STRATEGIES EMPLOYED BY MULTINATIONAL COMPANIES TO AVOID TAX

INTRODUCTION

If there is a reduction in corporate revenue as claimed by Governments all across the globe, the cause or causes should be identified so that laws and policies will be put together to discourage the surge of tax injustice the world faces due to tax avoidance strategies employed by multinational corporations which has deprived governments of the much needed revenue for growth. Indeed, so much has been said and done to address the issue of tax avoidance strategies employed by multinational companies in order to avoid or even evade their tax liabilities but it seems that the overall effect of these policies is minimal. What is certain however is that tax injustice does not happen by chance. It typically happens as a result of careful and deliberate planning, more so in the case of the aggressive tax avoidance industry. Huge resources are devoted to this industry because the profitability of tax avoidance is far higher than that of most other types of financial services activity. This paper will identify some of the tax avoidance strategies employed by multinational corporations which keep on increasing as the days go by. Indeed these avoidance strategies do not descend from heaven; they are products of ingenuity from experts in law, accounting, banking and other financial experts.

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1 This paper is written by Oladiwura Eyitayo, a Legal Practitioner in Nigeria.
There is no legal or moral compulsion for company directors to indulge in tax evasion or avoidance. Rather, tax avoidance strategies is a choice that multinational corporations make in pursuit of higher profits, remuneration, status and media accolades.\(^3\) It is important to note that multinational corporations rarely provide information about their tax avoidance and evasion strategies, they are revealed as a result of the issues brought to public attention by parliamentary committees, courts, regulators, and investigative journalists. Some of these strategies include: The use of Tax Havens, Transfer Pricing, Accounting Technologies, Contract Manufacturing, Double-Irish and Dutch Sandwich amongst others. These strategies are aimed at profit maximization in countries all over the world and are made possible by professionals, and offshore financial centers. Most of these techniques are seen as legitimate reduction in taxes on the part of the multinational companies even though the dividing line between tax evasion and tax avoidance remains blurred. These corporations see tax planning as an incident of their operations which span across jurisdictions. The legal justification for legitimate reduction in tax liabilities can be traced to the famous case of *IRC v. DUKE OF WESTMINSTER*\(^4\) where Lord Tomlin held as follows:

“To order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of ‘the substance’ seems to me to be nothing more than an

\(^3\) Prem Sikka: ‘*Smoke and Mirrors: Corporate Social Responsibility and Tax Avoidance*’ Journal homepage:<www.elsevier.com/locate/accfor> accessed 22\(^{nd}\) June 2013

\(^4\) (1936) A.C 1
attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable”.

In support of the principle espoused in the case above, it is obvious that every company has the option of carrying out tax planning in order to minimize tax liability within the law of the territory in which it operates but what needs to be discouraged is aggressive tax-avoidance by multinational corporations. Some of the factors considered by multinational corporations before they establish subsidiaries in different parts of the world have been identified as follows⁵:

1. The country the company will establish its head office: This is because of the varied tax rates levied by countries. A Multinational corporation may choose to establish its head office in a country because of its low tax rate.

2. Where the company will establish its subsidiaries: the structuring of multinational companies requires several affiliates that have presence in different territories. Considerations of tax rates determine the establishment of these subsidiaries in territories. A company may decide to establish a subsidiary in tax haven like the Cayman Island, Bermuda or Switzerland.

3. Which company will or will not be included in its group structure: companies may decide not to include a company in its group structure especially because of liabilities that might wreck its group structure.

4. What terms of trade will be used between group companies: multinational companies term it “transfer pricing”. Transfer pricing is a strategy used to reduce tax liabilities by pricing

⁵ ibid
goods and services within a group structure in a way that it does not reflect the arm’s length transaction.

5. Other considerations include, where the company will record its costs, sales, assets, where the company will employ its staff, where it will borrow money, where the company will locate its intellectual property, where the company will seek special tax privileges etc.

All these factors identified above have direct influence on the amount of tax payable by multinational companies to Governments and as such importantly contemplated by them in structuring their operations.

