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The battle between multinational tax avoidance and corporate competitiveness

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**THE BATTLE BETWEEN MULTINAIONAL TAX AVOIDANCE AND
CORPORATE COMPETITIVENESS**

By

NICO KOOP

A thesis submitted as a partial fulfillment of the requirements for
The Honors in the Major Program in Finance
in the College of Business Administration
and in the Burnett Honors College
at the University of Central Florida
Orlando, Florida

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Thesis Chair: Dr. Robert Sweo

Abstract

In the past decade, there has been a significant decrease in US corporate tax revenues. Multinational companies have been employing several different techniques of tax avoidance to get around paying corporate taxes. Tax avoidance is used by any large multinational corporation for a variety of reasons. The US has one of the highest corporate tax rates in the world and is seeing many companies relocate their operations abroad to lower their tax expenses. The different methods of tax avoidance are discussed in this thesis, as well as the different reasons behind their use.

To understand how companies implement tax avoidance techniques, it is necessary to understand US corporate taxes. I have researched the few key items of US corporate taxes, which are vital to understanding the implementation of tax avoidance techniques. Through different examples you will see how tax avoidance occurs and how it benefits multinational companies.

Acknowledgements

I would like to express my most sincere and deepest gratitude to all those who made my thesis possible. Thank you to Dr. Robert Sweo who helped guide me through this long process. Without your help and assistance, all of this work would have been much more difficult. I would also like to thank Dr. Ray Sturm and Dr. Dean Cleavenger for being on my committee. Your input has been extremely valuable in preparing this thesis. To Denise Crisafi and Kelly Astro at The Burnett Honors College, thank you for your unquestionable devotion in guiding all Honors in the Major scholars with their research. Your assistance is greatly appreciated and a necessity with The Honors in the Major program. And to my family, Joan Koop, Hermes Koop, Andree, Anneke and Hans, thank you all for being there for me. I love you all and am very fortunate to have such a wonderful family. To all my professors, teachers, and family, thank you for all that you have done for me.

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Introduction

Throughout this thesis I will be looking at several international companies and studying their relationships with corporate tax rates. Companies continuously avoid paying taxes by using various techniques. Looking at the past, records of these companies will show the different methodologies they use to manage their way through tax laws. Governments are losing huge revenues to these tax avoidance schemes. In recent years, governments have started to track down international companies and question their various ways of tax avoidance. In this thesis I will be asking the question of what are the different tax avoidance techniques that international companies use and how are different national governments trying to control them?

There are many reasons why companies are moving abroad or relocating their operations to another country. Besides the fact that many are trying to keep up with competition and continuously grow, many need to find ways to gain an advantage over the competition. To increase revenue and expand on profits, companies need to find ways to avoid paying unnecessary expenses. By moving their operations overseas, corporations largely reduce, or avoid paying altogether, corporate taxes. Corporate taxes play a vital role in governmental revenue generation, however, by reducing corporate taxes, multinational companies gain an enormous advantage over their competitors and greatly increase their after tax profits. There are many different ways multinationals do this which we will look at throughout this thesis. Looking at the different tax laws regarding the taxation of multinational companies shows how these companies avoid paying taxes on the international scale. Though they play an important role in

government revenue generation, corporate taxes are avoided in many different ways by multinational companies to increase their income and reduce their expenses. Through the examination of company tax payments we will see how much they actually pay in taxes and the various implementations they use to avoid the payment of corporate taxes.

Literature Review

To have a better understanding of how companies are working around the tax system, we first need to understand the different tax systems in several parts of the world. The following section provides a review of how the different tax systems operate. There are many different opinions on the avoidance of taxes by international companies. While companies are trying to reduce their tax expenses, many believe that companies should pay their full fair share of taxes to support their governments. Further into this thesis we will show what authors say about the subject and the different methods that companies are using.

Before getting into how companies decrease their annual tax liability, we first need to have a general idea of how corporate taxes work in different countries. There are two main types of systems implemented in the world today. The first is the transaction based system, which is used in the U.S., Canada, and Germany. In accordance with this system, except for the U.S., taxes on active business income in a foreign country are exempt from their home country corporate taxes such as company sales and service income. The US does tax all active business income from foreign countries which leads to the taxation of income in the foreign country as well as in the US. The difference is that the U.S. allows a foreign tax credit of income that has already been paid to foreign countries to avoid a double taxation of income. This gives companies with operations in a foreign country a tax break from their US expenses. The second type of system is used in countries such as France, Japan, and the UK. They have a jurisdiction based approach which taxes all income of foreign subsidiaries. There is a stipulation in the tax

code however. They exempt any active business income with a local connection from home country taxation. (Hines Jr. Feb. 20, 2009) This encourages foreign investment and allows a tax break for jurisdiction based countries. They do however tax all income of subsidiaries from low tax countries, such as tax havens.

In the example below you will see how the foreign tax credit is utilized. The US parent company, USCo, has a foreign subsidiary, ForCo. As you can see, the foreign tax credit decrease's the US tax liability of USCo by the amount paid in taxes to country X. There is a limit on the amount of your foreign tax credit. It is equal to your foreign source net income divided by your total worldwide net income multiplied by your US tax on worldwide income before the foreign tax credit. Also note that if USCo had brought in its income from ForCo and didn't pay its taxes to country X, the 35% tax on the worldwide income would be the same for corporate taxes paid by USCo to its country of origin.

Chart 1

ForCo	
Country X taxable income	\$1,000
Country X income tax @ 35%	<u>\$350</u>
Net income	\$650
USCo	
US source income	\$1,000
Dividend from ForCo	\$650
Foreign tax gross up on dividend	<u>\$350</u>
Taxable income	\$2,000
US tax before FTC @ 35%	\$700
FTC limit*	\$350
FTC	<u>\$350</u>
US income tax after FTC	\$350
Worldwide operations of USCo	
Income	\$2,000
Income tax	\$700

$$* \text{ FTC Limit} = \left\{ \frac{\$1000 \text{ Foreign Source Net Inc.}}{\$2000 \text{ Worldwide Net Income}} \right\} \times \$700 \text{ US Tax on WW Inc. (before FTC)}$$

In our ever growing world, companies are looking to expand their operations and increase their profits. To do this, as we are finding out, companies focus on decreasing their overall tax liability and there are two main ways a company can do this. They can either open up new branches or subsidiaries in foreign countries with lower corporate tax rates, or they can completely move their main business operations to that separate country. Both of these techniques have their advantages and disadvantages. By doing either one of these different tax avoidance techniques, companies can significantly increase their overall profit and decrease their expenses at the same time. These two techniques are regularly used by many multinational companies and will be looked into later in this thesis.

