A Territorial Corporate Tax Would Reward Corporate Tax Avoidance and Could Encourage Offshoring

By Alexandra Thornton and Seth Hanlon  September 22, 2017

One of the major corporate tax cuts included in President Donald Trump’s and congressional Republicans’ tax plans is meant to reduce the U.S. tax rate on overseas corporate profits to zero—a proposal known as territorial taxation. But such an approach would reward massive corporate tax avoidance and lose revenue needed to invest in the domestic economy—and it could hurt American workers by further incentivizing offshoring of investment and jobs.

A ‘territorial’ system would reduce the U.S. corporate tax rate on overseas profits to zero

The United States formally has a “worldwide” tax system for corporate profits. Under the existing tax code, U.S. corporations pay U.S. corporate income tax on both domestic and foreign profits. However, they can defer paying U.S. tax on foreign profits for years by holding their earnings in foreign subsidiaries. And when they do pay U.S. tax, they can reduce the tax by claiming a credit for any foreign taxes paid on that income.¹

Some officeholders and experts say that to level the playing field between multinational and domestic businesses, corporations should not be allowed to defer paying tax on their foreign profits.² In fact, as a presidential candidate in 2016, Trump proposed taxing the domestic and foreign earnings of U.S. companies at the same rate, without the opportunity to defer taxes on foreign earnings.³ But this year, the president changed his position 180 degrees and now aligns with House Republicans in proposing to shift to a “territorial” tax system, in which U.S. corporations would never owe U.S. tax on the profits they report overseas.⁴
A territorial tax system would reward corporate tax avoidance, likely resulting in more of it

Under the existing U.S. international system, U.S. multinationals have myriad opportunities to avoid paying U.S. taxes on their foreign profits—as well as to avoid taxes on their domestic profits by characterizing them as having been earned overseas. The United States allows multinational companies to delay paying tax on their foreign earnings until they repatriate the earnings—in other words, until their foreign subsidiaries dividend the earnings to their U.S. parent companies. By categorizing these earnings as permanently reinvested offshore on their financial statements, many firms avoid paying U.S. tax indefinitely. Multinationals also often repatriate earnings selectively in ways that maximize the reduction of U.S. tax using foreign tax credits. By contrast, domestic corporate earnings are taxed in the year they are earned.⁵

Therefore, the existing system creates two mutually reinforcing incentives for U.S. corporations—to earn profits overseas and to report profits as earned overseas even if they were earned in the United States. Through aggressive “transfer pricing”—manipulating the terms of intercompany transactions so that more profits appear to be earned by foreign affiliates and less appear to earned by U.S. affiliates—and other tactics, U.S. multinationals have artificially shifted hundreds of billions of dollars in profits to a handful of small countries that impose virtually no corporate tax. According to an analysis by economist Kimberly Clausing, in 2012, seven of the top nine locations where U.S. multinationals reported the most profits had effective tax rates of 5 percent or less but accounted for 50 percent of all foreign income earned by affiliates of U.S. multinational firms.⁶ At the same time, these five countries accounted for 5 percent of all foreign employment of those firms.⁷ Figure 1 depicts U.S. multinationals’ profits and effective foreign tax rates paid in these seven countries based on the most recent data, from 2013.
Through such maneuvers, multinational corporations manage to avoid U.S. tax on billions of dollars of profits annually. Altogether, U.S. multinationals currently hold roughly $2.6 trillion of profits in their foreign subsidiaries on which they have paid no U.S. tax. Many experts have found that as a result of the deferral rule and other tax loopholes, the largest multinational corporations pay actual or effective tax rates on their worldwide income that are nearly half the statutory tax rate or less, with many paying hardly anything.
Moving in the direction of a territorial system would exacerbate the biggest problems with our current international tax system. Rather than being able to defer U.S. tax on foreign earnings, multinationals would be able to avoid U.S. tax entirely—creating an even bigger incentive to artificially shift profits from the United States to tax havens. The biggest winners from the change to such a system would be the multinational corporations that have been the most aggressive and effective at avoiding taxes by parking their profits in tax havens. As tax expert Edward Kleinbard has said, these multinational corporations would become “instant winners” in the tax avoidance lottery.10

Funding for priorities that strengthen U.S. competitiveness could be threatened

A shift to territorial taxation is likely to lose revenue in the long run.11 The shift to any new international system may raise revenue in the near term if it includes a so-called deemed repatriation, in which past overseas earnings are deemed to be repatriated, even if still offshore, and thus taxed. By accelerating the payment of tax on the roughly $2.6 trillion of these overseas earnings, a deemed repatriation would result in a temporary spike in revenue, even if the tax rate is less than the full U.S. rate that would otherwise have been owed. Moving to a territorial system would likely lose substantial revenue over time, however, since a significant portion of the tax base—foreign earnings—is eliminated, and corporations would find new ways to shift profits in order to make domestic profits appear foreign and thus take advantage of the territorial system.

