International University of Applied Sciences Bad Honnef . Bonn

Masters in International Management

How MNCs Exploit Various Tax Optimization Techniques

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Abstract

This research focuses on how and why the major firms or the Multi-National companies (MNC's) in the United States dodge taxes in their home countries and choose Tax Haven countries like Ireland, Cayman Islands and other autonomous territories. The Transfer Pricing and Royalty Payments are the most common techniques employed by the global firms in order to achieve their goal of reduced tax payments. This, however, is not achieved so easily, several tax loopholes have to be explored and exploited. Especially these firms have an incentive of using various tax structures to avoid tax at home and in foreign country with the use of tax havens. The role of Big 4 Accounting Firms like PwC, Ernst and Young (EY), Deloitte, and KPMG is huge in creating tax exemptions for the companies. The impact of paying less taxes on the national (The US) and the global economy is also uncovered at a later stage of the research. This paper looks into the relevant Literature done by other researchers which then this paper is further carried by Research Methodology and Research Analysis. The Research Analysis will be structured by analyzing the companies domiciled in the U.S. and performing their operations in Europe.

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Introduction

The main criteria or the instrument in avoiding the tax by Multinational Companies (MNC's) is by using tax havens, wherein the company routes its profits to another country (foreign) country where the amount of tax which has to be paid is way less when compared to the tax rate to that of the home country. This usage of tax havens, however, is a debatable question because it deals with not only ethical issues but also the legalities. The recent release called "Panama Papers" exposes the dark side of the offshore financial centers. The "Panama Papers" not only focus on the tax evasion by the companies operating on a global scale but also on the individuals (elite class) in the countries researched. The Advance Pricing Agreement (APA) is one method used in Transfer Pricing. This APA is a long-term agreement between a tax authority and a MNC that specifies the price of a related transaction. The regulations in the Transfer Pricing apply a principle called Arm's Length. The arm's length principle is meant to ensure that every department in the company earns a congruent profit and therefore pays the correct amount of corporate tax to its respective tax authority. The so called Big 4 Accounting firms use this agreement very effectively as part of their transfer pricing technique. The relationship between tax avoidance and the use of Big 4 accounting firms seems somewhat pervasive (Sikka & Wilmot, 2013). It is estimated that the firms in the US avoid taxes of $130 billion annually (Zucman, 2014), whereas around 25% of global profits are shifted into jurisdictions where little, if any, real activity takes place (Cobham & Jansky, 2015). "The tax policymakers are discussing the potential impact of shifting from a system of worldwide taxation to a territorial tax regime to deliberate on whether to impose a minimum tax on foreign income earned in low tax jurisdictions" (Donohoy, McGill and Outslay, 2012). According to the Organization for Economic Co-Operation and Development (OECD), the losses in tax payments amounted to between $100 billion and $200 billion

Literature Review

(Kutera, 2017) states that:

"Tax reduction methods can take many forms. Some of them are legal and raise no doubts, some are focused on searching for and taking advantage of loopholes in the law. Both the above groups are classified into the tax optimization category, albeit more or less aggressive. Tax evasion, which is illegal, is a completely different story. The essence of tax evasion is failing to pay taxes regardless of having a duty to do so under legal regulations. Of course, the border between ordinary tax optimization, tax avoidance and tax evasion is not clear-cut. In the last two situations, the existence of a tax liability is an important criterion. In the case of tax avoidance, no such liability appears. On the other hand, in the case of tax evasion, the liability exists, but the taxpayer does not pay it. In many cases, companies take conscious risk when deciding on a specific solution. However, this is what ordinary corporate financial management is about. It is therefore necessary to differentiate these three areas and clearly define them. However, it must be borne in mind that an ideal tax law cannot be developed and adopted, In this regard, practice will always be one step ahead of legislation and will ruthlessly take advantage of any loopholes in it (Kutera, 2017).

