Taxing Multinational Corporations

Citizens for Tax Justice

March 1993, updated 2006

What is the United States trying to do when it comes to taxing multinational corporations?

Companies that do business only in the United States have to pay federal income taxes on their profits (at least as the tax code defines “profits”). We want multinational corporations—both American-owned and foreign-owned—to pay taxes on their U.S. earnings, too. That's the main goal.

In addition, at least some of the time, we try to make American-based multinationals pay U.S. taxes on the profits they earn in low-tax foreign tax havens. The purposes here are both to raise revenue and to avoid giving American companies a tax incentive to move their operations—or artificially shift profits—to low-tax foreign countries.

Why is that so complicated? Why don't we just exempt foreign profits—or at least non-tax-haven profits—from tax, and leave it at that?

Actually, that's not a bad way to think about what our system attempts to do, albeit in a somewhat roundabout way. But here's the problem. Whatever system we adopt, we still have to figure out how much profit a multinational company earns in the United States—the company's “domestic source income” in tax lingo. If we didn't have any rules, companies would simply tell the IRS that their profits were earned abroad.

Wait a minute. How could they do that?

Let's say a big American company has $10 billion in total sales—half in the U.S. and half in Germany—and $8 billion in total expenses—again half and half (in reality). With $1 billion in net U.S. profits and a 35% tax rate, the company ought to pay $350 million in federal income taxes. But suppose that, for U.S. tax purposes, the company treats 5/8th of its expenses—or $5 billion—as U.S.-related. If you do the arithmetic, you'll see that leaves it with zero U.S. taxable profit. If we just exempted what the company calls “foreign income” from tax, the company would owe no U.S. income tax at all.

Do we let companies play those kind of games?

Often it can work out that way, although the approach we use usually isn't quite as bad in practice as simply exempting foreign profits from tax.

O.K., I'll bite. Tell me how our system works.

The U.S. tax code generally doesn't tax U.S. companies on the profits they earn abroad through foreign subsidiaries until the profits are brought back into the U.S. (a tax break called “deferral”). When (and if) foreign profits are brought back home (usually as a dividend from a foreign subsidiary to its U.S. parent), our laws say that if a company paid foreign taxes on those foreign profits at a rate at least as high as the U.S. rate of 35%, then we won't tax those profits again.

Technically, we tell U.S. companies to report their total profits on their federal tax return—including amounts they receive from their overseas subsidiaries—but then we give them a “foreign tax credit” equal to their actual foreign taxes or 35% of their foreign profit (whichever is less).

Huh? Give me a for instance.

Let's go back to our example, and assume that all of a company's foreign profits come back into the U.S. (and thus there's no “deferral”). When it fills out its U.S. tax return, our U.S. company reports its worldwide net earnings of $2 billion. Before the foreign tax credit, it will owe $680 million in federal income tax to the U.S.

Suppose that our company's German income taxes (paid by its foreign subsidiary) came to $550 million. If the company properly allocates its expenses 50-50 between the U.S. and Germany, it will get a foreign tax credit of $350 million, and pay $350 million in U.S. tax—just as it's supposed to. You'll note that, in this hypothetical case, our system comes out just like exempting German profits from U.S. tax.

But if our tax rules let the company treat 5/8th of its expenses as U.S.-related, its foreign tax credit will be $550 million. (The credit, remember, is the lesser of its actual foreign taxes or 35% of its $2 billion in inflated “foreign source income”). That will cut the company's U.S. tax bill to only $150 million ($700 million minus $550 million). That's a better result than an exemption system, but it's still not right.

Your example implies that the company may be telling one thing to the German tax department and something quite different to the IRS.

Now you're getting the idea.

Why can't we stop that? Doesn't anybody at the IRS speak German? Lots of Germans speak English.

Sharing information among countries can be a big help. But often our tax laws don't require that companies tell the same story to the U.S. that they tell to foreign governments.

It gets even more complex because of “deferral” —the fact that we usually don't require companies to report their foreign income on their U.S. tax returns until the profits are brought back into the United States.

Thus, when it comes to foreign-source income, the IRS is usually not looking at total current foreign profits, but instead is dealing with dividends paid out of the after-tax income of foreign subsidiaries, often income earned in a prior year.

You make it all sound so complicated that there can't be any solution to the problems.

Sorry, but this is the simplified version. It gets worse. Every transaction that an American company has with the foreign corporations it owns (or is owned by) is an opportunity for tax minimization. If an American company charges a related foreign corporation too little for products or know-how or whatever, or if it pays the related foreign corporation too much for something, then it will shift U.S. profits to foreign-source income (and cut its U.S.-source taxable income). Recently, there's been a lot of publicity about how foreign corporations with American-based subsidiaries are playing these kinds of tax-avoidance games to cut their U.S. tax bills. But American-owned multinationals do it, too.

