Funding the Future

How companies avoid tax - a quick summary in 8,000 word...

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I've been asked to give examples of how companies avoid tax.

Now, that's a mighty big subject. Can I start by suggesting you read chapter 4, here?

For those who don't want to follow the link, read on here (although I should add, about 8,000 words follow):

Companies can manage their tax bills in three ways, each of which has its own description. For the sake of clarity these are worth noting:

* *1.* ***Tax evasion is an illegal activity undertaken to reduce a company's tax bill. It might be for example that the company:***
* ***a. Fails to declare all or part of its income;***
* ***b. Makes a claim to offset an expense against its taxable income which it did not incur or which is of a type not considered suitable for tax relief in the country in which the claim is made;***
* ***c. Makes a tax claim which looks legal but only because a relevant fact with regard to that claim has not been disclosed to the tax authorities, and if it were the tax claim would be denied.***

* ***2. Tax compliance is the other end of the spectrum from tax evasion. When a company seeks to be tax compliant it does the following:***

* ***a. Seeks to comply with tax law in all the countries in which it operates;***
* ***b. Makes full disclosure of all relevant information on all its tax claims;***
* ***c. Seeks to pay the right amount of tax required by law (but no more) at the right time and in the right place.***

This activity attracts remarkably little attention, but some companies do

practice it.

* ***3. Tax avoidance. Tax avoidance is the grey area between tax compliance and tax evasion. When tax avoiding a company seeks to ensure that on of these happens:***

* ***a. less tax is paid than might be required by a reasonable interpretation of the law of a country, or***

* ***b. tax is paid on profits declared in a country which does not appear to be that in which they were earned, or***

* ***c. tax is paid somewhat later than the profits to which it relates were earned.***

The difference between tax avoidance and tax compliance is that tax compliance seeks to ensure that tax is paid in accordance with a straightforward interpretation of the letter of the law whilst tax avoidance seeks to reduce tax paid by working between the letters of the law. Both can claim to be legal, but only tax compliance can justify that claim with certainty. Tax avoidance relies on the existence of doubt for its validity. The practices referred to in this report fall largely in the area of tax avoidance, and suggest ways in which companies seek to minimise their tax bills whilst working around the law of one or more countries.

Tax planning

Any company, anywhere in the world has the opportunity to undertake tax planning within the law of the territory in which it operates. Sometimes this planning is a simple matter of making choices between various options quite deliberately made available within taxation law about how a transaction may be treated. This is an issue of tax compliance. On other occasions the planning may seek to find loopholes within the domestic law of the country in question, at which point it moves into the area of tax avoidance. The range of domestic options for planning available to companies is so wide, and yet are so locally specific that the purpose of this paper is to consider those options that are instead available to international companies, because these tend to be easier to categorise and are of greater significance for those involved with international justice, development and the interaction of taxation and the relief of poverty.

International tax planning can take place whenever a company trades across an international boundary, but it is much more likely to take place when a company actually undertakes its activities in more than one country. When this happens it becomes a multinational corporation (MNC). It is likely that less than 10 per cent of the world's companies are part of MNCs[1] ***and maybe less than 1 per cent are the parent companies of multinational groups but it is estimated that their intra-group sales (i.e. transactions across international borders but between companies with common ownership) account for more than 60 per cent of***

world trade[2].

To understand this it is important to note that whilst MNCs like to appear to be one entity, and indeed will publish accounts that suggest this is the case, MNCs are typically consist of large numbers of separate companies. A parent company usually owns all or most of the others, and controls all the others because ownership of a company's shares provides that right in company law. The companies that the parent owns are called its subsidiaries. There can be just a few of these. There may be thousands. For example, a recent count at BP suggested it had more had more than 3,000 subsidiary companies around the world[3].

This means that whilst the corporation may like to present a single front to the world, and one published glossy set of accounts, the reality is that when it comes to taxation there is no such thing as an MNC. Each company that makes it up is taxed separately. It will usually be taxed in one of two places. The first is the country in which it is incorporated. For example, a company established under English law is always taxable on its worldwide income in the UK. Secondly it may be taxed where it trades. So, for example, a company incorporated in England but which has a branch in France will be taxed in France in the first instance on the income of the French branch and then, for a second time in the UK, but with credit given for the French tax already paid under the terms of the double tax treaty between the UK and France which has as its intention the elimination of double taxation. It is precisely because of the complications that this arrangement causes that most MNCs have separate companies for each activity they undertake in each country in which they operate. As a by product the resulting complex structure is guaranteed to provide enormous opportunity for an MNC to plan its taxation liabilities. The ways in which it might do so include decisions on the following:

