



## Corporate tax avoidance by multinational firms

**SUMMARY** *The scale of Member States' (MS) losses through the increasingly aggressive use of tax-avoidance schemes by multinational companies (MNCs) is difficult to estimate, but is considered serious. Press reports have highlighted the low tax paid by well-known, very successful companies.*

*The tax reduction methods used by MNCs have been well known for decades. They include transfer pricing, the use of lower-tax jurisdictions, over-charging entities in higher-tax countries to reduce taxable profit and (legally) completing a transaction in a lower-tax country, different to the country which the business relates to. These actions have been significantly aided by the digital economy and a rise in the value of intangible assets e.g. brands. Tax law appears out of date compared to MNCs' business practices.*

*While MNCs - who now represent a large part of global trade - benefit, domestic competitors are unlikely to be able to gain similar tax advantages*

*The problem is relatively clear and law-makers want a situation where businesses not only operate within the letter but also the spirit of the law. MNCs have responded that they are complying with tax laws, pay all the taxes that they should by law, and that it is not companies but governments that decide tax regimes.*

*The national and international corporation tax environment is complex, with many constraints, and a solution to this long-lasting issue will be difficult to achieve.*



© Comugnero Sijvana / Fotolia

### In this briefing:

- Background
- The problem
- Tax reduction methods
- Company examples
- EU and other international actions
- Consideration of changes
- Main references

### Glossary

**Tax avoidance:** seeking to minimise a tax bill without deliberate deception but contrary to the spirit of the law.

**Tax evasion:** the illegal non-payment or under-payment of taxes.

### Background

[MNCs](#) account for a large part of the world's GDP, with intra-firm trade a growing proportion. They have global operating models with integrated supply chains and functions centralised at regional or world levels. The digital economy (products and processes) also means more of their activities being located distant from customers.

Countries levy taxes in order to fund public spending, and one important source of taxes is that on company profits: [corporate income tax](#).

The [Organisation for Economic Cooperation and Development](#) (OECD), an international organisation comprising 34, mainly rich, economies, and the [OECD Global Forum](#) are dealing with aggressive tax planning and tax information exchange.

### The problem

A country does not look at an MNC as a whole for tax purposes ("the unitary approach"), but

only the part(s) operating in its jurisdiction (the "separate entity approach"). In order to avoid this leading to the double taxation of profits of growing global MNCs, from the 1920s an [international tax regime](#) came into operation. Based on model [OECD](#) / [United Nations](#) treaties, with shared principles and common standards, over 2 500 worldwide tax agreements now exist between countries to eliminate double taxation. However, these structures have allowed under-taxation or no taxation at all. This has become more prevalent from the 1960s onwards, as tax competition increased.

Also, countries have different tax rules and rates and offer different tax advantages in order to attract investment from other MS and outside the EU. Some countries may not tax some income at all, or at significantly lower rates than others.

Furthermore, MNCs now have a far greater ability to separate their different functions (e.g. sales, research and development etc.). The digital economy allows MNCs to operate different remote, internet business processes and has given more value to intangible assets, like intellectual property rights (IPR), to create profits.

Given these elements, managers of MNCs, often given targets to operate in the most effective and profitable way, may adjust their structures and locations to be as tax efficient as possible.

Any resulting low or non taxation will then be of concern where:

- the use of different tax rules leads to double non-taxation or taxation lower than the level of either jurisdiction.
- profits are shifted away from the jurisdictions where the economic

activities creating them take place, known as "base erosion and profit shifting" (BEPS). This can be particularly true of internet-enabled transactions.

Most [double-taxation treaties](#) tax the [income](#) of a firm where it has its [permanent establishment](#) (PE). The main element determining if a business has a PE in a country is whether it sells or not: legally this is determined by the location where contracts are signed. In the internet era sales activities may occur in a country but can be

legally finalised electronically elsewhere...in a lower-tax state. Thus MNCs now often do not pay tax where they do business, but rather where they finalise their activities. A company thus legally moves revenue there from its business market. It gains a competitive advantage, which is not normally available to domestic businesses.

Governments' tax authorities have to try to verify MNCs' (increasingly) complex tax structures.

Businesses make a number of different tax payments to governments, thereby financing public goods and services. Some of the most important are:

- value added tax (VAT): a direct consumption tax on goods and services purchased
- income tax: citizens contribution based on their salary
- social security: citizens contribute for their health, pension and other social cover
- corporate tax: based on the profit of the enterprise.

## Tax reduction methods

The methods of tax avoidance by MNCs in developed countries are well documented, although there is a lack of reliable and consistent data, whereas those for developing countries are less well understood. The method revolves around shifting income from higher-tax to lower- or no-tax countries.

### Profit shifting strategy

This is achieved by limiting operational activities (and related income) in the higher-tax state, by moving them to a subsidiary located in a lower-tax state.