It also states, that the role played by tax havens in the tax optimization is very prominent. In general, a "tax haven" is defined as a group of countries or territories that "provide favorable conditions for foreign nationals to run businesses, mainly by exempting them from income tax or by levying income tax at only a symbolic rate." According to the Organization for Economic Co-Operation and Development, the tax haven is defined as "a place where the existing legal system allows non-residents to reduce taxes in their country of residence" [OECD 2009, pp.11]. The core principle of using tax havens is that taking advantage of the tax rate in those territories and routing (shifting) the profits over there. However, royalties is a different term to that of tax haven when using the techniques of tax optimization. It is defined as "payments of any kind receives as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematography films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience" [OECD, 2014]

(Chris Jones, 2016) states that:

"The firm-specific and country-specific factors interact with one another. A firm will not use multiple offshore subsidiaries if it has no firm-specific advantage. Hence, non-location bound firm-specific advantages (FSA's) are essential if the firm is to take advantage of tax avoidance. Classic examples include the registration of patents and trademarks offshore to allow royalty payments to be shifted from high to low tax jurisdictions. These authors made a Hypothesis for supporting the above statements. The first Hypothesis states that "The size of a MNEs tax haven network depends positively on the ratio of intangible assets to total assets. It links tax haven FDI to the varieties of capitalism (VOC) framework. If MNEs from countries with a more liberal market orientation (LMEs) have a greater propensity to set up tax haven activity compared with their competitors who have origins in one of the coordinated market economies (CMEs). They base these statements on certain factors: (1) Path-Dependency, i.e. economic geography linked to colonial history; (2) financial risk linked to a choice between equity financing versus debt financing; and (3) governance factors, and in particular co-determination whereby the rights of workers are enshrined in legislation that make it more likely that they have a presence at the board level. Their Hypothesis 2 states that "The size of a tax haven is higher for MNEs who originate and operate in LMEs compared with MNEs and CMEs."

"MNEs do not take decisions about tax haven use in a vacuum. As intermediaries, there exist a plethora of law and financial services firms that help MNEs to shift profits to lower tax jurisdictions. However, Big 4stand out, since they may not only provide technical support and confirmation of ta strategies, helping MNEs to navigate the regulatory environment, but are often also the creators and vendors of particular strategies. This can be clearly seen with PwC in particular, for example, in the leaks of Luxembourg tax rulings." The above statement has led to a third hypothesis wherein it states that "The size of a MNEs tax haven network depends positively with MNEs who are audited by of the Big 4. This paper concludes by saying that "firm specific and country-specific factors determine the extent to which MNEs utilize tax havens in order to shift profits abroad and take advantage of the high degree of secrecy that these locations provide. It also further looks into the investors benefits by mentioning that their portfolios might to better which avoid auditing by the so called Big 4 firms or those that that switch to the Big 4. This statement is mainly made because of the fact that the purpose of Big 4 firms is to shift profits from home countries to the subsidiaries in the foreign countries. They look into loopholes rather than making a clean audit.

(Lahav, 2016) states that:

The authors deal with the Transfer Pricing (TP) in their paper. They state that, "the accuracy of pricing intercompany transactions for tax purposes is essential. It has been established that improper TP can harm an MNE, especially, if it must contend with profit adjustments and is required to pay fines and interest. Even if the MNE chooses to dispute a tax adjustment, legal procedures can be extremely costly, and therefore, MNEs are more likely today to view Advanced Pricing Agreements (APAs) as a preferred alternative to eliminate that risk through advance negotiations rather than arguing about the transfer price ex ante. They show that, in addition to the high cost of an APA, fixing profit margins in advance eliminates uncertainty regarding the profitability of the subsidiary at the expense of the parent that incurs additional risk. Although it seems that the provision of such a profit insurance service is an internal matter of the MNE, the arm's length approach involves the interest of policy makers and regulators. Like any other intercompany services provided by one entity to another, this one should also be prices at arm's length." This paper also deals with the model called Profit Margin Guarantee, which is driven by several goals. They try to put this model as simple as possible because according to Felgran et al. (2009), the APA program always searches for methods or procedures that can include some changes in the business and economic environments that subsequently affect the profitability of MNEs that enter into APAs. These changes made can be difficult to perceive. They also use Arbitrage Pricing Theory (APT) and Capital Asset Pricing Model (CAPM) in their model. Although these two are asset pricing models, some speculation or assumptions have to be made in order to get the beta value. The APT need a minimum of 3 macroeconomic factors to get an estimated value. However, these macroeconomic are not described clearly. The assumptions made are based upon the current market, economic and political conditions in a specific country. The paper ends with some open issues of which the need to incorporate fluctuations in exchange rates. "

"When an intercompany transaction is international and the two entities reside in jurisdictions that use different currencies, fluctuations in the exchange rate increase the risk of the parent when it provides a profit margin guarantee. The average duration of an APA is more than 6 years and exchange rates can change dramatically during such a long period." They conclude by saying that "the model in its current version is appropriate for many intercompany transactions around the world, and encourage both MNEs, policy makers, regulators and Transfer Pricing professionals to implement it to preserve the arm's length approach and to promote the accuracy and reliability of the tax systems.

