March 23, 2011
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Congress Should End "Deferral" Rather than Adopt a "Territorial" Tax System

Understanding the Debate Over the U.S. International Corporate Tax Rules

America's corporate income tax should raise revenue in an efficient manner without encouraging corporations to shift jobs or profits abroad. The current U.S. corporate tax fails to do this. A "territorial" tax system, which some corporate leaders are promoting, would be an even greater failure. A "pure worldwide" tax system would be much more successful in meeting this goal.

I. The Basics of Territorial, Pure Worldwide, and Deferral Tax Systems

If Congress is going to reform our corporate tax system, it must make one of several choices regarding our international tax rules.

First, it could enact a "territorial" tax system, in which the U.S. would generally tax corporate profits only if they are generated in the United States (with the significant exceptions noted below).

Second, it could enact a "pure worldwide" tax system, in which all profits of American corporations, whether they are generated in the U.S. or abroad, would be taxed by the U.S. American corporations would continue to receive a credit against any taxes they pay to a foreign government (the foreign tax credit) so that profits are not double-taxed.

Third, Congress could preserve the system we currently have, which is a hybrid of the two. The U.S. technically has a "worldwide" tax system in which all profits of U.S. corporations are subject to U.S. taxes, but it undermines this rule by allowing taxes on offshore profits to be "deferred" until those profits are brought back to the U.S. (repatriated). Often, these offshore profits are *never* repatriated.[1]

There are some types of offshore corporate profits that are supposed to be immediately taxable by the home country under any of these tax systems because they would otherwise be too easily manipulated for tax avoidance purposes. These include "passive" income like interest, dividends, rents, and royalties, which both the U.S. and the governments with territorial systems try to tax immediately even if they are generated offshore. But these rules

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[1] Additional types of tax systems are also possible. For example, a formulary apportionment system would allocate profits of a multinational corporation based on certain factors, like the share of sales, payroll and property the corporation has in the United States vs. other countries. States in the U.S. use this system now to allocate multistate corporations' profits, although the weight given to each factor, and the number of factors used, varies from state to state. It is worth considering some form of formulary apportionment as a replacement or supplement to our current tax system, although it may not be as simple as a pure worldwide tax system.

are very difficult, if not impossible, to enforce.[2]

But offshore profits that take the form of "active" income (which can best be thought of as the profit earned from simply selling a concrete good or service) are never taxed under a territorial tax system, immediately taxed under a pure worldwide system, and taxed only after they are repatriated under the deferral system that the U.S. currently has.

For example, a U.S. corporation might have a wholly owned subsidiary corporation in another country. The U.S. corporation (the "parent" corporation) can "defer" U.S. taxes on the profits generated by the offshore subsidiary until they are repatriated. (Typically, repatriation would take the form of a dividend paid by the subsidiary to the U.S. parent corporation.)

The current hybrid system (the "deferral" system) causes two major problems. Both of these problems would get worse if Congress enacted a territorial system.[3] Both would largely go away if Congress enacted a pure worldwide system.[4]

The first problem is that deferral may give American corporations an incentive to move operations and jobs offshore. Because the U.S. does not tax profits generated offshore (unless the profits are repatriated), corporations could pay less in taxes by moving production to a country with lower corporate income taxes.

The second major problem is that deferral creates an incentive for American corporations to disguise their U.S. profits as "foreign" profits. They do this by engaging in transactions that shift their profits to subsidiaries in countries that tax the profits lightly or not at all (countries that serve as corporate tax havens). For example, a U.S. parent company may transfer a patent to its wholly owned subsidiary based in a tax haven and then tell the IRS that it has no profits because it had to pay huge fees to the subsidiary for the use of that patent. The subsidiary is thus claimed to have high profits — but the U.S. parent company can "defer" (not pay) taxes on those profits because they are (allegedly) generated abroad.

