading partners, however, that reduce or eliminate this withholding tax, and let the country of residence have the primary (or sole) taxing power. These treaties are part of an overall system designed to ensure that income earned by foreigners here and by Americans overseas, is taxed once, but not multiple times.

The problem is that some multinational corporations based in countries that do not have a tax treaty with the United States have found ways to exploit this system to slash their taxes on their U.S. profits. For example, imagine Shifty, Inc. is a corporation based (on paper) in Bermuda, a tax-haven country that has no tax treaty with the United States. Shifty, Inc. has two subsidiaries, one based in Switzerland and another based in the United States. The subsidiary in the U.S. makes an interest payment to the one in Switzerland. The payment is deductible, reducing Shifty-US's taxes on its U.S. earnings. Under our treaty with Switzerland, no U.S. tax will be withheld. In contrast, 30 percent would be withheld if the payment was made directly to Shifty, Inc. in Bermuda.

Then the subsidiary in Switzerland then makes a deductible royalty payment to Shifty, Inc. in Bermuda for the use of the "Shifty" trade name. Under Swiss tax law, no tax is withheld from this payment, and Bermuda imposes no tax of its own either. The result is that Shifty has shifted part of its U.S. profits to Bermuda, and that income is not taxed by any country.

This two-step payment arrangement has no purpose other than to avoid the U.S. withholding tax. Indeed, the "foreign" company ostensibly based in Bermuda may really be an American company that reincorporated itself up in Bermuda specifically to avoid paying U.S. taxes.

Proposal Targets Tax Avoidance by Companies Based in Tax Havens, Not Our Trading Partners

The Doggett proposal would close this loophole with a simple rule: the U.S. subsidiary would be required to withhold whichever withholding tax is larger, either the one applying to a payment made to the subsidiary in the tax treaty country, e.g., Switzerland, or the one that would apply if the payment was made directly to the parent company in the non-treaty country, e.g., Bermuda.

Some members of Congress, no doubt prodded by lobbyists from corporations that have supported their political campaigns, have railed against this proposed reform. One argument we've heard is that the Bush administration is already taking steps to close the loophole by renegotiating our tax treaties. But the Congressional Joint Committee on Taxation (JCT) has found that over the next 10 years, $7.5 billion dollars in taxes will be collected if the Doggett proposal is enacted. Of course, that wouldn't be possible if the loophole was already closed.

Faced with this fact, opponents of this proposal then make the argument that this legislation targets companies in countries that have tax treaties with the U.S. and who are major trading partners. This argument is simply wrong. The JCT found that 90 percent of the revenue raised will be paid by companies that are not based in countries the U.S. has a tax treaty with.

A related argument is that this proposal violates our tax treaties. To the contrary, this proposal actually enforces the rules set out in our treaties. Opponents have put forth the following example to make their argument. Imagine a company named Buyout, Inc. is based in Japan. It has a subsidiary in the U.S. and another in a European country. If the U.S. subsidiary makes a payment directly to the parent corporation, Buyout, Inc., it will be subject to a 10 percent withholding tax, as spelled out in the tax treaty between the U.S. and Japan.

But suppose that the tax treaty between the U.S. and our European trade partner completely eliminates the withholding tax. Then under current law, if the U.S. subsidiary makes a payment to the European subsidiary, the payment will not be subject to any withholding tax.

The Doggett proposal, opponents say, will raise taxes on this foreign company even though it is partially located in a treaty country. But that's exactly what our tax treaty with Japan envisions: that money flowing from a subsidiary in the U.S. to its parent corporation in Japan will be subject to a 10 percent withholding rate, no more and no less. The Doggett proposal would merely close the loophole that allows some companies to undermine this rule.

Opponents Intentionally Misrepresent Doggett Proposal for Partisan Gain

Perhaps the most disturbing argument made during this debate is the openly crass claim that anti-tax members of Congress can make political gains by misrepresenting this measure as a tax hike on Americans. Congressman Tom Cole of Oklahoma, was quoted by the Washington Post as saying "We can just say they're raising taxes because people have such a low opinion of the Democratic Congress that they are certainly willing to believe that they are raising their taxes."

If some members of Congress believe that they can win votes for their political party by defending a loophole for foreign-based tax dodgers, then that represents a new low in our national discourse over tax policy.