Corporate Tax Havens: Analysis of an Aggressive Tax Approach as a Strategic Necessity for Large Multinational Corporations

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Abstract

This study will examine the complexities of corporate tax planning, with a focus on tax deferral strategies employed by United States multinational corporations, providing a financial and ethical analysis of corporate tax entities. The focus will be on multinational corporations, primarily Fortune 500 Companies. It will then evaluate trends across industries and contrast the patterns of unrecognized tax benefits reported by large and small scale public companies. Additionally, the paper will analyze the effective tax rate paid by a sample of corporations of varying size and industry, and how these characteristics of the business correlate with this rate. The study will include a foundational background on corporate tax havens, the benefits of deferred taxation, and an outsider’s perspective on the subject matter – namely, the difference in perception of the general public versus that of a shareholder. Furthermore, this paper will reference case studies of large multinational corporations that have received publicity for their tax avoidance strategies. While the acceptability corporate tax havens is an area of controversy, and many argue that corporations have an obligation as global citizens to pay taxes, this paper will present that in order to remain competitive as a large, multinational public company, an aggressive tax deferral strategy can be not only instrumental, but essential to success.

Background

For decades, one of the most distinctive hallmarks of a successful, industry-leading multinational corporation has been the strategic implementation of an aggressive tax strategy. While the objectives of such strategies include goals such as maximizing shareholder value, reducing expenses, and maximizing after-tax income, the role of corporate tax havens is often viewed by its critics as a tradeoff with corporate social responsibility (Dharmapala 2008). When multinational corporations implement an international tax strategy to reduce their effective tax rate, some professionals argue that corporations have a social responsibility to pay taxes, rather than use any conceivable means to reduce them (Dowling 2013). While corporate social responsibility may not have an immediate financial impact for shareholders, it endorses a corporation’s reputation and integrity, and thereby encourages investment. Indeed, many Fortune 500 corporations walk a fine line between effective and permissible tax havens and their much less ethical counterpart – aggressive tax shelters. However, I will later present that Fortune 500
corporations have survived the competitive and capitalist nature of American business with the assistance of such forward tax haven implementation. A sample of large multinational corporations across a variety of industries all report lower effective tax rates, and proportionately larger unrecognized tax benefits than their smaller public counterparts within their respective industries.

**International Approaches for Taxing Foreign Income of Corporations**

Traditionally, there are two widely practiced and recognized approaches for taxing foreign income. The most common approach (among countries that are not tax havens themselves) is the Territorial scheme, in which a nation will tax income generated within its borders, regardless of whether the corporation is domestic or foreign (Dharmapala 2008). For example, if no creative tax strategy were applied, a parent company based in Country A with a subsidiary in Country B would pay tax according to Country A’s provisions for the parent company’s income, and according to Country B’s tax law for the subsidiary’s income.

Alternatively, the United States and Japan subscribe to the Worldwide system of taxation. This system taxes all income earned by corporations based in the aforementioned countries, regardless of the country where the income is earned. Countries known for subscribing to the Worldwide approach to taxation implement some of the highest marginal tax rates. However, these countries implement a foreign tax credit to counteract potential double taxation. (Dharmapala 2008). Since United States based corporations only pay United States taxes on their repatriated foreign earnings – taxes on all other foreign earnings are deferred until the time of repatriation – this ultimately does not significantly differ from foreign nations which only tax income earned within their borders. Earnings per share see an increase from this deferral of unrepatriated earnings. In order for multinational corporations to continue deferral, they must
attest that these foreign earnings are indefinitely reinvested, thus the books treat these foreign earnings as if they were never paid, and the company does not record a corresponding deferred tax liability.

From a financial reporting perspective, United States based corporations report current year net income from international operations in year income is earned. However, under the United States worldwide system of tax, income from international operations is generally not reported on federal tax return, as it is deferred from United States taxation until income is repatriated back to the country as dividend or other payment. At this point, it is taxed on a residual basis, that is, the repatriated earnings are taxed to extent that the United States rate exceeds the foreign tax rate (Donohoe et. al. 2012).