Many businesses have started new branches in Ireland because of its low tax bracket. Many U.S. based companies are opening up new operations in Ireland and leaving their profits over there. Because they leave their income in Ireland, they will increase their profits and decrease their expenses due to the difference between the corporate tax rates. According to current U.S. tax law, companies don't pay the 35% tax on profits unless they bring those profits back to the U.S. They pay the effective lower tax rate in the foreign country and take a foreign tax credit in the U.S. (Sasseen May 2009) However, companies will leave most of their profits in a country with no tax or very little corporate tax which means they will receive no foreign tax credit. They use mispricing and transfer pricing schemes with goods to reduce home country taxes which will be discussed later.

Any successful company is looking to make a profit with their operations and the corporate tax rate is a driving force in relocating core company operations and profits abroad. Corporate taxes are a large expense to any corporation and give companies incentive to relocate their operations to another country with lower corporate tax rates. By reducing their tax liability and leaving profits in foreign countries, corporations obtain excess profit and can reinvest it in whatever manner they see fit for the company. Many technological firms such as Microsoft and Dell have opened branches in Ireland due to its low corporate tax incentive. (Murray-West 1999)

With one of the highest corporate tax brackets in the world, the U.S. has seen an increase of companies relocating their core business operations to foreign countries. The highest current corporate tax rate in the U.S. is set at 35% without the added surtax. This corporate tax rate far

exceeds the corporate tax rate in Ireland, which has an effective 12.5% tax on all trading profits in the country. (Murray-West 1999) This means that companies with commercial or industrial services will benefit from the tax by moving their operations there. Companies are going to base their operations where they can make the most profit and reduce their tax expenses. There are many countries that offer either no corporate tax rate or a very minimal one. These low tax countries are becoming a key part of tax planning strategies in recent years. They are referred to as Offshore Financial Center's or OFC's in a legal and professional sense. (Larudee 2009) They are more commonly referred to as tax havens or tax shelters which are more comparable to the nature of their business.

When another branch of a multinational company is opened, the profits from sales are generally held within that country. In 2006, only 10.5% of sales of US controlled foreign corporations made it back into the US. (Hines Jr. Feb. 20, 2009) If sales were to be brought back into the US then they would be taxed at the appropriate corporate tax rate for that company. Most US controlled foreign corporations will either keep the sales in the country of origin or transfer them to a tax haven with a little to none corporate tax rate. As we saw before, companies can obtain a foreign tax credit for any taxes they have paid to foreign governments. The amount of the foreign tax credit is limited however to the amount of foreign source income divided by that company's worldwide income. That amount is then multiplied by the product of the US tax of worldwide income. Since the US has one of the highest corporate income taxes in the world, companies have no need to worry about the limit of their foreign tax credit. They will generally be below or at the same level of their foreign tax credit limit. If another country had a higher

corporate tax rate than the US, then that company would be limited on the amount of their foreign tax credit. The foreign tax credit will always be proportionate to the US corporate tax rate of 35 percent and will limit the credit to 35 percent of foreign source income. Multinational companies, for the most part, will never pay taxes in a country with a high corporate tax rate.

While many companies are starting to relocate their operations overseas, in the U.S., there are laws that regulate them from moving abroad. If a company feels compelled to move outside of the U.S., they will be taxed on the difference between the current value of their stock and the book value. (Murray-West 1999) Gerry Fagan, who is a Financial Controller at Jefferson Smurfitt, says this is one reason why companies, once established in the U.S., tend to stay there. (Murray-West 1999) This is a very large disadvantage to moving abroad but could prove profitable in the future if done properly and in the right situation. Many U.S. based companies have said if given the chance to start their companies again, they would choose another country. Bob Perlman, head of tax at Intel, said if he was to start his company again, he wouldn't start it in the U.S., but in a low tax country such as the Cayman Islands. (Murray-West 1999) Tom Armstrong, who is vice president of tax at Dell, is in strong agreement with Perlman and says every tax payer in the U.S. feels that way. (Murray-West 1999)

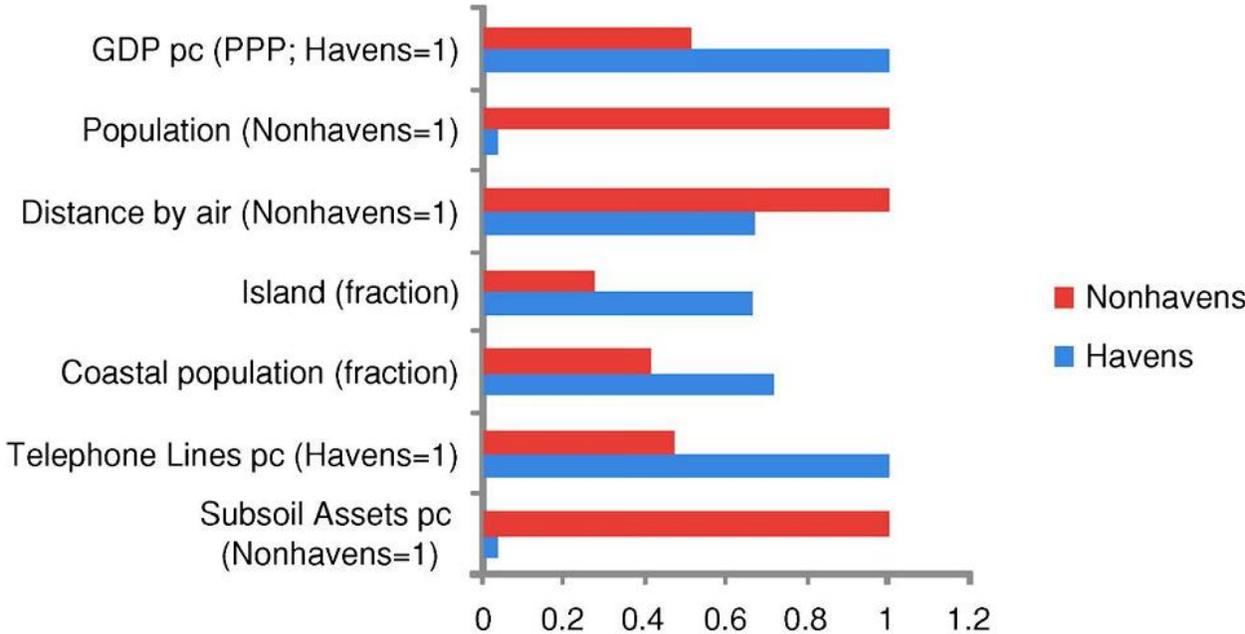
There are many different countries where a company can centralize its operations. They are referred to as OFC's or tax havens as discussed before. Many companies prefer to delegate their main business operations and bank accounts here because of their low tax incentives. These countries often have very little or no taxes at all. Some tax havens even have a set of firm secrecy