(Michael P.Donohoe, 2012) states that:

This paper aims to educate the policymakers, analysts and the media with some insights on how to analyze and interpret a U.S. multinational company's financial statement disclosures of its international operations. It discusses a case study of Apple Inc. and analyses its 10-K annual report. After analyzing Apple's 10-K report, they found out that their effective tax rate was 24.2 percent and cash tax rate was 9.8 percent (using the profit before income taxes as the denominator for both ratios). However, the difference between both the tax rates in nowhere mentioned in the paper which make it bit to comprehend the further research conducted by them. They conclude by saying that, "academic researchers who rely on financial statement data (e.g., Compustat), should acknowledge the limitations and diversity of practice with respect to financial statement disclosure of international operations, and should not accept Compustat at face value (Earnes and Luttman, 2010)"

(Brajcich, 2015) states that:

They present a simple model that can be used to impute or estimate the impacts of "influential observations" when such data are unavailable. They describe that a patent is much easier to transfer to an overseas subsidiary than brick and mortar factories. Thus, companies operating in the pharmaceutical and technology industries (whose income producing assets are disproportionally patents and other intangible assets) are often presented with a greater opportunity to transfer foreign earnings beyond the reach of the U.S. They particularly focused on pharmaceutical companies in their study. According to them, the "U.S. taxes its corporations on their worldwide income regardless of where the income is earned. The Corporation located in the U.S. is obliged to pay the tax to the U.S. Treasury Department on that income. This tax paid is addition to that of any tax paid in the foreign jurisdiction. However, if a U.S. corporation forms a subsidiary corporation in a foreign jurisdiction, U.S. tax law respects that subsidiary as a separate taxpayer." It is almost impossible to bring the foreign subsidiary to the country where the corporation is domiciled. Thus, forming a subsidiary to accumulate foreign earnings allows U.S.

corporations to temporarily or altogether avoid U.S. tax on those earnings. If the foreign subsidiary pays a dividend to the U.S. parent, it will then be subjected to U.S. tax. Although this deferral of U.S. tax is subject to many limitations in the Internal Revenue Code (IRC), yet U.S.-based MNCs are still able to effectuate the technique in certain circumstances. Avoiding U.S. tax in the current period is often referred to as an interest free loan from U.S. government. The authors voluntarily admit that they have failed to include information about control variables other than subsidiary location and industry.

(Shaxson) states that:

The existence and routing of profits to tax havens is legal. The officials in tax havens point out that those places are sovereign nations meaning, that they have every right to set their own tax laws. The author questions the above statement by quoting that the countries harmed by havens have every right to take strong countermeasures against them. The officials in havens note that people have the right to privacy and need relief from unjust laws. But the people who use tax havens are extremely rich and powerful. The author lashes out the tax optimization system stating that, the tax havens are formidable bastions of wealth and power, but because they hurt nearly everyone, the campaign against them could conceivably draw together a vast array of allies.