Multinational corporations are notorious for exploiting the gaps in tax policies and laws of countries all over the world with the ultimate aim of huge reduction in their tax liabilities. It is trite that countries have different principles for imposition of tax. Take for example, the income tax on the profits of multinationals in the United States, until foreign income returns to the United States parent corporation, the U.S. tax on such income is deferred. Deferral encourages corporations to shift profits offshore or disguise U.S. profits as foreign profits by creating subsidiaries in a no- or low-tax country since U.S. corporations are not taxed on income earned by foreign subsidiaries until they distribute that income back to the U.S. parent company.⁶

There have been suggestions on how to deter corporate tax avoidance by multinational companies. Arguments are being canvassed for unitary taxation which seeks to jettison the ‘creative games’

played by multinational corporations either through transfer pricing, thin capitalization, offshore transfer of profits or any other tax avoidance strategy employed by multinational corporations. 7

A study of the attitude of multinationals in avoiding tax can be best explained under the Structuration theory which posits that agents and structure do not exist independently of each other and cannot be understood separately from one another. Even though there is a façade of ‘separate personality’ in law and each subsidiary can sue and be sued independent of the parent company, multinational companies still structure their operations in a way that behind the smokescreen, there is indeed a rational collectivities of social actors engaged in purposive goal-oriented activities within the domain of a clearly defined boundary.8

Some of the examples of the tax avoidance strategies by multinationals are examined below.

3.1 TRANSFER PRICING

Transfer pricing involves determining the prices for sales between different entities within a multinational. It is estimated that more than 60% of international trade is now intra-firm trade between subsidiaries of the same multinational.9 Transfer pricing has been defined as the process by which subsidiaries of multinational corporations deal with each other for the purpose of determining the income of each of the entities.10 Transfer Pricing, means the ‘setting, analysis,
documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property). While it is lawful for prudent multinational corporations to determine the prices of goods and services sold within a group structure, what is wrong is abusive transfer pricing, often referred to as transfer ‘mis-pricing’ which is the determination of prices goods and services are sold within related firms outside the arm’s length transaction between un-related entities.

It has been said that transfer pricing is the leading edge of what is wrong with international tax. The reason is clear. Transfer pricing is a potent strategy with far-reaching effect of depriving host governments of revenue due to them as a result of the allocation of profits from high-tax jurisdictions to low-tax jurisdictions. When two companies trade under common ownership, they do not want the best price for the individual company but a price that creates the best overall result for the multinational corporation to which they belong. The companies will therefore often allocate the profit between the two subsidiary companies in such a way that minimal amount of tax has to be paid in high-tax jurisdictions which in a way erodes the fair share of taxes accruable to jurisdictions where those profits were generated from. Considering the basic reason why taxes are paid; provision of funds needed for the development and growth of countries, governments are deprived of the funds needed to fulfill their duties whenever multinational corporations exploit the strategy of transfer pricing. The impact of the erosion of revenue is felt more in developing and under-developed countries that are struggling to meet up with provision of basic amenities needed for growth. For instance, the Danzer group, a multinational corporation engaged in logging

11 Definition of transfer pricing < www.wikipedia.org> accessed 16 June 2013
13 Supra note 6
activities in the Democratic Republic of Congo (DRC) utilized several means including transfer pricing to reduce its tax liabilities due to the DRC Government and avoided about £7.8 million in tax revenue.\textsuperscript{14} Greenpeace international estimates that this huge amount lost to tax avoidance strategies of the Danzer Group could have met over 80\% of Government’s investment in public health for the year 2000, cost of vaccination for over 700,000 Congolese children, and is 50 times the DRC’s Ministry of Environment’s annual operating budget.\textsuperscript{15} The DRC is a third world country ravaged by poverty, lack of basic health care, poor sanitation, and lack of education amongst other social ills and should not be subjected to tax injustice in addition to the numerous challenges confronting her as a nation.

Having identified the negative effect transfer pricing has on the revenue of government world over, governments in a bid to curb this strategy have made transfer pricing guidelines to adjust prices that do not reflect an arms-length transaction principle. Arms-length principle means the price should be equivalent to the open market price that would apply between unrelated and independent companies. It also means a transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest.\textsuperscript{16} Whenever multinational companies exploit this principle of transfer-pricing, it gives rise to abusive mispricing which has been defined as ‘the manipulation of prices of transactions between subsidiaries of multinationals, or more specifically, the sale of goods and services by affiliated companies within a multinational corporation to each other at artificially high or low prices.’\textsuperscript{17} On

\textsuperscript{15} ibid
\textsuperscript{16} Supra note 10
\textsuperscript{17} Supra note 6
the part of multinational corporations, transfer pricing as a strategy for reducing tax liabilities is justified on the following grounds:

