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An Analysis of Where American Companies Report Profits: Indications of Profit Shifting

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Congressional Research Service

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Abstract

This report uses data on the operations of U.S. multinational companies (MNCs) to examine the extent to which, if any, MNCs are moving profits out of high-tax countries (or out of the U.S.) and into low-tax countries with little corresponding change in business operations, a practice known as "profit shifting." To do this, the profits reported by American firms in two groups of countries are compared with measures of real economic activity in those locations. The first group consists of the five countries commonly identified as being "tax preferred" or "tax haven" countries, and includes Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland. The second group, which provides a baseline for comparison, consists of five more traditional economies. This group includes Australia, Canada, Germany, Mexico, and the United Kingdom.

Consistent with the findings of existing research, the analysis presented here appear to show that significant shares of profits are being reported in tax preferred countries and that these shares are disproportionate to the location of the firm's business activity as indicated by where they hire workers and make investments. For example, American companies reported earning 43% of overseas profits in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, while hiring 4% of their foreign workforce and making 7% of their foreign investments in those economies. In comparison, the traditional economies of Australia, Canada, Germany, Mexico and the United Kingdom accounted for 14% of American MNCs overseas' profits, but 40% of foreign hired labor and 34% of foreign investment. This report also shows that the discrepancy between where profits are reported and where hiring and investment occurs, as examples of business activity, has increased over time.

Additional evidence that profit shifting has increased over time is found from a comparison of business profits with economic output (gross domestic product) in the two country groups. MNC profits as a share of gross domestic product (GDP) in the traditional economies averaged from 1% to 2% between 1999 and 2008, while their profits in the tax preferred countries profits averaged 33% of GDP in 2008, up from 27% in 1999. Individual countries within the tax preferred group displayed more dramatic increases in the ratio of profits to GDP. For example, profits reported in Bermuda have increased from 260% of that country's GDP in 1999 to over 1000% in 2008. In Luxembourg, American business profits went from 19% of that country's GDP in 1999 to 208% of GDP in 2008.

This report may be of interest to Members of Congress for at least four reasons. First, profit shifting has been the specific target of recent Congressional action, including a September 2012 hearing held by the Senate Permanent Subcommittee on Investigations, as well as several bills introduced in the 112th Congress. Second, anti-abuse provisions have been included in general tax reform proposals in the 112th Congress. Third, most general tax reform proposals would lower the top corporate rate which would diminish the incentive to shift profits. And fourth, to the extent that profit shifting is reduced, federal tax revenues would increase which could assist in addressing the country's debt and deficit problems.

Keywords

multinational companies, profit shifting, tax haven countries, tax preferred countries

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Summary

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Introduction

American based companies reported earning $938 billion in profits overseas in 2008 (most recent data).[1] The U.S. will generally defer levying a tax on this income until it is brought back (repatriated) to the United States, although the countries where American companies operate may tax this income at the time it is earned. The United States' method for taxing American based companies gives rise to two principal issues in the international tax debate. First, American companies can use tax deferral and other techniques to avoid or delay taxes by moving profits out of high-tax countries (or out of the U.S.) and into low-tax countries with little corresponding change in business operations, a practice known as "profit shifting." Second, the ability to defer taxes on income earned abroad allows American companies to reinvest earnings in foreign markets and expand business operations alongside foreign counterparts.

This report focuses on the profit shifting aspect of international business behavior in response to taxation. Data on the activities of American based companies with overseas operations is analyzed to understand the degree to which, if any, profit shifting may be occurring. The analysis appears to show that American companies report earning profits in tax haven or tax preferred countries that, when compared to more traditional economies, appear to be disproportionate to hiring and capital investment in those countries.[2] Profits reported by American companies also appear to be disproportionate to national output in the tax haven countries, and in some countries, these reported profits actually exceed total economic output. By all indicators examined in this report, profit shifting has generally trended upward overtime.

The findings of this report are in agreement with a large body of economic research that has found evidence that American companies are shifting profits in an attempt to reduce their tax liabilities and that U.S. tax revenues suffer as a result.[3] For example, economist Kimberly Clausing has estimated that profit shifting by American companies cost the government between $57 billion and $90 billion in lost revenue in 2008.[4] Economist Martin Sullivan also estimated

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[1] U.S. Department of Commerce, Bureau of Economic Analysis., *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates (Revised 2008 Statistics)*, Table II.A.1, November 2011, http://www.bea.gov/scb/account_articles/international/iidguide.htm.

[2] "Tax haven" is not a precisely defined term, but in most usages it refers to a country—in many cases a small one—where non-residents can save taxes by conducting various investments, transactions, and activities. Attributes that make a country a successful tax haven include low or non-existent tax rates applicable to foreigners; strict bank and financial secrecy laws; and a highly developed communications, financial, and legal infrastructure. The term "traditional" is used as a label to distinguish countries that are not commonly viewed as tax havens. The traditional country group could be defined differently. For example, China, France, and Japan rank among the top ten U.S. trading partners (http://www.census.gov/foreign-trade/top/dst/current/balance.html) and could have been included. The countries chosen for this analysis were picked because they consistently ranked among the top places where American companies reported profits abroad and that were not considered tax havens.

