Issue Brief: Offshore Tax Haven Abuse

Corporations' international tax avoidance costs Mainers millions of dollars at home

by Sarah Austin, Policy Analyst | February 5, 2020

Corporations depend on things like an educated workforce, consumers with enough income to pay for services and products, and infrastructure that facilitates commerce. As a state and a nation, we fund the investments that help businesses succeed and create a strong economy that allows them to profit.

In return, corporations are supposed to pay taxes — just like families do — to help sustain and improve strong economic conditions for future generations.

But every year, large US-based companies such as Apple, Pfizer, Exxon Mobil, Google, and others use a complex system of international accounting loopholes to move their domestic profits in foreign countries with lower tax rates.[1] Instead of contributing what they should at home, these corporations exploit "offshore tax havens" to pay lower or no taxes abroad on profits generated in the US — including here in Maine.

While companies such as Microsoft have undergone extensive investigation of questionable tax avoidance practices by the IRS, many instances of tax haven abuse are totally legal, or at least difficult to enforce under existing laws.[2]

These tax avoidance schemes reduce the resources available to fund investments that create economic opportunity and prosperity for the future. This is a $100 billion dollar problem at the federal level, but Maine pays a price too: **Offshore tax haven abuse costs Maine up to $52 million annually.[3]**

Companies exploit offshore tax havens to avoid paying their fair share

Massive corporations can afford to pay the army of lawyers and accountants necessary to establish the various offshore shell companies and financial gimmicks needed to exploit the offshore tax haven loophole.

The money spent establishing this infrastructure pales in comparison to the billions of dollars in US taxes they avoid by shifting their profits offshore. In 2016, Fortune 500 companies held a total of $2.6 trillion in offshore profits.[4] A 2008 US Senate Subcommittee report estimated that the US loses roughly $100

What is an offshore tax haven?

Offshore tax havens generally have three qualities, and many companies will use global accounting schemes to maximize the benefits of each feature.

- **Low or no tax on corporate profit.** Some offshore tax havens may have reasonable corporate tax rates on paper but allow certain kinds of investment income or income from intellectual property, such as patents for things like drugs or software, to be exempt from tax.
- **Financial secrecy and lack of transparency.** Countries such as Switzerland allow high levels of financial secrecy and non-disclosure and are uncooperative in handing information over to foreign taxing entities investigating the use of offshore accounts to avoid taxes.
- **Lax rules that allow businesses to register without requiring any actual business activity.** For example, the Cayman Islands and Luxembourg allow US corporations to register shell companies without any scrutiny of whether the companies are legitimately doing business in the jurisdiction.

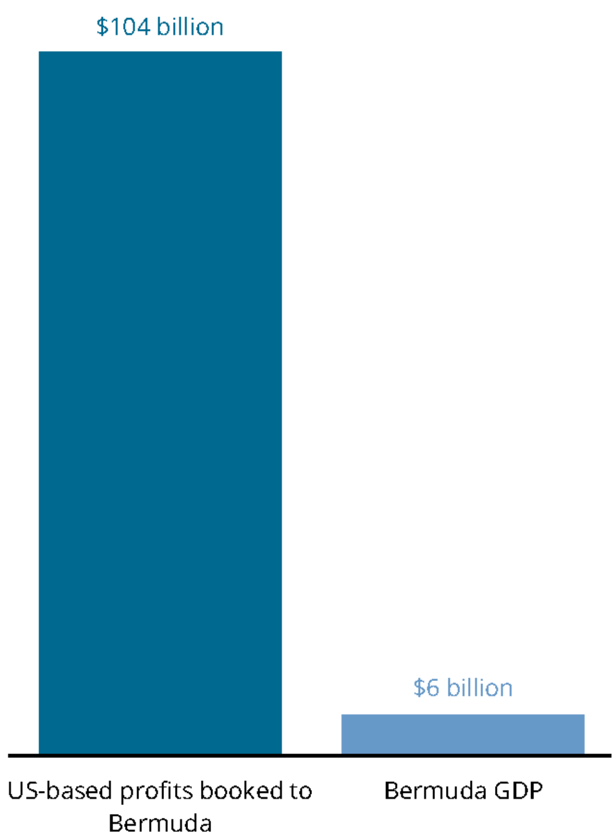
billion in tax revenues a year due to offshore tax haven abuse.[5]

One telling sign of this abuse of international finance is the disparity between the US profits booked to shell corporations in offshore tax havens and the GDP of those countries.

For example, US-based multinational companies reported in IRS filings that $104 billion in their combined profits were generated in tax haven Bermuda in 2012, despite the GDP of the country being only $6 billion that year.[6] This disparity shows clearly that these profits were not generated from substantial business activity in Bermuda, and instead were the result of offshore tax haven abuse.

Supporters of the 2017 Tax Cuts and Jobs Act claimed that provisions of the sweeping federal tax cut would discourage corporations from shifting profits into offshore tax havens.[7] However, evidence shows that the vast majority of tax haven abuse remains intact even after the law took effect.[8]

Chart 1: US corporations book profits in Bermuda worth 17 times national GDP



Note: Figures from 2012 IRS and World Bank data.

