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International Tax Avoidance Schemes: An Investigation of Multinational Technology Companies

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Abstract
The opportunity to use tax havens leads to a decline in tax revenues of many resident countries of multinational technology companies. Several studies have proven that havens aid multinational technology companies to engage in income shifting and tax avoidance. This paper deconstructs how technology firms are able to avoid taxes. The paper looks at what motivates these firms and proffers recommendations on ways to minimize or curb the practice.
Keywords: International Taxation, Tax Havens, Multinational Technology Companies

Introduction

Almost half of all global commerce passes through tax havens in spite of the fact that they account for about 3% of global GDP (Christensen & Murphy, 2004). Gravelle (2013) indicates that a large number of multinational firms shift profits from jurisdictions with high tax rates to low tax jurisdictions[1]. In the view of Gravelle (2013), an effective way by which multinational firms, including technology companies, avoid paying high taxes is by shifting debt to high tax jurisdictions. This decreases profit margins and tax liabilities. In the case of multinational technology companies, they transfer Intellectual Property[2] to subsidiaries in low tax jurisdictions to shift income and pay lower taxes as a result (Gravelle, 2013).

Some studies such as Wells (2010) suggest that US multinationals are at a competitive disadvantage because of the high US tax rate[3] and also for the fact that many non-US multinational firms have the leeway to employ a host of tax minimization strategies. These studies, whilst not endorsing tax evasion seem to posit an understanding of why some US multinational companies use all kinds of strategies to avoid taxes. Multinational technology firms, in the words of Markle & Robinson (2011) have the discretion as to where to locate their geographically-mobile operations and that this increases their ability to defer or avoid taxes.

[1] According to Gavelle (2013), provisions against profit shifting should include changing present tax laws
[2] Intellectual Property is an asset that includes Patents, Trade Secrets, Copyrights and Trademarks. When a multinational company forms an IP Holding subsidiary it transfers its IP assets to the Holding company. Such a transfer is not a taxable event (Nguyen, 2005)
[3] According to the OECD , US have a headline corporate tax rate of 40%

Source and Residency Concepts of International Taxation: Panacea to Tax Avoidance?

In a world economy which is integrated, it is essential that resources are allocated efficiently; and this will stem from how national tax systems recognize international capital and inflow of goods (Frenkel *et al.,* 1990). Frenkel *et al* (1990) posit that movement of goods and capital impacts taxation. In all international taxation discussions, there is the issue or possibility of tax avoidance. As Frenkel *et al* (1990) put it, export in one country leads to import into the destination country. The Source[4] and Residence[5] concepts of international taxation have sought to eliminate double taxation and tax avoidance[6].

According to Frenkel *et al* (1990), countries may calculate tax liabilities on different kinds of incomes using a mix of the two concepts even though if all nations adhere to the same concept, double taxation and tax avoidance will be eliminated. However, with international technology companies, it is difficult to categorize income using the Source and Residence concepts (Schafer & Spengel, 2002). Schafer & Spengel (2002) argue that the Source and Residence concepts were developed when commerce was largely through "bricks and mortar" presence. Without a physical entity the business could not function.

The face of international commerce has greatly changed with the evolution of technology and the availability of digital infrastructure. In the words of Schafer & Spengel (2002) "employees can telecommute from a geographical jurisdiction which may not be the resident country of the business". There is also the availability of digital markets, which make international taxation of sales of an international technology company a difficult exercise. According to Schafer & Spengel (2002), international technology companies can manipulate their tax attributes as not only the Source concept, but also the Residence concept is susceptible to manipulation.

History and Current International Taxation Issues

Advances in science and technology have resulted in a new type of valuable intangible corporate asset called Intellectual Property (Nguyen, 2005). In the view of Nguyen (2005), Intellectual Property has become important over the years and it now occupies an important role in international trade relations. Over the years, many multinational companies have accumulated Intellectual Property portfolios, with IBM alone receiving three thousand four hundred and eleven patents in 2001 (Nguyen, 2005).

With the increased importance of Intellectual Property, companies in their bid to maximize revenues, create a subsidiary in a tax haven to hold its Intellectual Property (IP) away from the nation of incorporation (Warpole, 2001).Companies are therefore able to shift profits from a high to a low tax jurisdiction by overstating expenses in the former (Pricewaterhouse Coopers, 2009, p. 15). According to Markle & Robinson (2012) many multinational companies have a subsidiary in a tax haven [7]and that 56% of US multinationals indulge in the practice.