Research by Carlos Jiménez-Angueira (2008) at the University of San Antonio demonstrates that large companies reserve uncertain tax positions as a form of earnings management. Items such as indefinitely reinvested foreign earnings may be treated as a sort of cookie jar reserve that could be reversed in reporting periods of less profitability, as a means of decreasing financial volatility period over period. Ultimately, combination of contributing factors, including industry and organizational elasticity determine the size of such a benefit that a corporation would accumulate over time (Bucovetsky and Haufler 2006).

**How Multinational Corporations are Deferring Taxation on Foreign-Earned Income**

Regardless of the nation’s approach, multinational corporations are able to defer taxation in one way or another. Later on, this paper will examine how successful Fortune 500 companies such as Google have structured their tax havens, but more generally, advantageous tax haven
strategies can be implemented through a corporation’s debt structure; borrowing in a country that has high tax rates and directing interest payments to countries with much lower tax rates.

Corporations also reduce their tax expense through the implementation of transfer pricing on inter-entity transactions. Governments typically require arms-length transactions, but multinational corporations use transfer pricing to their advantage (Dharmapala 2008). Typically, transfer pricing refers to when a foreign subsidiary located in a low tax country sells assets to the United States based corporation at artificially inflated price. Since the tax rate on United States-earned income is greater than that of the foreign country where the subsidiary is located, firms bypass these higher tax brackets via their artificially inflated inter-entity prices, directing most of the profit to the foreign tax entity. The United States tax rates would then only be applied to the proportionally small markup on the asset sale to the final customer, resulting in a lower tax expense on domestically earned profits (Wilson 2007).

Finally, and perhaps most well-known, are offshore intellectual property havens. This tax strategy is implemented by a multinational corporation establishing a subsidiary in a low tax foreign nation (commonly Bermuda or other Caribbean island countries). The subsidiary buys intellectual property from the parent company and collects royalties from sales of this trademarked or patented property. For U.S. based corporations, royalties earned on intellectual property must be reported to IRS, but payments made from the foreign subsidiary back to the U.S. are under discretion, and therefore often minimal, thus reducing the effective tax rate (Donohoe et. al. 2012).

Which international ventures prove most favorable?
Tax havens are typically found in countries with stable legal and political systems and low levels of corruption (Dharmapala 2008). While these seem to be positive traits and favorable environments, the public still historically perceives tax havens as a crooked means of shifting dollars where they should not be. Tax havens are typically established in relatively wealthy nations, particularly those with small populations, and are commonly found on island countries (Dharmapala 2008). These island countries or other regions tend to be dependent territories, often subscribing to a legal and political system than mirrors that of England -- common law and a parliamentary legislature (Dharmapala 2008).

As Ireland’s corporate tax rate is a mere 12.5%, less than 1/3 of that in the United States, it is a common tax haven location for the manufacturing industry. The Cayman Islands and other island nations are more common target locations for the “post office box” type of tax haven. These havens, popular for intellectual property sales, require only a mailbox owned by the corporation to qualify as a physical location and reap the nation’s generous tax benefits.