But we must have some rules to deal with those kinds of shenanigans.

Kind of. In theory, every transfer of goods, services, money, advice, patents, know-how and so forth between a U.S. company and related foreign corporations is subject to an “arm's-length” test. Conceptually, this means that such transactions—even informal ones—must be treated the same way as if the U.S. company were dealing with a stranger. But in practice, there's no reasonable way the IRS can keep tabs on all the transactions and make sure all the “transfer prices” are right. In fact, it's often not clear what “right” means.

States have the same problem when they try to figure out how much profit multistate companies earn in a particular state. That's why most of them have abandoned the so-called “arm's-length” approach in favor of a simple formula that allocates taxable profits based on the location of a company's sales, workforce and property.

This is all pretty dry. Do you have examples?

Sure. Try these:

■ In its 1987 annual report, IBM said that a third of its worldwide profits were earned by its U.S. operations. But for federal tax purposes IBM appears to have treated so much of its R&D expenses as U.S.-related that it reported almost no U.S.-source earnings. As a consequence, IBM's federal income taxes were almost entirely offset by foreign tax credits, reflecting the high tax rates the company says it pays in places such as Australia, Japan, the U.K. and Germany. Of course, it's possible that, notwithstanding what it says in its annual report, IBM really didn't make any money in the United States in 1987. But based on IBM's $25 billion in U.S. sales in 1987 and its $31 billion in U.S. assets, that doesn't seems likely.

■ Schering-Plough noted in its 1987 annual report: “The company has subsidiaries in Puerto Rico and Ireland that manufacture pharmaceutical products for distribution to both domestic and foreign markets. These subsidiaries are operating under tax-exemption grants expiring at various dates between 1990 and 2001.” In 1987, the company's assets in Puerto Rico (which is, in effect, a U.S. “foreign tax haven”) and Ireland represented 9% of the company's total worldwide assets. But, claimed the company, its Puerto Rican operations alone contributed 29% of the company's worldwide pretax earnings and almost half of its U.S. pretax profits.

■ In its 1987 annual report, and presumably for tax purposes as well, Massachusetts-based Prime Computer asserted that almost two-thirds of its worldwide pretax earnings are from foreign sources. It made this claim even though only 11% of its manufacturing and research square footage is outside the United States. The company's incentive to treat its profits as foreign was obvious: because its foreign activities were centered in tax havens (notably Ireland), its reported foreign profits were taxed by foreign governments at a rate of less than 6%. A company spokesman told *The Boston Globe*: "We didn't set out to build a plant in Ireland and Puerto Rico, but the government offered incentive and we took advantage and that lowered our tax rate. If that means we paid low taxes, so be it."

■ Hearings over the past few years before the House Ways and Means Oversight Subcommittee suggest that Japanese and other foreign-owned companies doing business in the United States are paying far less than they should because of "transfer-pricing" abuses. Likewise, a May 1992 Congressional Budget Office report found that "[i]ncreasingly aggressive transfer pricing by . . . multinational corporations" may be one source of the shortfall in corporate tax payments in recent years compared to what was predicted in 1986.

So, what do you recommend?

A number of steps ought to be taken to make better sense out of how we tax multinational corporations. For instance:

● ***The "arm's-length" "transfer-pricing" system*** should be abandoned in favor of a formula approach similar to that used by most states. Although it would take considerable work to achieve, this far-reaching reform could solve most of the major problems we now face in taxing multinational corporations.

● ***Deferral*** of tax on foreign profits should be eliminated. Companies should report their worldwide profits—including the profits of their foreign subsidiaries—to the IRS each year as they are earned. Among other things, this would curb current incentives to move American investments and jobs to foreign tax havens.

● ***"Allocation" rules*** that now explicitly allow companies to misallocate too much of their expenses—interest, research, overhead, etc.—to reduce their U.S. taxable profits should be repealed. These breaks encourage some U.S. companies—notably those with lots of research costs—to set up foreign manufacturing plants.

● ***Tax havens:*** Taxes paid to high-tax foreign countries shouldn't reduce U.S. taxes on profits earned in tax-haven countries. Current law in this area can provide a perverse incentive for American companies to move jobs abroad. A 1991 bill by Rep. Dave Obey and then-Rep. now Sen. Byron Dorgan addresses part of this "runaway-plant" problem, and its enactment would be a good first step in this area.

More important, we must try to force tax-haven countries to fully disclose the information we need to enforce out tax laws. Secrecy is the tax evader's best friend, and we need to bring things into the sunshine.

These proposed reforms don't come from out of the blue. Indeed, tax reform acts since the mid-1980s actually have moved in the directions suggested. But we have a long way still to go.

It's time to end the tax gamesmanship. Multinational corporations, whether owned by Americans or by foreigners, ought to pay federal income taxes on the profits they earn in this country. And our tax laws should stop giving American companies incentives to move capital and jobs overseas.