1. tax is a cost
2. costs must be minimized
3. Their duty to their shareholders requires them to avoid tax.\textsuperscript{18}

Taxation rules on the other hand strive to control transfer prices between head office, subsidiaries and permanent establishments within a multinational enterprise in order to allocate profits and ensuing tax revenue among the countries where the firm operates.\textsuperscript{19} In the field of taxation of multinational enterprises, transfer pricing rules try to ensure that each involved country will be able to tax corporate income generated within its territory.\textsuperscript{20} To rule out tax injustice caused by transfer pricing employed by multinational corporations as a tax avoidance strategy which often times is exploited, there is need for each country to adopt rules that would ensure that host governments get a fair share of profits due to them. As a step forward towards promoting tax justice, the Organization for Economic Co-operation and Development (OECD) came up with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 (the Guidelines) which prescribe principles that ensure transfer prices fixed by multinational corporations reflect arm’s length transactions.

Application of transfer-pricing rules to transactions within related companies begins with comparing the prices to that between unrelated companies so as to ensure that the country where the transaction was carried out gets a fair deal. Transfer pricing rules ensure that the majority of

\textsuperscript{18} ibid
\textsuperscript{19} Wolfgang Schon: ‘Transfer Pricing Business Incentives, International Taxation and Corporate Law’ Page 1
business entities that qualify as ‘permanent establishments’ will be taxed in accordance with the taxation rules of the countries where they are situated. International tax law starts from the assumption that the allocation of income to a certain taxpayer pre-empts the allocation of the right to tax this income to the country where the taxpayer resides. For permanent establishments however, this general rule is modified to the extent that profits which are attributable to a permanent establishment are taxed in the country of source. Under the Guidelines, the permanent establishment is treated as a fictitious taxpayer and transactions between the permanent establishment and the head office are controlled under the ‘arm’s length’ principle.  

A key reason why the intercompany trade differs from trade of full competence is the fact that multinational business can alter their transactions to minimize their tax burden around the world. For example, firms may use transfer pricing techniques that allow them to shift profits to jurisdictions with low tax rates and thus minimize their overall tax burden. Seeing the extent to which transfer pricing can be exploited by multinational corporations, the Guidelines state that the transfer prices are significant for both taxpayers and tax administrations because they largely determine the income and deductions, and therefore the tax base of the associated companies in different tax jurisdictions.

Tax authorities strongly face the challenge of effective audit of cross-border transactions bearing in mind that some companies may conceal some of these inter firm transactions by virtue of the complexities evident in their activities. The Draft Handbook on Transfer Pricing Risk Assessment highlights some of these challenges faced by tax authorities in assessing transactions within related companies. It defines risk identification and assessment process as ‘The process of

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21 Ibid
23 Prepared by the Steering Committee of the OECD Global Forum in November, 2011
an audit from the filing of the tax return and the tax administration’s initial analysis of the taxpayer’s related party transactions to concluding that a transfer pricing adjustment should be made.

In essence, transfer pricing has the effect of either increasing or decreasing the cost of goods, services supplied within a chain of inter-related businesses depending on the location, whether in a high tax jurisdiction or a low tax jurisdiction. With aggressive tax planning by multinational companies aided by the complexities involved in trans-border transactions, tax authorities are on a close watch and some have enacted transfer pricing guidelines. However, determination of how intangibles should be priced at arm’s length may be a difficulty. Transfer pricing rules with respect to intellectual property are further complicated because of cost sharing agreements, where different affiliates contribute to the cost. If an intangible is already partially developed by the parent firm, affiliates contribute a buy-in payment. It is very difficult to determine arms-length pricing in these cases. Companies can have their transfer pricing rules; it however has to be in compliance with the transfer pricing guidelines operating in their jurisdictions.

Transfer pricing rules are very useful in the fight against the tax avoidance strategy of transfer pricing exploited by multinational corporations but a major problem tax authorities face is the determination of ‘arms-length’ especially when it comes to pricing intangibles.