**Tax Havens and Book Tax Differences**

Organically, book-tax differences drive from factors such as depreciation, but beginning in the 1990’s there was a substantial increase across many large corporations that resulted from other factors, namely aggressive tax strategies (Wilson 2007). Firms likely to use tax shelters often report larger ex post book tax differences, and commonly have aggressive financial statement reporting (Wilson 2007). It should be noted that permanent book tax differences are never deductible, while temporary differences are, if favorable. Recent trends have shown that book-tax differences have a positive correlation with the participation in tax havens (Wilson 2007). Investors tend to interpret large positive book-tax differences as a red flag, leading them to question the integrity of the firm’s tax strategy (Wilson 2007).
Across industries, recent years have shown an overall increase in book tax differences. The 1990’s saw a growing variance between book and tax income. The variance grew from $92.5 billion in 1996 to $159 billion in 1998 (Wilson 2007). Stock options, international operations, and depreciation are common, less controversial contributors, yet these account for less than 50% of the 1998 BTD cited (Wilson 2007). Some studies attribute the difference to aggressive financial reporting to simply defer tax expense, but not necessarily indicate the use of tax havens (Wilson 2007). While firms are required to accrue for a loss on any uncertain tax positions if loss is “probable and reasonably estimable,” this is designated as a tax cushion and of course the designation as “probable and estimable” is a matter of management discretion.

**Unrecognized Tax Benefits**

Firms are required to disclose unrecognized tax benefits on their books when their uncertain tax positions may not be sustained. This term refers to tax reductions that have been claimed on corporate returns, but will unlikely pass an audit. For multinational corporations, they are primarily used as a means of moving profits to tax havens. Unrecognized tax benefits present a challenge as an indicator of tax aggressiveness. This is because corporations who implement aggressive tax planning are also likely to practice aggressive financial reporting. While an aggressive tax approach would likely correlate with high unrecognized tax benefits, conservative financial reporting would typically result in just the opposite. Managers face a tradeoff between increasing book income, and therefore tax expense, and minimizing taxable income and tax expense, which thereby increases financial reporting costs (Frank et. al. 2009). While companies with political power and leverage commonly have high unrecognized tax benefits, these high balances more often correlate with corporations that are moving dollars to international tax havens (Kim and Zhang 2013).
Corporate Social Responsibility – Does the Public Care about Low Effective Tax Rates?

Large multinational corporations that are able to drastically reduce their effective tax rate are often criticized doing so, the argument being that these companies have a social responsibility to pay taxes, even if they can legally avoid them (Dowling 2013). In complying with the IRS, these corporations are subject to obeying the letter of the law, but the CSR argument is whether they are obeying the spirit of the law. CSR is a term founded on the belief that corporations should consider more than just profit maximization, but the social implications of their actions as well. CSR supporters believe tax minimization to be a morally corrupt business practice, viewing it in the same light as corporations which cut costs through damaging the environment or providing poor working conditions. Fisher (2014) states that such negative publicity surrounds tax avoidance practices that long term financial benefits are greater than the initial benefits of establishing tax havens.

However, as long as these firms are acting within the law, I would argue that an aggressive tax haven strategy is essential for large multinational corporations to remain competitive. If an individual multibillion dollar firm were to pay the statutory 35% federal tax rate, their financial performance would not hold a candle to their industry peers, and the investor community would look upon it unfavorably. In short, the firm would not survive the economic competition of its cohorts (Dowling 2013).

In 1999, it was estimated that United States corporations avoid upwards of $10 billion per year through the use of tax arbitrage, and this number has only grown since. While the IRS often pursues individuals with offshore accounts and tax havens with increased audit scrutiny (Dowling 2013), firms are not required to disclose their tax shelter involvement on their 10-K. For multinational corporations, tax haven information only becomes known ex post, through a
court case, divestiture, or other extreme consequence. Even then, it is nearly impossible to evaluate the tax benefit received from the use of tax havens (Wilson 2007).

The Tax Reform Act of 1986 effectively pushed multinational corporations into foreign tax havens, as other loopholes were eliminated. To cut costs, tax expense was an easy target (Wilson 2007). Corporations in United States are only required to disclose “significant” subsidiaries. Exhibit 21 on the 10-K is intended to disclose all significant foreign subsidiaries and their country of origin. Significant subsidiaries are defined as those with assets or pretax income from continuing operations that is greater than 10% of the consolidated amount (Donohoe et. al. 2012).