[3] For a detailed discussion of profit shifting, including techniques employed, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle. Additional research on the subject and discussions of the literature that are not discussed here include: Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, vol. 56, March 2003; Part 2. James. R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation," *National Tax Journal,* vol. 52, June 1999, pp. 305-322; and James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *The Quarterly Journal of Economics*, vol. 109, no. 1 February 1994, pp. 149-182.

[4] Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, March 28, 2011, pp. 1580-1586, and Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, (continued...)

significant revenue losses, although they were generally less than half of Clausing's estimates for the most recent year analyzed by both researchers, 2004.[5] Employing a different approach than Clausing and Sullivan, professors Charles Christian and Thomas Schultz have estimated that on net $87 billion was shifted out of the U.S. in 2001, which, at a 35% tax rate would imply a revenue loss of about $30 billion.[6] A number of media outlets have also recently published stories which report that companies such as Apple, Cisco, Facebook, Google, and Microsoft may be using sophisticated tax planning techniques to shift profits to low tax countries and lower their U.S. tax liabilities.[7]

Policymakers here at home have taken notice of possible profit shifting. For example, the Senate Permanent Subcommittee on Investigations held a hearing in September 2012 on the methods companies use to shift profits and possible options for curbing such behavior.[8] Witnesses included IRS officials, academics, private tax consultants, and executives from the tax departments at two American companies (Hewlett-Packard and Microsoft). Profit shifting has also been the specific target of several bills that were introduced in the 112th Congress (H.R. 2669, S. 1346, S. 2075), as well as part of broader reform proposals in the 112th Congress, including S. 727 (Senators Wyden, Begich, and Coats), S. 2091 (Senator Enzi), and a House Ways and Means "discussion draft" (Representative Camp).[9]

The issue of profit shifting has also attracted the attention of foreign policymakers. Several recent foreign media stories have called attention to what is perceived by some to be tax avoidance by American companies operating abroad.[10] According to those reports, Prime Minister David Cameron and members of the British Parliament have expressed concern over the rather low tax liability of several American companies operating in the United Kingdom.[11] Furthermore, German Finance Minister Wolfgang Schäuble and British Chancellor of the Exchequer George

(...continued)

vol. 62, December 2009, pp. 703-725.

[5] "U.S. Multinationals Shifting Profits Out of the United States," Tax Notes, March 10, 2008, p. 1078-1082; and Martin A. Sullivan, "Shifting of Profits Offshore Costs U.S. Treasury $10 Billion or More," Tax Notes, September 27, 2004, p. 1477-1481.

[6] Charles W. Christian and Thomas D. Schultz, ROA-Based Estimates of Income Shifting by Multinational Corporations, *IRS Research Bulletin*, 2005 http://www.irs.gov/pub/irs-soi/05christian.pdf.

[7] Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," The New York Times, April 28, 2012, p. A1; Jesse Drucker, "Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes," Bloomberg, October 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html/; and Jess Drucker, "IRS Auditing How Google Shifted Profits Offshore to Avoid Taxes," Bloomberg, October 13, 2011, http://www.bloomberg.com/news/2011-10-13/irs-auditing-how-google-shifted-profits-offshore-to-avoid-taxes.html.

[8] U.S. Congress, Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, Offshore Profit Shifting and the U.S. Tax Code, 112th Cong., September 20, 2012, http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code.

[9] For more information on the Ways and Means Committee discussion draft, see http://waysandmeans.house.gov/taxreform/. CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle, discusses the proposals in greater detail.

[10] For example, see Dominic Rushe, "Starbucks Dismisses Tax Avoidance Claims," *The Guardian*, November 1, 2012, http://www.guardian.co.uk/business/2012/nov/01/starbucks-dismisses-tax-avoidance-claims, Patrick Wintour and Dan Milmo, "UK and Germany Agree Crackdown on Tax Loopholes for Multinationals," *The Guardian*, November 5, 2012, http://www.guardian.co.uk/business/2012/nov/05/uk-germany-tax-loopholes-multinationals.

[11] Jim Pickard and Vanessa Houlder, "Google and Starbucks face tax questions," *The Financial Times*, October 30, 2012, http://www.ft.com/cms/s/0/493d4d24-2298-11e2-8edf-00144feabdc0.html#axzz2BjcmHeLz.

Osborne, in a joint statement, have called on the G20 countries to coordinate efforts to prevent profit shifting by companies of all nationalities and to protect the global corporate tax base.[12]

Analysis of American Multinational Companies

The Bureau of Economic Analysis (BEA) collects data on where American based companies that operate in foreign markets report profits and various other pieces of business information. These companies, often referred to as U.S. multinational companies (MNCs), are a combination of a U.S. based "parent" company and "affiliates," which are owned by the parent and operate in foreign markets. Because U.S. based parents can have various degrees of ownership, and hence control over their foreign affiliates, the BEA distinguishes between affiliates with a parent that has a majority ownership stake and affiliates with a parent that has any ownership stake. The BEA also distinguishes between bank and nonbank parents and affiliates.