### 3.2 THIN CAPITALIZATION

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24 For example, Nigeria made its Transfer Pricing Regulations in 2012; Income Tax (Transfer Pricing) Regulations 2012.
25 For example royalties paid for copyrights, patents between affiliated companies.
A company is financed through two major means, through debt and equity. Debt can either be from external creditors or internally. The way a company is financed especially within a multinational group structure is significant because it impacts on the amount multinational corporations pay in the end as taxes over their profits. For example, debt and interest are allowable expenses and when a subsidiary in a high-tax jurisdiction borrows more from another subsidiary in a low-tax jurisdiction, the taxes such subsidiary pays in a high-tax jurisdiction is greatly reduced because apart from the capital it is meant to pay back, it also pays with interest which are tax deductible. Dividends paid to creditors on the other hand are not tax deductible. Thin capitalization is a tax avoidance technique whereby multinational subsidiaries are financed primarily by debt from the parent company instead of equity capital. It’s often referred to as ‘hidden capitalization’ or ‘hidden equity’.27

One particularly important element in multinational corporations' tax-planning is their ability to structure their finances in terms of debt and equity not only for the corporation as a whole but also internally.28 Even in instances where subsidiaries have access to external loans, multinational companies may decide to raise loans from within in order to expand the influence of affiliates in high tax jurisdictions.

Governments in high tax jurisdictions now get little or no revenue to tax as a result of thin capitalization between affiliates. Affiliates in high tax jurisdictions deliberately keep on borrowing from those in low tax jurisdictions. In response to this strategy, governments enact Thin Capitalization or Earning Stripping Rules which is a form of restriction on debt finance. It provides for a certain level of debt that can be borrowed and extent of interest payable by multinationals.

The US Internal Revenue Code provides for instance that where the debt-to-equity ratio is above 1.5 to 1 and the net interest exceeding 50% of the adjusted taxable income in a taxable year, the portion exceeding the 50% is not tax deductible. This interest restriction also applies to interest paid to unrelated parties that are not taxed to the recipient. In practice, Thin-Capitalization rules are often not limited to debt directly financed by shareholders. Tax administration or legislation will usually also prohibit what is known as back-to-back constructions, where the affiliate issues external debt, which is, however, guaranteed or secured by a deposit from the parent-company. Thin capitalization is a major mode of shifting profits from a high-tax jurisdiction to a low-tax one by borrowing more in high tax jurisdiction and less in low tax jurisdiction. This shifting of debt can be achieved without changing the overall debt exposure of the firm. Thin capitalization rules or Earning Stripping rules as some will term it are products of a counter reaction to thin capitalization by multinationals. In practice, thin capitalization rules differ widely across countries in the restrictions they put on the tax deductibility of interest on company debt, and even in some instances the extent of intercompany loans. The inadequacies of these rules become obvious as countries modify them year in year out. For example, the United Kingdom modified its Thin Capitalization three times between 1994 and 2002. Germany also altered its rules in 2000, 2003 and 2007. The United States is also proposing a reform of how multinational corporations are

29 Section 163(j)
31 Supra note 21
33 ibid
taxed in the U.S which would include reforms on interest deductibility by multinational corporations.\textsuperscript{36}

Germany, unlike the United States uses the interest limitation approach instead of the Debt-Equity approach. By this method, German tax authorities avoid the possibility of earnings stripping that can occur with the Debt-Equity approach.\textsuperscript{37} In the case of Denmark, the thin capitalization rules place some restrictions on interest deduction. First, it limits deductibility of interest from affiliates. Second, it places a limit on deductibility of interest based on the rate of interest of qualifying assets. Lastly, it places a restriction on interest deductibility to 80\% of the firm’s earnings before interest and taxes.\textsuperscript{38}

Facing the increased ability of multinational corporations to make use of the tax shield by debt in high-tax countries, governments are desirous of modifying Thin Capitalization rules to restrict the use of debt by means of improved Thin-Capitalization or Earning-Stripping rules. Those rules typically limit interest deduction up to a fixed relation between equity and debt, usually qualified as the debt which is financed by a shareholder, or deny the deduction of interest expenses above certain thresholds. Then, the interest paid for an excess leverage cannot be deducted from the tax base and governments in the end gets a fair share of the profits.

3.0 DOUBLE IRISH & DUTCH SANDWICH

This is not a type of fast food even though it sounds like one. It is another important scheme employed by multinational companies to reduce their tax obligations. Basically, Double Irish works in this manner; there are 3 companies all within the same entity but with separate

\textsuperscript{36} Supra note 31
\textsuperscript{37} Germany passed the Interest Disallowance Rules in 2007 and 2008
personalities. One will be located in a high tax jurisdiction maybe because of sales, materials needed for manufacturing, cheap labour or other reasons, the remaining two in a low tax jurisdiction Ireland for example.\textsuperscript{39} The first company has a cost sharing agreement to exploit intellectual property rights with the remaining two located in tax havens through the use of its transfer pricing rules.