* ***Where it will incorporate its head office:***
* ***Where it will incorporate its subsidiary companies:***
* ***Whether it will use tax havens or not;***
* ***What companies it will, or will not include in its group structure (which means which ones are added into the glossy accounts, and which ones are not);***
* ***On what terms it will trade between group companies.***
* ***Where it will record its sales;***
* ***Where it will incur its costs;***
* ***Where it will locate its assets;***
*

Where it will employ its staff;

* ***Where it will borrow money;***
* ***Where it will locate its intellectual property;***
* ***How it will structure its operations;***
* ***Whether it will seek special tax privileges.***

This is a long list. Each needs to be explored to show how a group of companies might plan its taxation affairs.

* ***1. Where to locate a head office.***

This requires deciding in which country a head office will be located. Sometimes the decision relates to what are called ‘intermediate holding companies’ instead.

The importance of the decision is determined by the fact that a company usually has to pay tax in the country in which it incorporated. So, choosing to locate a company in a high tax territory such as the USA (which has amongst the highest corporate tax rates in the world) can be expensive[4]***. However, quoted companies usually need to be incorporated in a major financial centre such as London, New York or Frankfurt. The result is that tax cannot be minimised in those locations.***

Instead companies set up what are called ‘intermediate holding companies’. These are owned by the parent company and in turn own the operating subsidiary companies. Little or nothing happens in the intermediate locations, except that they collect dividend income from the subsidiary companies they own and then usually loan, but not pay as dividends, the resulting cash that they hold to the parent company in London, New York, or wherever. The intermediate location is chosen for having low tax rates on dividend income received, a lot of double tax treaties with other countries to ensure that it is not treated as a tax haven (even though it is) and a favourable regime for taxing interest income, of which it may have a great deal. The most popular locations are Ireland, the Netherlands, Luxembourg and Switzerland, all of which offer these arrangements.

* ***2. Where a company will incorporate its subsidiaries.***

A combination of tax law and other regulation makes it almost certain that an MNC will have subsidiary companies in each territory in which it operates. But then it has to decide if it needs others in locations that are purely tax driven.

Non-tax haven countries tend to have higher tax rates than the tax havens. A few geographically smaller developed countries, such as Ireland and the Netherlands also offer low tax rates on profits of some or all sorts. In this they join with the tax havens in seeking to increase their tax revenues by attracting profits to their shores which were not earned there but which are relocated to that country using some of the mechanisms described elsewhere in this report.

Any group of companies has a simple decision to make. It has to decide if it wants to relocate its profits from the place in which they were really earned to places in which they may be declared, with reasonable chance of getting away with the relocation, with lower taxes being paid in consequence.

Many MNCs claim they have a duty to their shareholders to minimise the tax that the company pays[5]. ***There is in fact no such requirement in the law of many countries, including that of the UK where a much wider degree of discretion is provided to the directors of companies as to how they might manage the affairs of the entity they manage[6]. In that case, this claim of a 'duty' is actually used as an excuse to justify chosen corporate behaviour.***

* 3. Whether a company will use tax havens or not

This question is related to that of where subsidiaries may be located, but not entirely. There may of course be a valid reason for locating a subsidiary in what is called a tax haven if a real trade is undertaken there. For example, a retail company running a store in Guernsey may wish to have a Guernsey based company for that purpose, and no suggestion of tax avoidance would result. However, when planning a group structure a company does have to decide if it not only wants the tax advantages some countries, such as the Netherlands, supply but the lack of transparency that is also usually associated with tax havens where accounts and even proper ownership details do not have to be filed on public record.

Some companies undertake transactions which they would prefer not to disclose to the public, their shareholders, competitors, or regulatory agencies including tax authorities. The anonymity provided by tax havens allows them to obscure the reporting of the trades they undertake in order to secure profit for their groups of company.

It is now almost universally agreed that transparency reduces risk, enhances the quality of corporate governance, reduces corrupt practices (including fraud) and must therefore be of benefit to society. But not all companies behave as if the interests of society coincide with those of their shareholders. If that is their opinion tax havens may well be attractive to them because the risk of their trade being subject to serious scrutiny is reduced. On the other hand, they face questions as to the reasons for their choice of location from both taxation authorities and others, but might believe this a price worth paying for secrecy.

Such decisions are rarely made for taxation reasons alone.

