The Mechanics of Aggressive Tax Planning by Multinational Corporations

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Irony 1

- Marshall Aid-funded 1952 report drew the attention of the IDA to the case of Puerto Rico, whose 'favoured position' included being within the US trading market but outside the US tax system
  - Frank Barry and Mícheál Ó Fathartaigh (2012) *The Industrial Development Authority, 1949-58: Establishment, Evolution, Expansion of Influence*

Irony II

- Minister for External Affairs Liam Cosgrave and T.K. Whitaker at Finance worried that Export Profits Tax Relief (1956) would be in breach of 1955 OEEC rules against artificial aids to exporters (including remission of direct taxes).
  - Frank Barry: "Foreign investment and the politics of export profits tax relief, 1956", *Irish Economic and Social History*, 2011.

Irony III

EU Complains that Use of Tax Havens gives US Firms a Competitive Advantage

- “.... illegal effort to subsidize US exports by making them more competitive”
    - New York Times, May 30 2000

1998 OECD definition of ‘tax haven’

- Four criteria:
  - (i) No or only very low taxes

OECD warns that this criterion is not sufficient

- Optimal tax rate higher for large, core economies
  - Large economies attractive to inward FDI
  - Centrality (closeness to purchasing power) also attractive
  - Easier for long-developed economies to spin off successful firms

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Effective tax rates, 2012:

M. Devereux: CBT Corporate Tax Ranking

Ranking	Country	EATR (%)	Country	EMTR (%)
1	Ireland	11.1	Italy	-10.0
2	Slovenia	15.7	Greece	5.2
3	Slovak Republic	15.9	Switzerland	7.1
4	Czech Republic	16.1	South Korea	7.2
5	Greece	16.1	Ireland	7.3
6	Poland	16.7	Slovak Republic	7.4
7	Turkey	16.9	Netherlands	8.1
8	Switzerland	17.4	Czech Republic	8.3
9	Iceland	17.7	Turkey	8.7
10	South Korea	18.0	Slovenia	9.7
11	Hungary	18.6	Poland	10.7
12	Netherlands	19.1	Luxembourg	11.2
13	Chile	20.2	Iceland	12.0
14	Israel	21.3	Israel	12.1
15	Austria	21.6	Hungary	12.5
16	Finland	22.0	Austria	13.1
17	Denmark	22.4	Belgium	13.5
18	Italy	23.0	Portugal	14.9
19	Sweden	23.2	Canada	15.8
20	Luxembourg	23.8	Sweden	16.0
21	Canada	24.4	Finland	16.2
22	**United Kingdom**	**24.8**	Denmark	16.3
23	Portugal	25.2	Mexico	17.1
24	New Zealand	25.8	France	17.9
25	Norway	25.9	Spain	18.2
26	Mexico	26.1	Germany	18.2
27	Australia	26.6	Australia	19.1
28	Germany	27.0	Chile	20.7
29	Belgium	28.1	New Zealand	21.0
30	France	29.8	Norway	21.5
31	Spain	30.0	**United Kingdom**	**22.3**
32	United States	34.9	United States	23.2
33	Japan	36.0	Japan	27.0

OECD criterion 2

– (ii) Lack of transparency (special deals available)

- Jim Hines misinterpreted ‘grandfathering’ as use of tax holidays
- Possibly same misinterpretation in Apple testimony to US Senate?

How did Ireland get to be classified as ‘tax haven’ in White House statement of 2009?

- Hines and Rice (American Economic Review, 1994) add data contained in the US Internal Revenue Manual to lists of tax havens that others have compiled.
- US Government Accountability Office (2009) add the Hines list to one of their own
- GAO list was referred to in the White House press briefing that discussed “curbing tax havens and removing tax incentives for shifting jobs overseas”.

Tendency for blacklists to become self-referential

- Venezuelan officials copied the Mexican blacklist word for word
  - Because Mexico had blacklisted Venezuela, Venezuela ended up blacklisting itself!

OECD criterion 3

– (iii) Secrecy laws preventing the effective exchange of information for tax purposes with other governments

Irony IV

- *Time Magazine:* 1984 US exemption that allowed non-residents to receive interest payments tax-free and in secret made the US into “the largest and possibly the most alluring tax haven in the world”.
  - http://www.time.com/time/magazine/article/0,9171,926782,00.html

Jurisdictions Ranked in Terms of Secrecy Score

Jurisdiction	Secrecy Score	Jurisdiction	Secrecy Score	Jurisdiction	Secrecy Score
Bermuda	85	Monaco	75	USA	58
Netherlands Antilles	83	Mauritius	74	Cyprus	58
Bahamas	83	Hong Kong	73	Germany	57
British Virgin Islands	81	Singapore	71	Netherlands	49
Liechtenstein	81	Luxembourg	68	United Kingdom	45
Jersey	78	US Virgin Islands	68	Ireland	44
Gibraltar	78	Austria	66	Denmark	40
Switzerland	78	Guernsey	65	Spain	34
Cayman Islands	77	Isle of Man	65		

