How do companies avoid tax?

Tax avoidance techniques for multinational companies are all about **location**. They consist of where a company chooses to open offices and create subsidiaries, and where it chooses to allocate its profits and expenses.

Companies who want to minimise their tax bills shift their profits to subsidiaries where there is a low or zero tax regime, e.g. a tax haven, and therefore pay less tax on them while they try to record their expenses in high tax jurisdictions that often offer good rates of tax relief.

They use a number of techniques to artificially move their money around, including using tax havens, manipulating prices and creating artificial structures that have little to no real economic value.

But multinational companies do not have to use these techniques at all. They have a **choice**.

They can choose:

To exploit loopholes in tax law, play country’s tax regimes off against each other and hide transactions in secrecy jurisdictions - at the same time as hiding the true nature of their behaviour in their accounts.

Or

To be transparent about their operations, make decisions based on factors other than taxation and contribute a fair amount of tax to each country in which they operate;

Both options are perfectly legal. But only one is right. Fair Tax encourages companies to start choosing to do the right thing; to increase their transparency and pay their dues.

Multinationals avoid paying their fare share of tax by choosing where they locate:
Company incorporation

- Multinational companies can choose to create intermediate holding companies and subsidiaries in tax havens or low tax regime countries.

Holding companies: These companies can perform a number of tax-reducing functions such as minimizing tax paid on dividends – by collecting and then loaning dividend money to the parent company – and hiding the nature of certain transactions from the authorities. Conveniently, these intra-group transactions, and the locations where the profit is actually generated, are hidden from published accounts.

The most popular locations for this kind of holding company are Ireland, the Netherlands, Luxembourg and Switzerland, all of which have a low corporation tax rate and offer these arrangements.

Holding companies can range from being a single office to acting as regional headquarters. For example, Amazon used its European headquarters, which is based in Luxembourg – and owns the separate trading companies that operate in the UK, France and elsewhere – to absorb its profits and reduce the amount of tax it pays in the actual countries where it trades.

Occasionally, companies choose to move their head offices for tax reasons, e.g. Alliance Boots relocated to Switzerland. However, usually, the head offices of quoted companies need to be incorporated in or near a major financial centre such as London, New York or Frankfurt. The result is that tax cannot easily be minimised in those locations.

Subsidiary companies: If a company is motivated by wanting to reduce its taxable income, it will choose to open subsidiaries in countries with a low tax rate or in tax havens and reallocate its profits to these locations.

Companies can choose to shift their profits to these subsidiaries via a number of methods, by manipulating intra-group trading prices, by creating companies that provide services – for which the other subsidiaries within the group have to pay a fee, – or by creating companies that can use their non-resident status for tax advantage in other countries (see below for examples).

There are particular benefits for companies who locate subsidiaries in tax havens especially if they wish to undertake transactions that 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.

Moreover, current accounting standards do not require companies to list more than their principal subsidiaries and many choose not to declare certain subsidiaries even though transactions with the subsidiary company play a role in their annual accounts.

Sometimes, even the transactions of tax haven subsidiaries are deliberately left out of financial statements. Companies take advantage of tax haven's secrecy laws to create an ‘orphan’ company – it then records any transactions with this company as a third party in order to manipulate how its balance sheet appears and reduce its tax bill.

**Pricing Rules**

- Multinational companies trading between two subsidiaries of the same group can choose to manipulate ‘arms length’ transfer pricing rules by artificially reducing the cost of products and services sold from higher tax regime countries to another company in a lower tax regime country and then inflating the costs of the same products sold on from the new country, which pockets the difference as reduced–tax profit.

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, the best overall result for the multinational company to which they belong often includes minimising their tax liabilities.

Under transfer pricing rules, companies are obliged to set ‘arms length prices’, meaning a ‘fair market’ value for goods and services they trade within the group. This is believed to result in a just allocation of profit to the country where it was generated.

In reality, however, many companies choose to take advantage of their large volume of international transactions, and the inherent difficulty in assessing a ‘fair market value’ for many goods and services, in order to manipulate the prices at which they buy and sell in different locations. This changes where a group allocates most of its profits and losses and ultimately can significantly reduce its tax bill. As nearly 60% of the world’s trade now occurs within groups of companies, this is a serious issue.
For example, a UK parent company might own two separate companies in Cyprus and France.