* 4. Which companies will, or will not be included in the group structure

It seems logical to assume that all companies over which an MNC has control should be included in its group accounts and so be subject to scrutiny as part of its operations. Many companies, however, choose to hide transactions "off balance sheet". This may be because the companies in question include liabilities that they would rather not recognise since they would make the MNCs' finances look worse; or those companies are being used to undertake transactions that change the view of the MNCs financial results e.g. by inflating profit (as was the case in the notorious situation of Enron).

MNCs can take advantage of situations where they can create 'orphan' companies. These are usually companies which are heavily dependent on the MNC for the trade that they undertake but which are theoretically not owned by it. This is usually achieved by placing ownership of the orphan company in a charitable trust located in a tax haven. This structure is then claimed to move both ownership and control of the orphan company outside the group so that its transactions may be treated as if undertaken by an independent third party. This technique is often used for financing debt e.g. from credit card customers, the customers of utility companies or mortgages, but the technique can also be used for other purposes, as Enron proved all too clearly ***[7].***

The use of what are clearly artificial structures created by professional people e.g. lawyers and accountants who claim independence from their clients whilst clearly working under their direction and control, raises questions about the ethical standards of these professions.

* *5. What terms of trade will be used between group companies*

When companies engage with their customers or suppliers ('third parties') it is assumed that each party is out to get the best deal possible for themselves and that the resulting prices set for the trade will reflect that fact. These are called 'arms length prices'. However, when two companies that are under common ownership trade with each other they do not necessarily want the best price for each individual company but may be motivated to set a price that gives the best overall result for the MNC of which they are a part. This will be influenced by the amount of tax that is, or is not, paid as a result of the consequent allocation of profit between the two subsidiary companies. For example, a company in Cyprus (tax rate 10 per cent) selling to a French company (tax rate 33.33 per cent)***[8] has a strong incentive when both are owned by a UK parent company to overstate the selling price in Cyprus if the third party selling price in France is fixed because this will mean more profit is taxed in Cyprus at a lower rate than is charged in France than would otherwise be the case. This process of selling between related companies in an MNC is called 'transfer pricing' and is completely legal. Abuse of transfer prices may be illegal however, depending upon the countries involved.***

MNCs have to set transfer prices. There can be no trade within the group if they do not. When doing so, however, they are in a position to make choices. Since before the Second World War the principle has been established in

international law that prices between related companies in an MNC should be set on an 'arms length basis'. This is believed to result in the allocation of the profit earned to the country in which it was generated and this is considered a just and equitable outcome.

Companies can decide whether they want to achieve this outcome. They can use their best endeavours to do so. It must be stressed however that this is not straightforward. There may be no way of determining the 'third party' price for some products transferred across international borders e.g. the price of a part finished component that will never be sold in that state to a customer has by definition no 'arms length price' and so estimates have to be made. Such process of estimating can be undertaken in good faith, or with the intent of disguising the reallocation of profit. Likewise, companies can decide to only operate 'arms length prices' in locations where a challenge to their policy is likely e.g. in the major developed economies where these matters are now subject to routine enquiry by tax authorities. This is not the case in developing countries. In December 2004 the Big 4 accountants Deloittes reported in South Africa that they had never seen a successful transfer pricing challenge out of Africa[9], and most countries in Africa do not at present have the legislation, the expertise or the commercial confidence to raise such challenges against the MNCs that operate there.

* *6. Where a company will record its sales*

It is inevitable that an MNC will trade internally. When doing this it can relocate transactions to give rise to favourable outcomes for taxation and other purposes. One transaction that can be relocated is where a sale is recorded.

Some products can be recorded as being sold from almost anywhere, and it is hard to prove that the claim is wrong. This is particularly the case with software and other such products sold on-line over the internet.

Where real, physical products are involved it can be harder to relocate where a sale is recorded, but by no means impossible. For example, in the case of a mining company ore is extracted from the ground. That ore is, in the vast majority of cases destined for export. Decisions can be made as to where the sale of that ore is to be recorded. In the first instance, there must be a sale from the country in which it was extracted. That is obvious. But the condition in which it is sold is clearly a decision, and that can be tax driven. If the tax rate in the country of extraction is high, the ore may be shipped in unprocessed state even if that increases transport costs. The added value resulting from processing then takes place elsewhere. Alternatively, the ore can be processed first. That changes its value. The decision as to where to undertake this process changes the location in which the sale of the processed ore is located.