This section analyzes the BEA data to determine the extent to which, if any, U.S. MNCs may be shifting profits. To do this, 10 countries, formed into two country groups, are analyzed. The first group consists of the five countries commonly identified as being "tax preferred" or "tax haven" countries, and includes Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland.[13] The second group, which provides a baseline for comparison, consists of the five more traditional economies. This group includes Australia, Canada, Germany, Mexico, and the United Kingdom.[14] The profits reported by foreign affiliates of U.S. MNCs in the two country groups are presented and analyzed. The countries in each respective group were chosen because they consistently ranked among the top places where American companies reported profits.

The profits reported by American based companies in the two country groups are then compared with their real economic (business) presence in the country groups. Two measures of the real economic presence of MNCs are considered. The first measure is the share of total foreign affiliate employment in each country group. Foreign affiliate employment represents the number of workers employed by U.S. MNCs outside of the United States. The second measure is foreign affiliate capital expenditures on property, plants, and equipment. Capital expenditures represent investment in physical assets by U.S. MNC affiliates. These two variables were chosen because the BEA data guide describes them as good indicators of the size of U.S.-owned business operations in affiliate countries.[15] It is also likely that these measures are less susceptible to reporting manipulation by firms than say, financial variables, since they involve tangible economic factors.[16]

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[12] HM Treasury, "Statement by the Chancellor of the Exchequer, Rt Hon George Osborne MP; Britain & Germany call for international action to strengthen tax standards," press release, November 5, 2012, http://www.hm-treasury.gov.uk/chx_statement_051112.htm. http://www.hm-treasury.gov.uk/chx_statement_051112.htm.

[13] "Tax haven" is not a precisely defined term, but in most usages it refers to a country—in many cases a small one—where non-residents can save taxes by conducting various investments, transactions, and activities. Attributes that make a country a successful tax haven include low or non-existent tax rates applicable to foreigners; strict bank and financial secrecy laws; and a highly developed communications, financial, and legal infrastructure.

[14] See footnote 2.

[15] U.S. Bureau of Economic Analysis, A Guide to BEA Statistics on U.S. Multinational Companies, March 1995, pp. 46.

[16] Economists have used other economic measures to study profit shifting behavior. For example, Martin Sullivan used variables such as research expenditures, employee compensation, sales, property, and value added to analyze profit shifting by U.S. firms. "U.S. Multinationals Shifting Profits Out of the United States," Tax Notes, March 10, 2008, p. (continued...)

Next, the profits reported in the two country groups are compared with the size of economies that comprise each country group. To measure the size of the economies analyzed, the gross domestic product (GDP) for each country was obtained from the *Economist Intelligence Unit*.[17] GDP is the value of all final goods and services produced by the citizens and firms in an economy. Alternatively, GDP can be interpreted as the total income earned by the citizens and domestically based companies in a country. Thus, the profits (income) of U.S. MNCs reported in a particular foreign country will not count toward that country's GDP. The GDP figures used in the analysis were adjusted for purchasing power parity (PPP). PPP is the method preferred by economists when making cross-country comparisons.[18]

Only U.S. MNCs with a nonbank parent with majority-owned nonbank foreign affiliates were considered in the analysis because the BEA did not start collecting information on firms in the banking and financial industries until 2007, and has only recently begun to collect more information about these firms. The analysis was further limited to majority-owned foreign affiliates because the BEA does not adjust affiliate data for the ownership stake of the parent, which could potentially affect the analysis if affiliates that have a U.S. parent with a minority stake engaged in, or do not engage in, a particular tax strategy. Majority-owned foreign affiliates accounted for 94% of affiliates in 2008.

Where Profits Are Reported

Figure 1 displays the share of profits that foreign affiliates of American MNCs reported in the tax preferred and traditional country groups between 1999 and 2008.[19] The share of overseas profits reported in tax preferred countries has fluctuated around 40% since 2002 after increasing from a low of 24% in 2000. In the most recent data year available (2008), American MNCs reported earning 43% of their overseas profits in the country group comprised of Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland.

In comparison, American MNCs reported 14% of all profits earned abroad in 2008 in Australia, Canada, Germany, Mexico and the United Kingdom. The relatively low share of profits reported in the traditional economy group follows a general decline in profits reported in these countries over the last decade. In 1999, for example, the traditional economies accounted for 35% of profits reported abroad. Viewed another way, profits reported in the five traditional county group economies have decreased approximately 60% over the sample period.

The trends displayed in **Figure 1** could be explained by economic factors. If companies are shifting real production and business activities, then it should be expected that the location of profits would change as well. At the same time, it could be that the location of reported profits has changed without a corresponding change in real business activities. If this is the case, it could be indicative of profit shifting since, by definition, profit shifting involves a disconnect between where profits are reported and where real business activity occurs. The next two sections analyze

(...continued)

1078-1082;