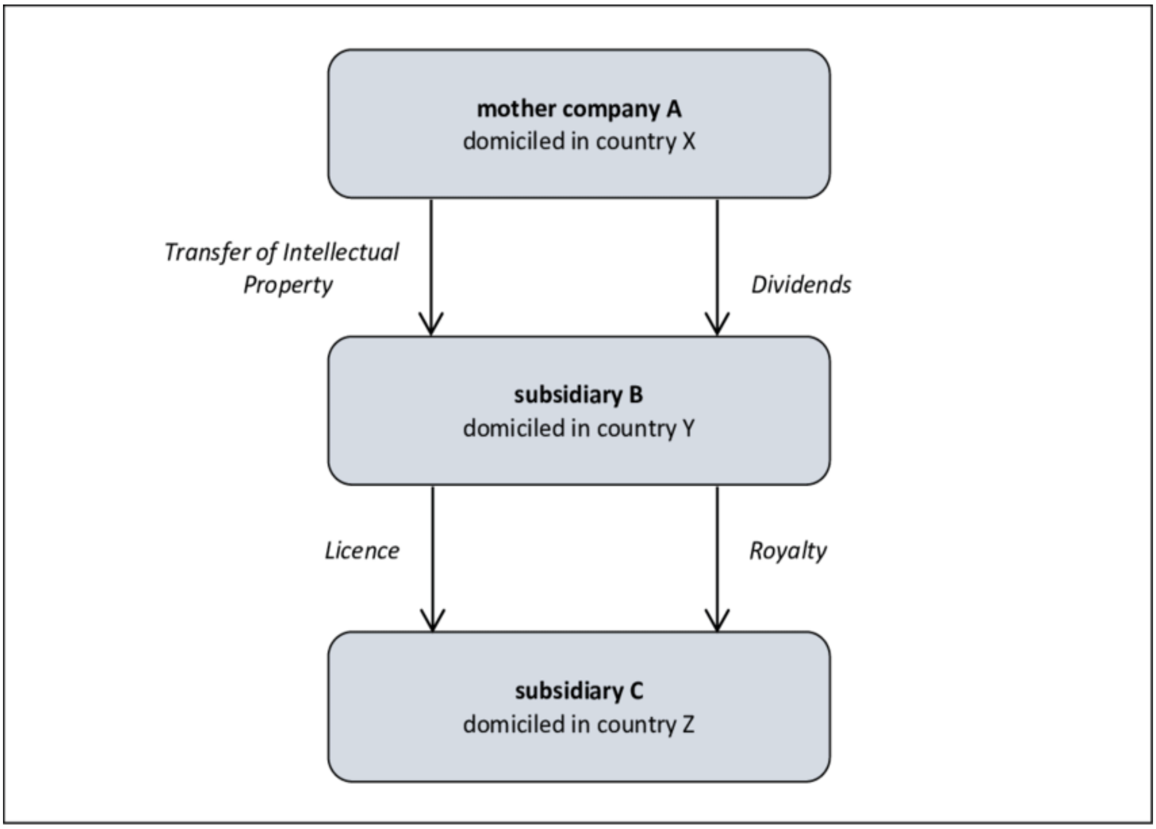
Research Methodology

The main purpose of this research, presented in the introduction is to show how the big corporations in the U.S. avoid taxes by using tax optimization techniques such as royalty payments and transfer pricing. The key tool in conducting this research further is to compare the taxes which have to be paid actually and the taxes that have actually been paid by large corporations. For providing a strong valid argument to this research, the operations of large corporations which are domiciled in the U.S are taken beyond boundaries (by showing their operations in the Europe as well). The comparison technique is being used in this research because it is easy to conduct and a detailed information can be obtained from valid sources. The other possible approach for this research could potentially be Statistical Analyzing of Data taken from various sources. But, we restrict to the comparable analysis owing to the complexity and time consumption involved in the other methodology.

Research Findings

Functioning of Royalty Model

The European Union (EU) has taken an initiative to offer tax preferences for profit on patents on order to increase the region's economic growth rate and attract new companies into EU (Kutera, 2017).



Source: (Kutera, 2017)

According to the above figure, the parent company A is domiciled in country X and it establishes a subsidiary B in country Y which applies reduced tax rate to revenue from licenses, and the parent transfers all its intellectual rights to this subsidiary. Then, the "subsidiary B grants the property rights to another company C which is located in country Z, which actually runs business based on the license. Under this agreement company C pays regularly pays higher royalties to company B. In this way, it overestimates its costs while at the same time understanding its income tax base. In addition, it is under no obligation to withhold a tax because in most cases no tax is withheld if the royalties are paid to a company registered in another EU member state. Company B, in turn, has high revenues, but they are taxable at the preferential tax rate of country Y" (Kutera, 2017). In the end, the profits which are generated from company B is paid as dividends to the parent company A. As part of this transaction, the tax withholding in country Y can often be avoided, as can the income tax in country X. However, in reality the subsidiaries are created in tax havens. This is the principle used by large corporations in the U.S (especially pharmaceutical and technology firms because the patents and the intellectual property can be effectively shifted from the home country to a tax haven in a very effective way) to shift their profits to foreign country by using royalty model. This model, however, cannot be employed by corporations (e.g., industries), where the raw material is produced and used within the home country. If shifting the material a possibility to use royalty model, then it is only possible theoretically but not in practice because it would not make any sense in transporting all the raw materials from one country to another just to achieve tax optimization.