Faced with a lessening of tax revenues, various governments are scrutinizing transfer pricing. From 2005 to 2006, one thousand seven hundred and twenty four (1,724) adjustments were made to tax computations in the United Kingdom (Hansard, U.K House of

[4] Source principle uses the income source to compute tax liabilities (Frankel *et al.*,1990)

[5] Residence principle- with this principle, tax liabilities is computed on income from the tax payers place of residence (Frankel et al, 1990)

[6] Unlike evasion, tax avoidance refers to a legal reduction in taxes (Gravelle, 2013)

[7] Tax havens are low-tax countries that aid income tax avoidance (Hines & Rice, 1994)

Commons Debates, 2006, Col.1258). According to the U.K House of Commons Hansard (November 2008, Col.938), additional tax revenues of one thousand one hundred and thirty four (1,134) million pounds sterling was realized through tax adjustments between 2003 and 2007.Tax authorities in Australia also reported additional tax revenue of about 2.5 billion Australian dollars from 2000 to 2005 coming out of transfer pricing audits (Sydney Morning Herald, 2006).

According to Bartlett (2013), G20 countries have endorsed an Organization for Economic Co-operation and Development (OECD) action plan on Base Erosion and Profit Sharing[8] (BEPS). The plan as stated by Bartlett (2013) *inter alia,* is to reform current international tax regulations to forestall the situation whereby multinational technology companies form subsidiaries with no physical presence. The plan will not just regulate transfer pricing, but also require multinational companies to declare their international tax obligations and arrangements. As Bartlett (2013) puts it, this action plan shows that there is a growing worldwide pressure on multinational companies as authorities seek to erase loopholes.

The crackdown on international tax avoidance seems to be gaining momentum. According to Molly & O'Hora (2013) the European Commission is investigating US multinationals over concerns that Ireland offers them special deals[9]. This comes on the heels of a US congressional revelation which accuses Apple of using a complex mechanism, including international subsidiaries to avoid paying taxes to the US government[10] (Friedman & Beekman, 2013). Tax avoidance is not limited to Apple. Together with Google, eBay and Hewlett-Packard and other technology companies they have sheltered in excess of $225 billion outside of the United States (Drange, 2013). In all of this, Apple is still one of Americas top corporate tax payers having paid $6 billion to the U.S treasury in fiscal year 2012 (Friedman & Beekman, 2013).

Tax Avoidance as a Corporate Social Responsibility Issue

All countries use tax revenues to finance health and education and also to provide social amenities and infrastructure (IBIS & Global CSR, 2002, para. 1). Corporate social responsibility issues are not only centered on voluntary activities of companies, but also activities such as human rights and tax payments (IBIS & Global CSR, 2002, para. 5). Tax avoidance of multinational technology companies could be considered a business ethics issue. Businesses choose to interpret tax laws and hence pay only taxes they deem legal and this thus makes the issue of tax avoidance one of ethics (Institute of Business Ethics, 2013, para. 5).

Paying taxes amount to the most basic way by which corporations engage with the broader society (Christensen & Murphy, 2004). When firms pay a fair amount of tax in the countries within which they run their operations, they are recognized as providing funds for various public services including education, health care and provision of infrastructure (Institute of Business Ethics, 2013, para. 7).

Governments and people expect corporations to pay a "fair share[11]" of tax even when it is not coded in law (Institute of Business Ethics, April 2013, para. 15). Corporations on the

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[8] A project launched by the OECD to address the challenge of tax avoidance and double non-taxation

[9] According to Guiglielmol (2013, May 31), Ireland has denied any special tax deals with Apple and have stated that the country is not a tax haven for multinational companies as its tax system is set out in statute.

[10] According to Friedman & Beekman (2013, May 20) Apple uses its subsidiary, Apple Operations International which is incorporated in Ireland but managed in the US to avoid paying taxes. On dividends of $29.9 billion from 2009 to 2013 it paid no taxes as the US taxes according to where a firm is incorporated and Ireland taxes according to where a company is managed.

[11] Taxes paid depend on profit which may be a function of actual performance or just how the profit is calculated. (Institute of Business Ethics, April 2013)

other hand, as contended by Berle (1931), have a responsibility to maximize profits for shareholders. International technology firms such as Google seem to agree with Berle (1931), as they devise complex, but legal corporate structures to minimize their tax liabilities. Firms should strive to balance maximizing profits and returning a good amount to society in the form of taxes. In the view of Dodd (1932) businesses have responsibilities to society and therefore managers should voluntarily and without waiting for legal compulsion fulfill such responsibilities.

