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Peter G. Peterson Institute's Misguided Defense of Offshore Tax Loopholes

The Peter G. Peterson Institute has come out against provisions in H.R. 4213 that would prevent multinational corporations from abusing foreign tax credits. The two-page complaint written by Peterson's Gary Hufbauer and Theodore Moran attempts to defend practices by corporations that are indefensible.[1]

Background

The Senate is currently debating a bill, H.R. 4213, that includes an extension of badly needed unemployment insurance benefits, Medicare funding for states and other measures vital to prevent the recession from worsening. The bill also includes extensions of small tax breaks (mostly for business) that members of Congress and their staffs call the "tax extenders." Congress enacts the tax extenders every year or so, but what's different this year is that they would offset the costs of these tax breaks by closing unfair tax loopholes.

One set of loophole-closing provisions targets abuses of foreign tax credits by U.S. corporations. In a previous report, we explained what the foreign tax credit is and why these provisions will ensure that it is used only for its intended purpose, which is to prevent double-taxation of income earned by American taxpayers abroad.[2]

Imagine you earn significant income in the U.S. and you also earn some in a foreign country. Because you've earned a lot in the U.S., your marginal U.S. income tax rate is 35 percent. The foreign country where you also earned some income taxes the income earned there at a rate of 30 percent. The U.S. does, in theory, tax all of your income, no matter where you earned it. Does that mean you have to pay the 30 percent tax levied by the foreign country and the 35 percent levied by the U.S., for a total of 65 percent, on your foreign income? No, because you use the foreign tax credit (for the 30 percent you paid to the foreign country) against your U.S. taxes. That way, you only pay 5 percent to the U.S. on your foreign income.

The foreign tax credit is available to U.S. corporations, as well as individuals, but the deal is even better for corporations because they can indefinitely "defer" the U.S. taxes on their foreign income until they bring it back to the U.S. (which may never happen).

Why Congress Needs to Tighten the Rules Regarding the Foreign Tax Credit

The problem is that U.S. corporations have figured out how to take foreign tax credits in excess of what they need to avoid double-taxation. Even worse, they sometimes take foreign tax credits for foreign income that is not even taxable in the U.S. This means that the credit is

[1] Gary Clyde Hufbauer and Theodore Moran, "Destroying Jobs and Hobbling Exports," Peterson G. Peterson Institute for International Economics, June 2010. http://www.iie.com/publications/interstitial.cfm?ResearchID=1587

[2] Citizens for Tax Justice, "Key Provisions in H.R. 4213 Would Prevent Abuse of Foreign Tax Credits," May 28, 2010. http://ctj.org/pdf/ftc2010.pdf

really being used by corporations to reduce their U.S. taxes on their U.S. income. Or, put another way, it's being used to subsidize foreign countries by helping U.S. corporations pay their foreign taxes.

There are different schemes that U.S. corporations use to accomplish this tax avoidance that are the targets of the provisions in H.R. 4213.

One is called "splitting" the foreign tax credit from the foreign income that it is supposed to shield from double-taxation. For example, U.S. corporations are supposed to be able to defer U.S. taxes on income of foreign subsidiaries only if those subsidiaries are corporations. But a U.S. corporation could own a foreign entity that is considered a partnership by the foreign government but is considered a corporation by the U.S. government. This means that the foreign entity pays taxes to the foreign government and the U.S. parent corporation takes foreign tax credits for those taxes paid to the foreign government — even though it is deferring all U.S. taxes on this foreign income. The result is that the U.S. corporation is using foreign tax credits for income that is not even taxable in the U.S. This is just one of the abuses that the provisions in H.R. 4213 would block.

The Peterson Institute's Criticism of H.R. 4213 Provisions Regarding Foreign Tax Credits

In their paper, Peterson's Gary Hufbauer and Theodore Moran complain that the philosophy of President Obama seems to be that "no matter where in the world they do business, US-based MNCs [multinational corporations] should pay the U.S. corporate tax rate."