Even if the ore is not processed, alternative arrangements can be made for its sale. For example, it might be sold straight to a third party for processing. Alternatively, it may be sold within the MNC to a central marketing organisation (a common arrangement) which then adds a profit margin for the work it undertakes. As a result part of the sale price has been relocated from the country of origin of the ore to the country in which the marketing operation is located, which may well be a tax based decision.

Some of these decisions may be determined by genuine external factors e.g. the capacity of the country of origin to process the ore. Often they are not.

* *7. Where a company will incur its costs*

Just as there is an incentive to shift sales to low tax areas, there is an opposite incentive to shift costs to high tax areas where they will benefit from the greatest value of tax relief. This can be of importance for developing countries with relatively high tax rates. For example, many South American countries engaged in the extractive industries have nominal tax rates in 2006 of around 25 per cent.

Companies may decide to load costs into territories with relatively high tax rates. This trend may be exacerbated if this ‘cost loading’ gives rise to other benefits as well. Such a benefit might arise by inflating the apparent cost of production in the extractive industries, for example, which can have the benefit of both reducing tax and reducing the proportion of production due to the host government under some mining and oil concessions, so giving a double benefit to the company engaging in such practices.

Cost loading can be as hard, or harder, to identify than sales mis-pricing since in many cases it will be even harder to establish a market price for the items in question. The principle of the ‘arms length rule’ of pricing still applies in these cases, but companies have considerable discretion over how they can interpret that obligation.

* *8. Where a company will locate its assets*

A company has to buy certain physical property to undertake a lot of the work that it does. In the extractive industries, for example, this might include all the mining or drilling equipment it uses. Logically these would be owned in the country in which they are used by the entities which have the benefit of using them in their operations. In tax planning little is that simple.

The reason is that many countries offer special incentives to companies that invest in capital assets and give them tax reliefs and allowances which are much more generous than the accounting charges made for their use in the owning company’s published reports. The result is that the effective tax rates of the companies are reduced and the dates for payment of tax are deferred.

These reliefs can be exploited when combined with asset leasing arrangements. Some countries provide tax relief on the cost of assets that are leased to the legal owner i.e. the lessor. Others provide it to the lessee who hires the asset. If the lessor company gets the tax relief on ownership then it is also liable to tax on the income arising on the asset. Conversely, in countries where the lessee gets relief on the expenditure incurred on creating the asset they rent the lessor who has legal ownership of that asset is usually exempt from tax on most of the income it gets from renting it.

Companies can decide to exploit these rules for their benefit. They do this by a process called ‘tax arbitrage’ where they chose to locate transactions so that they get maximum tax benefit from them by trading off the rules of one country against the rules of the country that is taxing the other side of the arrangement.

So, for example, they might lease an asset from a country which gives generous reliefs both for expenditure on capital assets and also on the incomes received by the lessor company. The outcome of these favourable treatments is that the lessor company generates considerable up front tax losses on the deal, which are only cancelled out over a considerable period, and that company then leases the asset to a territory where the lessee company gets the relief on the capital cost of the expenditure, but no tax relief on the rentals paid. This means that company also gets considerable up-front tax relief compared to cash expense incurred. The result is something called ‘double dipping’ in tax terms, where two lots of tax relief have been generated on one expense in effect, with in this case the transaction taking many years (maybe 25 years) to reverse, about which no one cares much since they will no longer be in their jobs by the time any reversal of the effect takes place.

As a result assets are frequently legally owned in locations far removed from those where they are actually used.

* *9. Where a company will employ its staff*

It seems logical that a company would employ its staff where they work. And so it can be for those who are on average earnings for the location in question. The company is likely to rely on these people to be the backbone of their operation, and those people are also unlikely to be either significantly mobile as to the location in which they wish to work or to be willing to engage in any serious tax planning on their employer’s part.

But this might not be true for the more senior management of an MNC, many of whom will have joined it precisely because it offers the opportunity to work in a number of locations. They will most probably be internationally mobile and will be willing to participate in tax planning for their own and their employer’s benefit.

The result is that these senior managers might be employed in locations which suit tax planning even if their duties are undertaken elsewhere. In fact, the split between the employment location and the place in which duties are undertaken may be deliberate. The reasons are:

* Managers might obtain a favourable tax treatment for their earnings if they are employed in a location which is not their long term home. This is because part of their

income might not be taxed anywhere.

* The employer may choose to place the employment in a location where the tax or national insurance charges on employing the manager are low, as is typically the case offshore.

