INTERNATIONAL TAXATION

INTERNATIONAL TAX PLANNING/AVOIDANCE

BASICS

- Are multinationals paying their fair share of taxes to the countries they are doing business in?
- The tax planning activities of multinationals have attracted a lot of attention from governments, NGOs and the public.
- Details of the tax planning practices of large MNEs; Amazon, Apple, Google and Starbucks Groups came to light during 2012 and 2013.

BASICS…Cont'd

- These practices vary from group to group
- Many of these practices are often referred to as tax avoidance but can also be classified as tax evasion.
- Tax avoidance refers to companies (or individuals) transactions entered into solely or mainly for the reduction of taxes within the law.
- Tax evasion refers to activities that are illegal under tax legislation such as claiming fraudulent deductions and not reporting foreign income.

Introduction

- Global group of companies have come under scrutiny in the recent past due to the perception that they manage to avoid tax in countries they operate in.
- The companies plan so that under the current international tax rules most of their profits are taxable in countries with little or no tax.
- MNEs exist primarily to make profits and what matters most is the after-tax profits used to reward shareholders.

Benefits of Tax Planning

1. Increased after-tax profits
2. Reduced tax liability
3. Reduced effective tax rate
4. Increased cash and liquidity

Costs of Tax Planning

1. Transaction costs incurred in setting up the tax planning strategy
2. Risk of detection if the activities are illegal or in the 'grey' area.
3. The increased ability of managers to use the opaqueness required to disguise some transactions
4. Incentives required to encourage tax managers/directors to engage in these activities, as they face personal costs if detected.

Costs of Tax Planning…Cont'd

- Further costs if the tax planning activity is detected and disallowed

1. The unpaid tax liability and back taxes
2. Tax benefits that may be disallowed
3. Interest on the tax deficiency
4. Penalties imposed on the firm and the managers
5. Disruption from normal activities to comply with a tax audit.

Corporate Tax Avoidance Methods

- The main objective of international tax planning consists of minimising the overall effective tax rate of the whole group.
- There are different methods used by companies to shift profits from high-tax to low-tax jurisdictions.

Tax Planning Strategies

1. Thin Capitalization
2. Use of Tax Havens
3. Transfer Pricing
4. Contract Manufacturing
5. Marketing Services and Trading Company Structures
6. Double Irish and Dutch Sandwich
7. Treaty Shopping
8. Hybrid Mismatch Arrangements

1. Thin Capitalisation

- Sometimes referred to as earning stripping
- Subsidiaries are financed by debt from the parent company instead of equity.
- An entity that is financed through a relatively high proportion of debt compared to equity is said to be highly geared, leveraged or thinly capitalized
- Interest on loans is tax deductible as opposed to dividends on equity/share capital
- The interest expense is offset against taxable profits in the high-tax regime thereby reducing tax liability
- Also interest rates paid on intra-company debt may be multiple times higher than interest rates paid on external debt

1. Thin Capitalisation…Cont'd

- Thin Capitalization Rules are enacted to counter this strategy

In Kenya, a company is thinly capitalised if all of the following occur;

1. The company is controlled by a non-resident person alone or together with four or fewer persons.
2. The company is not a bank or financial institution.
3. The company is not a micro and small enterprises registered under the Micro and Small Enterprises Act, 2012.
4. Gross interest paid/payable is in excess of 30% of EBITDA (Finance Act 2021)

2. Use of Tax Havens

- MN groups use tax havens to reduce and/or defer payment of tax on profits by legal means.
- Many tax havens are located in the Caribbean.
- Are often heavily involved in banking due to the ease of money transfer and documentation.
- However not all major banking centres are tax havens
- Countries considered to be tax haven often prefer to be referred to a off-shore financial centres (OSCs).

What is a Tax Haven

- OFCs are jurisdiction in which transactions with non-residents far outweigh transactions related to the domestic economy.
- In general a ‘tax haven’ is loosely defined to include any country having a low or zero rate of tax and offering a certain level of banking or commercial secrecy.
- The OECD defines a tax haven as a country which imposes low or no tax and can be used by corporations to avoid taxes which would otherwise be payable in a high tax country.

