

June 2004

# INTERNATIONAL TAXATION

## Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-04-856](#), a report to the Chairman, Committee on Governmental Affairs, U.S. Senate

## Why GAO Did This Study

The federal government was involved in about 8.6 million contract actions, including new contract awards, worth over \$250 billion in fiscal year 2002. Some of these contracts were awarded to tax haven contractors, that is, U.S. subsidiaries of corporate parents located in tax haven countries. Concerns have been raised that these contractors may have an unfair cost advantage when competing for federal contracts because they are better able to lower their U.S. tax liability by shifting income to the tax haven parent.

GAO's objectives in this study were to (1) determine the conditions under which companies with tax haven parents have a tax cost advantage when competing for federal contracts and (2) estimate the number of companies that could have such an advantage. GAO matched federal contractor data with tax and location data for all large corporations, those with at least \$10 million in assets, in 2000 and 2001, in order to identify those companies that could have an advantage.

## INTERNATIONAL TAXATION

# Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting

## What GAO Found

There are conditions under which a tax haven contractor may have a tax cost advantage (lower tax on additional income from a contract) when competing for a federal contract. The extent of the advantage depends on the relative tax liabilities of the tax haven contractor and its competitors. One way for a contractor to gain a tax cost advantage is by reducing its U.S. taxable income from other sources to less than zero and by using its losses to offset some or all of the additional income from a contract, resulting in less tax on the contract income. A company would thereby gain an advantage relative to those competitors with positive income from other sources and may be able to offer a lower price or cost for the contract. While some domestic corporations may also have a tax cost advantage, tax haven contractors may be better able to reduce U.S. taxable income to less than zero because of opportunities to shift income to their tax haven parents. Whether a contractor has a tax cost advantage in competing for a particular contract depends on the tax liabilities of other competitors. Also, the contractors with a tax cost advantage are not necessarily the successful competitors because the tax cost savings may not be reflected in actual prices, and prices may be only one of several factors involved in awarding contracts.

Using tax liability as an indicator of ability to offset contract income, GAO found that large tax haven contractors in both 2000 and 2001 were more likely to have a tax cost advantage than large domestic contractors. In 2000, 56 percent of the 39 large tax haven contractors reported no tax liability, while 34 percent of the 3,253 large domestic contractors reported no tax liability. In 2001, 66 percent of large tax haven contractors and 46 percent of large domestic contractors reported no tax liability.

**Tax Status of Large Tax Haven and Domestic Contractors in 2000 and 2001**

U.S. federal contractors	Contractors with tax liability		Contractors without tax liability	
	Number of companies	Percentage of companies	Number of companies	Percentage of companies
<b>2000</b>				
Tax haven	17	44	22	56
Domestic	2,132	66	1,121	34
<b>2001</b>				
Tax haven	17	34	33	66
Domestic	1,888	54	1,636	46

Source: GAO analysis of IRS data.

[www.gao.gov/cgi-bin/getrpt?GAO-04-856](http://www.gao.gov/cgi-bin/getrpt?GAO-04-856).

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

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**Abbreviations**

FPDS	Federal Procurement Data System
GSA	General Services Administration
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
OECD	Organisation for Economic Co-operation and Development
SOI	Statistics of Income

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United States General Accounting Office  
Washington, D.C. 20548

June 30, 2004

The Honorable Susan M. Collins  
Chairman  
Committee on Governmental Affairs  
United States Senate

Dear Chairman Collins:

The federal government was involved in about 8.6 million contract actions, including new contract awards, worth over \$250 billion in fiscal year 2002. Some of the companies that were awarded these contracts were U.S. subsidiaries of corporate parents located in tax haven countries.<sup>1</sup> In this report, we will refer to such contractors as “tax haven contractors.” We reported in October 2002 that four of the top 100 federal contractors that were publicly traded corporations in fiscal year 2001 were tax haven contractors and that three of these were originally U.S.-headquartered corporations that had reincorporated in tax haven countries through corporate inversions.<sup>2</sup>

Because tax haven contractors may have opportunities to shift income between the U.S. subsidiary and the corporate parent in ways that reduce U.S. tax, you have raised concerns that tax haven contractors may have an unfair cost advantage over U.S.-headquartered contractors when competing for federal contracts. Because of the concerns, you asked us to determine the extent, if any, to which tax haven contractors have an advantage when competing for federal contracts.

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<sup>1</sup> In such cases, the U.S. subsidiary is a U.S. corporation, incorporated in the United States, but is owned by a parent company incorporated in a tax haven country. The term tax haven is used by the Organisation for Economic Co-operation and Development (OECD) to refer to a country that has no or nominal taxes on corporate income and also meets other criteria related to the transparency of its legal and accounting systems and to its openness to the exchange of tax information with other countries.

<sup>2</sup> See U.S. General Accounting Office, *Information on Federal Contractors That Are Incorporated Offshore*, GAO-03-194R (Washington, D.C.: Oct. 1, 2002). An inverted company is a U.S. subsidiary of a foreign parent where ownership of the U.S. subsidiary had been transferred to the foreign parent. The term “inversion” is used to describe a broad category of transactions through which a U.S.-based multinational company restructures its corporate group so that after the transaction the ultimate parent of the corporate group is a foreign corporation. See U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications* (Washington, D.C.: May 17, 2002).