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[2]The U.S. tax system bars deferral of taxes on "subpart F" income (named for the relevant part of the tax code), which is offshore corporate profits that take the form of rents, royalties, interest, dividends or other types of "passive" income. However, there are serious holes in subpart F. First, many U.S. corporations manipulate foreign tax credits in ways that effectively allow them to defer taxes on these types of offshore income. Second, in 1997 Congress enacted an exception in subpart F for what is often oxymoronically called "active financing," including certain insurance and banking income and income from manufacturers' financing of sales of their products (such as cars). This exception has been extended several times. Congress ought to allow it to expire.

[3]Many noted tax experts have concluded that these problems would worsen under a territorial tax system, even if these experts do not agree among themselves on the best alternative. See Amy S. Elliott, "Territorial System Largely Rejected by Corporate Tax Panel," *Tax Notes*, December 6, 2010. Some emphasize the increased problems with offshore profit shifting that would result from a territorial system. See Edward D. Kleinbard, "Throw Territorial Taxation from the Train," *Tax Notes*, February 5, 2007. Others have noted that there is reason to be concerned about the impact on jobs of a territorial system. See James R. Repetti, "Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform," Boston College Law School Legal Studies Research Paper Series, April 12, 2007.

[4]Several tax experts have concluded that a pure worldwide system in the U.S. (repeal of deferral) would be superior to either our current system or a territorial system. For example, see Samuel C. Thompson Jr., "An Imputation System for Taxing Foreign-Source Income," *Tax Notes*, January 31, 2011; J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," Journal of the Australasian Tax Teachers Association 2008 Vol.3 No.2.

Some corporate leaders are pushing Congress to adopt a territorial tax system, which would make both of these problems worse. Currently, American corporations have an incentive to move jobs offshore or shift profits offshore because they are not taxed on offshore profits unless those profits are repatriated. Under a territorial system, American corporations would not be taxed on their offshore profits ever, regardless of whether or not they are repatriated.

We believe Congress should move in the opposite direction by enacting a "pure worldwide" tax system, which simply means that deferral would be repealed.[5] This was first proposed by President Kennedy, and most recently proposed as part of the Wyden-Gregg tax reform bill.[6]

Under a pure worldwide tax system, corporations would have little or no tax incentive to move jobs offshore or to shift profits offshore using shady transactions involving tax havens, because the U.S. would tax profits of American corporations no matter where they are generated.

American corporations would continue to get a credit against their U.S. taxes for foreign taxes they pay. That means that when an American corporation has profits in a country with a lower corporate tax rate than ours, they would pay to the U.S. government just the difference between the foreign rate and the U.S. rate. When an American corporation has profits in a country with a higher corporate tax rate than ours, they would pay nothing to the U.S. government. This is how the system works now, except that American corporations also can "defer" (not pay) the U.S. taxes entirely, and the combination of deferral and the foreign tax credit can create more opportunities for tax avoidance.

A tax reform that repeals deferral and other tax expenditures could also include a small reduction in the corporate tax rate, which would partially offset the loss of tax subsidies for some companies. However, it would be foolish for Congress to use *all or most* of the savings from ending deferral and other tax expenditures to pay for a deep corporate tax rate reduction. Instead, corporations and their owners should play an important role in helping solve our long-term deficit problem.[7]

II. A Territorial System Would Increase Incentives to Move Jobs Offshore. A Pure Worldwide System Would Remove These Incentives.

Corporate leaders often speak of how they need a tax system that allows their companies to be "competitive." We need to make America competitive, but in a way that is quite different from what many corporate leaders are talking about.

The key question is whether or not the United States is attractive to investments that create

[5]The same argument is made by Samuel C. Thompson Jr., "An Imputation System for Taxing Foreign-Source Income," *Tax Notes*, January 31, 2011. For additional arguments about why ending deferral would be superior to either our current system or a territorial system, see J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," Journal of the Australasian Tax Teachers Association 2008 Vol.3 No.2.

[6]The Bipartisan Tax Fairness and Simplification Act of 2010 (S. 3018) was introduced by Senators Ron Wyden and Judd Gregg on February 23, 2010.

