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Financial Accountability & Corporate Transparency

FACT Sheet

Questions & Answers about Territorial Corporate Tax Systems

A central theme of corporate tax reform is how to create a system that works in a global economy.

Several proposals have called for a territorial corporate tax system — a system in which a company only pays taxes on what it claims as profits in a given country rather than looking at the companies' global footprint.

Below are questions and answers about territorial tax systems as outlined in recent reform proposals.

Question: Shouldn't U.S. companies only pay taxes on U.S. profits?

Answer: U.S. companies should pay taxes like you and me. We are U.S. citizens so we pay taxes on what we earn, regardless of where we earn it. But companies are not people with a single residence. They can divide themselves into multiple entities and house profits in foreign subsidiaries. They can also locate shell companies in tax havens and avoid taxes through accounting gimmicks. The proposals tend not to specify what loopholes they will close to account for the fact that large companies will move revenues around the globe to avoid booking any profits to the U.S. company. If the goal of territorial proponents is to zero out the tax liability of multinational companies, then let's have that debate. Territorial proposals can be a backdoor way to get there.

Question: Why should we tax companies' foreign profits?

Answer: These are U.S. companies that we are talking about. They recruit from U.S. colleges and universities, benefit from U.S. laws, our stable economy, and are protected by our military. The shell companies they create are more of a legal fiction than a 'foreign citizen.'

We should (as we currently do) give a credit for any taxes paid to foreign governments so that we avoid double taxation, but no U.S. individual or company should benefit from the rights and privileges of being American without also assuming responsibilities. A territorial system allows companies the former without the latter and is, therefore, an invitation to rampant tax avoidance.

Question: Many developed countries have a territorial tax system. Won't this will help us be more competitive?

Answer: No. It will likely make matters worse. Our current hybrid system allows U.S. companies to house profits overseas untaxed. If they are brought back into the U.S., then they are taxable. That has likely kept some companies from moving all their profits offshore. Eliminating this last hurdle in a territorial system would remove any and all barriers to profit shifting. In fact, one reason world leaders are cracking down on profit shifting is because of the mass tax avoidance taking place under territorial tax systems. If we move toward a territorial system, the only companies left paying U.S. corporate income taxes would be those too small to game the system.

Question: Even if there is some moving of money or "profit-shifting", it can't be that much, and isn't the alternative a lot of double taxation?

Answer: It is an enormous amount of money. U.S. companies currently hold roughly $2.5 trillion in offshore accounts, robbing taxpayers of an estimated $718 billion. In 2010, GE alone claimed a U.S. profit of $4 billion but received a refund of $3.2 billion largely based on the company's ability to shift profits to offshore subsidiaries. And Apple had established an offshore subsidiary that reported receiving profits totaling $30 billion over four years, but paid no corporate income taxes on those profits to any national government anywhere in the world.

The myth of double taxation should not drive us to a policy of non-taxation.

Question: How do they actually move the money?

Answer: There are a number of ways:

- The most popular is manipulation of transfer prices between U.S. and foreign subsidiaries. Transfer prices are what units of the same company charge one another for what each does.
- Practice of earnings stripping, which is when a company reduces its taxable income by paying excessive amounts of interest to a foreign subsidiary.
- Offshoring of intellectual property. This is when a U.S. company sells the rights to its U.S. patents and other intellectual property to a subsidiary in a low-tax country, for a very low price. The U.S. company then pays its foreign subsidiary excessive amounts to use its own intellectual property.

Question: Under a territorial system, if we don't tax 'foreign' profits, then won't companies bring some of that offshore money back to the U.S and invest it here?

Answer: First, let's remember that these are not really profits of foreign companies but profits of U.S. companies categorized as foreign through accounting gimmicks. Second, most of the money is in the U.S. already. Companies don't want their money invested in other currencies or in financially less stable economies. The subsidiaries often buy U.S. treasuries or U.S real estate or other U.S. assets so it is safe and secure. There is no economic windfall for our economy to "bring this money back" because it is largely already here.

Question: Companies can have subsidiaries but they have to be headquartered somewhere, right? Won't a territorial system catch companies where they live?

Answer: No. Apple's headquarters are in California with a significant subsidiary incorporated in Ireland. The line on a form declaring their residence is blank because the criteria for corporate residence in the U.S. is where a company is incorporated (that's in Ireland) but for the Irish it's where one's management is located (that's in the U.S.). Apple is, legally speaking, a company without a country. A territorial system would not catch these kinds of avoidance schemes.

Question: So what should we do?

Answer: Congress should immediately pass S. 922, the Corporate Tax Dodging Prevention Act to end the deferral of taxes paid by U.S. companies on revenues of their 'foreign' subsidiaries. In addition, Congress should pass the Stop Tax Haven Abuse Act (H.R. 297/S. 174) to close other loopholes that allow for unjustified tax avoidance. These bills would close loopholes and create clear definitions so that multinational corporations will no longer be able to play by their own set of tax rules.

Territorial tax systems are an invitation to even greater tax avoidance. The purpose of corporate tax reform should be to increase integrity and fairness. Territorial systems take us in the wrong direction.

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