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After reviewing the relevant literature, determining what data were available, and meeting with your staff, we decided to (1) determine the conditions under which corporations with parents in tax havens have a tax cost advantage when competing for federal contracts and (2) to the extent possible, estimate the number of companies that have characteristics consistent with having such an advantage. We did not try to determine the size of any tax cost advantage or whether the tax cost advantage had an effect on the competition for specific contracts.

To address our objectives, we collected and analyzed information on government contracting practices and business decision-making processes. Using this information, we built a simple qualitative model to explain the conditions under which a corporation may gain a tax cost advantage in competing for federal contracts over other competitors whose headquarters are not located in tax haven countries. We matched contractor data from the General Services Administration's (GSA) Federal Procurement Data System (FPDS) to tax and location data of corporations from the Internal Revenue Service's (IRS) Statistics of Income (SOI) division to estimate the number of companies with characteristics that the qualitative model identifies as consistent with a tax advantage. For our analysis of contractors in 2000, we selected the 3,924 corporations that appeared in both FPDS and SOI in that year that had total assets of at least \$10 million. For our 2001 analysis, we selected the 4,264 corporations in both databases that had total assets of at least \$10 million. In this report, we refer to corporations with at least \$10 million in assets as large corporations.<sup>3</sup> The SOI sample includes the universe of such large corporations in 2000 and 2001. Because it is the universe, there is no sampling error for the information that we report about these corporations.

Some companies may have reasons to locate in tax haven countries that are unrelated to tax advantages. For example, some companies may locate their operations in tax haven countries because of business conditions in the tax haven related to costs and profitability. Location in a tax haven country does not by itself establish that a company has adopted a tax-minimizing strategy.

We requested comments on this draft from the Commissioner of Internal Revenue and the Secretary of the Treasury. We conducted our review from

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<sup>3</sup> The designation large corporation, as used in this report, is not related to the business size standards used in determining small business status for federal government contracts.

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July 2003 through June 2004 in accordance with generally accepted government auditing standards.

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## Results in Brief

There are conditions under which contractors, including tax haven contractors, may have a tax cost advantage when competing for contracts, including federal government contracts. The extent of the tax cost advantage depends on the relative tax liabilities of a contractor and its competitors. The tax cost of the contract is the tax liability on the additional income derived from the contract. One way for a contractor to gain a tax advantage is by reducing its U.S. taxable income from other sources to less than zero and by using its losses to offset some or all of the additional income from a contract, resulting in less tax on this income. A company would thereby gain an advantage relative to companies with positive income from other sources and may be able to offer a lower price or cost for the contract. While some domestic corporations may also have a tax cost advantage, tax haven contractors may be more likely to have such an advantage because of opportunities to shift income to their tax haven parents. Whether a contractor has a tax cost advantage in competing for a particular contract depends on the tax liabilities of other competitors. Also, the contractors with a tax cost advantage are not necessarily the successful competitors because the tax cost savings may not be reflected in actual prices, and prices may be only one of several factors involved in awarding contracts.

Using tax liability as an indicator of ability to offset income from the contract, we determined that in both 2000 and 2001, large tax haven contractors were more likely to have a tax cost advantage than large domestic contractors. In 2000, 56 percent of the 39 tax haven contractors reported no tax liability, while 34 percent of the 3,253 domestic contractors reported no tax liability. In 2001, 66 percent of tax haven contractors and 46 percent of domestic contractors reported no tax liability. While in 2000 and 2001 tax haven contractors were more likely to have zero tax liability, companies may have low or zero tax liabilities for a variety of reasons, such as overall business conditions, industry or company-specific performance issues, or the use of income shifting.

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## Background

Corporations can be located in tax haven countries through a variety of means, including corporate inversions, acquisition, or initial incorporation abroad. Location in a tax haven country can change a company's tax

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liability because the United States taxes domestic corporations differently than it taxes foreign corporations.

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## U.S. Tax Treatment of a Domestic Corporation

The United States taxes the worldwide income of domestic corporations, regardless of where the income is earned; gives credits for foreign income taxes paid; and defers taxation of foreign subsidiaries until their profits are repatriated in the form of dividends or other income. However, a U.S. parent corporation is subject to current U.S. tax on certain income earned by a foreign subsidiary, without regard to whether such income is distributed to the U.S. corporation.

Through “deferral,” U.S. parent corporations are allowed to postpone current taxation on the net income or economic gain accrued by their subsidiaries. These subsidiaries are separately incorporated foreign subsidiaries of U.S. corporations. Because they are not considered U.S. residents, their profits are not taxable as long as the earnings are retained and reinvested outside the United States in active lines of business. That is, U.S. tax on such income is generally deferred until the income is repatriated to the U.S. parent.