### Transfer pricing

This is the setting of prices for transactions between companies that are part of the same MNC. In the past this mainly concerned physical goods but now involves

the rights to use intangible goods, and use of services such as headquarters' support.

Over half of international transactions are inter-company transactions, and are therefore not at "arms-length" prices, i.e. as if purchased from an unrelated third party. Where the price is inflated, "abusive transfer pricing" is said to occur. This is one way to move profits where a subsidiary in a medium or higher-tax jurisdiction buys products from another group company in a lower-tax country.

It is often not obvious how arms-length prices should be determined. The UK tax authority has around 65 experts in transfer pricing.

### Corporate debt-equity

Inter-company loans given from entities in lower-tax states to subsidiary companies in higher-tax countries pass interest income to the lower-tax state, reducing the taxable profit in the higher-tax country. This profit is further reduced the higher the interest rate or level of debt. Luxembourg has beneficial tax treatment of interest income.

### Payments for intangibles

A group company in a lower-tax environment with company IPR ownership rights, charges another group entity in a higher-tax state for use of an intangible, such as a technology royalty, licences, brands or patents. The pricing should reflect the value of the technology, i.e. how important the technology is in the creation of the profits.

An MNC can have a company owning its IPR in a country where no taxes are payable on licence fees, and then charge its affiliates around the world for their use.

### Shell holding companies

These are found mostly in jurisdictions with an extensive tax-treaty network and offering low tax rates on dividends and capital gains e.g. Belgium, Ireland, the Netherlands and Switzerland.

The holding company may be a shell company (no real trading, production or

distribution activities) or may have centralised financing, licensing and other management activities.

Shell holding companies are used in multiple ways for tax planning activities.

### Hybrid entities

These revolve around obtaining a deduction of the same cost, such as loan interest, from two different countries based on the company's affiliates' structures. Similar happens when countries allow dual-residence companies. Ireland, for example, has companies that are legally based in Ireland and another country – typically a tax haven, such as Bermuda.

#### The "Double Irish with a Dutch sandwich"

This is a known tax-reduction structure between wholly-owned subsidiaries, which involves transactions in Ireland, the Netherlands and Bermuda. The Irish affiliate has dual residence with Bermuda and moves profits through another Dutch affiliate. Profits go to Bermuda and are not taxed since Bermuda has no corporate income tax.

### Conduit

This is where a corporation channels money through a country (e.g. the Netherlands, Luxemburg or Mauritius) so benefiting from a favourable tax rate. Large sums pass via these preferential tax regimes:

- 30-40% of all of India's investments are via Mauritius, which has received the investment money from other countries, often India itself ("round tripping").
- the British Virgin Islands were the second largest investor in China (14%) in 2010
- the top investor in Russia in 2010 was Cyprus (28%)

### Company-specific tax rulings

Some countries (e.g. the Netherlands, Cyprus, and Luxembourg) allow the direct negotiation of a tax rate between a company and the tax authority.

Special tax treatment for individual companies is practised in many countries, in

an attempt to attract foreign direct investment.

## Company examples

Many well-known MNCs have been mentioned in the press recently over their level of corporate tax. They include:

**Adobe** had a recent average tax rate on its overseas profits of below 7%. Its Irish operation generated 80% of its non-US income. Adobe's local units around the world have a tax residence in their markets, but not as sellers of software, rather as "service providers", i.e. a support function. This is known for tax purposes as the "Service PE" model.

It was reported that **Amazon** paid little or no UK corporate tax between 2009 and 2011, on sales of over £7.6 billion. Amazon UK, with over 15 000 staff, is a service operation for its Luxembourg-based company.

**Apple** had a reported effective rate of tax of around 2% in recent years on its non-US profits – approximately 60% of the total – with sales routed through its Irish subsidiaries. A US Senate [investigation](#) which included [Apple's](#) tax strategy concluded that its tax arrangements do not reflect its business.

**Google** had a reported effective tax rate of 2.4% in 2009 on non-US profits, with the [majority](#) of Google's non-US sales billed in Ireland. Google Ireland paid, for example, for the services provided by the 1 300 staff in the UK, with most UK-related sales of £3.2bn routed through Ireland. The UK Labour party leader said that Google paid £10 million in tax between 2006 and 2011 on revenues of £11.9 billion.

**Starbucks** paid UK corporation tax of £8.6 million between 1998 and 2011 on sales of over £3 billion. Taxable profit was reduced through interest payments to other parts of the business and by the 4.7% paid to a Netherlands based company for intellectual property (such as its brand and business processes). The latter pays a 20% mark-up to a Swiss-based company on its coffee-buying operations.

The UK Parliament's Public Accounts Committee has [investigated](#) MNC tax avoidance, including some of the above companies. Many more companies – US, European... - follow similar strategies, indeed they may be at a competitive disadvantage if they do not.