laws for the reporting of company transactions and bank accounts. In general, tax havens tend to be small island countries with small populations and very large GDP's. (Dharmapala 2008)

These small island nations need a way to attract business so they lower their corporate tax rates significantly so that companies from around the world will open subsidiaries in their country.

They are located in central areas to several major countries for account access and coordination of companies operations. Tax havens are just countries looking to expand their economies by offering incentives, such as low tax rates. Graph 1, pictured below, shows some typical features of tax havens compared to non tax havens.

Graph 1



Dharmapala and Hines (2006).

There have been many questions raised as to whether companies use tax havens for tax evasion or tax avoidance. In tax avoidance, companies implement a tax planning strategy to decrease their tax liability in a legal way. For examples, a company can store funds in a tax deferred or tax exempt account in its country of origin. For an international strategy with tax avoidance, companies can locate all their profits and income in a bank account, generally in a foreign tax haven. With tax evasion, companies are using illegal planning strategies to set up the illusion of a small tax liability. There are a variety of different ways companies do this, such as misleading company information on their pro forma or not recognizing all company profits in their tax filings. Companies will lie about their total earnings or not list all of their total assets which will decrease their taxable income. What we are looking at in this thesis are the different ways that companies implement their use of tax avoidance to decrease their tax expenses. We will look at tax avoidance strategies of a company and see how it affects its country of origin with its decreased tax liability.

Since the early 1930's, corporations have been opening subsidiaries in tax havens and opening bank accounts in them to store their funds. The first well known tax haven was Switzerland because of its strong banking secrecy laws. Tax havens first started as a place for Al Capone and the mob to hide their money. They were a popular place for drug trafficking money and casino revenues. Soon the Bahamas, with some of the world's strictest secrecy laws, became a favorite place for the mob to keep their money. In 1966, The Cayman Islands, which already had zero taxes, adopted strict banking secrecy laws which made it a rapidly growing tax haven. The market for tax haven's soon exploded with the Eurodollar market in the late 1960's and

1970's. It is said that by the end of the 1970's, 385 billion Eurodollars were booked offshore in total, with 30 billion of those dollars booked in the Cayman Islands. (Larudee 2009)

To have an effective tax planning strategy and implement tax avoidance, companies concentrate their income and subsidiaries in low corporate tax countries, such as tax havens. Companies have had effective tax planning strategies for decades using tax havens. As tax havens have been growing in popularity, many countries are increasing regulations for utilizing them. There can be huge fees and penalties for leaving one country and incorporating in another country, such as those discussed before with the U.S. penalty. Many companies are beginning to regret the decision not to incorporate in a low tax country. In 2002, U.S. multinational firms alone had over \$639 billion of untaxed earnings offshore. Currently, tax havens hold at least \$10 trillion dollars in assets. (Larudee 2009) This statistic shows how widely used tax havens are, and how much they are utilized.

In order to utilize a tax havens low tax rates, companies' first need to transfer and store their funds in a subsidiary located in a tax haven. One of the most common ways of transferring money to a company's subsidiary in a tax haven is by transfer pricing. This method not only shifts profits to tax havens, but also distorts data used in a company's financial statements. What will happen is a multinational company will set up a subsidiary in a tax haven and a production plant in a host country with relatively low production costs. The production plant will sell its goods to the subsidiary in the tax haven at the cost of production. This will show as zero profit in the host country and will present the production plant with no tax liability in its host country. The

subsidiary in the tax haven will then sell the goods at a large markup to the parent multinational company in the US or country of incorporation. This shows the subsidiary in the tax haven as having a large profit. Since there is little to no tax in these tax havens, the subsidiary will retain almost all of its profits. The goods are then shipped straight from the production plant to the multinational company without ever passing through the subsidiary. The subsidiary is mainly just a mailing address with minimal staff and office equipment. (Larudee 2009) Once the subsidiary repatriates its profits to the parent country, if it ever does, they will be eligible for standard corporate tax rates.

Once the main multinational company has exported and imported all of its goods, it needs to put the shipments on paperwork. When the company reports its data, the shipments from the production plant in the host country to the subsidiary in the tax haven will be understated and the shipments from the subsidiary to the multinational company will be overstated. Since the goods were sold from the production plant to the subsidiary at the cost of production, they will be undervalued. And the subsidiary will show large profits from selling the goods to the multinational company at a large markup. In both the production plant and the multinational company, profits will be greatly understated. (Larudee 2009) The production plant is selling at an extremely low price and the multinational company is buying at a significantly higher price. The subsidiary in the tax haven will appear to have generated all the profit from the goods and will make the production plant and multinational company appear as if they have made little to no profit.