The U.S. system also contains certain anti-deferral features that tax on a current basis certain categories of passive income earned by a domestic corporation’s foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. Passive income includes royalties, interest and dividends. According to the Internal Revenue Code (I.R.C.), passive income is “deemed distributed” to the U.S. parent corporation and thus denied deferral. The rules defining the application and limits of this antideferral regime are known as the Subpart F rules.

In order to avoid double taxation of income, the United States permits a taxpayer to offset, in whole or in part, the U.S. tax owed on this foreign-source income. Foreign tax credits are applied against a corporation’s U.S. tax liability. The availability of foreign tax credits is limited to the U.S. tax imposed on foreign-source income. To ensure that the credit does not reduce tax on domestic income, the credit cannot exceed the tax liability that would have been due had the income been generated domestically. Firms with credits above that amount in a given year have “excess” foreign tax credits, which can be applied against their foreign source income for the previous 2 years or the subsequent 5 years.



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This system of taxation of U.S. multinational corporations has been the subject of ongoing debate. Specific issues in international taxation include whether to reform the U.S. system by moving from worldwide taxation to a territorial system that exempts foreign-source income from U.S. tax. These issues have become more prominent with the increasing openness of the U.S. economy to trade and investment.

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## U.S. Tax Treatment of a Foreign Corporation

The United States taxes foreign corporations on income generated from their active business operations in the United States. Such income may be generated by a subsidiary operating in the United States or by a branch of the foreign parent corporation. It is generally taxed in the same manner and at the same rates as the income of a U.S. corporation. In addition, if a foreign corporation is engaged in a trade or business in the United States and receives investment income from U.S. sources, it will generally be subject to a withholding tax of 30 percent on interest, dividends, royalties, and certain types of income derived from U.S. sources, subject to certain exceptions. This tax may be reduced or eliminated under an applicable tax treaty.

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## Scope and Methodology

For objective 1, we collected and analyzed information on government contracting practices and business decision-making processes. We also reviewed the economics literature and reports of the Department of the Treasury and the Joint Committee on Taxation to determine how differences in the tax treatment of corporations can contribute to a tax cost advantage. Using the information we obtained, we built a simple qualitative model to explain the conditions under which a tax haven company may have a tax cost advantage in competing for federal contracts relative to other companies whose headquarters are not located in tax haven countries. For a description of the model, see appendix I.

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For objective 2, we used the qualitative model to identify companies that had characteristics consistent with having a tax cost advantage. We matched contractor data (name and taxpayer identification numbers) from the GSA's FPDS for 2000 and 2001 to tax and location data from the IRS's SOI corporation file. In this matched database, we analyzed information about large corporations, those with at least \$10 million in assets.<sup>4</sup> We identified the large corporations with characteristics consistent with a tax cost advantage compared to other large corporations and counted the number of these advantaged and disadvantaged corporations. We divided the SOI data into categories that differentiated between federal contractors (domestically owned and foreign owned) and noncontractors (domestically owned and foreign owned). We further divided the foreign-owned corporation data by those headquartered in tax haven countries from those not headquartered in tax haven countries.<sup>5</sup>

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## Data Limitations and Reliability

SOI is a data set widely used for research purposes. SOI corporation files are representative samples of the population of all corporations that filed tax returns. Generally, SOI data can be used to project tax return information to the universe of all filers. However, the total corporations that matched in both the SOI and FPDS databases could not be used to project the results of our analysis to the universe of all corporations. Because SOI's sampling rate for smaller corporations is very low, our matched database contained very few smaller corporations and would not lead to reliable estimates of the properties of the universe of smaller corporations. Therefore, the results of our analysis cannot be projected to the universe of all corporate filers. However, our results do represent the universe of large tax haven contractors. SOI samples corporations with at least \$10 million in assets at a 100 percent rate so that the SOI sample

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<sup>4</sup> We did not include in our analysis corporations that were real estate investment trusts, regulated investment companies, or subchapter S corporations because these pass-through entities are treated differently for tax purposes than ordinary corporations.

<sup>5</sup> As of December 2003, OECD had identified 39 countries or jurisdictions that they consider to be tax havens. In this report, we refer to these countries and jurisdictions as tax haven countries. They are Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, The Principality of Liechtenstein, Malta, The Republic of the Marshall Islands, Mauritius, The Principality of Monaco, Montserrat, The Republic of Nauru, Netherlands Antilles, Niue, Panama, St. Christopher (St. Kitts) and Nevis, St. Lucia, St. Vincent and the Grenadines, Samoa, San Marino, Seychelles, Turks & Caicos, U.S. Virgin Islands, and Vanuatu.

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includes the universe of these larger corporations. For this reason, we report the results of our analysis without sampling error.

IRS performs a number of quality control steps to verify the internal consistency of SOI sample data. For example, it performs computerized tests to verify the relationships between values on the returns selected as part of the SOI sample and manually edits data items to correct for problems, such as missing items. We conducted several reliability tests to ensure that the data excerpts we used for this report were complete and accurate. For example, we electronically tested the data and used published data as a comparison to ensure that the data set was complete. To ensure accuracy, we reviewed related documentation and electronically tested for obvious errors. We concluded that the data were sufficiently reliable for the purposes of this report.