[7]For more on why Congress should raise revenue from corporate tax reform, see Citizens for Tax Justice, "Revenue-Positive Reform of the Corporate Income Tax," January 25, 2011. www.ctj.org/pdf/corporatetaxreform.pdf

jobs for Americans. Some corporate lobbyists argue that lowering taxes on corporations (and any businesses) is the most important factor, but clearly there are many other factors that are as important or more important for creating jobs. Businesses flourish in the U.S. because of the infrastructure that makes commerce possible, the education system that provides a skilled workforce, the legal system and other public services that will not be possible if those who profit from them (including corporations) do not pay enough in taxes.[8]

U.S. multinational corporations and their lobbyists sometimes emphasize a different type of competitiveness. They claim that American corporations operating abroad need to be competitive with corporations based in other countries. For example, if a German company and an American company are competing to sell a good or service in China, we should want the American corporation to be more competitive. If the American company pays higher taxes than the German company, that means the German company can pay higher dividends to shareholders, meaning it can raise capital more easily.

According to this line of thinking, the best thing the U.S. could do to help the American corporation in this example would be to move to a territorial tax system so that the company does not have to pay any taxes to the U.S. at all on foreign profits.

The reality is that the interests of the U.S. multinational corporation may or may not be aligned with the interests of the American people. The corporations claim that the jobs they create offshore *complement* their job creation here in the U.S., meaning they hire people in the U.S. to support their offshore operations. That may be true in some cases. We can imagine situations in which a U.S. corporation creates research and development jobs and administrative jobs in the U.S. to support the manufacturing jobs that it creates in other countries.

But in other cases, the jobs created offshore *substitute* for job creation here in the U.S. This simply means that U.S. corporations sometimes eliminate jobs in the United States and replace them with (usually lower-paid) positions abroad.

Unfortunately, the substitution effect is almost certainly greater than the complementary effect. Martin Sullivan has found that between 1999 and 2008, U.S. multinational corporations have created 2.4 million foreign jobs while reducing their U.S. workforce by 1.9 million positions. He concludes that “U.S. multinational corporations are not net domestic job creators.”[9]

Politicians, corporate leaders and economists may never agree on whether multinational corporations’ offshore investment creates U.S. jobs or destroys U.S. jobs. But we should be able to agree that our tax system should not favor investment and job creation offshore over investment and job creation in the U.S. Our current system does exactly that, and a territorial

[8] In fact, research indicates that when an American corporation must decide which states to operate in, these other factors are far more important than the states’ corporate income tax rates. See Institute on Taxation and Economic Policy, “Taxes and Economic Development 101,” July 2010. http://www.itepnet.org/pdf/pb42.pdf

[9] Testimony of Martin A. Sullivan before the Committee on Ways and Means, U.S. House of Representatives, January 20, 2011.

system could actually increase this bias in the tax code.[10]

Ending deferral and moving to a pure worldwide tax system would end this bias. This would mean that any profits of a U.S. corporation, no matter where they are generated, would be subject to U.S. tax, so the corporation would not gain tax advantages by moving jobs abroad.

III. A Territorial System Would Increase Incentives to Shift Profits Offshore (Disguise U.S. Profits as "Foreign" Profits). A Pure Worldwide System Would Remove These Incentives.

American corporations currently have an incentive to disguise their U.S. profits as "foreign" profits so that they can defer paying U.S. taxes on them. Under a territorial system this incentive would be even greater because foreign profits would *never* be subject to U.S. taxes.

The profit shifting described in Section I often involves a U.S. parent company transferring an asset like a trademark or a patent to a subsidiary in a low-tax country (a corporate tax haven) and then paying artificially high fees to the subsidiary for the use of that asset. Then the U.S. parent company can claim to the IRS that the fees wiped out much or all of its U.S. profits, so that it owes little or no U.S. taxes. The profits that are effectively shifted to the subsidiary in a tax haven are not subject to U.S. taxes unless they are repatriated (brought back to the U.S.). In many cases the offshore subsidiary conducts no actual business and consists of little more than a post office box.