An important part of transfer pricing are the “Check the Box” regulations. Implemented in 1997 by the US Treasury, these regulations allow multinational companies located in the US to use hybrid entities. The subsidiaries of a multinational company are classified as a separately incorporated affiliate under the tax rules of another country, or as unincorporated branches under the tax rule of the US. The “Check the Box” regulations were initially designed to reduce the administrated burdens faced by small firms. The new regulations were meant to allow small firms to choose their organizational form for tax purposes. If an entity has at least two partners, it could classify itself as a partnership or as a corporation. (Dharmapala 2008) Little did the US Treasury know that large multinational corporations would soon take advantage of these new regulations. This new regulation allows subsidiaries of multinational corporations to be classified as a separately incorporated affiliate of the parent company. The “Check the Box” regulations are a vital part in a multinational corporation’s use of subsidiaries. These regulations allow the multinational corporation subsidiaries to appear as if they are a separate entity, which permits them to incorporate in another country under that countries tax laws.

Another important aspect of these incorporated affiliates is how they control ownership interest. Multinational corporations will set up several subsidiaries around the world. Each subsidiary will hold a percentage of interest in the main company or another incorporated affiliate. The subsidiaries in this instance are referred to as brother and sister corporations. Each brother or sister corporation will have up to five individuals who will hold up to an eighty percent interest in their subsidiary or another affiliated subsidiary. This gives the individuals a majority control over the separate brother of sister corporations with their shareholder rights. The

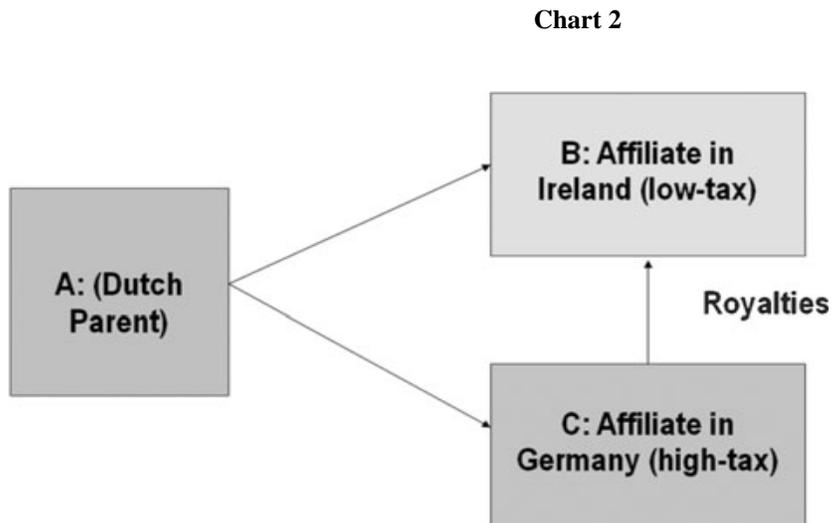
individuals who hold the ownership interest are associated with the main parent company act in the best interest of the corporation. In 1999 United Parcel Service was held liable for 1.7 billion dollars in taxes and penalties in connection with one of its subsidiaries in Bermuda. They set up an insurance agency which would charge the shipper for its risk insurance. The US tax court decided the subsidiary was charging three times more for what was actually suitable. The subsidiary was determined to be a brother sister affiliate of UPS and was deemed a profit center by the US tax court. (Lonkevich 1999)

There are several different strategies that can be used which are centered on transfer pricing. There are many different divisions inside of a company, and a vital division for growth is research and development. This division mainly consists of intellectual property and has income based on royalties. Another strategy that we will go over is the strategic use of debt. Debt can generate deductions on a company's annual tax filings. A company may have many different debt sources which play a critical role in that companies tax planning. These two strategies are going to be the main focus of our look into transfer pricing.

Below in Chart 1, you will see an example where a company owns intellectual property and is having its royalty payments flow to a low tax country. In this example, a Dutch company, firm A, has subsidiaries in Germany and Ireland. Firm A will locate its intellectual property in Ireland along with its stream of royalties. All royalty payments located in Firm A and its subsidiaries will be streamed to its low tax subsidiary. In this case Ireland has the lowest tax rate out of its other branches. US multinational companies with a large focus in research and

development will use this strategy to generate a lower tax liability with its intellectual property.

(Dharmapala 2008)

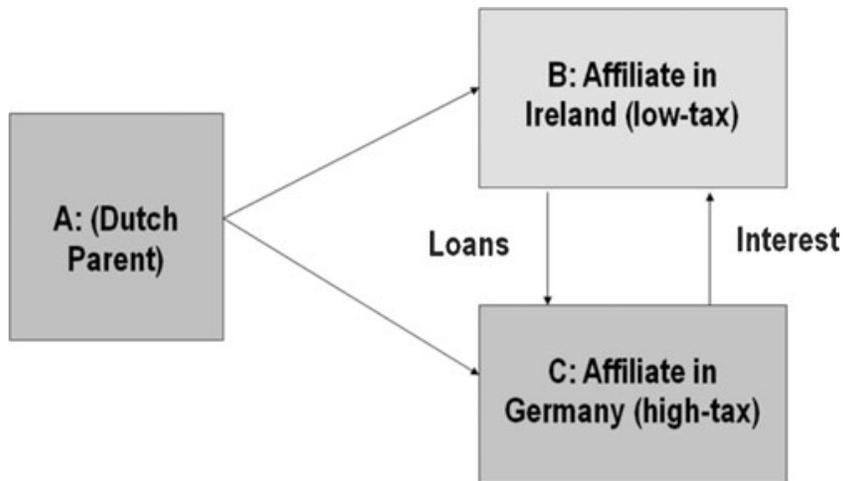


Dharmapala and Hines (2006).

Transfer pricing has a somewhat different approach with a company's debt. The strategic use of debt will benefit the multinational company when they locate their debt in a high tax country. This method is known as interest stripping or earnings stripping. (Dharmapala 2008) As you can see in Chart 2 below, affiliate B in Ireland makes a loan out to affiliate C in Germany. This allows for a tax deduction, based off of the interest payments, in Germany. Interest payments made on loans are generally tax deductible and vary from country to country. The interest payments are paid to the affiliate in Ireland where the profit is made. This allows the parent company to decrease its taxes in high tax countries, while paying smaller taxes on its profits made in the low tax country. Since profits and funds are already transferred to low tax

countries, the use of debt in high tax countries will bring the tax liability in that country to virtually zero.

Chart 3



Dharmapala and Hines (2006).

