Tax Avoidance by Multinational Companies: Methods, Policies, and Ethics

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Why an Acquaintance with International Tax Issues Is Essential for Scholarship, Teaching, and Strategy

To most international business (IB) scholars and educators, global taxation may appear to be an obscure topic. But actually, it is central to global decision-making: most foreign direct investment (FDI) and global operations are biased by tax considerations. The numbers are huge. For instance, with around US$10 trillion worth of world trade being intrafirm and a similar portion being intermediate (as opposed to finished products or services), the multinational firm can decide internally what unit price it will type on its export invoices. No "arms-length" equivalent benchmarks are easily available.

Because of a US tax provision, between US$2.1 and $3 trillion in accumulated profits from US multinational foreign affiliates have not been repatriated (a firm is classified as an FDI "affiliate" if at least 10% of its shares are held by a foreign owner; a "subsidiary" is also an affiliate, but denotes majority or full ownership by a foreign entity or owner.) I conservatively estimate that out of the million-odd foreign affiliates of all multinationals listed in the United Nations Conference on Trade and Development (UNCTAD) 2015 database, between 300,000 and 400,000 are shell or dummy companies (firms that have no economic activity except for a part-time accountant or a lawyer behind a shining brass nameplate). The entire FDI statistics of major nations such as China and India, for example, are biased by the "round-tripping" of *local* investment masquerading as *foreign* investment.

Global strategists and IB scholars grapple with a key dilemma – the tension between a world divided into 190-odd territorial and tax jurisdictions versus the desire of multinational corporation (MNC) executives to view the planet as a single economic space within which to optimize shareholder (or private corporate) value by shifting taxable profits, operations, and finance from one country to another. Awareness of and sensitivity to international tax avoidance are growing, exemplified by the EU's introduction of a "Tax Avoidance Package" in early 2016 and by strident voices on both sides of the American political aisle. US presidential candidate Bernie Sanders describes tax avoidance as a "scam." Donald Trump has labeled corporate inversions "disgusting."

An Overview of Tax-Avoidance Methods and Their Relative Importance

The seven tax-avoidance methods summarized below, starting with the one that has the biggest impact, are legal because they use provisions and loopholes granted by the countries involved.

1. Exemption/Deferral of Foreign Affiliate Income (The "Biggest Break")

Most advanced nations typically tax the profits generated by multinationals' home-country operations, but not their foreign affiliates' profits (Markle, 2015). Others, including the US, treat their multinationals' worldwide income as taxable. However, the US offers a gigantic loophole: after paying each country's taxes, MNCs can defer additional US taxes on foreign affiliates' profits indefinitely by simply not remitting those profits back to the US. Instead, the funds are parked in tax havens (like Bermuda) and reinvested in other foreign operations (Contractor, 2015a). Unrepatriated profits of US multinationals' foreign subsidiaries—which have legally escaped US taxation—are estimated at US$2.1 to US$3 trillion.

2. Transfer Pricing

In international supply chains, multinationals ship goods and services with unit values often biased by tax considerations. Consider two affiliates, A and B, both owned by the same MNC. Affiliate A has been exporting 1,000 items per year to Affiliate B, invoiced at US$1.30 each. Initial pre-tax profits are $1,000 in A and $2,000 in B. But if these items are invoiced at US$1.80 each, B would then pay A US$500 more annually. Firm A's profit would increase, and B's would decrease--but the MNC *as a whole* would increase its after-tax income from US$2,250 to US$2,325. The idea is simple: pay higher amounts to affiliates where taxes are lower, and report lower values where taxes and/or tariffs are higher (See Figure 1 and Table 1).

Figure 1. An Illustration of Transfer Pricing

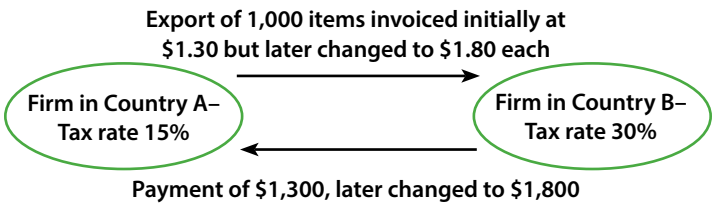

Table 1. Export of 1,000 Items – Payment of $1,300 Changed to $1,800

	Before Change in Transfer Price (Export Shipment Invoiced at $1.30 Each)		After Change in Transfer Price (Export Shipment Invoiced at $1.80 Each)	
	Firm A	Firm B	Firm A	Firm B
	Tax Rate 15%	Tax Rate 30%	Tax Rate 15%	Tax Rate 30%
Pretax Profit	1,000	2,000	1,500	1,500
Tax	150	600	225	450
After-tax Profit	850	1,400	1,275	1,050
Total MNC After-tax Profit	**$850 + $1,400 = $2,250**		**$1,275 + $1,050 = $2,325**	

No real change has occurred, and production cost does not change. However, one simple keystroke changes the invoiced unit price from US$1.30 to US$1.80 and so allows the MNC to increase global after-tax profits. This is only one example. Millions of shipments are made annually—a great many where the exporter and importer are the same MNC, which can decide the invoice value depending on the tax differential between the import and export nations. Intrafirm trade is huge, estimated between 42 and 55% of world trade (around US$23 trillion). Moreover, much international trade is in intermediate (not finished) products, some with unique designs and embedded proprietary technology. So with no comparative arms-length valuations, the MNCs themselves declare their shipments' value (Lanz & Miroudot, 2011).

