Offshore Corporate Profits

The Only Thing 'Trapped' Is Tax Revenue

By Kitty Richards and John Craig January 9, 2014

Recent investigations have revealed that multinational corporations are stockpiling trillions of dollars in "offshore" income, purportedly trapped overseas because of U.S. corporate taxes.[1] This has created the illusion that there is a large stock of cash somewhere offshore, just waiting to be invested in our struggling economy, if only we could somehow unlock it. For example, House Majority Leader Eric Cantor (R-VA) asserted that "encouraging businesses to bring overseas earnings back home to America will spur investment, economic growth and job creation,"[2] while Cisco Chairman and CEO John Chambers and Oracle President and CFO Safra Catz wrote that "by permitting companies to repatriate foreign earnings at a low tax rate—say, 5%—Congress and the president could create a privately funded stimulus of up to a trillion dollars."[3]

These arguments are wrong. They are based on a faulty premise; these "trapped overseas" profits are neither overseas nor trapped. It is true that for accounting purposes, multinational corporations keep these dollars off of their U.S. books. But in the real world, the money is often deposited in U.S. banks, circulating in the U.S. economy, and available for a wide variety of domestic investments. For nearly all practical purposes, that money is already here, being put to work in the U.S. economy.

But that does not mean the system is working perfectly. On the contrary, there is in fact something trapped on the balance sheets of U.S. multinationals. But it is not corporate profits—it is federal tax revenue. Profits characterized as overseas for accounting purposes may be little different economically from any other profits, but because of a provision known as deferral, explained in the next section, these profits can accumulate for years, sometimes indefinitely, without being taxed. According to Joint Committee on Taxation estimates, this costs the federal government $50 billion per year,[4] and this cost is growing over time[5] as corporations find ever more creative ways to make their U.S. profits look like offshore income. The problem with these accumulated corporate profits is not that they are "offshore"—it is that they are untaxed. This problem is real and serious.

Unfortunately, some advocates have been capitalizing on the confusion around these untaxed profits to push for policies such as repatriation holidays—tax breaks for multinationals that shift their profits back onto the books of their domestic parent corporations. These policies are supposed to induce corporations to "bring their offshore profits home," but the profits are already here. These special tax breaks will just provide a windfall to the corporations that have most aggressively sheltered their profits from taxation, causing the government to lose even more revenue while having no positive effect on the economy.

There is no trillion-dollar stockpile of cash under a collective corporate mattress in Luxembourg, waiting to be put to use in the American economy if only tax policy were different. That money is already here, and the only thing "trapped offshore" is federal revenue.

Background: How does the current tax code treat 'foreign' earnings?

Under current law, U.S. corporations theoretically owe U.S. corporate income tax on all of their profits, wherever they are earned, with two important caveats.

First, U.S. corporations never face "double taxation" by two different countries; corporations—and individuals—are entitled to a foreign tax credit that reduces their U.S. tax liability by the amount of tax paid to foreign jurisdictions.[6] For example, imagine a U.S. corporation that faces a 25 percent marginal effective corporate tax rate in the United States and a 10 percent marginal rate in Ireland. If this corporation generates a dollar of profit from investments in an Irish subsidiary, it will pay 10 cents to Ireland and only 15 cents to the United States, because it will take a 10-cent foreign tax credit on its U.S. tax return.

Second, a provision known as "deferral" allows U.S. corporations to delay paying taxes on their foreign income for long periods of time or even indefinitely.[7] This means that companies can avoid paying U.S. corporate tax on any profits that they book (record for tax accounting purposes) as overseas profits earned by controlled foreign subsidiaries. The deferred tax is only triggered if a U.S. parent corporation repatriates its foreign subsidiary's profits, bringing them back onto the parent company's balance sheet. This gives corporations an enormous incentive to shift profits onto the balance sheets of their foreign subsidiaries and leave them there as long as possible. Recent analysis indicates that U.S. corporations are currently holding as much as $2 trillion in untaxed profits booked as offshore income.[8]

Offshore income, for tax purposes, is income controlled by a foreign subsidiary that is not immediately returned to the U.S. parent corporation. In some cases, the income associated with a foreign subsidiary is derived from the sales and operations conducted in the subsidiary's jurisdiction, and is reinvested by the subsidiary in activities in its own jurisdiction—that is, the foreign income is from real economic activity in a foreign country. But companies are increasingly able to use accounting games to shift profits overseas for tax purposes, even when the profits really stem from activities taking place in the United States.[9]