* Having a manager employed offshore allows the employer to create a new business based in the offshore location which supplies ‘management services’, the value of which for transfer pricing purposes is hard to prove so that profit can be extracted in this way from the company that receives the charge for these services.

A company might decide to organise their employment structures in this way for three reasons:

* It allows them to manipulate their tax arrangements by adding another international service into the group which can be used for the purposes of profit reallocation to low or zero tax jurisdictions;

* It can reduce the cost of employing staff;

* It can increase the net reward to staff, so encouraging them to stay at no extra cost to the employer.

But in each case the local market for labour is upset. Overseas staff are favoured over local people. Allegiance to the company is greater as a result than allegiance to place. The duty of the staff to any particular country is undermined. And mobile staff who are dependent on their employers to create artificial structures which inflate their earnings tend to be more compliant, less inclined to whistle blow and more tolerant of other abuses if they happen within or without the company because that culture will pervade their own employment environment.

10. Where a company will borrow money

All business activities require finance to establish a physical presence in a location and to fund the day to day activities of the business. This money can be provided in two ways: share capital or loan capital. Share capital earns dividends payable from profits. Loan capital is paid interest regardless of whether or not profits are generated. Loan capital can be supplied by an external source e.g. a bank or venture capitalist group, or from an internal finance company within a group of companies. Internal finance companies are often set up offshore in locations such as the Netherlands and Ireland which have deliberately created tax structures to attract such ‘businesses’.

Interest is much more favourably treated for tax than dividends. Interest is deducted from the paying company’s profits for tax purposes and so reduces its tax bill. This does not apply to a dividend. Dividends can be subject to tax withholding from the country in which they arise i.e. part of their value has to be paid to the host country government. This is by no means always true of interest. A company can often arrange to receive interest in a low tax area and create a permanent tax saving. This is harder to achieve for dividends, especially if there has been tax withholding before they are paid.

The outcome of this different treatment is predictable. Companies have a bias to loan capital. So great is this incentive that by choice they will use almost no share capital and will have substantial loan capital in a foreign subsidiary. This is called 'thin capitalisation'. This reduces the profits in high tax areas because interest is paid from them, and also reduces the overall tax bill within the group because it allows for the interest to be received in a low tax area. The company might also, unless there is regulation in place to stop it, seek to charge whatever rate of interest it likes to maximise the profit it can extract from subsidiary company in a high tax area to then transfer it to a low tax location.

Companies undertake this activity to maximise their financial return from the activities in which they invest by creating what can, quite often, be arbitrary financial structures motivated not by the needs of group financing but by a desire to abuse tax rules for the sake of increasing the after tax profit.

The abuse is often complex. For example, third party funds are borrowed in territories with relatively high tax rates and efficient capital markets where there is no restriction on the use of those funds when it comes to giving tax relief. The UK is an example of such a location.

The funds are then lent with very low margins earned to a financial centre e.g. Dublin. From there they are loaned on to foreign subsidiaries and the charge is inflated, especially if that subsidiary is in a high risk area such as a developing country, with the justification being that the funds to be used there if borrowed directly would have been subject to a higher rate of interest even though the group itself is not.

In effect this is another form of transfer pricing abuse, but this time on financial products created specifically for this purpose.

This practice is normally well regulated in developed countries, but this is not generally the case in developing countries.

11. Where the company will locate its intellectual property

This decision perpetuates a recurring theme throughout this discussion, which is one of how an MNC might structure its affairs in order to maximise the number of transactions crossing international borders. Doing this maximises the opportunities for relocating profit to low tax areas.

Intellectual property comprises patents (on which royalties are paid) and copyrights (on which licence fees are paid). There are other variations on this theme but these two categories are sufficient to cover most issues.

Intellectual property may have been acquired by an MNC from a third party or, more likely, has been created by it. For example, Audi claim they filed 9,621 patent applications when creating their new A6 car. Any company might decide where it wishes to locate ownership of its patents or copyrights and this need not be the country of their creation, with little or no tax penalty arising on relocating them to a low tax country before they have been used and have therefore been proved to have commercial worth. The same is true of copyright material, such as logos. The Virgin corporation, for example licences the use of its Virgin logo to all Virgin operations from the British Virgin Islands. Microsoft holds the copyright of most of its products for sale outside the USA in Ireland — a low tax state. The result is that it appears to be largest company in Ireland, though the vast majority of its income in that country has little or nothing to do with its activities in that country.