Criterion 4 (re definition of tax haven)

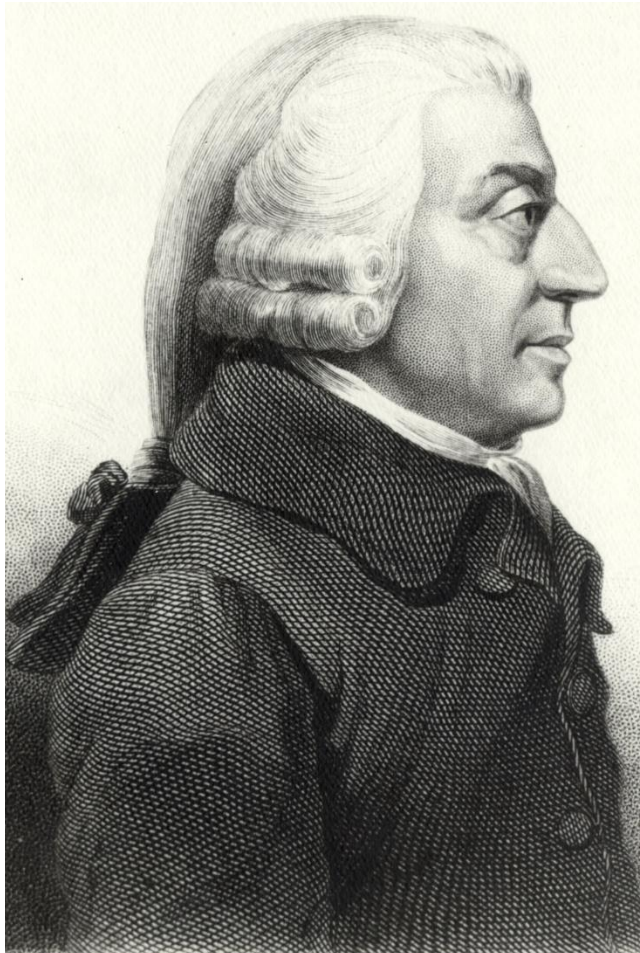
- (iv): no substantial activities
  - Vetoed by administration of George W. Bush!

- US has been paralysed on corporation tax policy since Kennedy Administration

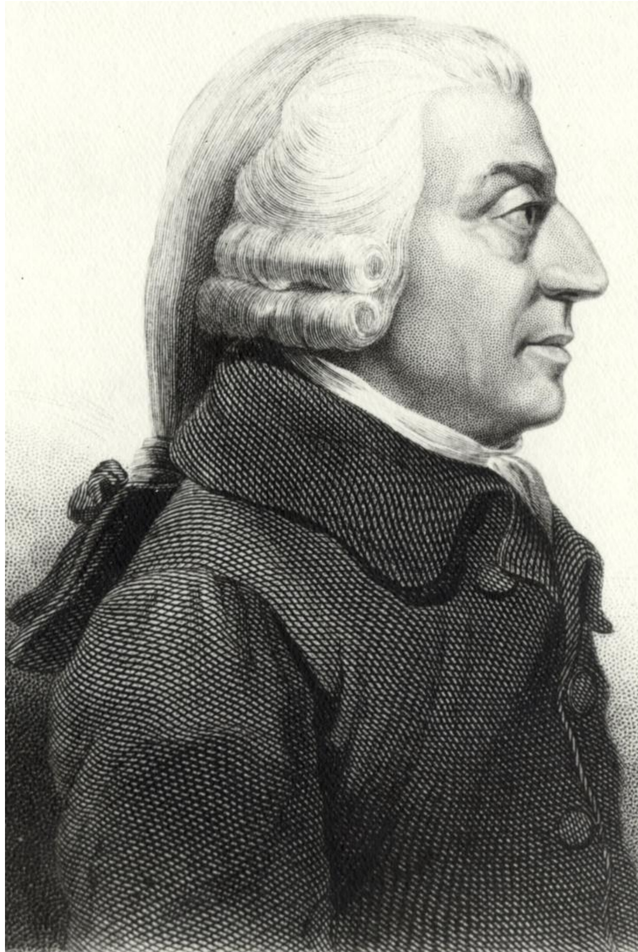
Coming Up!

Three slides (only)
on the morality issue

Adam Smith: *The Wealth of Nations* (1776)



- Key concept is "the invisible hand"
  - "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."



- Second most famous quote:
  - “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

Spend on Corporate Lobbying in US, 2012

Sector	$ millions
Oil and gas	140
Computer/internet	133
Defence	131

Source: Center for Responsive Politics

Brief history of US tax policy

- Until 1962, foreign subsidiaries of US corporations were able to avoid US taxation so long as their profits remained offshore ("deferral")
- Principle: subsidiaries operating in foreign markets should face the same tax regime as local firms in those markets.

