September 2017

The Consequences of Adopting a Territorial Tax System

More Tax Avoidance, Less Investment in the U.S.

President Trump and Republican leaders in Congress have proposed a "territorial" tax system, which would allow American corporations to pay no U.S. taxes on most profits they book offshore. This would worsen the already substantial problem of corporate tax avoidance and result in more jobs and investment leaving the United States. Lawmakers should know some key facts about the territorial approach:

1) A Territorial Tax System Would Expand Existing Breaks for Offshore Corporate Profits.

Under the federal tax code, corporations already receive substantial breaks on their offshore profits. They can defer paying U.S. taxes on most of their offshore profits indefinitely — unless and until those profits are brought to their U.S. parent company. They are also allowed a tax credit for any taxes they pay to foreign governments. This generous treatment of offshore corporate profits is already causing massive problems in our tax system.

A territorial system would worsen those problems because it would provide an even larger tax break for offshore profits. Whereas our current rules allow corporations to defer U.S. taxes on most offshore profits, a territorial system would exempt most offshore corporate profits from U.S. taxes entirely.

2) A Territorial System Would Increase Use of Offshore Tax Havens.

Corporations would have even greater incentives to engage in accounting gimmicks to make their U.S. profits appear to be earned in offshore tax havens such as Bermuda and the Cayman Islands, where corporate profits are not taxed. In the most recent year on record, American corporations reported to the I.R.S. that their subsidiaries in Bermuda earned $104.3 billion in profits. This is impossible because the entire economic output of Bermuda that year was only $5.5 billion.[1] Clearly our corporations are engaging in offshore tax avoidance on a massive scale. Under a territorial system, most profits designated as foreign earnings would never be taxed at all, providing an even greater reward for this practice.

3) A Territorial System Would Increase Rewards for Corporate Offshoring.

The ability to avoid U.S. taxes entirely on profits from foreign operations, rather than simply deferring taxes on those profits, would provide a strong incentive to locate real investment overseas rather than in the U.S. Less investment in the United States would put downward pressure on American workers' wages.

4) A Territorial System Would Raise Less Revenue Needed for Public Investments that Create Jobs in the U.S.

The economist Kimberly Clausing estimates that the cost of offshore tax dodging by U.S. corporations likely exceeds $100 billion a year.[2] If corporations engage in accounting gimmicks to obtain the benefit of deferral under our current tax system, they will do so even more to obtain the more generous break offered by a territorial system. This would drive the cost of offshore corporate tax avoidance even higher.

5) A Territorial System Would Disadvantage Small Businesses and Other Domestic Companies.

By increasing incentives for global corporations to shift profits and investment offshore and use tax-avoidance strategies, a territorial system would increase their competitive advantage over small business and domestic companies that create jobs and profits in America. Unlike multinational corporations, small domestic businesses cannot shift profits offshore using high-priced lawyers and accountants.

6) Attempts to Fix the Territorial Approach Have Failed.

Policy makers in the U.S. have tried but failed for decades to prevent offshore tax avoidance under our current system. It is difficult to understand how they could succeed under a territorial system, which would provide even greater rewards for using accounting gimmicks to make profits appear to be earned abroad.

Meanwhile, other countries with territorial tax systems have suffered tremendous tax avoidance, prompting the Organization for Economic Co-operation and Development (OECD) to spend years on a list of suggestions to make complex rules to keep these territorial systems from collapsing altogether. While these rules are unlikely to fully address the problems with territorial systems, even their weak remedies were opposed by Rep. Paul Ryan, then-chairman of the House Ways and Means Committee, and Sen. Orrin Hatch, chairman of the Senate Finance Committee.[3]

7) A Territorial System Would Make Our Tax Code More Complex

Adopting a territorial approach would make our tax system far more complicated than it already is. The transfer pricing rules, which attempt to distinguish where profits are earned in a web of related companies spanning the globe, would come under even more pressure as the benefits of shifting profits offshore intensified. Corporate offices would focus even more on gaming the tax rules rather than making productive investments in communities and employees. Congress could adopt the rules recommended by the OECD to prevent tax-dodging, but those rules are themselves complex.

8) The Public Opposes the Territorial Approach, and President Trump Used to Agree with Them.

Three-quarters of Americans say they would oppose a tax system that does not tax offshore profits. A June 2017 Hart Research poll found that 32 percent of respondents believe that foreign profits of U.S.-based companies should be taxed at a *higher* rate than their U.S. profits while another 40 percent believe they should be taxed at the same rate. Only 8 percent believe foreign profits should be taxed at a lower rate, and only 4 percent said they should not be taxed at all — which is what a territorial tax system would do.

During his campaign, President Trump sided with the vast majority of the public on this issue. He campaigned on a tax plan that would move in the opposite direction by taxing offshore corporate profits the same way that domestic corporate profits are taxed.[4] The administration's recent territorial proposal is a reversal for the president.

For more information, see ITEP's longer report on adopting a territorial tax system.

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[1] Citizens for Tax Justice, "American Corporations Tell I.R.S. Majority of Their Offshore Profits Are in 10 Tax Havens," April 7, 2016. http://ctj.org/ctjreports/2016/04/american_corporations_tell_I.R.S._the_majority_of_their_offshore_profits_are_in_10_tax_havens.php

[2] Clausing, Kimberly A. "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *National Tax Journal*. December. 69(4). 905-934.

[3] House Ways and Means Committee, press release, "Ryan Responds to OECD BEPS Proposal," October 25, 2015. https://waysandmeans.house.gov/ryan-responds-to-oecd-beps-proposal/

[4] The Donald Trump presidential campaign, "Tax Reform that Will Make America Great Again." https://assets.donaldjtrump.com/trump-tax-reform.pdf