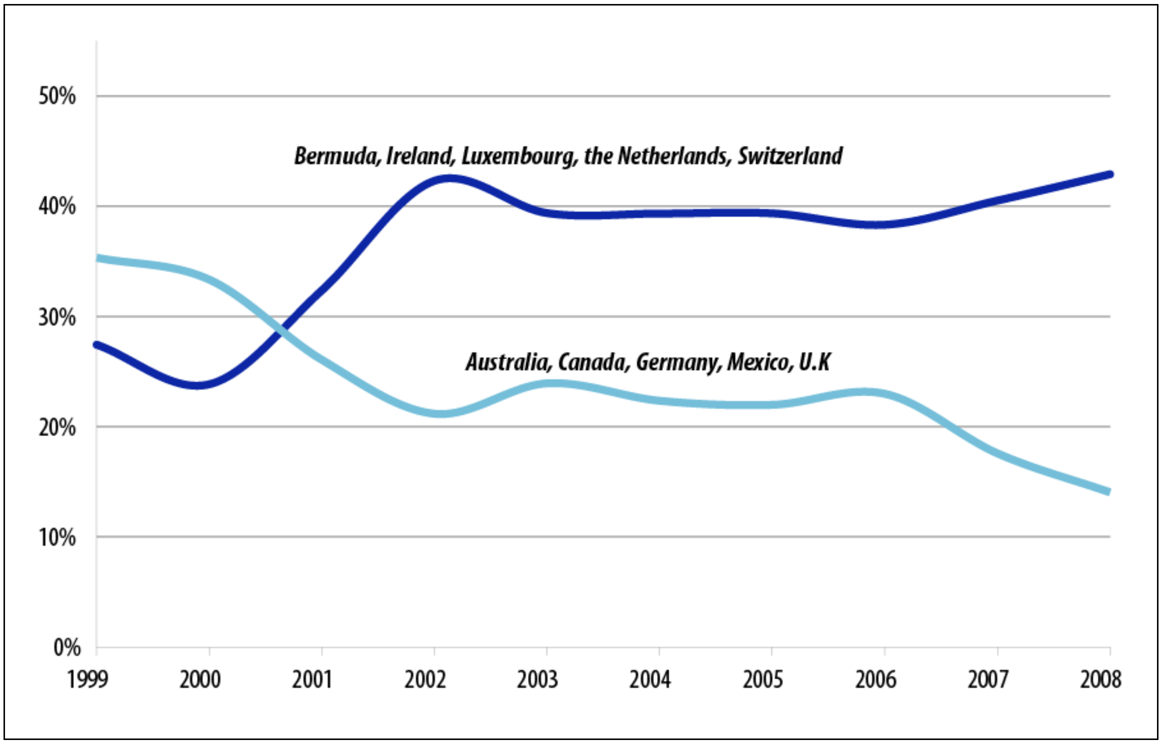
[17] http://www.eiu.com/.

[18] PPP-adjusted GDP was not available for Bermuda, so a market exchange rate measure of Bermuda's GDP was used.

[19] All figures reported hereafter are for majority-owned nonbank foreign affiliates of nonbank U.S. parents. Profits are measured as reported net income plus foreign income taxes. Thus, the measure of profits used is a pre-tax measure.

this further using three measures of business and economic activity—employment, investment, and GDP.

Figure 1. Profits of American MNCs in Select Country Groups As A Percentage of Total Profits Reported Abroad by American MNCs



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates.*

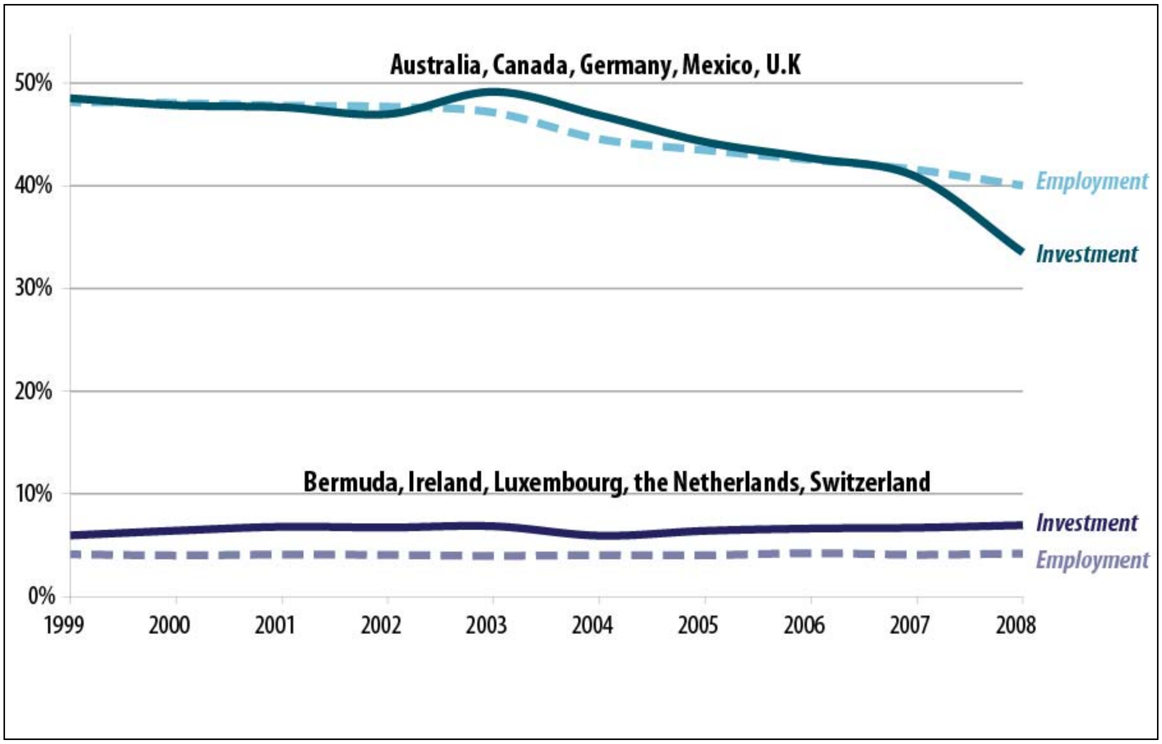
Notes: Profits displayed are for majority-owned nonbank foreign affiliates of nonbank U.S. parent companies.