We have previously reported that there are limitations to the accuracy of the data in FPDS.<sup>6</sup> The data accuracy issues we reported on involved contract amounts and classification of contract characteristics. For this report, the only FPDS data we used were the contractors' names and taxpayer identification numbers. Our previous report did not address the accuracy of these data elements. Therefore, our match of the FPDS and SOI data may contain some nonsampling error; that is, due to inaccurate identification numbers, we may fail, in some cases, to correctly identify large corporations in SOI that were also federal contractors. However, we expect this nonsampling error to be small, and we concluded that the data were sufficiently reliable for the purposes of this report.

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## There Are Conditions under Which Tax Haven Contractors May Have a Tax Cost Advantage

Contractors, including tax haven contractors, that have a lower marginal tax rate on the income from a contract than other contractors would have a tax cost advantage when competing for a contract. Furthermore, there is some evidence that a tax haven contractor may be able to shift income between the U.S. subsidiary and its tax haven parent in order to reduce U.S. taxable income.

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<sup>6</sup> U.S. General Accounting Office, *Reliability of Federal Procurement Data*, [GAO-04-295R](#) (Washington, D.C.: Dec. 30, 2003).

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## Contractors with Lower Marginal Tax Rates May Have a Tax Cost Advantage

There are conditions under which a contractor could have a tax cost advantage when competing for a contract. The tax cost of the contract is the tax paid on the additional income derived from the contract. A contractor that pays less tax on additional income from a contract gains a tax cost advantage compared to companies that pay higher tax. One way to gain a tax cost advantage is by offsetting income earned on the contract with losses from other activities. The contractors with a tax cost advantage are not necessarily the successful competitors because the tax cost savings may not be reflected in actual bid prices or price proposals, and prices or costs are only one of several factors involved in awarding contracts. This reasoning holds for all contractors, including tax haven contractors, and all contracts, including federal contracts.

The appropriate measure of the tax cost of the contract is the corporation's marginal tax rate. The marginal tax rate is the rate that applies to an increment of income. As such, the marginal tax rate would be the rate that applies to the additional income that would arise from the federal contract. For example, if a contractor in a 34 percent tax bracket earns \$1 million of additional income from the contract, it would owe \$340,000 in additional tax. The 34 percent statutory tax rate is this contractor's marginal rate.

A lower marginal tax rate may confer a tax cost advantage when companies are bidding on contracts because it indicates a higher after-tax rate of return on the contract. All other things being equal, a lower marginal effective tax rate is equivalent to a reduction in cost, that is, a reduction in either the tax rate or cost would produce a higher after-tax return. For example, a contractor with a 30 percent marginal tax rate on a contract producing \$1 million of income pays \$300,000 in taxes and receives \$700,000 in additional after-tax income. On the other hand, a contractor with a 34 percent marginal tax rate on the same contract producing \$1 million of income pays \$340,000 in taxes and receives \$660,000 in additional after-tax income. The \$40,000 difference in after-tax income due to the difference in marginal tax rates is the tax cost advantage. In this example, the contractor with the tax cost advantage can, in theory, underbid the competitor by as much as \$40,000 and earn an after-tax income at least as large as the competitor. In this sense, the competitor with the lower marginal tax rate would have a tax cost advantage over a competitor with a higher marginal tax rate.

A contractor gains a tax cost advantage if it has a lower marginal tax rate compared to other companies that are competing for the contract. However, the available data are not sufficient to measure marginal rates

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accurately. In order to compute marginal rates, detailed information is required about the tax status of the contractors and types of spending by the contractors associated with the contracts.

Although the marginal tax rates are not available, conditions under which the marginal rates may be lower for some companies than others can be inferred from their current taxable income. Specifically, a company that has positive taxable income may be more likely to have a positive tax liability on the incremental income from the contract than companies with zero or negative taxable income. Therefore, a company with zero taxable income may have a lower marginal tax rate relative to companies with positive taxable income.<sup>7</sup> Tax losses in the United States on other activities could absorb incremental income generated from a contract. All other things being equal, a company competing for a federal contract that reported taxable income in the United States would face a higher tax cost than a competitor without taxable income.

While a zero tax liability provides an indicator of a tax cost advantage, it does not necessarily mean that the advantage exists. Whether a contractor with zero tax liability has a tax cost advantage when competing for a particular contract depends on the tax liabilities of the other competitors. The contractor with zero tax liability would have no tax cost advantage if all the other competitors also had no tax liability.

Even if a contractor can be shown to have a tax cost advantage when competing for a federal contract, this advantage does not imply that the contractor's bid or proposal will be successful. A tax cost advantage may not be reflected in the contractor's bid or price proposal, the content of which depends on the business judgment of the contractor. For example, in order to include more profit, a contractor may decide not to use any tax cost advantage to reduce its price. Even if the tax advantage is reflected in the bid or price proposal, other price or cost factors that affect whether the bid or proposal is successful may not be equal across the companies competing for the contract. For example, a bidder may have a tax cost

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<sup>7</sup> Besides depending on taxable income and potential availability of tax losses to offset income, the likelihood of a zero marginal rate also depends on the availability of accumulated tax credits, which can directly offset tax liabilities. We emphasize taxable income here because the availability of tax losses is more directly connected to the income shifting discussed in the next section. Our estimate of the number of contractors with an advantage is based on whether they have positive or zero tax liability, which includes the effects of both loss and credit carryforwards.