It is notoriously difficult to prove the value of intellectual property. This means it is an especially popular mechanism for shifting the location of profits from both developed and developing countries into low tax locations.

Almost any company can ‘create’ licensed intellectual property. Even its own name can fall into this category. In many cases the legal registration of this property is quite unnecessary. The charging of a fee for its use is quite often even less justified.

An MNC has to decide if it wants to undertake this activity which is largely designed to facilitate the shifting of profits to low tax areas.

12. How a company will structure its operations

This theme brings together a number of previous threads. It involves decisions on:

* Where to incorporate;
* Where to borrow;
* Where to place subsidiaries and intermediate holding companies.

Each of these, and indeed the other issues addressed above, can be seen as discrete decisions. But they are also viewed collectively by most MNCs. What they are seeking to do is to create a structure for their MNC which minimises tax. In doing so they are likely to:

* Make full use of taxation treaties between countries to ensure that the least possible tax is deducted at source from any dividends, royalties, interest or licence fees paid, thus ensuring they arrive in the parent company with as little paid in tax as possible;

* Secure favourable tax treatment by accumulating reserves in low tax jurisdictions such as the Netherlands, Ireland and Switzerland with an extensive range of double tax treaties;

* Seek to use ‘conduit’ companies to turn income from relatively unacceptable sources e.g. those subject to a tax holiday (e.g. in a developing country) into an acceptable

source to which a double tax treaty exemption from further taxation can be applied. Cyprus is frequently used for this purpose.

* Seek to exploit loopholes between double tax treaties to minimise tax obligations e.g. by double dipping as noted above. This practice has recently been attacked by a number of tax authorities.

Other possibilities occur and are exploited by some companies.

The decision the company makes on this issue is essentially political. It is one of deciding whether the corporation exists within national spaces called countries, and is therefore subject to the rules and regulations of those spaces, or whether it wishes to float above and between those spaces and exploit the gaps between them by finding loopholes in the double taxation treaties that regulate the international taxation environment.

The current structure of accounting encourages MNCs to see themselves as independent of any nation state. The accounts that they publish are ‘consolidated’. They do not actually represent the results of any individual company within the group. Instead they represent the net outcome of the transactions between all the MNCs and third parties. But transactions within the MNC are entirely eliminated from that reporting.

As a result the local base for each and every company within the MNC is ignored in the published accounts, which consequently float above the national spaces as if independent of the locations in which the company works.

This perception is one that many companies now replicate in their tax planning. They can create complex group structures knowing that they do not have to report on them. They can also exploit the gaps between the countries in which they either work, or in which they choose to locate operations for the benefit (as they see it) of their investors (even though they are, inevitably rooted in those self same national spaces) because whatever they do is similarly unaccountable.

The structures of international tax have also until recently encouraged this because they have been poor at exchanging information between nation states or at enforcing international taxation liabilities. The consequence has been that an ethos of abuse has developed, with the interests of the company being seen as superior to those of the state.

The company has to do decide whether to accept this philosophy, or not.

13. Whether a company will seek special tax privileges

There is a final option available to companies. They might simply ask the state for special tax concessions.

Sometimes these are given by way of grants or subsidies. On occasion they are given by special tax allowances e.g. by granting accelerated tax allowance for capital expenditure in certain industries which have the effect of ensuring that MNCs in that sector do not pay tax for an extended period even though they are profitable. They can simply involve taxation holidays granted to particular companies whilst they are establishing themselves in a territory e.g. a ten year period is common in this respect. Alternatively, they can involve specially negotiated tax rates as is frequently possible in tax havens.

The final option is to negotiate what is called a ‘fiscal stability clause’ which guarantees the company that the state’s tax laws will not be changed to its prejudice for the foreseeable period. This period can be 25 years or more. These provide certainty to the company undertaking inward investment but seriously limit the scope for future economic management through use of fiscal policy on the part of the country that offers them.

The acceptability of these practices varies. Some subsidies and grants are almost above suspicion. Special tax allowances are usually beyond international reproach if offered to both local as well as incoming businesses. This is sometimes acceptable to a government because there is almost no local trade of similar type. Tax holidays and negotiated tax rates are widely frowned upon and income subject to such regimes is usually denied the benefit of the favourable treatment often afforded by double tax treaties. However conduit tax havens such as Cyprus can often be used to convert income of this unacceptable sort into income that is acceptable under double tax treaties.