- Kennedy Administration proposed to switch to a different principle: that overseas income of US corporations should be taxed exactly the same as income earned in the US

- Because US corporations would pay higher global taxes than competitors from lower-tax jurisdictions, Congressional Republicans argued that this would damage their international competitiveness

The 1962 compromise

- “Subpart F”
  - US taxes cannot be deferred on passive income (royalties etc.)

US has been gridlocked on deferral ever since....

- Irish Times; Oct 11, 1975:

  "Keating Warns US of Tax Risk to Development"

  (Justin Keating, Minister for Industry & Commerce)

  - "US Legislature discussing deferral of US taxation by overseas subsidiaries of US corporations..."

Operation of US tax credit system (i)

- US tax credits are available (up to a limit) for taxes paid abroad.

- So: the residual tax liability to the US is higher the lower the level of foreign taxes paid.

  - Dyreng and Lindsey (2009) show that US firms in Ireland (and a number of other low-tax locations) have higher US tax liabilities than otherwise-similar US MNCs
    - Journal of Accounting Research

US tax credit system (ii)

- Firms in low-tax foreign locations can face substantial US taxes upon repatriation

- These liabilities can be reduced if the firm has paid above the US tax rate in other high-tax locations (because US obviously won't give a refund on this!)
  - allows high-tax countries to continue to be able to attract significant levels of foreign investment.
  - Helps explain weakness of the evidence on "race to the bottom" (Desai et al., 2006)

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- Tax burden on corporate income in OECD countries has fallen little, if at all, over the past 25 years
  - Griffith, Rachel and Alexander Klemm, What has been the tax competition experience of the last 20 years? ***Tax Notes International***, 28 June 2004, 34 (13), 1299-1315.
  - Hines, James R., Jr., Will social welfare expenditures survive tax competition? ***Oxford Review of Economic Policy***, Fall 2006, 22 (3), 330-348.).

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- Thin capitalisation (lending from a subsidiary in a low-tax country to one in a high-tax country) also facilitates high-tax countries in continuing to attract FDI
  - Hines JEP 2010

One further point about deferral

- Represents an interest-free loan from the US government to the MNC
- Reduces the cost of funds to finance overseas investments
- Reinvested earnings finance around 40 percent of US FDI in Europe (Lundan, 2006).

The Emergence of Hybrid Entities

- New IRS regulations ("check the box") introduced in 1997 paved the way for creative tax-avoidance planning options.

- "... thwarts the application of Subpart F"

Memo from Senator Levin, Subcommittee chairman, 20 Sept 2012

Check-the-box tax regulations issued by the Treasury Department in 1997, and the CFC Look-Through Rule enacted by Congress as a temporary measure in 2004, have reduced the effectiveness of the anti-deferral rules of Subpart F and have further facilitated the increase in offshore profit shifting, which has gained significant momentum over the last 15 years. On

- The IRS rapidly tried to row back on "check the box" but corporate lobbying prevented this; instead, it got written into law (as the Look-Through Rule)!
  - http://www.reuters.com/article/2013/05/30/usa-tax-checkthebox-idUSL2N0E90RO20130530

- “Check the box” (CTB) allows certain foreign entities to be amalgamated for US tax purposes.
- For example: A US corporation sets up a holding company in Ireland and has this holding company own the corporation’s operating company in Ireland.
- With “check the box”, any monies paid to the holding company – which would have been SubPart F – are now treated as though earned by the holding company

- The holding company and the operating company are both incorporated in Ireland so by US law they are Irish companies.

- Irish law is different. The two companies are American because that’s where ownership and control resides.

- The operating company is tax resident in Ireland because it has substantive operations here. The holding company is not, because it doesn’t!

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- Hybrid entity: entity with a single owner that is treated as *a separate entity under the relevant tax laws of a foreign country* and *as a branch* of a foreign subsidiary that is its sole owner *for US tax purposes.*
  – US Congress, X-37-10, p. 48

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- Cross-border tax arbitrage: purposeful use of two countries' conflicting treatment of a single entity...
  - http://www.taxanalysts.com/www/features.nsf/Articles/58D8A3375C8ECCD18525793E0055EB9B

- ‘Virtual' residency is traceable to a series of UK law court rulings culminating in the 1929 *Egyptian Delta Land and Investment Co.* case, which found that a company registered in London but without any UK activities was not subject to British taxation

- Laid down the rule for all jurisdictions whose legal framework derived from that of the UK.

Did Ireland relax its laws when US “check the box” rules came in?

- No. Finance Act 1999 tightened them.

- An Irish-incorporated company which is under the ultimate control of (EU or US) persons AND ... is related through ownership to a company with substantive activities in Ireland will continue to be able to be non-resident under the management and control test

Example of a ‘Dutch sandwich’:

- Ireland doesn’t have tax treaties with the Caribbean tax havens, so withholding tax might be applied on royalty payments
- Will not be applied on payments to the Netherlands
- Netherlands does not apply withholding taxes on payments to the Caribbean
- So a Dutch company is inserted between the Irish operating company and the Caribbean holding company