In contrast, the United Kingdom’s Companies Act of 2006 requires corporations to disclose all subsidiaries and their location for financial reporting purposes. This regulation applies to companies which are based in the United Kingdom, but not to British subsidiaries of corporations of international origin. This level of detail in financial disclosure is extremely costly, so much so that corporations oftentimes willingly elect to pay a fine for incomplete disclosure rather than comply (Dyreng et. al. 2014).

Non-Tax Costs of an Aggressive Tax Strategy

In addition to the tax aggressiveness/corporate social responsibility tradeoff, there are significant non-tax costs of implementing tax havens and international subsidiaries than cannot be entirely overlooked. Particularly for physical entities overseas, reorganization costs, training of new employees, and the impacts of time difference can be quite costly. From a tax auditor perspective, disclosing all subsidiaries and investments would be require significant resources. Reputational cost should also be considered -- shareholders favor more income and appreciation
in shares, however if they do not support the business strategy of a corporation, they will not invest at all (Heller 2014).

**Public Perception**

While the public may perceive tax havens as corrupt, a robust argument can be made that they represent strategic business. Corporate executives and decision makers are adverse to public scrutiny, yet investors have learned to interpret unrecognized tax benefits as an indication of higher earnings. Because the corporation will be paying a reduced tax expense, the logic is that the company has strong strategic leadership in positioning itself to pay less in taxes (Dyreng et. al. 2014). Additionally, the company’s “obligation to shareholders” to maximize value can be substantially achieved through minimizing tax expense (Drucker 2010).

Firms typically disclose very little information in regards to geographic operations and foreign tax structures. Multinational corporations’ 10Ks require the disclosure of earnings by region, but defining the scope of that region is up to the firm’s discretion (Dyreng et. al. 2014). Ever-changing disclosure requirements cause firms to adjust their tax position, to reduce number of havens, and implement new reporting procedures. Any multinational corporation is reluctant to disclose any more information than is explicitly required by the SEC (Dyreng et. al. 2014). Rather, corporations often only disclose “significant locations”, with little to no insight to completeness of this list or whether these are physical offices staffed with employees or simply serving a post box purpose. If the exact location were to be revealed, investors and competitors can make an educated guess (for example, a location in the Cayman Islands is likely to be merely a post box), but even this basic information is not required by the SEC.

**How Fortune 500 Companies are Minimizing Current Tax Expense**
As previously noted, aggressive financial statement reporting often goes hand in hand with aggressive tax reporting, which is a management tactic consistently employed by large multinational corporations. Since effective tax planning very well can increase shareholder value, investors are often less likely to scrutinize an aggressive tax strategy if they are reaping the benefits via greater dividends (Wilson 2007).

Book tax differences are also a useful vessel for tax aggressiveness, but if they are significant enough in size, this could be interpreted as a red flag by the investor community. If book tax differences are disproportionately large, and continue to accumulate exponentially over time, this could indicate controversial tax sheltering. In particular, research has shown a positive correlation in long term accrual based earnings and tax sheltering (Wilson 2007). However, investors concerned with these risks are also positively influenced by corporations with strong financial performance. As earnings per share increases, corruption speculation decreases (Wilson 2007).

Long run tax avoidance has a positive correlation with firm size, size being evaluated based on total assets. Firms which use tax shelters also often tend to have less debt, on average, than their peers in size and industry, as management has gone to great lengths to minimize tax expense. Wilson’s research also acknowledges the possibility that this relationship is actually reversed; that firms have less debt because they have a lower tax expense, through the implementation of tax havens (Wilson 2007).

It should be noted that in the United States, it is a criminal penalty for a corporation to disclose total taxable income (Wilson 2007). Corporations disclose their income before taxes, and then the taxes actually paid, but not taxable income itself. This omission enables some of the most successful corporations to maintain confidential and exclusive tax strategies (Wilson 2007).
Controversy and Case Studies

Google has a very intricate and tactical tax strategy that has been studied by many. Notably, the company’s international operations is headquartered in Dublin. The office accommodates over 2,000 employees, and claims 88% of Google’s $12.5 billion in foreign sales, but most profits are directed to a tax haven in Bermuda. In fact, Google has saved an estimated $3.1 billion just since 2007 through its tax structure. While the corporation has boasted high earnings and consistent growth year over year, it undeniable that this complex tax strategy is a contributing factor to Google’s continued success (Donohoe et. al. 2012).