In theory, we have "transfer pricing" rules that are meant to limit this type of tax avoidance, but they work very poorly. Transfer pricing rules are meant to require divisions within a corporate group (like the U.S. parent company and its offshore subsidiary in our example) to deal with each other "at arm's length." In other words, they require the U.S. parent corporation and its subsidiary to pretend to deal with each other as if they were unrelated companies. If these rules worked, they would mean that the U.S. parent company would charge a fair market price to its foreign subsidiary for the patent it transfers, and the subsidiary would charge fees at market rates for the use of the patent. There would be little opportunity to artificially reduce the profits of the U.S. parent company.

But this is not what really happens. It's often difficult or impossible for the IRS to prove that a transaction between two divisions of a corporate group were not conducted at arm's length. This requires the IRS to find and present comparable transactions that are conducted between unrelated parties. Sometimes there simply are no comparable transactions to those conducted between divisions within a corporate group, particularly those regarding intellectual property.[11]

Another problem is that U.S. companies can often take deductions against their U.S. taxes for the expenses of earning offshore profits. This is particularly insidious when it results in American corporations immediately deducting the costs of earning offshore profits even while

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[10] President Bush's Advisory Panel for Federal Tax Reform claimed that research showed no evidence that a territorial system would result in loss of jobs in the U.S. The research relied on actually concluded that no prediction could be made on this matter, and anyway suffered from some methodological problems. For an explanation and critique, see James R. Repetti, "Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform," Boston College Law School Legal Studies Research Paper Series, April 12, 2007.

[11] Michael C. Durst, "Congress: Fix Transfer Pricing and Protect U.S. Competitiveness," *Tax Notes*, July 26, 2010.

they defer the U.S. taxes on those offshore profits indefinitely.

Adopting a territorial system would result in even more companies deducting expenses of their foreign operations against their U.S. taxes, and would put even more pressure on transfer pricing rules which are already unable to counter the ingenuity devoted to corporate tax avoidance.[12]

On the other hand, a pure worldwide tax system (ending deferral) would eliminate most of these abuses and most of the complexity and enforcement problems associated with the current rules.

IV. Adoption of a Territorial Tax System Would Reduce Revenue While Adoption of a Pure Worldwide System Would Raise Revenue.

If the United States adopted a territorial system, the increased incentives to manipulate transfer pricing rules and expense allocation would result in a significant loss of revenue. President Obama's Economic Recovery Advisory Board's report on tax reform options cites "rough estimates from the Treasury" that adopting a territorial system, without changing other rules, would reduce revenue by approximately $130 billion over ten years.[13]

Most of the few tax experts who favor a territorial tax system claim they can mitigate its problems by including new expense allocation rules.[14] These rules would at least prevent U.S. corporations from deducting some of the expenses of their overseas operations from their U.S. taxable income, and would address *one* of the ways in which a territorial system could subsidize the shifting of jobs and profits offshore. The Congressional Budget Office (CBO) (citing estimates from the Joint Committee on Taxation) has reported that adopting a territorial system with improved expense allocation rules could raise $76 billion in revenue over ten years because this particular type of tax avoidance would be blocked.[15]

But reform of our expense allocation rules is a good idea on its own, whether or not it is attached to a territorial system. That's because our current deferral system provides similar opportunities for U.S. corporations to reduce their U.S. taxes by deducting some of their expenses of earning foreign profits. In 2007, then-House Ways and Means Committee

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[12]It's worth noting that even President Bush's Advisory Panel for Federal Tax Reform, which recommended a territorial tax system in its 2005 report, conceded, "Because insuring that related entities charge each other 'arm's length' prices for goods and services is even more important in a territorial system than under current law, additional resources would need to be devoted to examining these transfer prices." That's a very understated way of saying that the massive problems with enforcing transfer pricing rules would only get worse under a territorial system. The report does not explain how the enforcement of these rules, which has been hugely problematic for decades, will improve under a system that provides even more incentives to manipulate them. The President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," November 1, 2005, p. 134.