In the example above, if Firm A's country's tax rate were higher than Firm B's, or if Country A levied an import tariff, then the situation would be reversed: the MNC could under-value the shipment from A to B to reduce its total worldwide tax and tariff liability.

3. Royalty Payments

Tax avoidance through interfirm royalty payments occurs because:

1. Typically, MNCs are technology-intensive. Most value resides in proprietary technologies or intangible assets.
2. Even if research and development (R&D) costs have been incurred by Firm A (located in the home country of the MNC), current rules allow the transfer of the patents or brands to a holding company or affiliate (in a low-tax country, such as Ireland) or a shell company (in a zero-tax country, such as Bermuda), which then charges royalties to headquarters and other affiliates (Dischinger & Riedel, 2008).
3. Most governments allow deductions for royalty payments, which reduces the tax liability of the licensee—even if the licensee is part of the same MNC, and even if no R&D was performed in the licensee's nation.

In Table 2, a Japanese company conducting R&D in Japan establishes a subsidiary in the US. In Scenario 1, the US subsidiary pays no royalty for the Japanese technology. In Scenario 2, nothing has changed except that the Japanese parent has signed an additional side agreement with its US subsidiary, which will pay a 5% royalty to its parent. Under US rules, despite the US operation being the fully-owned "child" of its Japanese "parent," the royalty payments are a tax deductible expense. US tax liability is legally reduced from US$90 to US$75. And the total remittance (after taxes) to Japan increases from US$210 to US$225. True, less re-investible profits are left in the US operation, and more go to Japan. But this benefits the MNC overall if the effective tax rate in Japan (say 20%) is less than the US tax rate of 30%.

More aggressively, it is even better for the Japanese MNC to transfer the patent rights to another subsidiary in a low-tax nation, such as Ireland. By making the Irish subsidiary the licensor, royalties collected there would be taxed at an even lower corporate rate—perhaps as low as 10% instead of the Japanese rate of, say, 20% (Mutti & Grubert, 2009).

Further, the Japanese patents could be transferred to a Bermuda or Cayman Islands shell company—as Google, Apple, and many pharmaceutical firms have done—with royalties collected there at near-zero tax liability.

Table 2. Japanese MNC's US Subsidiary Royalties —Scenario 1–No Royalty vs. Scenario 2–5% Royalty

Scenario 1: Japanese MNC's US Subsidiary Pays No Royalty		Scenario 2: Japanese MNC's US Subsidiary Pays 5% Royalty	
Sales by Japanese subsidiary in USA	1,000	Sales by Japanese subsidiary in US	1,000
Total costs (no royalties involved)	700	Royalty (at 5% on sales)	50
Profit before tax	300	Total costs (excluding royalties)	700
US tax (at 30%)	90	Profit before tax	250
Profit after US tax	210	US tax (at 30%)	75
Total remittance to Japanese parent	**$210**	Profit after US tax	175
		Royalty remittance to Japanese parent	50
		Total remittance to Japanese parent	**$225**

4. Intracorporate Loans

Governments generally allow companies to deduct interest payments on loans as an expense. But if the lender and borrower are companies

within the same MNC, albeit located in different nations, then the MNC can reduce taxes in high-tax jurisdictions (e.g., by making its lower-taxed affiliates extend loans to affiliates in higher-tax nations, thus enjoying a juicier tax deduction on the interest payment).

FDI flows consist of three components: New Equity + Retained Earnings + Net Intracorporate Loans. Although we lack comprehensive data on the magnitude of worldwide intracorporate loans, they would conservatively exceed three quarters of a trillion US dollars (UNCTAD, 2015). We have no comprehensive idea of how many loans are motivated by tax avoidance, and even less about the extent to which the intracorporate interest rate deviates from the actual cost of capital to a lending affiliate or parent. In recent years, "a number of countries have imposed restrictions on the tax deductibility of interest" (DeMooij, 2011); but the enforcement of rules is lacking, especially in developing nations (Faccio, Lang & Young, 2010).

5. Other Central MNC/Parent Overheads and Costs

For reasons scholars have not fully understood, MNC R&D expenditures remain highly concentrated in the parent nation, or at least in far fewer countries than the number of territories in which the fruits of the R&D are derived (Belderbos, Leten & Suzuki, 2013). Some fraction of centralized MNC R&D costs and overheads logically have to be charged to each foreign affiliate (Sikka & Willmott, 2010).