In all cases there is a direct conflict in these arrangements between the state and the MNC, with the balance being decided between the amount of estimated economic benefit the state secures when traded against the tax it loses. If, however, the incentives offered are linked to unacceptable commercial practices the balance of the equation quickly moves into areas where fraud and other malpractice is either suspected or occurs in practice. When that is the case the state is unlikely to benefit from the negotiated arrangements even if the MNC does.

In deciding whether to avail itself of these options the company has to assess the risk to its reputation from doing so. A company might also consider whether it is allowing tax to cloud its commercial judgement: there are studies showing that tax incentives often result in business activities being undertaken in areas which are not favourable and that the outcomes do not meet the expectations of either the business or the government.

There is limited risk in taking opportunity of available tax reliefs or grants. There is increasing risk as a company moves into negotiating special allowances, tax holidays, special rates and fiscal stability clauses. Some companies choose not to do this. Others use the opportunities provided by the rules of corporate reporting, which allow intra-group transactions to be largely ignored to suppress details of such trading. This is done in the hope that the negative aspects of such deals can be kept out of scrutiny whilst the positive advantages to cash flow are enjoyed.

Along with many of the decisions to be taken by a company with regard to the issues listed in the paper, this is an ethical choice and the MNC has a position to take on this issue which it cannot avoid, and about which it should be open and accountable.

Example: What companies in the Extractive Industries do to reduce their tax bills

One of the most problematic industries in developing countries, and certainly the one to which more attention has been given than most, is the extractive industries. As an example of what can actually happen, companies in the extractive industries have a range of choices they can make to shift profits with little or no tax paid from the host countries in which they operate. These might be summarised as follows:

1. Negotiate favourable local tax arrangements

The MNC will seek to secure a favourable position for itself by negotiating special tax arrangements under the terms of its mining or oil extraction concession.

* Negotiate tax holiday so that tax is not paid during the first years of the life of the project. 10 years is commonplace.

* Negotiate special tax allowances for investment e.g. 100 per cent write off of capital costs to create early year trading losses which mean tax is not paid for some considerable time;

* Secure grants, allowances or subsidies for the operation which have the same effect as tax allowances, or might even be additional to them;

* Negotiate exemptions from domestic tax laws e.g. on tax withholdings from dividend payments so that profits may be extracted tax free. This is particularly attractive if no other tax is being paid during a tax holiday on profits;

* Negotiate special tax rules so that limited questions are asked on the expenses charged against profits within the local operation of the MNC, thereby reducing its taxable profits;

* Seek a fiscal stability clause for its own long term benefit, but not that of the host state;

* Seek special transfer pricing arrangements e.g. so that ore or oil is exported at prices below market rates e.g. on the basis of production costs plus a fixed mark-up, whatever the movements in price in the market place.

* Seek allowance for the vast majority of capital to be invested in the local operation to

be in the form of loans so that ‘thin capitalisation’ can take place and profits can be extracted from the host country by way of interest payments. Prior negotiation may take place to ensure that there are no limits on the rate of interest that may be charged.

* Ensure that no limitations are placed on royalty and licence fees paid by the company located in the host country.

* ***2. Establish tax effective holding company arrangement for the host country operating company***

The company seeks to ensure that profits that have not been taxed or which have been subject to low rates of tax in the host country retain that benefit when moved out of that territory.

Any special tax incentives offered by a host country will probably negate the benefit of double tax treaties with major financial centres where the MNC will have its headquarters e.g. the UK, the USA, etc. As a result a structure will be created that ensures that the profits flow from the host country to a low tax state with reasonably good double tax treaties (e.g. Cyprus, which is a full member of the EU) and from then on they will flow through what are called ‘participation agreements’ in jurisdictions like the Netherlands. This ensures that the benefits of low or no tax paid are preserved as the profits flow either into the parent company, or more likely into a group financing operation in the country running the participation agreement such as the Netherlands or Switzerland. These group financing operations are effectively intra-group banks which ensure that low taxed profits never have to reach countries with higher tax rates but are instead loaned to them.

* ***3. Source all equipment to establish the host country operation from within the group***

Supplying services and capital equipment from within the group means that prices charged can be arranged to ensure that profits flow to low taxed countries through the manipulation of transfer prices on sales into the host state. This has the dual advantage of reducing the taxable income of the host country operation and inflating its cost of production of ore or oil, which will probably reduce the royalties due to the host country as well.

a. Capital equipment will be sold or leased to the host country operation from another company within the MNC which is either in a low tax area or which allows a double tax deduction to be made on leased equipment costs by claiming the expense in two locations — a process known as ‘double dipping’.