At the first stage, the first company who claims the interest over the intangible rights located in Ireland escapes tax because it doesn’t fall within the provisions of Ireland’s tax law. Irish tax law provides that a company is tax resident where its central management and control is located, not where it is incorporated, so it is possible for the first Irish company not to be tax resident in Ireland.\textsuperscript{40} It then assigns its interest in the intangible to another subsidiary, a tax resident in the Ireland who will in turn give royalties or other payments to the first subsidiary in the tax haven. The second subsidiary will in addition receive income from the company in high tax jurisdiction for exploitation of its interest but forwards it to the first company in the tax haven, thus the tax liability of the company in the high-tax jurisdiction becomes reduced because it is allowed to regard the payment as deductible expenses.

In 2009, Google, Inc employed the Double Irish and the Dutch Sandwich, to reduce its overseas tax rate to 2.4% and its U.S. tax liability to 22.2\%\textsuperscript{41}

Apple, another multinational corporation is said to be the pioneer of the Double Irish and Dutch Sandwich strategy which it uses to reduce taxes by routing profits through Irish subsidiaries and the Netherlands and then to the Caribbean. At present, Double Irish and Dutch Sandwich is a

\textsuperscript{39} Other examples are the Cayman Island, Bermuda, Switzerland etc.
\textsuperscript{40} Double Irish Arrangement: <https://en.wikipedia.org/wiki/Double_Irish_arrangement> last accessed 18 June 2013
\textsuperscript{41} Bloomberg: ‘Google 2.4% Rate shows how $60 Billion is to Tax Loopholes’ http://www.bloomberg.com/news/articles/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes last accessed 19 June 2013
common tax avoidance strategy employed by hundreds of multinational corporations all across the world.\textsuperscript{42}

The difference in tax laws and policies of different countries gives room for the spread of this tax avoidance strategy. For instance, US tax law imposes tax on income of where values are created and not where they are sold. Intellectual property rights such as patents, copyright or trademarks may be created by the parent company located in a high-tax jurisdiction in favour of a subsidiary deliberately located in a tax haven. The subsidiary in the tax haven in return gets royalties from the parent company. The subsidiary in the tax haven pays little or no tax because it is not liable to tax while the company in the high tax jurisdiction also pays little or nothing because it is allowed to claim for the royalties paid as deductible expenses. It is Double Irish because two subsidiaries are created in Ireland, a tax haven. For example, Apple established two Irish subsidiaries named, Apple Operations International and Apple Sales International. These two companies are employed for routing profits from high tax jurisdictions like the U.S to Ireland. Robert Promm, Apple’s controller in the mid-1990s, called this strategy ‘the worst-kept secret in Europe.’\textsuperscript{43}

There’s a company in a high tax jurisdiction, it licenses its patents to a holding company in Ireland who then creates a Dutch subsidiary and licenses its interest to it in return for royalties. The Dutch subsidiary then creates an Irish Subsidiary in return for payments as well. The Irish subsidiary pays no tax because all the profits it makes goes to the Dutch subsidiary as royalties and the Dutch subsidiary in turn makes royalty payments to Ireland Holdings.


\textsuperscript{43} ibid
By this method, the Dutch subsidiary has nothing left to pay tax on because it remits all the royalties to the Irish holdings and the Irish subsidiary also pay no tax because Irish Tax laws uses a mind and management test for the basis for liability.\textsuperscript{44}

\textbf{CONCLUSION}

Some of the strategies discussed above are reasons why multinational corporations avoid tax and reduce revenue of governments all across the world. There has been a lot of resistance however to tax injustice caused by these strategies and that is why governments and bodies such as the OECD come up with anti-avoidance measures to checkmate erosion of funds from host governments. Although, the end of tax avoidance is not in sight but the essence of this paper is to challenge policy makers to really find more viable ways to curb aggressive tax avoidance which negates the principle of equality; a fundamental canon of taxation.

\textsuperscript{44} A corporation is an Irish resident based on where the central management and control actually abides. See \textit{De Beers Consolidated Mines Ltd. v. Howe} 1906 A.C. 455, 458
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