There are many different types of companies that implement the use of tax havens and transfer pricing. Tax havens are utilized by corporations, limited liability corporations and by government sponsored entities. A company or business can be privately or publicly owned and still implement the use of tax havens. Government contracted agencies have also been known to exploit the use of tax havens. In a 2004 U.S. Government report, 59 out of the 100 largest publicly traded federal contractors had subsidiaries in tax havens. (Larudee 2009) Tax havens are used by all companies; no matter what type of corporate structure or funding they may receive. Chart 3 below shows the top 10 federal contractors who have exploited the use of tax havens in 2001. These companies generate billions of dollars every year and pay only 2 to 3 percent in

corporate taxes every year. You will also see that each corporation has more than one subsidiary and more than just one tax haven they utilize.

Chart 4

Top 10 Federal Contractors with Subsidiaries in Tax Havens, by Total Value of Federal Contracts; Data for 2001

Federal Contractor	Federal Contracts (billions of US\$)	Contractor's Subsidiaries in Tax Havens (total, and two most numerous)
The Boeing Company	14.36	31 US Virgin Islands (23); Bermuda (6)
Raytheon Company	6.12	4 US Virgin Islands (3); Bermuda (1)
Northrop Grumman Corp.	5.64	2 Bermuda (1); Cayman Islands (1)
General Dynamics Corp.	4.93	4 Cayman Islands (1); Cyprus (1)
United Technologies	3.5	4 Cayman Islands (4)
SAIC	2.65	2 Barbados (1); Bermuda (1)
TRW, Inc.	2.5	2 Barbados (1); Bermuda (1)
McDermott International	1.89	9 Panama (7); Mauritius (1)
Honeywell International	1.44	2 Barbados (2)
Health Net, Inc.	0.95	2 Barbados (1); Bermuda (1)

Note: Lockheed Martin, the largest, with \$18.0 billion in federal contracts, is listed as having an "unknown" number of foreign subsidiaries; it is unclear whether the number of its tax haven subsidiaries is zero or unknown.

There are many different types of strategies that companies use with tax havens to reduce their overall tax liability. Tax havens are used by a majority of large corporations and are accountable for billions of dollars annually in decreased tax revenue. Some of the most well known tax havens are the Cayman Islands, Bermuda, Bahamas, Panama, and Switzerland. All of these countries offer some form of low tax incentive. They will offer either no corporate tax or a very low tax rate. On top of that they have very strict secrecy laws which prevent other countries

from accessing accounts and looking at company funds stored in banks there. According to the Organization for Economic Co-operation and Development, or OECD for short, there are 39 countries worldwide that are listed as tax havens. Through their low corporate tax policies, secrecy laws, and major company holdings they are considered to be a tax shelter for major corporations worldwide. In 1977, Castle Bank, located in the Cayman Islands, was regarded as the main tax shelter vehicle for American companies. (Larudee 2009)

To lower the tax avoidance techniques of companies, the OECD is implementing an Exchange of information agreement between known tax havens. They are working on an internationally agreed tax standard to help ease the loss of tax revenue in high corporate tax countries. Many countries are looking for new ways to stop companies from the avoidance of paying their fair share of corporate taxes. The agreement doesn't prevent companies from holding income in tax havens. It allows the easement of information flowing from one country to another in agreement with one another. In article 26 of the OECD Model Tax Convention on Income and Taxation, all contracting states, in agreement with the Internationally Agreed Tax Standards, shall exchange information concerning taxes of every kind on behalf of the contracting states. (Article 26 of the OECD Model Tax Convention on Income and Capital) This doesn't mean that every country who commits to the Internationally Agreed Tax Standards has to coordinate with all other countries in the agreement. You can commit to the Internationally Agreed Tax Standard but not have any agreements with any other countries. The Bahamas has just recently signed agreements with 7 different Nordic countries, which brings its total to 18 different contractual agreements, all with separate countries. (Article 26 of the OECD Model Tax

Convention on Income and Capital) When the Bahamas is in agreement with other countries, it is agreeing to share all relevant tax information with those countries which is stated in article 26 of the OECD Model Tax Convention on Income and Capital. (Article 26 of the OECD Model Tax Convention on Income and Capital) If a country reaches 12 agreements with 12 different countries, then they are said to be in the Substantially Implemented category as seen in Chart 4 below. (Article 26 of the OECD Model Tax Convention on Income and Capital)

Chart 5

Jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented					
Jurisdiction	Year of Commitment	Number of Agreements	Jurisdiction	Year of Commitment	Number of Agreements
Tax Havens³					
Andorra	2009	(0)	Marshall Islands	2007	(1)
Anguilla	2002	(0)	Monaco	2009	(1)
Antigua and Barbuda	2002	(7)	Montserrat	2002	(0)
Aruba	2002	(4)	Nauru	2003	(0)
Bahamas	2002	(1)	Neth. Antilles	2000	(7)
Bahrain	2001	(6)	Niue	2002	(0)
Belize	2002	(0)	Panama	2002	(0)
Bermuda	2000	(3)	St Kitts and Nevis	2002	(0)
British Virgin Islands	2002	(3)	St Lucia	2002	(0)
Cayman Islands ⁴	2000	(8)	St Vincent & Grenadines	2002	(0)
Cook Islands	2002	(0)	Samoa	2002	(0)
Dominica	2002	(1)	San Marino	2003	(0)
Gibraltar	2002	(1)	Turks and Caicos Islands		
Grenada	2002	(1)	Vanuatu		
Liberia	2007	(0)			
Liechtenstein	2009	(1)			
Other Financial Centers					
Austria ⁵	2009	(0)	Guatemala	2009	(0)
Belgium ⁵	2009	(1)	Luxembourg ⁵	2009	(0)
Brunei	2009	(5)	Singapore	2009	(0)
Chile	2009	(0)	Switzerland ⁵	2009	(0)
Jurisdictions that have substantially implemented the internationally agreed tax standard					
Argentina	Germany	Korea	Seychelles		
Australia	Greece	Malta	Slovak Republic		
Barbados	Guernsey	Mauritius	South Africa		
Canada	Hungary	Mexico	Spain		
China ²	Iceland	Netherlands	Sweden		
Cyprus	Ireland	New Zealand Norway	Turkey		
Czech Republic	Isle of Man	Poland	United Arab Emirates		
Denmark	Italy	Portugal	United Kingdom		
Finland	Japan	Russian Federation	United States		
France	Jersey		US Virgin Islands		

Methodology

Using data and statistics from several credible journals, my research will show the different ways that corporations are transferring their income and how much of it is taxable in their home country. Through charts and graphs I will show the difference in taxable income that companies would have overseas as opposed to in their home county. Tax charts and graphs will be the main output of my research. Through them I will show how companies are implementing international tax planning strategies and the effect they have on different countries and governments.

