CFC LOOK-THROUGH RULE ENABLES PROFIT SHIFTING TO OFFSHORE TAX HAVENS

An obscure-sounding tax provision—the “CFC Look-Through Rule”—has allowed U.S. multinational corporations to dodge billions of dollars in federal taxes over the past decade by shifting profits to offshore tax havens. Originally enacted as a “temporary” three-year measure in 2006, the CFC Look-Through Rule has been renewed multiple times since then. It is part of a package of “tax extenders” corporate interests are lobbying hard to renew. It expired in 2014, but along with all tax extenders, it is up for renewal.

The House Ways and Means Committee proposes to make this tax break permanent. Its 10-year cost is $22 billion, according to the Joint Committee on Taxation. The Look-Through Rule undermines 50 years of corporate tax policy intended to discourage corporations from engaging in offshore “profit laundering”: the use of internal financial transfers to shift profits from higher-tax jurisdictions to lower-tax ones.

WHAT’S A CFC AND HOW IS THE SYSTEM SUPPOSED TO WORK?
CFC’s are “controlled foreign corporations”: offshore subsidiaries of a U.S. corporation. For the IRS, a “look-through entity” is a business—like a partnership—that doesn’t pay income taxes itself, but in which profits and the resulting tax liability flow through to the ultimate owners.

The CFC Look-Through Rule allows a U.S. corporation to shift profits among its overseas subsidiaries without triggering the tax bill that would normally be due.

American corporations owe U.S. taxes on all their profits, wherever earned in the world, less a credit for any foreign taxes paid. But a big loophole called “deferral” allows companies to avoid taxes on their offshore earnings until they bring the money home. As a result, U.S. companies have indefinitely stockpiled over $2 trillion offshore. However, since certain kinds of income—like interest, dividends, rents and royalties—can be easily manipulated to disguise their actual origin, such “passive” income is not eligible for deferral: taxes are due immediately, regardless of the income’s supposed country of origin. Such income is called “Subpart F income” after the section of the tax code designed to prevent its tax-avoidance abuse.

THE LOOK-THROUGH RULE: PROTECTING AN INTERNATIONAL SHELL GAME
The CFC Look-Through Rule allows companies to dodge taxes on Subpart F income by removing their obligation to report the transactions that create it. Here’s how it works: An American corporation sets up offshore Subsidiary A, which conducts real business selling goods and services in a well-populated, economically developed foreign nation with commensurately realistic tax rates. Meanwhile, in a foreign tax haven with low or no corporate taxes, it...
establishes Subsidiary B, which often consists of no more than a post office box. The parent corporation grants ownership of important assets like brands and patents to Subsidiary B, which in turn “licenses” them to Subsidiary A at steep prices. These internal royalty payments artificially inflate Subsidiary A’s costs and therefore reduce its profits and tax liability and ultimately that of its parent corporation.

Because Subsidiary B is making all its profits from easily manipulated income, U.S. taxes would normally kick in under Subpart F, which was created precisely to foil these kinds of accounting tricks. But the CFC Look-Through Rule prevents Subchapter F from doing its job by making the tax-avoiding transactions disappear.

American corporations have used the CFC Look-Through Rule (or its close cousin, the “check-the-box” regulation) to avoid billions of dollars in U.S. taxes. Apple used its Irish subsidiaries to avoid all U.S. taxes on $44 billion in offshore profits made between 2009 and 2012, according to a Senate committee.11

LOOKING BAD: THE LOOK-THROUGH RULE SHOULD BE RULED OUT
The CFC Look-Through Rule so clearly contradicts the purported American tax policy of preventing offshore tax avoidance that even a prominent Wall Street tax lawyer wonders why it’s on the books.12 U.S. tax law should encourage American corporations to invest and create jobs at home, not to hide profits and ship jobs offshore. With budgets tight, we need corporate tax revenue to help working families get by and get ahead by investing in transportation, education, health care and more. It’s time to rule out the CFC Look-Through Rule.

ENDNOTES

7 PSI, p. 7.
9 PSI, p. 12.
11 PSI, p. 32.

1825 K Street NW • Suite 400 • Washington, D.C. 20006 • 202-350-0144
www.AmericansForTaxFairness.org • @4TaxFairness • www.Facebook.com/Americans4TaxFairness