[13]The President's Economic Recovery Advisory Board, "Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," August 2010, p. 90.

[14]For example, see Harry Grubert and John Mutti, "Taxing International Business Income: Dividend Exemption versus the Current System," American Enterprise Institute, January 2011. For a discussion of the decisions that must be made in implementing a territorial system, see "Testimony of Rosanne Altshuler Before the Senate Committee on the Budget," February 2, 2011.

[15]Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011. p. 187.

Chairman Charles Rangel proposed improved expense allocation rules that would have raised an estimated $106.4 billion over ten years[16] — *more* than CBO said would be raised by switching to a territorial system with improved expense allocation rules. Unfortunately, Rangel's reform proposal was blocked by strenuous corporate lobbying against it.

So there certainly is a strong argument for improved expense allocation rules. Tax reformers have been trying to achieve this goal since at least the 1970s. But tax avoidance caused by defective expense allocation rules is a problem that needs to be solved under either a deferral system or a territorial system. Calling for reform of our expense allocation rules is not an argument for adopting a territorial system.

It's worth noting that a more accurate expense allocation system is not what corporate lobbyists have in mind when they call for a territorial system. Instead, they have made it quite clear that they would oppose a corporate tax reform that moved in this direction.[17]

Meanwhile, governments with territorial systems generally lack accurate expense allocation rules[18] and are having tremendous problems enforcing their existing international corporate tax rules, particularly the transfer pricing rules.[19] In fact, the European Union is considering moving away from the territorial system for determining how corporate profits are allocated among its member states.[20]

In other words, lawmakers who think they can simply adopt the territorial tax system used by other countries and please corporate leaders will find that this is impossible — unless they are willing to allow increased corporate tax avoidance at great cost to individual taxpayers who must somehow make up for the lost revenue.

A far simpler, and more responsible, approach would be to adopt a pure worldwide system (end deferral), which would make expense allocation rules and transfer pricing rules far less

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[16]Congressman Rangel's 2007 tax reform bill (H.R. 3970) included a provision to defer deduction of expenses related to earning offshore foreign profits until those profits are subject to U.S. taxes. See Citizens for Tax Justice, "Congressman Rangel's Tax Bill Would Make the Tax Code Simpler & Fairer — and the Changes Are All Paid For," November 2, 2007. President Obama's Fiscal Year 2010 budget plan included a weaker proposal along these lines that made an exception for research and development expenses. The proposal would have gone into effect starting in 2011 and was estimated to raise $60 billion from 2011 through 2019. Department of the Treasury, "General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals," May 2009, p. 29 and p. 128. The following year, President Obama limited his proposal to defer just interest (not other expenses) related to earning offshore corporate profits, which reduced the estimated revenue gain that would result.

[17]For example, see Amy S. Elliott, "G.E. Executive Criticizes Possible U.S. Territorial System," *Tax Notes*, February 28, 2011.

[18]For a related discussion, see Randall Jackson, "Expensing Could Be Roadblock To a U.S. Territorial System," *Tax Notes*, January 31, 2011.

[19]Michael C. Durst, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Law," *Tax Notes*, January 18, 2010.

[20]The EU is considering an apportionment system similar to the one used by U.S. states to allocate corporate profits among themselves. Stephen Castle, "Europeans Introduce Corporate Tax Plan," *New York Times*, March 16, 2011. For an explanation of the proposal, see European Commission, "Common Consolidated Corporate Tax Base: Questions and Answers," March 16, 2011.

important.[21] The Treasury estimates that deferral of U.S. taxes on offshore corporate profits costs close to $50 billion *each year*, and many experts think this estimate is substantially understated.[22] The bottom line is that adopting a pure worldwide tax system (as the Wyden-Gregg tax reform bill does) should be part of any fiscally responsible corporate tax reform.