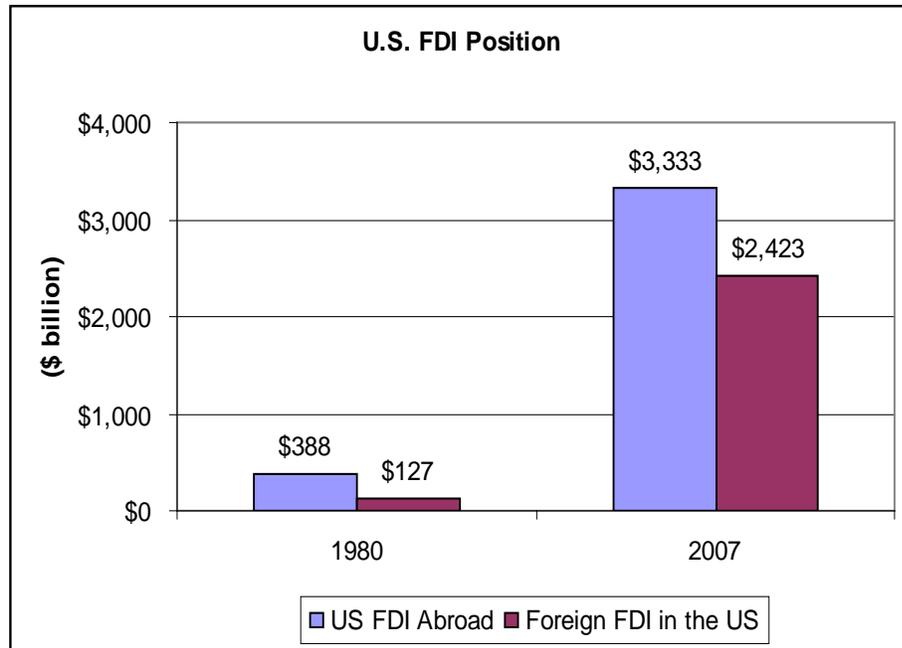
Data

Data for this research primarily came from scholarly journals. A majority of it came from the International Tax Seminar for Congressional Staff by James R. Hines Jr. This article shows different tax laws in the US and foreign countries. It supplies detailed charts and graphs about domestic and foreign income. Another Journal is “What problems and opportunities are created by tax havens” by Dharmapala. This scholarly journal explored several tax havens used by multinational companies and goes into detail how they affect different countries with their low tax policies. In The Overseas Tax Squeeze by Jane Sasseen, we heard of new policies that the US government is trying to institute regarding flow of funds between countries and new rules adhering to the US foreign tax credit.

Results

Graph 2, pictured below, shows the increase of foreign direct investment from the year 1980 to 2007. As you can see, the US has had a substantial increase in its foreign direct investment over the past few decades. The dollar amount is listed in billions of dollars and shows a larger increase of US foreign direct investment abroad, than direct foreign investment in the US. There was a 2,945 billion increase of US foreign direct investment abroad and a 2,296 billion increase of foreign direct investment into the US. The factual data from Graph 2 indicates a 649 billion dollar difference of investments abroad than in the US. In 1960, 18 of the world's 20 largest companies were headquartered in the US. (Hines Jr. Feb. 20, 2009) That statistic since then has fallen to 8, indicating that US multinational companies are moving abroad and investing in other countries. (Hines Jr. Feb. 20, 2009) These statistics show that the US is slowly losing foreign investment and is having companies reincorporate elsewhere. With lower corporate tax rates in other countries, multinational companies can increase their profits by moving their operations abroad. Basing your company headquarters in a country with a high corporate tax rate can be a questionable decision when compared to other low corporate tax countries and the incentives they offer.

Graph 2



Source: Bureau of Economic Analysis, International Investment Position

In 1999, Robert Murdoch's News Corporation had nearly 800 subsidiaries with about 60 of those in designated tax havens. The Economist reported that from 1994 to 1998, News Corporation and its subsidiaries had nearly 4 billion dollars in pre-tax profits. Of those 4 billion dollars in pre-tax profits, only 238 million dollars were paid in worldwide taxes. This amounts to an effective tax rate of just 6 percent. News Corporation has its main business activities set up in the US, United Kingdom and Australia, all with corporate tax rates of 30 percent or more. Disney, which is a rival to News Corporation, paid over 30 percent in corporate taxes in those years. Disney, which is also a multinational company, has different subsidiaries and divisions all over the world. This proves how the use of low tax countries can reduce a company's overall tax liability. Robert Murdoch's main British holding company, NewsCorp Investments, had reported

profits of 2.1 billion dollars in the 11 fiscal years before 2009. In all 11 of these years, Newscorp Investments paid no net tax. (Larudee 2009) It is unknown as to where Newscorp Investments is holding all of their earnings to have no net tax liability. The secrecy laws in different countries protect information about company holdings. Newscorp was formerly incorporated in South Australia and in 2004 re-incorporated in New York City where its headquarters are now located. (Butcher 2010) As pointed out earlier, both the US and Australia have corporate tax rates of 30 percent or more.

Transfer pricing and mispricing of imports and exports has become the primary method of Chinese and foreign firms for moving billions offshore. One analysis found that Chinese exports were underpriced by an average of 17 percent and imports were overpriced up to 9 percent. This caused 60 to 65 percent of nearly 400,000 companies with foreign investments to show negative profits. They paid no income taxes from the year 1996 to 2000. (Baker 2005) With these two methods, multinational companies benefit from almost all of their profits and reinvest it back into their operations. This is one of the main tax avoidance methods companies will use and has been practiced since the mid 1960's.