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advantage over other bidders, but if its costs of labor and material are higher, its tax cost advantage may be offset by its higher costs for those other elements of its bid. Further, where price or cost is not the only evaluation factor for award of the contract, any tax cost advantage may be offset by the relative importance of other factors such as technical merit, management approach, and past performance. Generally, the contractor's tax cost advantage would become a competitive advantage where other contractors would have to reduce their prices (or costs) and/or improve the nonprice (or noncost) elements of their proposals to offset the tax cost advantage.

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### Tax Haven Contractors May Be Able to Shift Income to Reduce U.S. Taxable Income

Tax haven contractors may be more likely to have lower tax costs than other contractors because they may be able to shift U.S. source income to their tax haven parents, reducing U.S. taxable income. Some, but not all, domestic contractors - those that have overseas affiliates - may also be able to shift income. Any income earned by the U.S. subsidiary from a contract for services performed in the United States would be U.S. taxable income. Such income would be taxed in the United States unless it is shifted outside the United States through such techniques as transfer pricing abuse.

Location in a tax haven country can confer tax advantages that are not related to income shifting and do not give a company an advantage when competing for federal contracts. When a parent locates in a tax haven country, taxes on foreign income can be reduced by eliminating U.S. corporate-level taxation of foreign operations. However, these tax savings are unrelated to the taxes paid on income derived from the contract for services performed in the United States and have no effect on the tax cost of the contract.<sup>8</sup> The tax haven contractor potentially gains an advantage with respect to contract competition because of the increased scope for income shifting to reduce U.S. taxable income below zero.

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<sup>8</sup> For a more detailed description of the potential tax advantages, see app. I.

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A tax haven contractor may be able to shift income outside of the United States by increasing payments to foreign members of the corporate group. The contractor may engage in transfer pricing abuse, whereby related parties price their transactions artificially high or low to shift taxable income out of the United States. For example, the tax haven parent can charge excessive prices for goods and services rendered (for example, \$1000 instead of \$500). This raises the subsidiary's expenses (by \$500), lowers its profits (by \$500), and shifts the income (\$500) to the lower tax jurisdiction outside the United States. Transfer pricing abuse can also occur when the foreign parent charges excessive interest on loans to its U.S. subsidiary.<sup>9</sup> Interest deductions can also be used to shift income outside the United States through a technique called "earnings stripping." Using this technique, the foreign parent loads the U.S. subsidiary with a disproportionate amount of debt, merely by issuing an intercompany note, thereby generating interest payments to the parent and interest deductions against U.S. income for the subsidiary. However, the U.S. subsidiaries would still be subject to the I.R.C. rules that limit the deductibility of interest to 50 percent of adjusted taxable income whenever the U.S. subsidiary's debt-equity ratio exceeds 1.5 to 1.

Determining whether companies shift income to obtain a tax cost advantage is difficult because differences among companies that may indicate shifting can also be explained by other factors affecting costs and profitability. For example, while differences in average tax rates and interest expenses may be consistent with income shifting, they do not prove that such activities are occurring. The differences might be explained by other factors, such as the age of the company.

As table 1 shows, tax haven contractors in 2001 had greater interest expense and lower tax liabilities relative to gross receipts than domestic or all foreign contractors. The greater interest expense associated with lower tax liabilities may indicate that the tax haven contractors have used techniques like earnings stripping to shift taxable income outside the United States. The pattern of tax liabilities and interest expense in 2000 is the same as in 2001 in all respects except one: the ratio of interest expense

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<sup>9</sup> There are various provisions in the I.R.C. designed to limit income shifting. The limits include the requirement (Section 482) that transactions between related parties use arm's length prices, that is, the prices that unrelated parties would or should use for the transactions.

to gross receipts for tax haven noncontractors is lower than the ratio for domestic or all foreign contractors in 2000. (For details, see app. II.)

**Table 1: Tax Liabilities and Interest Expenses of Large Contractors and Noncontractors in 2001**

	Contractors			Noncontractors		
	Number of companies	Tax liability as a percentage of gross receipts	Interest expense as a percentage of gross receipts	Number of companies	Tax liability as a percentage of gross receipts	Interest expense as a percentage of gross receipts
All foreign	740	0.89	6.55	7,093	1.01	8.53
Tax haven	50	0.75	8.33	787	0.91	16.32
Domestic	3,524	1.18	7.12	33,293	1.76	12.90
<b>Total</b>	<b>4,264</b>	<b>1.14</b>	<b>7.04</b>	<b>40,386</b>	<b>1.59</b>	<b>11.92</b>

Source: GAO analysis of IRS data.

Notes: Large contractors and noncontractors are companies with total assets greater than or equal to \$10 million. The number of companies does not sum to the total because tax haven contractors are included among all foreign contractors.