Charging royalties to each affiliate for centrally-developed technology is one technique. Other categories of overheads (e.g., the costs of maintaining brand equity, other headquarters administrative costs involving global information technology, supply-chain management, and human resources) should not be borne entirely by the parent firm, but spread over the various subsidiaries and foreign operations that enjoy the benefits of the MNC's central administration overheads.

In principle, this sounds fair, but how does the MNC carve up slices of its central overheads pie and proportionally allocate/charge a slice to each foreign affiliate? This is difficult because the allocation will vary depending on the weight of each country affiliate (in the planetary total) – the weighting for each country varying by numbers of employees, versus value added in the nation, versus assets, and so on. An obvious further complication is that exchange rates fluctuate, affecting the share of each affiliate in the worldwide total pie from year to year.

But, of course, MNCs are not tax-unbiased. They face a clear temptation, *ceteris paribus*, to allocate a larger slice of the overheads pie to operations in higher-tax nations and *vice versa*. There is no standard methodology. The EU has been attempting, since 2000, to formulate relevant rules for a combined pan-European system for the future; however, each formula has its problems and detractors (Picciotto, 2012; Altshuler, Shay & Toder, 2015).

6. "Round-tripping" and Shell Companies

In 2011, 70.1% of Chinese outbound FDI went to Hong Kong or Caribbean affiliates (OECD, 2013). Much of this Chinese money made a round trip, returning to mainland China under the guise of "foreign investment" in order to take advantage of the still better tax treatment, cheaper land or loans available to "foreign" as opposed to purely "domestic" investors. Another driver is evading capital controls (Contractor, 2015b), since Chinese renminbi (RMB) cannot be converted into dollars or euros without a written justification, such as FDI.

UNCTAD (2011) reported an implausible 434,248 Chinese foreign affiliates out of a worldwide total of 892,114 for *all* MNCs. Conclusion? A large number are shell companies, with no economic activity or purpose other than round-tripping or evasion of capital controls.

In Europe, shell companies account for over 80% of FDI into Luxembourg and Holland, over 50% in Hungary, and over 30% in Austria and Iceland (OECD, 2015). A third of FDI into India emanates from Mauritius because the two countries have a tax treaty. US multinationals use tax haven subsidiaries as "parking spots" for un-repatriated foreign affiliate profits and as licensors to collect royalties charged to other affiliates globally (Contractor, 2015a).

Considering these facts, I conservatively estimate that 30–40% of all FDI affiliates worldwide in the UNCTAD World Development Reports or World Bank databases are shell companies—a sobering thought for scholars using these data.

7. Inversions

An inversion involves a company shifting its corporate headquarters to a lower-tax jurisdiction by acquiring/merging with a foreign firm in a lower-tax country. The intended tax savings of the Pfizer (US)–Allergan (Ireland) merger were estimated at $150 billion since US taxes can be 35% while Irish taxes are 12.5% at most. Other examples since 2012 include Mylan moving to the Netherlands and Burger King to Canada, which have lower tax rates than the US.

The numbers of inversions have actually been few. For the US, only 44 occurred since 2000, and six in 2015, though each is typically huge (Contractor, 2016). As long as MNCs conclude that home nation taxes are higher than in other nations, inversions will continue in the future.

Ethical Pros and Cons

Pros

Many executives argue that taxes in nations like the US are already too high and that firms suffer a competitive disadvantage if higher taxes mean less after-tax income is reinvested in R&D and/or smaller dividends are distributed to shareholders. Some argue that if government rules allow loopholes, it is the company's fiduciary duty toward shareholders to take advantage of loopholes to (legally) avoid taxes.

Cons

Critics aver that tax avoidance may be legal, but loopholes in tax provisions have been written by corporate lobbyists. Multinationals enjoy all the tax-avoidance methods outlined in this article. Consequently, the much-trumpeted US corporate tax rate of 35% is actually only

the *marginal rate*, with *actual effective* rates variously estimated to be between 19.4%[1] and 27%,[2] putting the US tax burden in the middle of the OECD advanced-nation group (Contractor, 2016).

It is true that if a MNC pays higher tax, less money is left over for shareholder dividends or to replenish the R&D budget. But critics argue that the gains from tax avoidance may not go to R&D or dividends, but instead can be diverted into fatter bonuses and stock options for top executives.

Conclusion

No decision in large MNCs is made these days without assessing tax implications. The magnitude of the international tax-avoidance phenomenon—the extent to which global operations, supply chains, and location decisions are affected by tax considerations—places this issue at the heart of global strategy. In large companies, executives consider tax angles concurrently with strategy, rather than as an afterthought. Vanishingly few IB and strategy papers take taxes into consideration. Consequently, an acquaintance with this topic is unquestionably critical to IB scholarship, teaching, and practice.

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Endnotes

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