The significantly higher corporate tax rate in the U.S. has actually caused a reduction in investment and revenue in the country. Because of its high corporate tax rate, many companies find ways to avoid paying U.S. corporate taxes. In a statement on May 4, 2009, President Barack Obama criticized U.S. corporations for paying a little over 2% in taxes on foreign revenue to the U.S. government. In 2004, U.S. corporations took in \$700 Billion of foreign profit and paid \$16

Billion in taxes to the U.S. government. (Sasseen May 2009) This statistic does fail to mention how much was paid in taxes to foreign governments but clearly shows companies are avoiding paying U.S. corporate taxes and are still producing huge profits. They have been able to produce these significantly higher profits due to the fact that they are paying lower corporate tax rates in other countries.

To offset these corporate tax losses in government revenues, the US has a plan that threatens to increase costs by 200 billion dollars for US corporations operating overseas. The Obama administration is proposing tougher rules for when profits generated overseas are taxable in the US. They will also be looking at the methods of how companies move profits such as transfer pricing and mispricing. They will examine how they move these profits from high tax countries to low tax countries. According to a Brookings Institution study, 30% of the profits earned by US companies abroad came from the Netherlands, Ireland, and Bermuda. All of these countries are known tax havens. I wrote earlier about how a company can obtain a foreign tax credit if they have paid taxes to a foreign government. The company can immediately deduct those taxes off their annual tax filings. This ultimately gives the company a larger deduction in their taxes. Under the president's plan, a company wouldn't be able to obtain a foreign tax credit until the year it brings the profits home and pays its US taxes. If new tax laws were written to offset these corporate tax losses, it is predicted that the US government would recoup approximately 86.5 billion dollars in tax revenue between 2011 and 2019. (Sasseen May 2009) These new tax rules are only proposals and have not been put into effect in the US. The statistics you see are merely projected results that could be the product of the proposed changes.

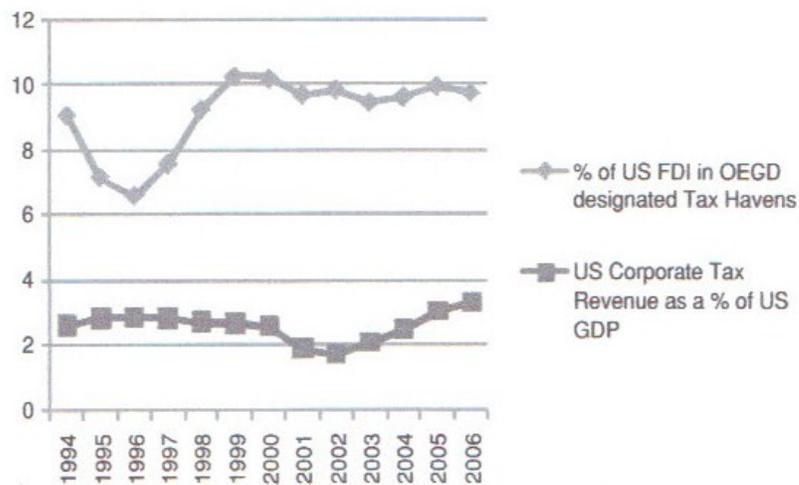
Evidence of the decline in governmental corporate tax revenue is also evident in the total percent of taxes paid over the last fifty years. In the 1950's, the corporate share of total tax revenue was only 27.5 percent. This number is far below the 35% corporate tax rate. During the 1990's that number declined to 10.5 percent, and in 2003 it dropped down to 7.4%. (Larudee 2009) Other countries such as Germany have also seen a decrease in corporate tax collections inside of their country. Hans Jurgen Mueller-Seils, who is head of taxation at BDI, has said Germany is losing investment in the country because of its high corporate tax rate. (Murray-West 1999) These countries are losing the interest of companies and it is slowing affecting their economies. Along with investment and capital, companies bring jobs, and corporate tax rates play a huge role in where a company will start up or open a new branch.

Graph 3 below is a great example of the impact that corporate tax avoidance and tax havens has on a country's tax revenues. As you can see there is a significant difference between the corporate tax revenues based on GDP and the actual corporate tax rate of 35 percent. The corporate tax revenues as a percentage of GDP never exceed the 4 percent mark. And as you can see, the percentage of US foreign direct investment in designated tax havens stays between 8 to 10 percent. There are other areas where a company will place its foreign direct investment which are not used for the purposes of this chart. Graph 3 just shows how much foreign direct investment is placed in designated tax havens, which are listed by the Organization for Economic Co-Operation and Development. The OECD Table 4 earlier lists all countries who have implemented the Internationally Agreed Tax Standards. As stated before this agreement is meant

to ease the flow of information between countries and doesn't restrict a country's tax laws. The OECD just acknowledges that these are known tax havens around the world.

Graph 3

Figure 5(b): US investment in OECD-designated tax havens and corporate tax revenues, 1994–2006



Source: Author's calculations, based on data on FDI and US corporate tax revenues from the US Bureau of Economic Analysis, available at <http://www.bea.gov> Tax havens are defined as in OECD (2000)—see Table 1