2. Use of Tax Havens

- **Tax havens** have the following characteristics'

1. Low or nil tax
2. Secrecy: banking and/or commercial
3. Absence of exchange controls
4. No requirement of substantial activity
5. Provision of off-shore banking facilities
6. Good communication facilities
7. Political stability
8. Favourable disposition to foreign capital
9. Availability of professional advisers
10. Convenient location, good climate for communications and to attract staff.

3. Transfer Pricing

- Firms can shift profits from high-tax to low-tax jurisdictions through the pricing of goods and services sold between affiliates.
- To properly reflect income the prices set between related parties should be the same as the prices set between unrelated parties
- That is, an arm's length price.
- By lowering the price of goods and services sold by parents and affiliate in high-tax jurisdictions and raising the price of purchases income can be shifted.

4. Contract Manufacturing

- Under contract manufacturing the principal entity enters into a contract with another company to manufacture its products according to certain specifications.
- A contract manufacturing arrangement is similar to a toll manufacturing operation.
- Under a contract manufacturing arrangement, the distributor/principal entity enters into a contract with the contract manufacturing company, to manufacture products according to the specifications under a buy-sell arrangement.

4. Contract Manufacturing…Cont'd

- Returns earned by a contract manufacturer are based on a cost-plus return on the manufacturing costs incurred by the contract manufacturer.

5. Marketing Services and Trading Company Structures

I. Marketing Services Structure

- In a marketing services agreement an MNE designates sales staff in a high-tax jurisdiction as ‘marketing’ personnel
- although these personnel maintain sales relationships the company’s employees in low-tax jurisdictions actually finalize the sale so that the majority of the profit is booked in the low-tax rather than the high-tax where the real sales activity took place.

5. Marketing Services and Trading Company Structures

II. Trading Company Structure

- In this scheme a company designates a subsidiary in a low-tax jurisdiction to control a function such as ordering from third-party manufacturers and inventory management for the whole group.
- The company will then state that the subsidiaries in high-tax countries which, in general, account for the bulk of sales are simply distributors in spite of the goods being held or services to end customers being provided from those jurisdictions.

6. Double Irish Dutch Sandwich

- The technique involved two Irish companies, a Dutch company and off-shore company located in a tax haven.
- The first Irish company (IRL1) would incorporated in Ireland but 'managed' from a tax haven like Bermuda.
- The second Irish company (IRL2) sold IP based products e.g. iPhones globally. The Irish tax system considers IRL1 a Bermuda company while the US considers it Irish so neither taxes it.

6. Double Irish Dutch Sandwich

- IRL2 can send its profits to IRL1 using a Dutch company as an intermediary taking advantage of the Ireland-Netherlands DTT, which provides for no withhholding tax
- avoiding Irish withholding tax on moving money between IRL1 and IRL2
- There is no withholding tax under Netherlands domestic law so the funds can be paid to the Bermudan holding company tax-free
- Since 2020 this strategy is no longer in use.

7. Treaty Shopping

- Treaty shopping refers to an analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty.
- It is the practice of structuring a multinational business to take advantage of more favorable tax treaties available in certain jurisdictions.

7. Treaty Shopping…Cont'd

- A business that resides in a home country that doesn't have a tax treaty with the source country from which it receives income can establish an operation in a second source country that does have a favorable tax treaty in order to minimize its tax liability with the home country.
- Most countries have established anti-treaty shopping laws to circumvent the practice.

8. Hybrid Mismatch Arrangements

- **Elements of hybrid mismatch arrangements**
- Hybrid mismatch arrangements generally use one or more of the following underlying elements:

1. ***Hybrid entities***: Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.
2. ***Dual residence entities***: Entities that are resident in two different countries for tax purposes.

8. Hybrid Mismatch Arrangements

3. ***Hybrid instruments***: Instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.
4. ***Hybrid transfers***: Arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralised loan.

Effects of Hybrid Mismatch arrangements

- hybrid mismatch arrangements aim at achieving;

i) **Double deduction schemes**

ii) **Deduction / no inclusion schemes**

iii) **Foreign tax credit generators**

Case Studies on International Tax Planning

1. Apple Inc
2. Google Inc
3. Amazon Inc

- Public Accounts Select Committee proceedings. Videos available on YouTube

1. UK v Google – Paying the Right Taxation
2. UK v Amazon - Paying the Right Taxation

Questions?