This can be done in many ways, but here is one example. A company whose profits are largely driven by intellectual property—patents and copyrights—can fairly simply make most of its profits appear to be from subsidiaries in low-tax jurisdictions. Imagine a U.S. corporation with research and development labs in California, churning out new technology that is then sold primarily to a U.S. market. The U.S. corporation establishes a subsidiary in a tax-haven country. The parent corporation then sells its patents and copyrights—the fruits of its U.S. R&D, and the source of all of its profits—to the wholly owned subsidiary in a low-tax jurisdiction, for a very low price. The subsidiary now owns the intellectual property and can charge royalties to the parent company in the United States, at very high rates, when the parent company wants to manufacture and sell the patented item. The royalty payments made by the U.S. parent company are considered costs to the U.S. parent and income to the foreign subsidiary.

Suddenly, the little wholly owned subsidiary in Luxembourg is one of the most profitable companies on earth, while the U.S. parent company is barely meeting expenses. Profits driven by R&D, manufacturing, and even sales in the United States are now considered foreign income for tax purposes and benefit from deferral.[10] By paying outrageous prices to rent back its own intellectual property from its own controlled subsidiary, the U.S. parent company has just stripped its U.S. profits into a tax-haven country and avoided paying U.S. corporate income taxes, without any change to the real-world structure of its business. The total pre-tax income of the multinational as a whole stays the same, all of the real activity—jobs, sales, manufacturing activities—stays the same, but the tax bill declines.

There are not yet enough data to say definitively how much offshore income is the result of pure profit shifting, but the accounting location of unrepatriated profits provides some clues. The balance sheets of U.S. multinationals show outsized profits in a handful of small tax-haven countries: Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland together contain less than one half of 1 percent of the world's population,[11] yet they managed to generate 43 percent of the overseas profits reported by American companies in 2008.[12]

‘Trapped offshore profits’ are an accounting illusion

Much ‘offshore’ income is actually already invested in the United States

To qualify as “offshore” for tax purposes, U.S. corporate money must be controlled by a foreign subsidiary, but it does not have to be invested abroad. In fact, for many corporations, these foreign profits already sit in Manhattan, in accounts in American banks.[13] For example, as of last May, Apple had $102 billion in “permanently invested overseas” income not subject to the U.S. corporate tax. On Apple’s books, this untaxed profit is “offshore” because it is controlled by two Irish subsidiaries—even though these subsidiaries park their funds in bank accounts in New York.[14] This $102 billion that has yet to be subject to U.S. taxation is already in the United States, not trapped in Ireland. Apple cannot use this money directly for American real estate acquisitions, dividends, share buybacks, or funding for operations in Cupertino, but the money is being loaned out in the American economy by American banks, funding American mortgages and small-business loans just like any other American deposit.

If bank accounts do not provide a high enough return, foreign subsidiaries of American corporations can use their unrepatriated income to purchase U.S. Treasury bonds or invest in the U.S. stock market, as long as the investments are in unrelated corporations.[15] Apple can use unrepatriated profits to buy General Electric stock, and General Electric can buy Apple’s corporate bonds, all without “returning the money to the United States.”

The drive to keep profits “offshore” for tax purposes may limit a parent corporation’s investment options somewhat, but domestic businesses and consumers still have access to multinational corporations’ foreign earnings. This money is not “offshore” economically, and it is not idle—it is already circulating in the American economy, being used for investments in American businesses and families.

Large multinationals can leverage their ‘offshore’ income to do almost anything

If companies can instruct their foreign subsidiaries to invest profits in U.S. banks, bonds, and stocks without repatriating the profits and triggering corporate tax, what can offshore profits *not* be used for? In theory, they cannot be used to invest in the U.S. parent corporation’s U.S. operations, and they cannot be used to pay shareholders through dividends or stock buybacks. But in practice, corporations with large stashes of unrepatriated earnings can leverage those earnings for almost anything, through the power of borrowing.