Actually, this is not just the "philosophy" of the current occupant of the White House. It's the tax system we've had since the income tax was established. Income that a U.S. taxpayer makes overseas is subject to U.S. taxes, if repatriated. The foreign tax credit ensures that they won't pay *more* than the U.S. tax rate that would apply if the income was generated here at home (unless the foreign tax rate is higher than the U.S. rate). Of course, corporations get to indefinitely defer their U.S. taxes on their offshore income until they bring it back to the U.S. anyway.

Hufbauer and Moran go on to say that "US-based MNCs are allowed many avenues to conduct business abroad and pay the foreign tax rate on their foreign earnings, with only a small additional payment to Uncle Sam." Well, this would not be troubling if they mean that small payment to Uncle Sam is the difference between a lower foreign tax and the U.S. taxes that would be owed if the income was generated in the U.S. That would mean that the system is working because the foreign tax credit avoids double-taxation, so that corporations only pay U.S. taxes on foreign income to the extent that the U.S. tax rate exceeds the foreign tax rate.

But that's clearly not what they mean, because if it was, they would have no problem with proposals that simply prevent corporations from using foreign tax credits in excess of what is needed to avoid double-taxation.

In several places, Hufbauer and Moran essentially acknowledge that the corporations are paying far less than the U.S. corporate tax rate as a result of their use of foreign tax credits.

This is remarkable because it's an open admission that the foreign tax credit is used for more than just avoiding double-taxation, even though that's it's only purpose. They complain that President Obama's policies ignore that "the US corporate tax rate . . . is one of the highest in the world," and that "competing MNCs based in Europe, China, India or Brazil pay far less than the US tax rate when they compete head-to-head with US firms."

Actually, corporate taxes in the U.S., as a percentage of GDP, are not particularly burdensome, compared to those of other industrialized nations. But let's set that aside. Even if U.S. corporations were justified in believing that the U.S. tax rate was too high, shouldn't they just go to Congress and ask for a lower corporate tax rate? How does it make sense that the solution is complex planning to use more foreign tax credits than are needed to avoid double-taxation?

What makes this even worse is that the provisions they're criticizing, to a large extent, focus on corporations that take foreign tax credits for income that is not even taxable in the U.S. These corporations are really using foreign tax credits to reduce their U.S. taxes on their U.S. income. Surely we should all agree that this is not the purpose of the foreign tax credit.

The paper also refers to studies that purport to show the economic benefits of U.S. firms investing offshore, which is a bit of red herring. A particularly entertaining reference is made to an oft-cited study showing that "10 percent greater foreign investment by the multinational [corporation] triggers 2.2 percent additional domestic investment."

This 2.2 percent additional investment in the U.S. is nice, but we cannot help but to think that if the corporation had chosen to put its 10 percent investment in the U.S., that would result in at least 10 percent of investment in the U.S. Which is a lot more than 2.2 percent.

The paper's conclusion is also quite revealing. "Instead of raising taxes on the foreign income of US-based MNCs," they write, "Congress should be lowering the corporate rate to 20 percent."

Now, many corporate lobbyists, and lawmakers friendly to them, have talked about a fundamental tax reform that would involve a lower corporate tax rate along with simplification, which would mean the removal of loopholes. The result, in theory could be a revenue-neutral tax simplification. Of course, reasonable people can argue about whether such a tax reform should be revenue-neutral. In fact, given that we face long-term budget deficits, one would think that supposed deficit-hawks (like Peter Peterson, the namesake and funder of the think-tank that published this paper) would want a tax reform that actually *raises* revenue by closing loopholes and *not* lowering tax rates.

Remarkably, these authors seem to believe that the corporate tax rate should be reduced *and* loopholes should *not* be closed. The idea that the corporations should still be able to use foreign tax credits in excess of what is necessary to avoid double-taxation while also enjoying a 15-point reduction in the U.S. corporate tax rate is incredible. It's also a radical departure from most ideas of "tax reform." We hope it stays that way.