This pattern of interest expenses and tax liabilities is largely consistent with tax haven contractors inflating interest costs to shift taxable income outside of the United States but does not prove that this has occurred. The differences may be due to such factors as the age and industry of the companies, their history of mergers or acquisitions, and other details of their financial structure and the markets for their products. Furthermore, low or zero tax liability is not necessarily an indicator of noncompliance. Companies may have low or zero tax liabilities for a variety of reasons, such as overall business conditions, industry- or company-specific performance issues, and the use of income shifting.



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The evidence on the extent to which income shifting is occurring is not precise. Studies that compare profitability of foreign-controlled and domestically controlled companies show that much of the difference can be explained by factors other than income shifting.<sup>10</sup> However, the range of estimates can be wide, contributing to uncertainty about the precise effect, and the studies do not focus on income shifting to parents in tax haven countries. The 1997 study by Harry Grubert showed that more than 50 percent, and perhaps as much as 75 percent, of the income differences could be explained by factors other than income shifting. A Treasury report on corporate inversions did discuss income shifting to parents in tax haven countries but did not provide any quantitative estimates of the extent of such shifting. According to the report, the tax savings from income shifting are greatest in the case of a foreign parent corporation located in a no-tax jurisdiction.<sup>11</sup> The Treasury report cites increased benefits from income shifting among other tax benefits as a reason for recent corporate inversion activity and increased foreign acquisitions of U.S. multinationals.

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## Tax Haven Contractors Were More Likely to Have a Tax Cost Advantage Than Domestic Contractors

Using tax liability as an indicator of ability to offset contract income, we determined that large tax haven contractors were more likely to have a tax cost advantage than large domestic contractors in both 2000 and 2001. In both years, tax haven contractors were about one and a half times more likely to have no tax liability as domestic contractors.<sup>12</sup> As table 2 shows, in 2000, 56 percent of the 39 tax haven contractors reported no tax liability, while 34 percent of the 3,253 domestic contractors reported no tax liability. In 2001, 66 percent of the 50 tax haven contractors and 46 percent of the 3,524 domestic contractors reported no tax liability.

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<sup>10</sup> See, for example, Harry Grubert, "Another Look at the Low Taxable Income of Foreign-Controlled Companies in the United States," *Tax Notes International* (Arlington, Va.: Dec. 8, 1997), 1,873-97, and David S. Laster and Robert N. McCauley, "Making Sense of the Profits of Foreign Firms in the United States," *Federal Reserve Bank of New York Quarterly Review* (New York: Summer-Fall 1994).

<sup>11</sup> U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*.

<sup>12</sup> The relative probability of contractors having no tax liability can be computed by comparing relative frequencies (percentages) of tax haven and domestic contractors with no tax liability. In 2000 and 2001, the relative frequencies were 1.65 (.56 divided by .34) and 1.43 (.66 divided by .46), respectively.

**Table 2: Tax Status of Large Tax Haven and Domestic Contractors in 2000 and 2001**

U.S. federal contractors	Contractors with tax liability		Contractors without tax liability	
	Number of companies	Percentage of companies	Number of companies	Percentage of companies
<b>2000</b>				
Tax haven	17	44	22	56
Domestic	2,132	66	1,121	34
<b>2001</b>				
Tax haven	17	34	33	66
Domestic	1,888	54	1,636	46

Source: GAO analysis of IRS data.

Under the conditions of our model, contractors with no tax liability would have a tax cost advantage compared to the contractors that did have tax liabilities in these years. Consequently, in 2000, the tax haven contractors without tax liabilities were likely to have a tax cost advantage compared to the 17 other tax haven contractors and 2,132 domestic contractors that had tax liabilities. The 1,121 domestic contractors without tax liabilities were also likely to have a tax cost advantage compared to these same companies. In 2001, the tax haven contractors with zero tax liability were likely to have a tax cost advantage compared to the 17 other tax haven contractors and 1,888 domestic contractors that had tax liabilities. Because they reported no tax liability, 1,636 domestic contractors were also likely to have a tax cost advantage with compared to these same companies.

This analysis of possible tax advantages does not show that income shifting is the only potential cause of the advantage. As mentioned above, the tax losses that confer the advantage may be due to income shifting, but may also be due to other factors such as overall business conditions, industry and age of the company, or company-specific performance issues.<sup>13</sup> In addition, the analysis does not show the size of the advantage in terms of

<sup>13</sup> In a prior report, we found that the ratios of tax liability and interest expense to gross receipts varied by industry. However, after controlling for the age and industry of the corporations, we found that U.S. subsidiaries of foreign parent corporations were more likely to have zero tax liability than domestic corporations from 1996 through 2000. See U.S. General Accounting Office, *Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000*, [GAO-04-358](#) (Washington, D.C.: Feb. 27, 2004).