Comparing Starbucks Pretax Profits and After-Tax Profits

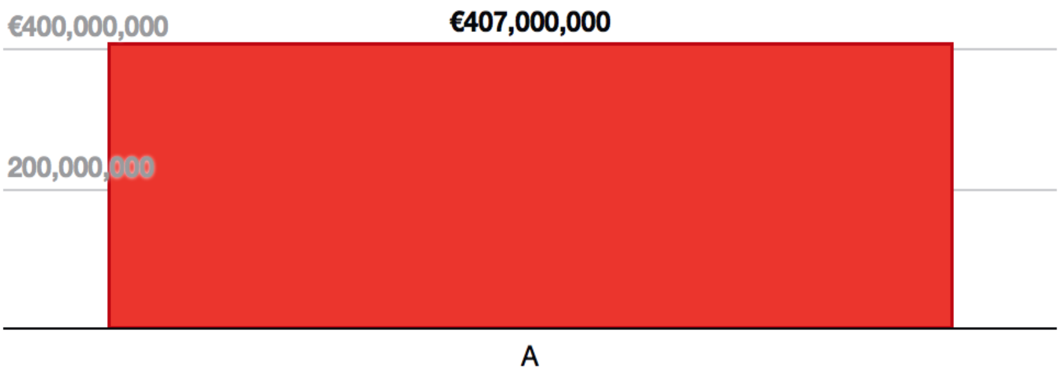


Figure A

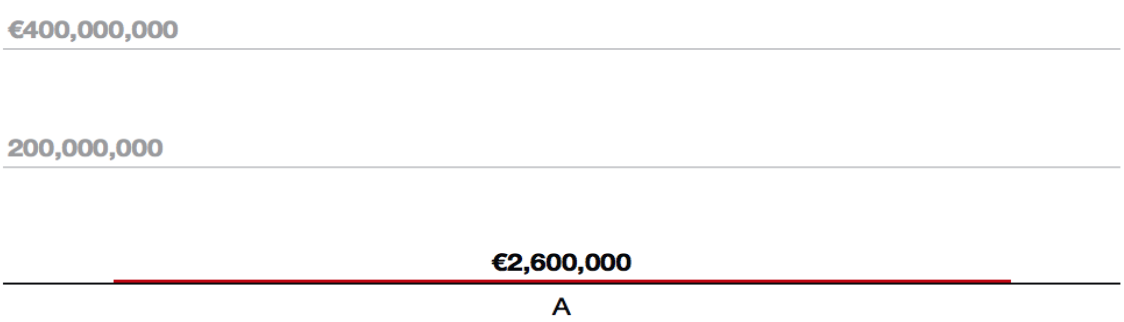


Figure B

Source: European Commission / New York Times

The above Figures shows Starbuck's estimated Pretax Profits and Taxes in The Netherlands. It can be observed that the Profits made by Starbucks in that region mounted to over 400,000,000 Euros, but the tax paid on those profits were mere 2,600,000 Euros. This was possible for Starbucks because The Netherlands has "granted a selective tax advantage". The amount paid by Starbucks is less than 1 percent. The European Commission got involved into this and ordered the government to recover back some amount of the tax. But, the Dutch government appealed the decision made by the European Commission in the court and Starbucks extended its support to this.