Dharmapala 2008

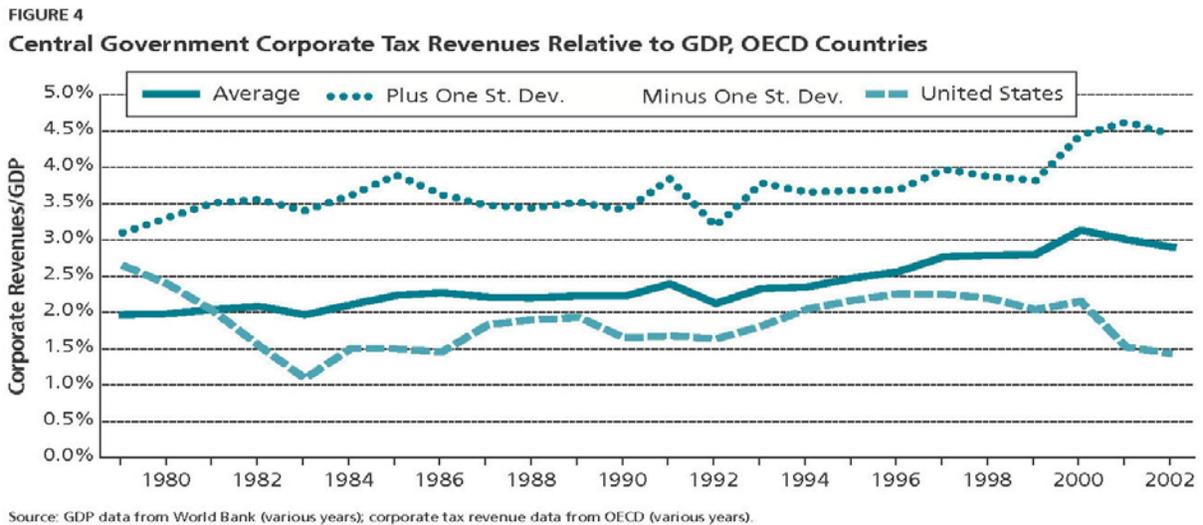
Governments are continually trying to prevent multinational companies from using the various tax avoidance methods we talked about. They have a significant impact on the revenues a government generates. Lately governments have been trying to restrict interest stripping through thin capitalization rules. Interest stripping, as we talked about before, is the strategic use of debt in a company's capital structure. A subsidiary of a company in a low tax country will make a loan to another subsidiary in a high tax country. They will then take tax deductions in the high

tax country and pay interest payments to the low tax country. The tax deductibility of interest payments has been reduced with firms who exceed a certain level of debt in their capital structure. This will compel a company to modify its capital structure or the company will be forced to pay a high tax liability. In 2001, foreign owned subsidiaries in Germany reduced their use of debt in response to the strengthening of thin capitalization rules. (Dharmapala 2008)

Conclusion

As you have seen through the body of this thesis there are many different ways that multinational companies avoid paying their fair share of corporate taxes. They implement strategies such as mispricing and transfer pricing, which relate to exports and imports that a company produces. With these two methods companies implement the use of tax havens which is one of the primary tools for corporate tax avoidance. Through the use of tax havens, multinationals companies are given an overall corporate tax rate of 1-3%. In graph 4 below you will see actual government revenues from corporate taxes as a percentage of GDP.

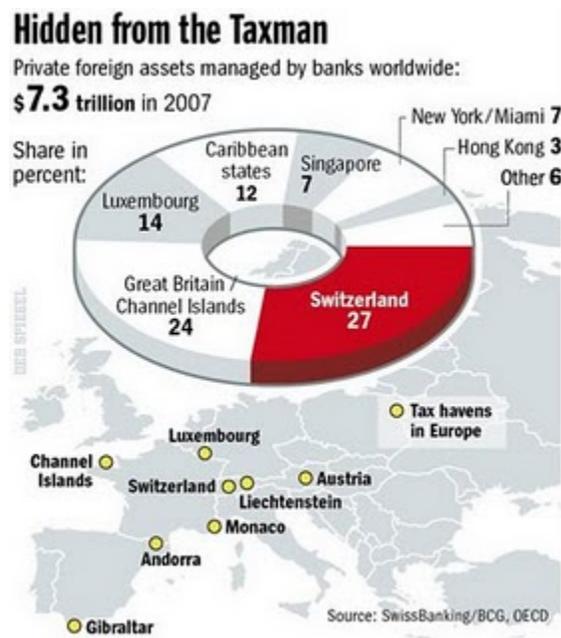
Graph 4



Tax havens are scattered all over the world, as seen above, and provide a huge incentive for multinational companies to gain significantly higher profits. Companies can effectively gain

a tax savings of at least 30% by relocating their operations and profits to a tax haven with little to zero corporate tax rates. By retaining this extra income, which would have been paid in taxes to the country of incorporation, companies can implement a stronger strategic plan and have a higher competitive advantage in their industry. This extra income, which is now essentially profit to a company, can be used to fund new products, purchase new machinery, pay off old debt, or be used by the company in any way suitable to their needs. All of these actions are extremely valuable and could be an essential key to a company's growth and development. In graph 5 below you will see how much of foreign assets are managed by different banks and tax havens around the world.

Graph 5



G20: If They Are Going to Strike at Tax Havens at Least Be Honest about It (2009)

In our world today, it would be impractical for a company not to utilize the use of a tax haven to gain a stronger competitive advantage. Our global economy is working at a phenomenal pace and companies need every advantage they can get. The use of tax havens is not an illegal action and should be used by every multinational company to gain a competitive edge. Not only will it give them a financial advantage, but they will be able to sustain their operations at a competitive level with their rivals. If other competitors are gaining corporate tax advantages through tax havens, why shouldn't all multinationals utilize the low tax rates of tax havens? It's an easy decision when you see how much of a company's profits can be retained by these low tax rates.

Another corporate tax avoidance technique is the use of the US foreign tax credit. If a company has subsidiaries in another foreign country and they pay taxes there, they can obtain a US foreign tax credit for those taxes paid. This gives the parent company a tax break if it's incorporated in the US. Otherwise when the profits are brought back into the US, the parent company would be paying taxes in both countries on the same profits earned.

If a multinational company is incorporated in a country with high corporate tax rates, such as the US, then reincorporating in a low tax country, such as Ireland, would benefit them. Companies shouldn't stay in a country with a high corporate tax rate no matter what the situation is. If a company desires to sell its products or services in a high tax country, they can open a subsidiary in that country. They could even just sell their goods to other merchants or dealers in the country. There is no reason to stay incorporated in a country with high corporate tax rates. If

there are severe enough penalties, such as the ones discussed earlier, it may be reasonable to stay. In the long run however, any company could benefit from the low corporate tax incentives offered by different countries around the world.

Corporate tax avoidance techniques on the international level are vital to a company's success. To stay competitive and to gain a sustainable advantage, it is the best interest of any multinational corporation to implement the use of corporate tax avoidance. These techniques are currently used by many multinational companies and have proven to be successful. They are what drive the competitiveness and rivalries with companies today. We need these corporate tax avoidance methods for companies to grow and develop in the fast pace world we live in. Without them, our global economy would be changing and growing at a much slower rate.

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