While rules exist that prevent corporations from using offshore income as direct collateral for bonds issued in the United States,[16] those foreign earnings drive down the interest payments that potential bond buyers demand in exchange for capital, allowing corporations to access cash at very low cost without repatriating untaxed earnings. Companies with large pools of unrepatriated earnings have favorable leverage and cash positions as a result of their unused cash. Those attributes result in high credit ratings and low—or sometimes even negative—borrowing costs.[17] A company with $100 billion in cash on hand is a pretty low-risk borrower.

A corporation with lots of unrepatriated earnings does not have to repatriate those earnings to engage in domestic investment or payouts to shareholders. It can just borrow money for its domestic activities, and this borrowing is almost costless because creditors know that the unrepatriated earnings can be tapped at any time.

Apple has given us a great example of how this works. In April, the company announced that it wanted to begin a $60 billion share buyback program. The only problem? "According to analyst estimates, Apple has $145 billion of cash - but only $45 billion on hand in the US, and thus not enough to fully fund the share buy-back program," Reuters reported.[18] In theory, share buybacks and dividends are exactly what corporations cannot do with unrepatriated income. In practice, however, Apple was easily able to fund its buyback program without paying a dime of tax.

In April, Apple issued $17 billion in corporate bonds—the largest bond offering in American corporate history.[19] The interest rate Apple paid on 10-year bonds was only 2.415 percent, or only 74 basis points above the rate on 10-year Treasury bonds that day.[20] But that is just the sticker price. In fact, the interest on the bonds is then tax deductible—at a 35 percent corporate tax rate, the business-interest deduction covers 84.5 basis points of the borrowing costs, lowering the after-tax interest costs to 1.57 percent, or 10 basis points lower than Treasuries. With expected inflation above this level,[21] Uncle Sam and bond buyers actually paid Apple to hold onto their money for 10 years.

Apple is not the only multinational corporation accessing low rates from the bond market instead of repatriating foreign earnings. Microsoft, with more than $60 billion in estimated untaxed overseas profits,[22] conducted a $2 billion U.S. bond sale in 2013 with interest rates on 10-year bonds at about 2.44 percent.[23] One industry analyst suggested that Microsoft was partially "selling the bonds to replenish its U.S. cash position after dividend payments and share buybacks."[24] Similarly, Walmart, DuPont, Coca-Cola, and Johnson & Johnson have all entered a favorable bond market in recent years despite having billions of dollars held overseas.[25]

Apple was able to get such a low interest rate because it had $145 billion in cash on hand, making it an extremely low-risk investment. For bond buyers, it does not matter that much of this cash is controlled by Apple's foreign subsidiaries and thus unrepatriated for tax purposes; it is still a hugely valuable asset wholly owned by Apple and available to pay Apple's U.S. corporate debts. Companies such as Apple can access all the benefits of their foreign income through cheap lending even if the money in those accounts cannot move directly toward dividends, share buybacks, or U.S. operational investments. And the cost, as Apple's interest rates demonstrate, can be negligible.

The only thing trapped offshore is federal revenue

Unrepatriated profits are already being put to use in the American economy, and "bringing them home" for tax purposes will not affect investment and growth. But that does not mean the corporate tax code is working the way it should. The average effective tax rate for America's largest, most profitable corporations now stands at 12.6 percent,[26] lower than what many middle-class families pay. What's more, some huge multinationals have gone years without paying any tax at all.[27] In fact, General Electric and Apache have both paid a negative average tax rate over the past five years,[28] while holding billions of dollars in unrepatriated earnings.[29] And governments all over the world are struggling to shore up their corporate tax bases as multinationals abuse international tax rules to shift profits into tax-haven jurisdictions.

It is important to understand that U.S. corporations owe tax on their profits wherever those profits originate. Under deferral, multinationals can put off paying that tax for years at a time, but these profits are not exempt from corporate taxation. It is also important to remember that deferral is not a normal part of the corporate tax; it is an enormous tax break that multinationals are able to take advantage of.