Amazon's Pretax and After-Tax Profits

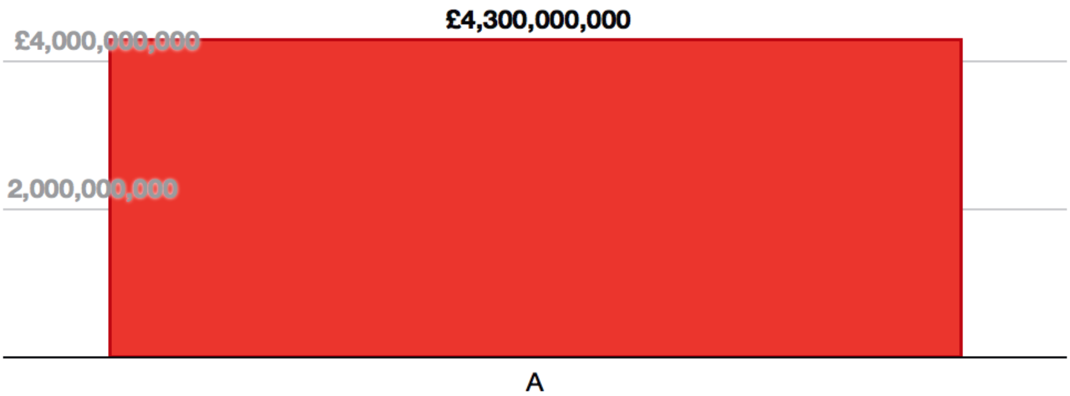


Figure C

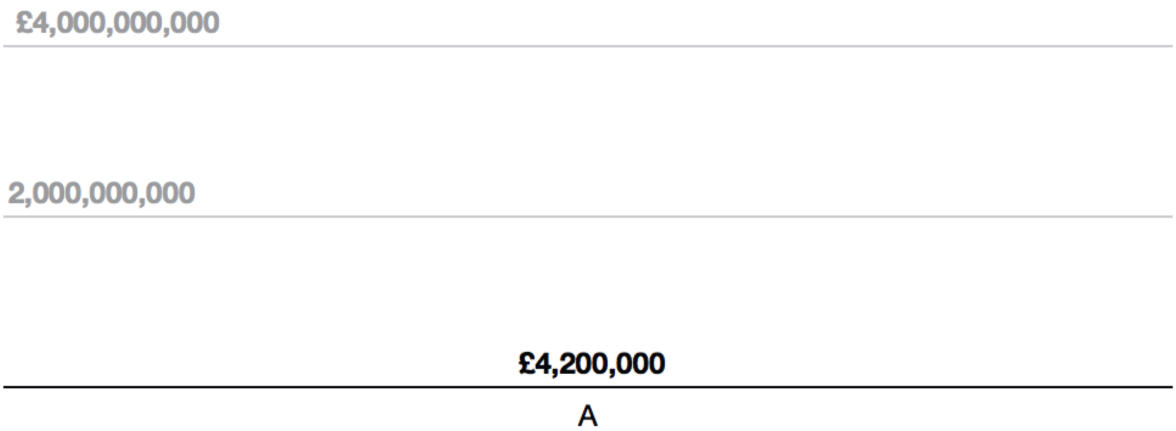


Figure D

Source: The Guardian

The Figures C and D shows that Amazon Inc. has made Pretax profits of 4.3 billion Pounds and paid an almost nil tax compared to what they are supposed to pay. This is achieved by holding the company in Luxembourg in the EU region and attributed all of its payments to its subsidiary in Luxembourg. However, there is a welcoming sign because Amazon EU Sarl has started establishing local EU branches. “As of May [2015], Amazon EU Sarl is recording retail sales made to customers through these branches in the UK, Germany, Spain, and Italy. Previously these retail sales were recorded in Luxembourg. The tax haven countries are usually small territories with population being just a couple of million. This is the reason why they do not have to levy huge taxes on to the corporations because the public interests can be fulfilled by less amount of taxes whereas the large countries need a high tax rate in order to compensate all sections of their population. This is the main reason why there exists anything like “Tax Havens”.

Conclusions

The implementation of royalty models and transfer pricing method, the main aim of the large corporations is to gain financial incentives. They try to find new ways with other financial services firms which help them to gain tax optimization. They create subsidiaries in tax havens and bill the sales and the payments in that country to achieve this. However, the methods employed are entirely legal because they are avoiding tax but not evading tax. But, this is definitely an ethical issue which can be discussed by experts in that field. This tax avoiding techniques are done by large corporations because they have to work in the shareholders’ interests, who expect their firm to generate more cash flows.

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