V. Another Repatriation Holiday Would Make Our Tax System Even Worse.

Some corporate leaders and anti-tax activists argue that if Congress cannot provide a comprehensive reform of the corporate income tax that lowers rates, then perhaps Congress can instead provide another repatriation "holiday" like the one enacted in 2004.[23] Offshore profits that were repatriated under that deal were taxed at a super-low rate of just 5.25 percent. At the time, corporate leaders claimed that if Congress nearly eliminated taxes on offshore profits on a temporary, one-time basis, then the corporations would repatriate those profits and use the money to create jobs.

The argument that the 2004 repatriation holiday would create jobs never made sense, because companies already had access to the offshore money by borrowing. Thus it is no surprise that the data show rather conclusively that the 2004 repatriation holiday did nothing to create jobs.[24] Repeating this holiday will once again reward the corporate tax dodgers and encourage them to shift even more profits offshore in anticipation of still another repatriation holiday.

To be sure, the 2004 repatriation holiday legislation did technically "require" that repatriated profits had to be used "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." But even the authors of this supposed "requirement" know it was meaningless, since money is fungible. Companies could and did simply say that their repatriated earnings went to job creation, while actually using the money for whatever purpose they desired (including continuing to shift jobs overseas). In fact, empirical studies found that most of the money was ultimately returned to shareholders through stock repurchases.[25]

One of the most disturbing things about the repatriation holiday is that it actually favors those corporations who are engaging in the most egregious tax avoidance. This is true for two reasons.

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[21]Transfer pricing rules and expense allocation rules would not be *entirely* irrelevant in a pure worldwide tax system because they would still be needed for calculating foreign tax credits.

[22]Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government: Analytical Perspectives," February 2011, p. 241. The full cost of deferral includes the basic deferral of taxes on income from controlled foreign corporations as well as the inventory property sales source rules exception, which allows deferral of taxes on income generated from selling U.S. inventory abroad. The cost also includes deferral of taxes on financial firms on certain income earned overseas (the "active financing" exception to subpart F) which Congress is likely to extend indefinitely until a comprehensive tax reform causes lawmakers to end this practice.

[23]Grover Norquist, "It's Time for Another Repatriation Holiday," *The Daily Caller*, March 7, 2011.

[24]Citizens for Tax Justice, "Will Congress Make Itself a Doormat for Corporations that Avoid U.S. Taxes?" January 30, 2009. http://www.ctj.org/pdf/repatriation.pdf

[25]For a summary of the studies showing that the 2004 repatriation holiday benefitted shareholders but did not lead to jobs creation, see Donald J. Marples & Jane G. Gravelle, "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis," Congressional Research Service, December 17, 2010.

First, U.S. corporations whose foreign subsidiaries are actually doing real business abroad are typically less able to repatriate much of their foreign earnings, since most of those earnings are invested in real foreign operations. For example, an oil company with offshore profits may reinvest those profits in oil wells in whatever foreign country they extract oil from. It's unlikely they will sell the oil wells and bring the profits back to the U.S. in response to a tax holiday.

On the other hand, a corporation that has shifted profits to a tax haven-based subsidiary that consists of nothing but a post office box can benefit immensely from a repatriation holiday. Since this company is not conducting any real business in the foreign country, the profits can easily be sent back to the U.S. parent company.

Second, offshore earnings that have been taxed by the foreign government can already be repatriated by a U.S. parent company without triggering the full 35 percent U.S. corporate income tax (because the foreign tax credit is taken to prevent double-taxation). But offshore earnings in a country that does not tax those earnings (offshore earnings in a tax haven, in other words) would be taxed at the full 35 percent U.S. corporate income tax rate if repatriated under the regular rules. This is another reason why the repatriation holiday actually favors corporations that are merely shifting their profits to tax havens rather than conducting actual business abroad.

The incentives to shift jobs and profits offshore can only increase if corporations believe that Congress will periodically call off taxes almost entirely on those profits. Perhaps the worst tax system that could be designed is a deferral system that provides a repatriation holiday every seven years. Congress should not move in this dangerous direction.