Source: Citizens for Tax Justice, 2016.

What is a shell company?

A shell company is a registered corporation, but only on paper. These companies often have no physical footprint or employees, but they do have financial ties to their parent company. US-based corporations establish subsidiary shell companies in low-tax countries to facilitate offshore tax haven abuse.

How companies shift profits into offshore tax havens

Offshore shell companies registered to tax haven countries are used to strip profits from US companies and subsidiaries to lower their US taxes. The following are two examples of how companies move profits into tax haven countries.

- **A US-based corporation can "sell" goods at no cost or even a loss to their own shell company registered in a tax haven.** These phantom "sales" are often on paper only. It's possible for those goods to sit in a US warehouse without ever moving to the tax haven. When the goods are eventually sold to customers at market price, the profits are booked to the tax haven shell company — leaving the US-based corporation with little or no tax liability.

- **US-based corporations use a similar scheme on intangible goods, such as royalties, drug and technology patents, food and product brand licensing, and more**. US corporations can use shell corporations in tax havens to register their own intangible properties. Then, the shell corporation charges the parent company a high price for royalties and licensing.

  For example: Imagine "American Shoe" is a corporation in the United States, but registers its brand trademark with "Shoes International," a shell corporation it established in the Cayman Islands, an offshore tax haven. When American Shoe sells a pair of shoes for $100 to a customer in Maine, it *"pays" Shoes International a $90 licensing fee for the right to use the American Shoe logo and trademark. As a result, most of the profit on that Maine sale is booked in the tax haven — even though the sale happened in the United States.*

These are just two ways that corporations exploit the complexity of the global economy with accounting schemes designed to avoid paying the taxes they should. But there are many others. The ways companies book debt, for example, can also reduce US taxes.

Offshore tax haven abuse affects Maine taxes too

When businesses artificially lower their US-based profits with offshore tax havens, Mainers also pay a price.

Companies that do business nationally pay income taxes in Maine based on the percentage of US sales generated within the state's boundaries. For example, if 3 percent of a corporation's nationwide sales took place in Maine, that corporation would owe Maine income taxes on 3 percent of its total nationwide profits. That's why even though a company such as Amazon is headquartered in Washington state, it still owes taxes to Maine.

As a result, offshore tax haven abuse affects Maine taxes too: If a company successfully uses offshore tax havens to erase or substantially lower the profits booked in the United States, Maine's share of that taxable profit is also reduced or eliminated. Offshore tax haven abuse is estimated to cost Maine up to $52 million annually.[9]

Maine can ensure corporations pay what they should in taxes

State policymakers can act now to make sure big corporations are paying their fair share.

Here are the two most effective approaches Maine lawmakers could take to stop corporations from avoiding Maine income taxes with offshore tax havens:

- **Treat foreign profits the same way Maine treats profits generated in other states:** Maine's already effective system of levying state income taxes on corporations could be expanded through a system of "worldwide combined reporting." Rather than determining a business's taxes based on the percentage of US-based sales generated in the state, policymakers could require businesses to pay taxes based on the share of global sales that took place in Maine. This would prevent companies from being able to move profits out of reach of Maine's tax code while still only assessing taxes based on the share of business happening in Maine. [10] A 2019 report from the Institute on Taxation and Economic Policy, or ITEP, estimates adopting worldwide combined reporting in Maine could raise $52 million a year. [11]

- **Specifically target profits in known tax havens:** While it would be a less comprehensive approach than worldwide combined reporting, the Maine Legislature could require corporations to include at least the profits booked in the most notorious tax havens in their Maine state income tax filings. Businesses would then pay taxes on their US and tax haven profits as a share of sales that happened in Maine. ITEP estimates that Maine could raise revenues between $8 million and $19 million annually depending on the countries included as tax havens under this approach.[12]

Action is needed at the federal level to fully rein in the use of offshore tax havens by multinational corporations based in the United States. However, Maine doesn't need to wait. These relatively straightforward policy solutions would help ensure corporations making profit off Mainers are paying their fair share for the investments Maine makes in its economy.

About MECEP

The Maine Center for Economic Policy is a nonprofit research and policy organization dedicated to economic justice and shared prosperity by improving the well-being of low- and moderate-income Mainers. Since its founding in 1994, MECEP has provided policymakers, advocates, media organizations, and the public with credible, rigorous research and analysis. MECEP is an independent, nonpartisan organization.

About the author

Sarah Austin is MECEP's lead policy analyst on tax and budget. She holds a master's degree in public affairs from the University of Wisconsin-Madison's La Follette School of Public Affairs and a bachelor's degree in environmental policy from Unity College. In addition to her role at MECEP, Sarah serves on the state's Consensus Economic Forecasting Commission.

Endnotes

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9 Phillips and Proctor, 2019.

10 This method of taxing businesses has been upheld by the US Supreme Court in 1983 in the case of Container Corp. v. Franchise Tax Board (CA), and in 1994 in the cases of Barclays Bank v. Franchise Tax Board (CA) and Colgate-Palmolive v. Franchise Tax Board (CA).

11 Phillips and Proctor, 2019.

12 Ibid.