Where Workers Are Hired and Investments Are Made

Figure 2 shows the share of workers hired (dashed lines) and investments made (solid lines) by American companies outside the U.S. in both groups of countries.[20] Three features of the data are immediately apparent. First, the amount of investment and hiring in the traditional economy group dwarfs that which occurs in the tax preferred countries. In 2008, for example, American companies hired 40% of their foreign labor from and made 34% of their foreign investments in the country group containing Australia, Canada, Germany, Mexico and the United Kingdom. In comparison, 4% of the workers hired outside the U.S. by American companies and 7% of the investments made abroad were in the country group of Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland.

[20] Capital expenditure was used as the measure of investment. Capital expenditure includes total expenditures on property, plant, and equipment, including spending on capital that is leased.

Figure 2. Employment and Investment in Select Country Groups As A Percentage of Foreign Employment and Investment of American MNCs



Source: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates.

Notes: Figures displayed are for majority-owned nonbank foreign affiliates of nonbank U.S. parents companies.

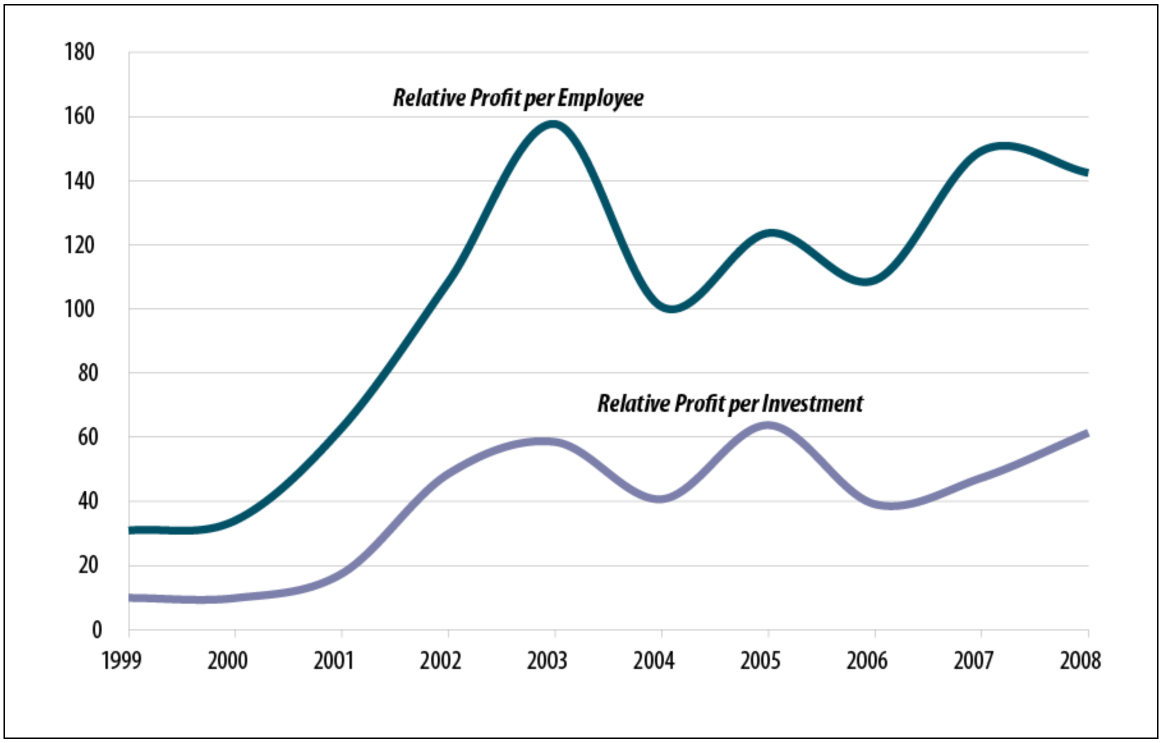
Second, American companies began curtailing employment and investment in the traditional group's economies in the early 2000s. Employment in these countries as a share of hiring abroad has fallen from 48% to 40%, as has investment, which has decreased from 49% to 34%. Because American companies appear to be reducing their real business presence in the traditional country group (relative to the rest of the world), it is perhaps not surprising that profits reported in these countries are also falling. It is not possible, however, to say how much of the reduction in profits reported is due to declining real activity and how much is due to profit shifting.

Third, while employment and investment have fallen over time in the traditional economy group, they have remained nearly constant in the tax preferred group at around 4% and 7%, respectively. In spite of the stability of employment in investment, **Figure 1** shows that reported profits have increased roughly 60% in the tax preferred countries over the sample period. Such a significant increase in profits without a corresponding increase in employment or investment is suggestive of profit shifting into tax preferred countries.