Since 2007, Google has paid a tax rate of 2.4% on foreign earnings, while its peers such as Microsoft, Oracle, Apple, and IBM (the top 5 technology companies) have reported effective tax rates of 4.5-25.8% on their own foreign earnings. Expert tax economist Martin A. Sullivan, whose credentials include work for the United States Treasury Department, finds it impressive that Google is able to reach such a low effective tax rate when the corporation operates predominately in high tax countries (corporate rates of over 20%; 35% in the United States – where Google has the largest market, and 28% in U.K. – home to Google’s second largest market (Donohoe et. al. 2012)).

Google achieves such a low effective tax rate primarily through redirecting income to Bermuda, where there is no corporate income tax. When an international company (located outside of the United States and therefore not a domestic sale) purchases advertisements through Google, payment is directed toward Google Ireland. Irish tax on corporate profits are 12.5%, however since Google’s earnings do not remain in the Ireland office, the company is exempt from paying this tax. Since Irish tax laws would require Google to make a large tax payment, were the money to be sent directly to Bermuda, the payment is first directed to the Netherlands.
Ireland does not tax qualified payments to other European Union members, so this transfer is exempt from paying tax to Ireland (Donohoe et. al. 2012).

Google’s office in the Netherlands is essentially a “post box office,” as it does not have employees, so the Netherlands office passes approximately 99.8% of the original payment from the customer to Bermuda. Thus, the company’s profits are shifted overseas through transfer pricing (Donohoe et. al. 2012).

Across many Fortune 500 companies, there has been an increasing trend in disclosing fewer “significant subsidiaries,” and Google is no exception. Google disclosed 108 of such subsidiaries in 2009 and only 2 (both located in Ireland) in 2011. The growing public interest in offshore accounts and where companies are forming tax havens has driven multinational corporations to be more discrete regarding their tax strategies, disclosing fewer locations over time (Donohoe et. al. 2012).

Microsoft has had considerable success in reducing its effective tax rate as well, experiencing a decrease of 15.6% as a result of “foreign earnings taxed at lower rates” for fiscal year end June 2011. This reduction translated into an impressive $4.4 billion in federal income tax savings (Donohoe et. al. 2012).

In addition to transfer pricing strategies, large multinational corporations also have the flexibility to change an assertion on whether unrepatriated earnings are permanently reinvested. This creates an opportunity to manage tax strategy via a potential cookie jar reserve. In recent years, General Electric has repatriated foreign earnings previously designated as indefinitely reinvested on multiple occasions (Velarde 2015). In 2009, GE decreased the disclosed amount of indefinitely reinvested earnings by $2 billion, resulting in a $700 million tax benefit (per their
statement in 10K) (Donohoe et. al. 2012). In April 2015, the company announced that it will be repatriating additional earnings and deferred tax assets, thereby reducing the size of its financial services business and generating a tax expense of $7 billion. Over the next two years, GE will be repatriating $36 billion in cash, resulting in $23 billion in after-tax expenses (Velarde 2015). If this trend of repatriating previously indefinitely reinvested earnings continues, GE’s tax expense will continue to grow.

Regulations regarding Tax Havens

§210.4-08(h)(1), Income Tax Expense states that the SEC requires companies to disclose income or loss before tax expense/benefit, classifying the income as either domestic or foreign. The SEC defines foreign income as income earned from company’s foreign operations – outside of its country of origin. U.S. companies are required to designate between foreign income and foreign income taxes for such income when foreign income is more than 5% of total income before taxes, or (less likely) than foreign taxes are more than 5% of total tax expense (Donohoe et. al. 2012).