Deconstructing Tax Avoidance Schemes Employed By Multinational Technology Companies

This paper will use a fictitious technology company as a case study. The following assumptions about the company have been made:

The company is a US multinational technology company whose products or services are utilized by customers globally. It is incorporated in the US from where it has patented its Intellectual Property. The company has a huge UK patronage from where it books its international sales (sales outside the US). Its non US Intellectual Property is also registered there. The company's profit for the year under review (2012) from its foreign operations was $2.6 billion. The headline corporate tax rate in the UK for the year 2012 was 24%. For its foreign operations the technology company paid about $620 million in taxes.

To avert incurring the huge tax liability of $620 million, the technology company will open a subsidiary in a tax haven such as Bahrain to hold the company's Intellectual Property. The Bahraini subsidiary will charge half the gross profits of the company as cost of using the Intellectual Property. The technology company will then move its headquarters for non US operations to Ireland.

Ireland has an effective tax rate of 20%. Furthermore, tax laws in Ireland give laxity to multinational companies to incorporate two Irish subsidiaries with one paying royalties on intellectual properties whiles the other collects the royalties in a designated tax haven (Bartlett, 2013). The technology company will then transfer $1.3 billion, being half of its gross profits to the Bahraini subsidiary as the cost of using the Intellectual Property. It will then pay 20% of the remaining $1.3 billion to the Irish authorities as taxes which amount to $ 260 million.

Analysis

The multinational technology company held its Intellectual Property in Bahrain for two reasons. The country has a 0% corporate tax rate for all non-oil [12]activities and there is also no restriction for the repatriation of cash. The chosen method will cut down taxes from $620 million to $260 million saving the company $ 360 million. A tax liability of $260 million on gross profits of $2.6 billion means the company paid 10% of gross profits in the resident country. Technology companies that follow this international tax path will argue that that they do so to return a good amount to shareholders and also pay a fair amount to society in the form of taxes even with the use of a tax haven. They will justify a 10% tax rate as satisfying both the (Berle, 1931; Dodd, 1932) principles.

The plan to minimize the tax obligation of the technology company only focused on its foreign operations. However, there are other companies such as Apple that employ schemes to minimize internal taxes as well as international taxes. As stated by Friedman & Beekman (2013, May 20), Apple, for instance, uses its subsidiary, Apple Operations International which

[12] The corporate tax rate for oil related activities in Bahrain is 46%. The taxability of corporate profits depends on whether Bahrain has a tax treaty with the country in which the headquarters of the company is located.

is incorporated in Ireland but managed in the U.S to avoid paying taxes. On dividends of $29.9 billion from 2009 to 2013 it paid no taxes as the US taxes, according to where a firm is incorporated and Ireland taxes according to where a company is managed.

Conclusion & Recommendation

A study by Desai *et al* (2004) concluded that when companies use tax havens the economic activity of non-haven countries in the region is bolstered. As indicated by Desai et al (2005), tax havens accelerate the process of tax competition between nations which in the view of Wilson (1999) may lead to inefficient under provision of public funds. Brennan & Buchannan (1980) on the other hand, argue that tax competition[13] restrains an expansive state. It is necessary for all firms to maximize profit for shareholders. Equally, businesses should uphold the tenets of corporate social responsibility and pay a fair percentage of earnings as tax bearing in mind the conclusions of Wilson (1999) and Brennan & Buchannan (1980).

According to Gumbel (2012), Amazon paid a measly $3 million in taxes to the UK authorities in 2012 even though 25% of its sales outside the US (about $5 billion annually) was made in the United Kingdom. In the same vein, Holder & Smyth (2013) reports that Google paid just £11.2 million sterling in corporate taxes to the UK tax authorities. The multinational technology companies such as Google and Amazon are currently not flaunting any tax law. They are capitalizing on international tax disparities.

According to Bartlett (2013), G20 countries have ratified an OECD plan to reform international tax regulations. In many ways tax havens abet income shifting and tax avoidance. Tax havens as noted by Gravelle (2012) thrive because there is little multilateral action to suppress their activities. The OECD, however, has an ongoing project of inducing transparency among tax havens which may ultimately help in minimizing their activities. This paper posits that it is actions such as embarked by the OECD, more than a call to adhere to corporate social responsibility tenets that will forestall the practice of transfer pricing and tax avoidance.

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