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Myths and Facts about Offshore Tax Abuses

On May 4, President Obama proposed several measures to address overseas tax avoidance and tax evasion. The proposals are steps in the right direction but could be far stronger. (See CTJ's description of the measures for more technical details.[1])

While the President's proposals are relatively modest, the corporate community claims that these measures are unfair and would limit economic growth in America.

The corporate lobbyists and spokespersons are wrong. Here are some of the frequently repeated myths, and the actual facts, about offshore tax abuses and what the President and many lawmakers want to do about them.

Myth: The practices that the Obama administration is trying to stop are not illegal, so the U.S. government should not interfere with them.

Fact: The practices that concern the Obama administration and others include both legal and illegal practices, and they *all* damage our ability to raise revenue in a fair manner to pay for public services and investments we need. There are three types of practices at issue:

First, there are tax abuses by American individuals that involve hiding income from the IRS. These tax abuses are always illegal, meaning they constitute tax *evasion*.

Second, there are tax abuses by American corporations that involve manipulating tax laws to reduce or eliminate their U.S. taxes in ways that Congress never intended. These tax abuses may be legal, meaning they constitute tax *avoidance*, but many of these practices *ought to be illegal*.

Third, there are features of our tax system that might encourage corporations to base their operations offshore rather than here in the U.S. These provisions should be reexamined by Congress.

[1] Citizens for Tax Justice, "Obama's Proposals to Address Offshore Tax Abuses Are a Good Start, but More Is Needed," May 8, 2009. http://www.ctj.org/pdf/offshoretax20090508.pdf

Myth: The first category of abuses listed above (involving individuals hiding income from the IRS) is no different than the sorts of steps everyone takes to pay as little tax as they can get away with.

Fact: Many people take legal means to lower their taxes through strategies that use various deductions and credits. But most Americans have no opportunities to actually *hide their income* from the IRS, which is very different (and very illegal).

For most of us who receive a wage or salary, our employers report our income to the IRS on W-2 forms. So if we try to hide our earnings from the IRS, there's a good chance we'll get caught.

A teen-ager mowing lawns for the summer might decide to not report the income to the IRS, and they might get away with that. But for the most part, the options for tax evasion are pretty limited for most Americans.

But it's a whole different story for wealthy people and corporations with access to complicated tax-planning schemes involving foreign countries. They can rely on accountants and lawyers to structure complex transactions that shift their income and income-generating assets into a country that has low or no business taxes and that has bank secrecy rules that prevent its financial institutions from telling the U.S. government which American citizens are among their clients and what they're up to.

In other words, wealthy American individuals and corporations wishing to hide their income from the IRS can turn to "tax havens." There is no official definition of a tax haven, but they generally have strict bank secrecy laws and low or non-existent taxes.

It's important to remember that these efforts to shift income and income-generating assets into tax havens do not represent real investments in those countries. These are transactions or investments on paper only.

Myth: The second category of abuses listed above (involving American corporations manipulating, but not necessarily violating, U.S. tax laws) are all steps that companies have to take in order to avoid double-taxation of their foreign income.

Fact: The foreign tax credit already protects against double-taxation. If an American individual or corporation has income that is taxed by a foreign government, the individual or corporation gets a credit against their U.S. tax. No one is proposing to repeal the foreign tax credit.

The U.S. taxes all of the income of its citizens, residents and corporations, no matter where it is earned. But individuals and corporations can take a credit against their U.S. taxes for foreign taxes that they pay, to avoid double-taxation.

Corporations get an additional benefit, which is that they get to "defer" U.S. taxes on the income they earn abroad until they bring that income back to the United States (until they "repatriate" that income).

The President proposes to limit "deferral" for corporations because it has been abused a great deal to reduce taxes in ways that Congress never intended to allow. But even if the President and Congress repealed deferral entirely (which would probably be a better policy), American individuals and American corporations would still be able to use the foreign tax credit, so there would be no fear of double-taxation.

It is true that one of the President's proposals would make changes to the foreign tax credit, but these changes would only ensure that the credit does its job of preventing double-taxation. Currently, American multinational corporations can use the credit against their U.S. taxes for taxes they paid to a foreign government on income that is not even taxable in the U.S. (for example, life insurance proceeds). This is clearly not the purpose of the credit. Addressing this problem would not prevent corporations from using the credit to avoid actual double-taxation.

Myth: Proposals to crack down on offshore tax abuses by corporations will make the U.S. businesses less competitive as they try to compete abroad.

Fact: Most of the corporate practices the administration wants to crack down on probably don't even involve companies that are truly competing abroad. Rather, they involve companies operating within the United States but using sham transactions to make their income appear to be earned abroad, so that the U.S. taxes on that income can be "deferred" (meaning "not paid.")

Even in cases where U.S. multinational companies are carrying out real business in a foreign country, their competition with other companies in that country is generally based on the price they charge for their products. Corporate income taxes don't affect the price a foreign subsidiary can charge so much as they affect the dividends the U.S. owners receive.

Myth: Even if everything explained above is true (that these practices mostly involve U.S. companies scheming to reduce their U.S. taxes on their U.S. profits) it's still a bad idea to crack down on these practices because corporations will simply leave the United States and take jobs with them.

Fact: The U.S. tax system is probably not a significant factor in a company's decision to relocate jobs. To the extent that the U.S. tax system is a factor, the current rules encourage investors to move jobs offshore more than the rules that would exist if the President's reforms were enacted.

Companies locate manufacturing plants where labor and inputs are available, and where regulations are favorable to corporate interests. Certain types of manufacturing need to be

near natural resource inputs or near the end market. For example, auto manufacturers are in the U.S. because that's where the cars are sold. It's too expensive to ship them from somewhere else. If a company sells services, the decision is influenced by the market it serves and by where the employees want to live.

To the extent that taxes do influence decisions about where to locate operations and jobs, the current tax rules are more likely to encourage investors to move jobs offshore than the rules that would be in place if the President's reforms are enacted. The fact that a U.S. corporation can defer taxes on income earned by its foreign subsidiaries might make it slightly more likely that it will base more of its operations abroad than here in the U.S. Obama's proposal to limit deferral would make it *less* likely that companies will base operations and jobs offshore.

Myth: U.S. Corporations need to lower their tax liability any way they can because America's corporate tax rate is so high compared to other countries.

Fact: U.S. corporations do not generally have high taxes compared to those of other countries because there are so many loopholes in the U.S. corporate tax.

The most effective way to compare the tax level of corporations across nations is to compare each nation's corporate tax revenue as a percentage of its economic output (its gross domestic product, or GDP). Compared to other industrial countries, the U.S. ranks below average by this measure.[2]

[2] Citizens for Tax Justice, "United States Remains One of the Least Taxed Industrial Countries," April 2007. http://www.ctj.org/pdf/oecd07.pdf