To quantify the discrepancy in reported profits relative to investment and employment that exists between the traditional country group's economies and the tax preferred group's economies, **Figure 3** displays two relative profit ratios. The first is the ratio of profits reported per employee in the tax preferred country group relative to profits reported per employee in the traditional country group. This figure shows that at one point (in 2003), American companies were reporting profits of $158 per employee in tax preferred countries for every $1 in profit per employee they were reporting in the traditional economies. In 2008, the latest data year, MNCs in the tax preferred group were reporting $142 per employee for every $1 per employee in the traditional economies.

The second ratio displayed in **Figure 3** is the ratio of profits reported per investment in the tax preferred country group relative to the ratio of profits reported per investment in the traditional country group. This ratio indicates that at its high, $64 of profit were being reported per investment dollar in tax preferred economies for every $1 of profit per investment dollar that American firms reported in the traditional economies in 2005. The most recent data show that MNCs in the tax preferred country group reported $61 of profit per investment dollar versus $1 of profit per investment dollar in the traditional country group.

Figure 3. Ratio Of Profits Per Investment Dollar and Per Employee In "Tax Preferred" Relative to "Traditional" Country Groups



Source: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates.

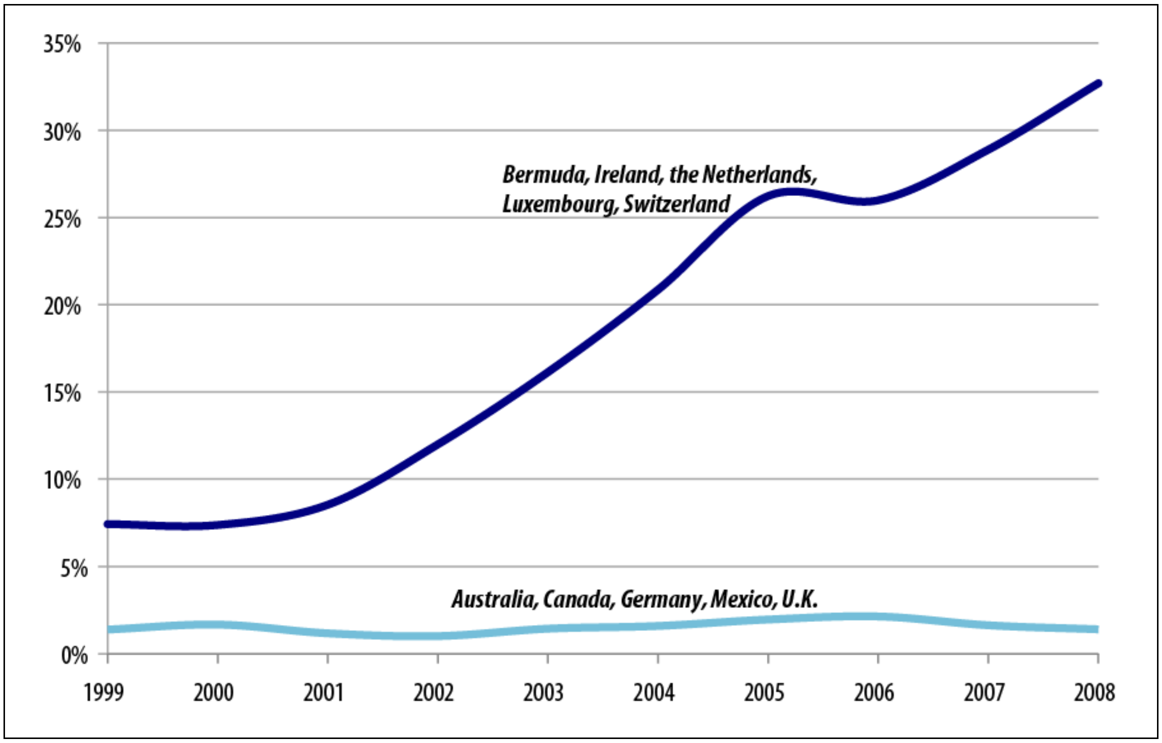
Notes: Figures displayed are for majority-owned nonbank foreign affiliates of nonbank U.S. parent companies.

The two profit ratios in **Figure 3** would appear to give an indication that the return to real business activities (hiring and investment) in the tax preferred countries are significantly higher than in the traditional economies. It could be argued, that it would be to the advantage of American MNCs to increase hiring and capital expenditures in the tax preferred economies. But as **Figure 2** indicates, the rise in profits reported in these countries is not associated with any increase in employment or investment in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland. This lack of any such relationship would again seem to support the hypothesis, held by some, that American MNCs are engaged in profit shifting.

Profits Relative to GDP

Further indication of profit shifting is found from a comparison of the business profits reported by U.S. MNCs in the two country groups as a share of GDP. **Figure 4** shows that on average, profits as a share of GDP in the traditional group's economies in aggregate has been between 1% and 2%, and that this average has been relatively constant since 1999. In contrast, average profits, as a share of GDP, in the tax preferred countries has been increasing steadily since the early 2000s, and reached 33% in 2008. All averages displayed in **Figure 4** were weighted to account for the relative size of the economies in each group.

Figure 4. Profits of American MNCs in Select Country Groups As A Percentage of GDP



Source: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates.