FAS 109, passed in 1982, requires that for balance sheet purposes, a company must increase accounting stock basis in foreign subsidiaries by the amount of that subsidiary’s unrepatriated earnings. When a company repatriates earnings, this reduces stock basis by amount of distribution. However, a company does not increase tax stock basis in foreign subsidiaries by unrepatriated earnings if earnings are deferred from United States tax, thus creating a book-tax difference (Donohoe et. al. 2012).

Additionally, disclosure rules require specific plans for reinvestment of foreign earnings. Corporations are required to provide such evidence when there is a history of asserting the
intention to reinvest indefinitely, but only a portion of these earnings are in fact reinvested. When firms maintain that they will reinvest indefinitely despite a prior history of repatriation, the SEC examines their filings with additional scrutiny (Ernst & Young LLP 2013).

Sample of Corporations

Larger Fortune 500 companies have significantly lower effective tax rates than those of smaller public companies, across industries (Zimmerman 1983). In this sample, small public companies often paid an effective tax rates greater than the 35% federal rate, while larger public companies paid significantly lower rates. These large multinational corporations use tax havens and aggressive deferral strategies to pay less than the statutory 35% for corporations earning in excess of $18,333,333.

The table below illustrates the effective tax rates paid by a sample of multinational corporations from 2007 to 2013. The upper section of the chart shows the large corporations, those which are Fortune 500 ranked, and the lower section shows smaller public corporations. The implementation of tax havens and complex corporate tax strategy that is often only possible with the resources a large corporation has. These corporations consistently pay below the statutory federal rate of 35%, and sometimes a negative rate, and both General Electric and Ford saw refunds. Ford’s effective tax rate in 2011 was an astounding -141%.
The smaller companies, in the lower section of the table, are consistently paying much closer to, if not greater than the federal statutory rate of 35%. These corporations often do not have the means or expert personnel to choreograph an aggressive tax haven strategy. They are smaller, some of them newly public, and establishing tax havens abroad requires informed corporate executives, financial and logistical resources, and furthermore, if the havens will not be saving millions of dollars as they do for the larger corporations, they may not be worth the painstaking process of being established. While it was not surprising that large multinational corporations reported lower effective tax rates than small ones, I did not expect such volatility in the effective rates year over year. Such companies dedicate substantial resources to their tax planning initiative, and while their effective rates are consistently below 35%, they have fluctuated drastically since 2007. Over the past seven years, GE’s effective tax rate has spanned a range of -11.5% to 28.5%, due in part to the implications of bringing cash back to United
States shores, and subjecting earnings that were previously permanently reinvested to federal
taxes.

The table below demonstrates the unrecognized tax benefits reported by the same sample
of corporations, from 2007 to 2013. The relative size of these tax benefits clearly mirror the
trends in the effective tax rates paid by these corporations. The lower the effective tax rate, the
more likely it is that a corporation will have a large, and growing unrecognized tax benefit.
While tax havens are not the sole contributor to these unrecognized tax benefits, they are a major
driver, and, not surprising, their balance tends to grow over time.

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<th>Unrecognized Tax Benefits ($M)</th>
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<td>2007</td>
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Multinational corporations that have successfully implemented tax havens have seen
significantly lower effective tax rates and growing unrecognized tax benefits, as compared to
small corporations that do not have the means to implement a complex international tax strategy.
While tax havens can be subject to public scrutiny, oftentimes, when they are within the laws and regulations of the tax code, investors view them to be a positive attribute. Although corporate social responsibility cannot be ignored, the most profitable corporations of the world do not maintain their status as such by paying the statutory 35% of income to the IRS. They maintain their financial success and status as industry leaders through innovative strategy, a part of which is tax minimization. While tax havens may be controversial at first glance, they are essential to industry-leading multinational corporations.
Works Cited