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tax dollars saved. The amount saved depends, in part, on the amount of additional income from the contract. If the contractor with no tax liability has insufficient losses to offset the additional income, it would pay taxes on at least part of the income, reducing the potential advantage. Lastly, the analysis identifies tax haven contractors that meet the conditions for having a tax cost advantage with respect to income from the contract in 2000 and 2001. The data do not indicate whether they have an overall tax cost advantage on a contract that produces income in other years. Furthermore, to the extent that losses are used to offset income in the current year, they cannot be used to offset income in other years. These smaller loss carryovers would reduce the overall tax cost advantage.

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## Concluding Observations

The existence of a tax cost advantage for some tax haven contractors matters to American taxpayers. First, the advantage could, but does not necessarily, affect which company wins a contract. A contractor with a tax cost advantage could offer a price that wins a contract based more on tax considerations than on factors such as the quality and cost of producing goods and services. Second, the potential tax cost advantage may contribute, along with other tax considerations, to the incentives for companies to move to tax haven countries, reducing the U.S. corporate tax base.

The issue of tax cost advantages for tax haven contractors is related to the larger issue of how companies headquartered or operating in the United States should be taxed. For example, the questions about how the worldwide income of U.S. multinational corporations should be taxed are part of a larger debate and beyond the scope of this report. Because of these larger policy issues, we are not making recommendations in this report.

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## Agency Comments and Our Evaluation

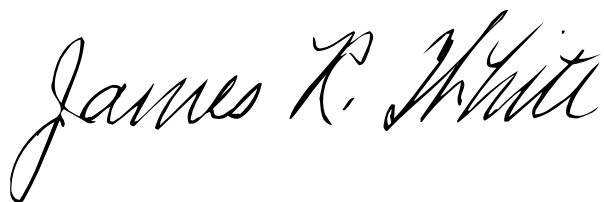
In a letter dated June 22, 2004, the IRS Commissioner stated that because IRS's only role in our report was to provide us with certain tax data, IRS's review of a draft of this report would be limited to evaluating how well we described the tax data it provided. The Commissioner stated that IRS believes that the report fairly describes these data. On June 28, officials from the Department of the Treasury's Office of Tax Policy provided oral comments on several technical issues, which we incorporated into the report where appropriate.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue and other interested parties. We will also make copies available to others on request. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you have any questions concerning this report, please contact me at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov) or Kevin Daly at (202) 512-9040 or [dalyke@gao.gov](mailto:dalyke@gao.gov). Key contributors to this report are listed in appendix III.

Sincerely yours,

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, prominent initial "J".

James R. White  
Director, Tax Issues

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# A Simple Qualitative Model for Assessing Potential Contracting Advantages

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A parent corporation that locates in a tax haven country may reduce U.S. tax on corporate income by shielding subsidiaries from U.S. taxation and by providing opportunities for shifting of U.S. source income to lower tax jurisdictions. Such a corporation could have an advantage because it is able to have a lower marginal tax rate on U.S. contract income than its domestic competitors or other foreign competitors. The simple qualitative model in this appendix specifies a set of conditions under which corporations with a tax haven parent may have a lower marginal U.S. tax rate.

The principal means by which a parent corporation that locates in a tax haven country may have lower U.S. tax liabilities are as follows.

- The corporation pays no U.S. tax on what would have been its foreign source income if it were located in the United States. To the extent that foreign subsidiaries are owned by a foreign parent, the U.S. corporate-level taxation of foreign operations is eliminated. Tax savings would come from not having to pay tax on the corporate group's foreign income.
- The corporation may be able to shift income outside of the United States by increasing payments to foreign members of the group. The corporation may engage in transfer pricing abuse, whereby related parties price their transactions artificially high or low to shift taxable income out of the United States.<sup>1</sup> Transfer pricing abuse can also occur when the foreign parent charges excessive interest on loans to its U.S. subsidiary. Interest deductions can also be used to shift income outside the United States through a technique called earnings stripping. Using this technique, the foreign parent loads the U.S. subsidiary with a disproportionate amount of debt, merely by issuing an intercompany note, thereby generating interest payments to the parent and interest deductions against U.S. income for the subsidiary. The subsidiaries would still be subject to the thin capitalization rules (I.R.C. section 163(j)) that limit the deductibility of interest to 50 percent of adjusted taxable income whenever the U.S. subsidiary's debt-equity ratio exceeds 1.5 to 1.

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<sup>1</sup> There are various provisions in the I.R.C. designed to limit income shifting. The limits include the requirement (Section 482) that transactions between related parties use arm's length prices, that is, the prices that unrelated parties would use for the transactions.

**Appendix I**  
**A Simple Qualitative Model for Assessing**  
**Potential Contracting Advantages**

When a parent corporation locates in a tax haven country, the elimination of U.S. corporate-level taxation of foreign operations can reduce taxes on foreign income. However, these tax savings are unrelated to the taxes paid on income derived from the contract and have no effect on the tax cost of the contract. Any income earned by the U.S. subsidiary from a contract for services performed in the U.S. would be U.S. taxable income. Therefore, the elimination of the corporate-level taxation of foreign operations provides no competitive advantage to a corporation that is competing for a U.S. government contract.