Notes: Figures displayed are for majority-owned nonbank foreign affiliates of nonbank U.S. parents companies.

The weighted averages displayed in **Figure 4** mask the increase in reported business profits as a percentage of GDP in the individual tax preferred countries (not displayed in this report). For example, in Bermuda, profits reported by U.S. MNCs affiliates have increased from 260% of GDP in 1999 to over 1000% of GDP in 2008. In Luxembourg, MNC's profits went from 19% of GDP in 1999 to 208% of GDP in 2008. That is to say, American companies are now reporting more business profits in Bermuda and Luxembourg than the reported value of all goods and service these two countries produce in a year. Ireland, the Netherlands, and Switzerland have seen a less dramatic, but still significant increase in profits as a share of GDP—from 5% in 1999 to 20% in 2008 in the case of the Netherlands, from 14% to 42% in the case of Ireland, and from 5% to 15% in the case of Switzerland.

Analysis Caveat

It is important to highlight a caveat to the analysis of the BEA data on MNCs. The income measure used to compute MNCs' profits includes income from equity investments, which some have argued can lead to double counting if there is a multi-level affiliate ownership structure within companies. Kimberly Clausing addresses this issue using an alternative data series produced by the BEA that does not suffer from the double counting problem.[21] This alternative data series, as Clausing points out, however, suffers from its own problems.[22] Still, Clausing finds similar results using the data series analyzed in this report, and the alternative BEA data. She concludes "while the adjustment for double-counting can make some difference, it is unlikely to be the dominant feature..."

Policy Considerations

The debate over taxing American MNCs may involve a number of policy considerations. While Congress has expressed an interest in limiting the use of complicated tax strategies that allow American companies to avoid taxation on their overseas operations, there is also concern that attempts to reduce profit shifting that are too stringent could limit access to funding for legitimate business reasons. In the larger context of tax reform, Congress has debated how profit shifting would be affected by a move to a more territorial-type tax system or to a more worldwide-type system for taxation of American companies. There have also been discussions about reducing the corporate tax rate in general, which could change the incentives for companies to move profits to low-tax countries. Congress may also want to consider, as some have suggested, the adoption of formula apportionment, and a wide-scale coordination effort with industrialized counterparts. The remainder of this report discusses these considerations in greater detail.

Profit Shifting vs. Funding Access

While there appears to be growing evidence that American companies are engaged in profit shifting, some private industry advocates have expressed concern that attempts to limit the practice may have the unintended consequence of raising the cost of investment financing both at home and abroad.[23] If, for example, the U.S. were to enact a policy that required MNCs to pay U.S. tax on income as it were earned by foreign subsidiaries (e.g., repeal deferral), the cost of capital would increase since the pool of financing that money represented would now only be available after tax.

This potential problem could be alleviated or at least mitigated if anti-abuse provisions were focused on operations in tax haven or tax preferred countries. The list of countries could be adjusted by the IRS if data suggested the profits reported in particular countries appeared not to be justified by the physical business presence of firms. In contrast to targeting the income earned

[21] Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, March 28, 2011, pp. 1580-1586.

[22] Particularly, the data does not fully capture corporate income because it excludes income from investment.

[23] See, for example, Barbara Angus, Stephen Bates, and Channing Flynn, "New and Proposed International Tax Changes and U.S. Technology Industry: Clouds Parting on the Horizon," *Tax Notes International,* September 12, 2011, pp. 813-822.

in specific countries, Congress has previously enacted anti-abuse provisions that target the type of income firms use to shift money to tax havens. This was the intent of subpart F which prevents deferral of highly fungible income that can be more easily shifted.[24]

Closely related to deferral and subpart F income is an important temporary exception to subpart F income for "active financing income" that is set to expire at the end of 2013.[25] The active financing exception relates to the income earned by American corporations that operate banking, financing, and insurance lines of business abroad, even if their primary line of business is quite different. On the one hand, there is the argument that there are real economic rationale for keeping this income abroad and that transactions involving active financing income are not necessarily for tax avoidance purposes. On the other hand, it could be argued that passive income is passive income, regardless of the underlying line of business. Nonetheless, active financing income qualifies for deferral and is only taxed when it is repatriated to the United States. Congress could choose to extend or modify the active financing exception if it believes the exception is used more to avoid taxes than to finance real operations.

Another option would take a hybrid approach, with the goal of minimizing incentives to shelter money in tax havens but still providing the ability to keep money abroad for real business operations. One variant of this option would impose a minimum tax on income earned in countries with low tax rates. The tax would be applied to deferred income earned in countries with a tax below a particular rate, for example, 20%. Income earned in countries with rates below 20%, thereafter, would be subject to a current U.S. tax of 20%. The income earned in countries with rates above this level would be exempt from U.S. taxation, either entirely or until repatriated. Some have expressed concern that designing such a minimum tax may be too complex.[26] An alternative to this approach, which creates a "cliff" effect by encouraging firms to move investment to countries with tax rates just above the minimum, is to impose an overall minimum tax with a credit for taxes paid.