### Top 50 US software, hardware & internet firms

| Permanent establishment | No | Overseas (\$ m) |       | Tax % |
|-------------------------|----|-----------------|-------|-------|
|                         |    | Income          | Tax   |       |
| Ireland                 | 19 | 79 730          | 4 568 | 5.7%  |
| In major markets        | 13 | 22 115          | 5 538 | 25%   |
| Switzerland             | 8  | 3 724           | 377   | 10.1% |
| Netherlands             | 5  | 4 324           | 239   | 5.5%  |
| Unclear                 | 4  | 3 800           | 942   | 24.8% |
| Luxembourg              | 1  | -338            | 22    | -     |

Source: Company accounts, Reuters 2013 [article](#)

## EU and other international actions

In its May 2013 plenary, the EP voted two non-legislative resolutions ([Fight against tax fraud, tax evasion and tax havens](#) and the [2013 Annual Tax Report](#)), which included calls for MS governments to close avoidance loopholes, combat aggressive tax planning, and coordinate their tax systems better including tax information exchange. It noted that tax lost to avoidance needs to be reduced. Also, the Commission was called to implement country-by-country reporting for cross-border companies. MEPs wish the EU to lead the efforts of multinational fora to improve tax transparency and information exchange.

The Commission in its December 2012 [Recommendation on aggressive tax planning](#) wants MS to strengthen their double tax conventions and to adopt a common general anti-abuse rule (GAAR). The GAAR would allow MS to tax on the basis of actual economic substance and ignore any artificial tax avoidance arrangements.

Communiqués in 2013 from the [G8](#) leaders' and [G20 Finance Ministers](#) included similar considerations on reducing taxation loss.

The Council of Europe has [noted](#) that tax losses – including tax avoidance – penalise ordinary taxpayers, public spending and threaten good governance, macroeconomic stability and social cohesion.

## Consideration of changes

Current systems have conceptual and practical difficulties in defining and dealing with tax avoidance, as they attempt to measure profits created in a given country. One of these difficulties is overseas PE schemes: French, Norwegian and Spanish attempts to overrule PE schemes to avoid tax have failed since judges appear reluctant to over-rule contractual agreements e.g. sales contracts.

The many previous attempts to structure business taxes "fairly and uniformly" have not brought a solution. Among the elements to resolve are:

- conflicts of interest between big and small countries.
- many countries design their tax systems to attract inward investment. This is a non-holistic approach, normally contrary to the achievement of a coherent international system.
- developed countries have higher overseas income from intangibles compared to emerging economies.
- business groups, including the main US group on international tax ([US Council for International Business](#)), say revising PE rules risks creating uncertainty.

The OECD has noted that the anti-avoidance measures (e.g. general anti-avoidance rules (GAAR), [Controlled Foreign Company](#) rules (CFC) or [thin-capitalisation rules](#)) adopted by many countries in previous decades are too complex, costly and often ineffective.

In July 2013, the OECD launched an [action plan](#) to address BEPS, but notes that unilateral action will not suffice: countries must apply a holistic and comprehensive approach given the cross-border nature of tax evasion and avoidance. This is to be noted since the fight against tax avoidance has been [considered](#) as basically a national issue, depending on factors that are not limited to tax law.

MNCs have to reconcile the pressures of being "good corporate citizens" and paying a fair share of tax with those of keeping up with competitors and giving their providers of capital a proper return. It has been [argued](#), however, that any change in rules should not separate profits from the economic activity that gives rise to them.

## Main references

1. [European initiatives on eliminating tax havens.....](#), DG IPOL study, EP, 2013.
2. [Factbox: How to tackle corporate tax avoidance](#), T Bergin, Reuters, 2013.
3. [Tax Havens and the Taxation of Transnational Corporations](#), M Henn, Friedrich-Ebert-Stiftung, 2013.
4. [It's not just Google...](#), T Bergin, Reuters, 2013.
5. [The fight against tax fraud and tax evasion](#), DG Taxation & Customs Union website, EC.
6. [Commission recommendation on aggressive tax planning](#), Dec. 2012 EC.
7. [Harmful tax competition](#), OECD, 1998.
8. [International Tax Policy Needed to Counterbalance the Excessive Behaviour of Multinationals](#), A de Graaf, EC Tax Review, 2013.

## Disclaimer and Copyright

This briefing is a summary of published information and does not necessarily represent the views of the author or the European Parliament. The document is exclusively addressed to the Members and staff of the European Parliament for their parliamentary work. Links to information sources within this document may be inaccessible from locations outside the European Parliament network. © European Union, 2013. All rights reserved.



<http://www.library.ep.ec>  
<http://libraryeuroparl.wordpress.com>