Proponents of a territorial system sometimes claim that they will develop new rules to prevent artificial profit shifting that would erode the U.S. tax base, known as base erosion, but there are many reasons to expect such rules to be weak or ineffective. Such rules have proven ineffective under our current system,12 and the pressure on them would be even greater under a territorial system. This has been noted by international tax experts Rosanne Altshuler, Stephen Shay, and Eric Toder.13 As they point out, “The United States already struggles with transfer pricing enforcement, and the pressure would be exacerbated with the reduced frictions of an exemption system. We have not seen evidence that other countries have found approaches that mitigate these pressures.”14

Neither the Trump administration nor its allies in Congress have outlined the anti-base erosion rules they intend to put in place. Recent territorial corporate tax proposals in the House and Senate do not take that approach and, in fact, open new loopholes. For example, international tax experts Stephen Shay, Clifton Fleming, and Robert Peroni found that recent territorial corporate tax proposals advanced by former Rep. Dave Camp (R-MI) and Sen. Mike Enzi (R-WY), respectively, would leave huge loopholes in
the corporate tax and would not prevent profit shifting. A territorial tax system would also give rise to a host of new challenges, such as how to determine what constitutes income earned abroad, how to handle foreign branches and subsidiaries that are only partially owned, and how to allocate income and expenses—all of which would bring with them associated opportunities for tax planning.

By draining tax revenue needed for government investments in education, health care, and infrastructure—priorities that are critical to maintaining the United States as an attractive place to do business—a territorial tax system would make the U.S. economy less competitive.

A zero percent tax rate on overseas profits would risk more offshoring of investment and jobs

Lowering the U.S. corporate tax rate on U.S. firms’ foreign profits would worsen the incentive for U.S. firms to locate real investment overseas instead of in the United States, which could lead to more, not less, offshoring—the very opposite of what proponents are claiming. As economist Jane Gravelle has stated, making foreign investment more attractive relative to U.S. investment “would cause investment to flow abroad, and that would reduce the capital ... in the United States ... so it should reduce wages.”

The economic effect of allowing tax-free repatriations is also frequently overstated. Economists who have looked at this question have concluded that switching to a territorial tax would have little impact on firms bringing foreign profits back to the United States or investing those funds in real economic activity domestically. Their analysis finds that, in practice, any tax disincentive to invest foreign earnings or locate real economic activity in the United States likely would be just as great under a territorial corporate tax as under the current tax system.

The frequent claim that U.S. multinationals’ overseas profits are “locked-out” of the United States is highly overstated. Many of those funds are deposited in U.S. banks and invested here in ways that do not trigger U.S. tax. As long as the funds are not directly invested in the U.S. parent company or paid out in dividends to shareholders, U.S. firms can have the benefit of tax deferral on their foreign earnings held in U.S. bank accounts as cash or certain other types of assets, such as U.S. Treasury bonds.

Moreover, even if multinationals repatriate more earnings—in other words, if they transfer funds from foreign subsidiaries to U.S. parent companies—there is hardly any guarantee that they will then invest more in job-creating activities in the United States. The corporations with the largest stashes of profits overseas are not currently
strained for cash in the United States and can finance new domestic investment relatively inexpensively, if they choose to do so.22

In fact, the best-known empirical evidence available—the 2004 repatriation holiday—demonstrated that firms that repatriated large amounts of foreign profits were more likely to use the funds for share buybacks or dividend payments, not to increase payroll or investment.23 They did this in spite of the fact that the 2004 legislation purported to require investments at home.

Finally, some proponents of a territorial tax claim that it will eliminate the problem of corporate inversions.24 In an inversion, a U.S. corporation merges with a smaller foreign firm and changes the residency of the resulting merged firm to the foreign country. While there can be substantial tax benefits associated with corporate inversions, including the ability to access untaxed offshore profits tax-free, repealing all tax on foreign profits in order to address tax abuses in corporate inversions would be an illogical response—tantamount to simply giving up on enforcing the tax laws against some of the most egregious tax avoiders.

In short, adopting a territorial corporate tax would put our tax code further out of balance by providing a huge giveaway to large corporations that have been the most sophisticated at avoiding tax, while providing no corresponding benefit to the U.S. economy or U.S. workers.

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Endnotes


6 Kimberly A. Clausing, “The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond,” National Tax Journal, December 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442. As Clausing notes, the data from the U.S. Bureau of Economic Analysis may count income more than once if there are multiple tiers of ownership within the same country, but the pattern is the same using an alternative data series that eliminates the possibility of double counting.

7 Ibid.


10 Kleinbard, “Throw Territorial Taxation From the Train.”


12 Clausing, “The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond.”


14 Ibid.


16 Patrick Driscoll’s analysis of the Tax Reform Act of 2014 participation exemption system for taxation of foreign income in Patrick Driscoll, “4 More Reasons to Question U.S. Territorial Tax Adoption.”


21 Kleinbard, “Throw Territorial Taxation From the Train.”