Territorial vs. Worldwide Taxation

The U.S. currently taxes MNCs according to what is roughly considered a worldwide based tax system. American companies are generally required to pay U.S. tax on all income, regardless of where it is earned, although they are allowed to defer certain taxes until income is repatriated, and may also claim a limited credit for foreign taxes paid.[27] There is interest from some in Congress to switch to a territorial based tax system. Under a territorial system, the U.S. would forgo (or mostly forgo) taxing income earned outside its borders. In turn, domestic companies competing in foreign markets would face the same (foreign) tax rates as their competitors, possibly enhancing the competitiveness of U.S. firms in foreign markets relative to the current system.

[24] U.S. Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, December 2000, pp. 1-22, http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf.

[25] The exception has been extended a number of times for various lengths since the most recent version of the provision was enacted by the by the Taxpayer Relief Act of 1997 (P.L. 105-34). The most recent extension was enacted by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

[26] This concern has been expressed by Ed Kleinbard, Professor of Law, University of Southern California Gould School of Law. Reported in Julie Martin, "Minimum Tax on Multinationals Could Slow Profit Shifting," *Tax Notes*, March 19, 2012.

[27] No country has either a pure worldwide or a pure territorial tax system.

There is uncertainty, however, over whether switching to a territorial system would actually increase the competiveness of U.S. firms. The effective U.S. tax burden on foreign earned income is already argued by some analysts to be quite low because of the ability to shift income to low-tax countries, suggesting that the current system may not be preventing American MNCs from competing abroad.[28] Additionally, depending on the specific design of the territorial system adopted, the tax on foreign earned income could actually increase.[29] For example, if the U.S. were to adopt a system like Japan recently instituted, a portion of foreign earned income would be subject to current U.S. taxation if the foreign country's tax rate was less than 20%.[30] In comparison, under the current system U.S. companies can use sophisticated tax planning techniques to lower their effective tax below the statutory 35% rate.

At the same time, without the proper anti-abuse provisions in place, it is possible that under a territorial system profit shifting could increase as firms maneuver to attribute more income to operations in low tax countries. Anti-abuse provisions particularly focused on the transfer of intangible assets (patents, intellectual property, etc.) out of the U.S. may be the most useful at curbing profit shifting under a territorial system. For a detailed discussion about profit shifting under a territorial system, see CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle.

Reduced Corporate Tax Rates

One topic that has been part of nearly every debate regarding corporate tax reform has been the 35% top statutory corporate tax rate. Reducing this rate would decrease the incentive to shift profits by reducing the tax savings such behavior would produce. Companies profit shift to take advantage of the differential between the U.S. tax rate and rates in low-tax countries. By reducing this discrepancy, the incentive to shift profits would be reduced as well. Note, however, that reducing the U.S. tax rate to within the range typically suggested, 25% to 28%, would still leave the U.S. as a high tax country relative to tax havens, implying that the incentive to profit shift would remain. A reduction in the top tax rate may also come at the cost of lost federal revenue resulting from lower tax rates being applied to corporate income. Combining a rate reduction with a broadening of the corporate tax base would help to offset any revenue loss. A reduction in the statutory tax rate is also central to other debates in the international tax policy area, particularly with regards to the debate over the effective (or actual) corporate tax rate and its effect on American companies' ability to compete in the world market.[31]

Formula Apportionment

Another option that has been suggested that would reduce profit shifting is the adoption of a formula apportionment approach to taxation. The current system effectively allows companies to engage in country by country tax accounting. This provides an incentive to shift as much profit as

[28] Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes*, September 5, 2011, pp. 1021-1042.

[29] For a more detailed discussion about this potential, see Kimberly A. Clausing, "The Future of the Corporate Tax," Social Science Research Network Working Paper, October 12, pp. 20-22.

[30] See Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income,* JCX-33-11, May 20, 2011.

[31] For more information, see CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

possible to low-tax country accounts. An alternative to separate accounting is to effectively pool the income earned around the world, and then allow countries to tax a share of total profits. The share each country could tax would be determined by a formula that measures real business activity conducted in each country. For example, if a U.S. company had 60% of its employees located domestically and 40% in Canada, and earned $100 million between the two countries, the U.S. would have the right to tax $60 million of that income, and Canada would have the right to tax $40 million. More realistically, the formula used to apportion profits would depend on more than just employee location, such as the location of assets and sales.

Coordination With Other Countries

Formula apportionment would likely require coordination with countries around the world. Whether or not formula apportionment is pursued there are indications that other large economies are concerned about profit shifting and are open to some coordinate effort to reduce the behavior. As mentioned at the beginning of this report, German Finance Minister Wolfgang Schäuble and British Chancellor of the Exchequer George Osborne have expressed their interest in a coordinated effort involving the G20 countries to address profit shifting. The U.S. Treasury has also met with European and Asian leaders to discuss coordination on tax avoidance at the individual level.[32] Thus, it appears that coordination on corporate tax avoidance is plausible. Given recent and projected budget shortfalls in the U.S. and in Europe, a coordinated effort to align tax revenue collections with the location of real business activity may be mutually beneficial. Any coordinated effort may, however, require renegotiating existing tax treaties.

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[32] U.S. Department of the Treasury, "Deputy Assistant Secretary Corwin to Travel to Europe, Asia, September 17-28 to Discuss FATCA Implementation," press release, http://www.treasury.gov/press-center/media-advisories/Pages/09172012B.aspx.