* Management services and seconded staff will be supplied from offshore locations to reduce the tax paid locally on employment costs, thus reducing the benefit to the host country of the operation being undertaken within their state, and to enable such costs to be sold to the host country operation at inflated prices, with the resulting benefit

being transferred to a low tax state;

* Charges will be made for the use of MNC owned patents, copyrights and 'management know-how', the ownership of which will be located in offshore tax havens. The value of this knowledge will be hard to prove and as such is particularly difficult to challenge under transfer pricing rules.

* Cash needed to fund the operation will be provided by group finance companies in locations such as the Netherlands, Ireland or Switzerland where low rates of tax are charged on the receipt of such income. This is especially likely if a tax holiday has not been negotiated.

* ***4. Arrange for sales to be made through group marketing arrangements.***

International sales are meant to take place at what are called 'arms length prices' under international tax conventions. The intention is to ensure that each country obtains the correct market price for the commodity sold from its territory and so taxable profits are correctly allocated between states.

Arms length prices have to be negotiated in MNCs since by definition they do not operate at arms length when selling on an intra-group basis and MNCs can exploit this in a number of ways to ensure that profit is extracted from its host country operation and moved to another territory where it might be more favourably treated.

* The MNC might seek to negotiate that 'arms length prices' do not apply to its sales from the host country. This is not uncommon.

* If arms length pricing is required the group might supply only limited, or no information to prove that this is actually the case.

* If arms length pricing is to take place the MNC will seek to ensure that there is no market comparison for its product e.g. it will be argued that the ore or oil extracted is significantly different from that available elsewhere and as such negotiated prices have to be used.

* Sales will be made from the host country to a group marketing company, typically located in a tax haven. The group marketing operation will claim a margin for the 'services' it supplies, thus reducing the price available in the host country.

* Ensure that processing of the ore or oil takes place outside the host country. This means that value is added elsewhere, thus suppressing the price paid to the host country. It also allows valuable side products (e.g. silver contained in copper ore) to be marketed from outside the host country. That makes transfer prices much harder to negotiate.

* Require that the ore or oil be sold with the benefit of group marketing arrangements for which a licence or royalty will be payable, usually to a tax haven.

Summary for the Extractive Industries

Given the range of options available to them, MNCs have considerable opportunity to plan their taxes. The range of opportunities available for tax planning are so large that most MNCs are able to engage in tax avoidance, which necessarily means the assumption of risk of getting such arrangements wrong. If they are undertaken without full disclosure of the nature of the transactions being made to all the parties involved they face the risk of being considered tax evasion, at which point these activities can be considered illegal. It is often the case that the divide between tax avoidance and evasion is one of judgement.

To minimise this risk for their shareholders and to ensure that the MNC settles its obligations as a corporate citizen in the states in which it really undertakes its activities it is recommended that any MNC undertake as few of the noted practices as possible.

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[1] ***This is based on the fact that only 0.5 per cent of all companies in the UK are plcs. Even if each has 20 subsidiaries on average in the UK that means 90 per cent of the register is UK based. Proof of this is not possible.***

[2] ***OECD Observer April 2002***

[3] ***BP Annual Return appendices dated 5 May 2005, lodged at Companies House in the UK***

[4] ***See Appendix 2 on corporate tax rates for comparative company data.***

[6] ***This issue was the subject of much debate during the passage of the UK's Companies Act 2006 through Parliament and it is clear as a result that whilst profit is important a much broader range of obligations need also to be considered by UK company directors. See section 172, Companies Act 2006 available at http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf accessed 25-1-07***

It would be interesting to speculate what change in behaviour might result from explicit changes in legislation in this area. Clauses requiring companies to comply with the spirit of taxation law in all the territories in which they operated were introduced to the House of Lords during the debate on the UK Companies Act (partly at the suggestion of the TJN) but were rejected by the government.

[7] ***For a broader discussion of this issue see pages 12 — 17 of a report written by the author of this paper for a Scrutiny Committee of the States of***

Jersey available at
http://www.taxresearch.org.uk/Documents/4180-12935-2962005.pdf accessed 25-1-07

[8] http://www.kpmg.com/Services/Tax/IntCorp/CTR/ accessed 7-11-06

[9] Reported in tax us if you can TJN 2005 available from
http://www.taxjustice.net/cms/upload/pdf/tuiyc_-_eng_-_web_file.pdf accessed 25-1-07