A corporation has a U.S. tax advantage in competing for a government contract when it would pay a lower marginal U.S. tax rate on the income from that contract than would the other companies competing for that same contract. The available data are not sufficient to measure marginal rates accurately. However, the likelihood that the rates are lower for some companies than others can be inferred from their current tax liabilities. The manipulation of interest payments and other transfer pricing can reduce U.S. taxable income. We can infer that the corporation may have a lower marginal tax rate on its U.S. contract income if the manipulation allows a corporation that would otherwise have positive taxable income to reduce its taxable income (excluding the net income from the contract) to a negative amount. Table 3 shows a set of situations, or cases, in which a corporation may and may not have a cost advantage when bidding on a contract.

**Table 3: Tax Cost Advantage of Corporations with Headquarters in a Tax Haven Country**

Case	U.S. income of a company in the United States	U.S. income of a company with its parent located in a tax haven country	Company has a tax cost advantage with parent in tax haven country
1	+	-	Yes
2	+	+	No
3	-	-	No

Source: GAO qualitative model of tax cost advantage.

In order to use this model to identify corporations with a tax cost advantage, we make two assumptions: (1) corporations with positive U.S. taxable income pay tax at the same rate based on the schedule of corporate tax rates (that is, their income before the contract income puts them in the same tax bracket) and (2) corporations with negative income have

sufficient losses to offset income from the contract. With these assumptions, we can draw inferences about relative marginal tax rates for the three cases. A U.S. corporation that has positive U.S. taxable income (before taking the income from the contract into account) and has a parent located in a tax haven country does not have a competitive advantage compared to a U.S. corporation with positive income (Case 2). Because they have positive income and pay the same rate of tax, neither has a lower marginal tax rate than the other. Likewise, a corporation with a tax haven parent that has U.S. tax losses and zero tax liability would not have an advantage compared to another corporation with tax losses (Case 3). Because the marginal tax rate is zero for both these corporations and they have sufficient losses to offset the contract income, neither has a tax cost advantage.

However, a corporation that has a tax haven parent and U.S. tax losses would have an advantage when compared to a corporation with positive income (Case 1). In this case, the corporation with losses has a zero marginal rate, which provides a tax cost advantage compared to a corporation with taxable income and a positive marginal rate. The assumption that a corporation with zero tax liability has sufficient losses to offset contract income may not be true in particular instances. For example, a corporation may obtain more than one contract (in the public or private sector) and the marginal tax rate on income from a particular contract will depend on how the losses are allocated across income from all the contracts. However, a corporation with zero tax liability is more likely to be able to offset the additional income than a corporation with positive tax liability. In this sense, tax liability is an indicator of the ability to offset income from the contract.

The qualitative model does not identify the causes of the advantage. The tax losses that confer the advantage may be due to income shifting, but may also be due to other factors. In addition, the model does not show the size of the advantage in terms of tax dollars saved. The amount saved depends, in part, on the amount of additional income from the contract. If the contractor with no tax liability has insufficient losses to offset the additional income, it would pay taxes on at least part of the income, reducing the potential advantage compared to contractors that have positive tax liabilities. Lastly, the model is used to identify tax haven contractors that meet the conditions for having a competitive advantage with respect to income from the contract in 2000 and 2001. The data do not indicate whether they have an overall tax advantage on a contract that produces income in other years.

# Additional Information about Contractors in 2000

The additional table of tax liabilities and interest expense for 2000 is provided for comparison with the data reported in the letter. It shows substantially the same pattern.

## Information on Large Contractors in 2000

Table 4 shows that in 2000, tax haven contractors had greater interest expense and lower tax liabilities relative to gross receipts than domestic or all foreign contractors. The pattern of tax liabilities and interest expense in 2000 is the same as in 2001 in all respects except one: the ratio of interest expense to gross receipts for tax haven noncontractors is lower than the ratio for domestic or all foreign contractors in 2000. The greater interest expense associated with lower tax liabilities may indicate, but does not prove, that the tax haven contractors have used techniques like earnings stripping to shift taxable income outside the United States.

**Table 4: Tax Liabilities and Interest Expenses of Large Contractors and Noncontractors in 2000**

	Contractors			Noncontractors		
	Number of companies	Tax liability as a percentage of gross receipts	Interest expense as a percentage of gross receipts	Number of companies	Tax liability as a percentage of gross receipts	Interest expense as a percentage of gross receipts
All foreign	671	1.25	5.01	7,173	1.27	11.62
Tax haven	39	0.31	9.92	787	1.10	6.32
Domestic	3,253	1.55	7.13	35,433	1.90	13.01
<b>Total</b>	<b>3,924</b>	<b>1.50</b>	<b>6.81</b>	<b>42,606</b>	<b>1.76</b>	<b>12.71</b>

Source: GAO analysis of IRS data.

Notes: Large contractors and noncontractors are those with total assets greater than or equal to \$10 million. The number of companies does not sum to the total because tax haven contractors are included among all foreign contractors.



# Staff Acknowledgments

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Amy Friedheim, Donald Marples, Samuel Scrutchins, James Ungvarsky, and James Wozny made key contributions to this report.

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