The Joint Committee on Taxation estimates that the U.S. Treasury will lose approximately $50 billion a year because of the deferral of corporate taxes on foreign profit.[30] The projected cost from 2013 to 2017 is more than $265 billion.[31] To put that in perspective, $265 billion is more than three times the full cost of President Barack Obama's early childhood investment proposal over 10 years.[32] Furthermore, the one-year cost—$50 billion—is equal to the entire cost of the job-creation initiatives in the president's "grand bargain" for jobs.[33]

This tax break is extremely valuable to the large multinational corporations that are able to take advantage of it, and they have responded by reporting more and more income on the books of their foreign subsidiaries. Some of this foreign income comes from real offshore activity, but a growing portion comes from complicated, arguably abusive, tax-avoidance schemes.[34]

This trend has hastened as firms have moved more income and operations abroad following the 2004 repatriation holiday.[35] In 2004, Congress created a one-year repatriation tax holiday that lowered the rate that America's largest corporations would have to pay to return income from controlled foreign subsidiaries.[36] The change in law made the effective tax rate on repatriated funds 5.25 percent for corporations in the highest tax bracket, down from the 35 percent statutory rate.

Proponents sold the tax giveaway as a means to increase employment and investment in the U.S. economy, but economic researchers have found that the holiday had no effect on employment or investment.[37] In the end, corporations that repatriated profits just used that money for dividends and other payouts to investors.[38] This is not surprising given that, as explained above, repatriation of profits that are offshore for tax purposes should not be expected to spur economic growth.

What's worse, not only did the repatriation holiday fail to spur investment and create new jobs, but it also introduced an even greater incentive for firms to move profits overseas. The holiday showed multinationals that profits can be brought back under very low tax rates if corporations wait and advocate for a second tax holiday. Firms that repatriated foreign profits during the 2004 repatriation holiday increased their average annual overseas profits from $60 billion to $122 billion between 2003 and 2007, according to tax experts Lee Sheppard and Martin Sullivan.[39] The 2004 repatriation tax holiday failed to stimulate the economy, cost the federal government substantial revenue at the time, and contributed to the rising revenue cost of deferral. The Joint Committee on Taxation found that instituting a second "one-time-only" repatriation tax holiday would cost the U.S. government $79 billion over 10 years.[40]

Congress should bring back revenue, not enlarge loopholes

There is no trillion-dollar pot of gold at the end of the offshore profits rainbow. There is no free stimulus to be had by "bringing the money home"—the money is already here. Corporations are already depositing these funds in American banks, investing them in American bonds and equities, and leveraging them for domestic activities and payments to shareholders. What corporations are not doing is paying taxes on these profits. That is the problem that policymakers should focus on.

The deferral of taxes on overseas income is one of the most expensive tax expenditures in the corporate tax code. It also creates an incentive at the margin to move real economic activity—jobs and assets—to low-tax jurisdictions.[41] Unlike "trapped profits," these are real problems worth addressing. One potential solution is to simply repeal deferral—taxing all profits in the same way, whether they are booked in Iowa or Ireland, would increase corporate tax revenues, reduce the incentive to move jobs and assets to low-tax jurisdictions, and put a stop to unproductive profit-shifting games.

There are a number of other reforms that could raise revenue and improve economic efficiency. A minimum tax on the earnings of U.S.-controlled foreign subsidiaries, as President Obama proposed in his "grand bargain" for jobs[42] and the Center for American Progress previously reported on,[43] would raise revenue while minimizing the incentive to relocate in tax havens.[44] The discussion draft on international tax reform recently released by Senate Finance Committee Chairman Max Baucus (D-MT) would similarly transition away from the current deferral regime while strengthening the rules that prevent international profit shifting.[45] The Obama administration has also proposed other options for containing the cost of offshore deferral, which would limit the current gaming of the international tax system,[46] and Sen. Carl Levin's (D-MI) Stop Tax Haven Abuse Act would raise more than $200 billion over the next 10 years through sensible reforms.[47]

Unfortunately, the proposals currently getting the most attention and being lobbied for the hardest by multinationals—versions of repatriation holidays and moves toward "territorial" taxation—are policies that would actually increase the distortions created by deferral, increase tax-avoidance opportunities, and decrease corporate tax revenue. These proposals will not stimulate growth, investment, or hiring; they will just lavish more tax cuts on profitable multinationals.

We all wish there was a quick, costless, and politically popular way to increase private investment in American jobs. But the idea that lavishing tax breaks on profitable, powerful corporations can "bring home" trillions of dollars really is too good to be true. That money is already here, and giving companies more expensive tax breaks on top of those they are already taking advantage of is just bad policy.

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