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With more than two trillion dollars in foreign profits being held abroad by U.S.-based multinationals, reform of international taxation has achieved a new priority in the national political agenda. And prominent in the discussion are ideas to change the way the federal government taxes foreign earnings of these companies.

Proposals have been advanced to move from the current system, which subjects U.S. companies' foreign profits to a steep federal levy when they are brought home (and thereby motivates multinationals to keep those earnings abroad) to a territorial

Now, in the first analysis to directly estimate companies' inbound and outbound cross-border transfers, a paper in the current issue of an **American Accounting Association** journal ***The Accounting Review*** suggests that a territorial system may very well lead to income-shifting abroad by hundreds of firms that now are financially constrained from doing so. But, at a time of federal budgets in the trillions, the loss in taxes is likely to be comparatively modest. While the authors caution that their study by no means includes all U.S. multinationals, it takes in a hefty sample.

Scott D. Dyreng of Duke University and Kevin S. Markle of the University of Iowa analyze the effect of financial constraints (that is, lack of readily available cash to meet domestic expenses) on income-shifting by 2,058 U.S.-based multinationals over the 14-year period 1998 through 2011. The professors estimate that, had a territorial system been in effect over that time instead of the so-called worldwide system that was enforced, the financially constrained firms in the sample would have shifted about $80 billion more of their income out of the country, which would have increased by about eight percent the amount the whole sample shifted. Assuming that the financially constrained firms paid the statutory corporate rate of 35% on that non-shifted income (which is more than the effective rate many companies actually pay), the loss to the federal treasury would have totaled $28 billion over the 14 years.

The findings reflect the fact that companies with ready access to funds to meet their expenses at home have reaped benefits from shifting income to low-tax countries that financially constrained firms have not been able to enjoy. Why? Because firms in the former group, not needing to tap foreign profits to meet company expenses, are free to leave that money abroad and defer the federal taxes they would have to pay by bringing the income home. In other words, they are free to take advantage of the fact that the U.S. tax code permits companies to defer taxes on foreign earnings as long as that money remains abroad. This tactic, by Microsoft, Apple, Yahoo, Google and

To gauge the effect of implementing such a system, then, the professors compare the difference in income-shifting over 14 years of the two groups – well-heeled firms unlikely to tap foreign earning for domestic expenses and financially constrained companies likely to do so. They employ three measures used in the scholarly literature as indicative of financial constraint – 1) a junk rating below BBB from Standard and Poors on company bonds; 2) a measure based on a firm’s size and age, with lower amounts associated with less access to cash; and 3) whether or not a firm pays dividends. About half the sample turned out to be financially constrained by the first and third measures and about one third by the second.

Firms with junk ratings (which, Dyreng and Markle write, “recent research suggests [to be] the most reliable measure of financial constraints”) were found to shift 19.5% less of their income abroad than relatively unconstrained companies over the 14 years studied. The professors add: “Assuming that the inability to defer repatriation [of foreign profits] is the primary factor preventing the U.S. worldwide tax system from being a de facto territorial system, we use our findings to estimate that adopting a territorial tax system could increase outbound income-shifting by about 8%.”

At the same time, they caution that their estimate “ignores unanticipated behavioral responses by firms and actions taken by governments that would certainly arise with a change in the tax system.” For example, legislators have proposed that initiation of a territorial system be accompanied by a reduction in the U.S. statutory corporate tax rate, which at 35% considerably exceeds the world average of 22.5%. Such a change, of course, could mitigate increases in outbound shifting of corporate income that the new research suggests a territorial system would occasion.

The new study, entitled “The Effect of Financial Constraints on Income-Shifting by U.S. Multinationals,” is in the November issue of ***The Accounting Review***, published every other month by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice.

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