When the Cyprus–based company (tax rate 10 per cent) decides to sell to the French company (tax rate 33.33 per cent), it has a strong incentive to overstate the selling price in Cyprus. The French company is obliged to sell the goods on at a fixed price, so by paying over the odds for them from the Cyprus company the UK parent company reduces its profit margin in France and increases it in Cyprus, where the company is taxed less.

The abuse of transfer pricing rules is illegal in some countries – increasingly tax authorities in developed countries look out for such practices. It is easier, however, for companies to manipulate prices for trading in and out of developing countries. In those countries, tax authorities do not have the capacity to challenge the sophisticated trading techniques used by multinationals and their teams of lawyers and accountants.

Companies can also get away with abusing transfer pricing rules by selling products and services that are notoriously hard to value. There may be no way of determining the market 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 or the cost of using a company’s logo. By definition these goods and services have no existing ‘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.

**Sales**

- Multinational companies can choose to sell their products to third parties from countries where they can gain the maximum profit at the minimum tax expense – even if that country is not where the product was originally created. They do this by moving products cheaply out of higher tax regime countries to subsidiaries that add ‘value’ to the products in lower tax regimes, after which they can then be sold for more.

The process of relocating sales can involve the manipulation of intra-group pricing rules or it can equally involve a complex means of adding value to products in different locations before the point of sale.

Some products can be easily relocated as they 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. For example, Amazon.co.uk records its UK sales as coming from Luxembourg for tax reasons.
Where real, physical products are involved it can be harder for companies to relocate where a sale is recorded, but it is by no means impossible.

For example, mining companies extract ore from the ground, which in the vast majority of cases is destined for export.

While there must clearly be a sale from the country in which it was extracted, companies can choose the condition in which it is sold. That choice can be tax driven. If the tax rate in the country of extraction is high, as is the case in many developing countries, the ore may be shipped in unprocessed state to another subsidiary in a lower tax regime first even if that increases transport costs.

The lower tax subsidiary can choose to sell the ore unprocessed directly to a customer or process it and sell it on at a higher cost. Either way, the added value resulting from processing takes place away from the country of extraction and the company profits from paying less tax on its income from both sales.

Alternatively, the multinational may sell the ore to a central marketing organisation (a common arrangement), which then adds a profit margin for the work it undertakes. Again, as a result, part of the sale price is relocated away from the country of origin often to reduce the company's tax bill.

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.

**Operating Costs**

- Multinational companies can choose to inflate the costs of their operations in higher tax regime countries thereby benefitting from the extra tax relief applied to business expenses.

In business and accounting, a cost is the monetary value that a company has spent in order to produce something i.e it is their expenses. Just as multinationals have an incentive to shift their profits to low tax areas, they have an opposite incentive to
shift costs to high tax areas where they will benefit from the greatest value of tax relief.

With the hope of attracting investment, many countries offer tax relief on a number of company expenses including capital expenditure (buildings and equipment) and interest payments on debt.

Companies can choose to load costs into territories with relatively high tax rates purely to reap the benefits of relief. Techniques include inflating the costs of production and other business expenses (cost-loading) or loading up companies with debt.

Cost loading can be as hard, or harder, to identify than sales mis-pricing since in many cases it will be very difficult 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.

The 'cost loading' trend may be exacerbated if it gives rise to other benefits as well. For example, if a company in the extractive industries inflates the apparent cost of production in a high tax rate developing country, it 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.

**Borrowing**

- Multinational companies can choose to create internal financing companies in low tax regime countries or tax havens that borrow money to then loan to other subsidiaries in the group. In another form of profit-shifting, the subsidiaries, often in higher tax regime countries, benefit from offsetting the interest payments to the financing company against their profits thereby reducing their tax bill. The financing company also pays little tax on its income.

All companies 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.

Companies tend to favour loan capital over share capital for tax reasons. 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.

Companies can choose to reduce their tax bills even further by being creative with how they get their loan capital. 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’.

Companies use internal finance companies set up in low tax jurisdictions to change how and where they pay interest on their loans. The internal finance company borrows money from an external source and then lends it on at a higher interest rate to the other companies in the same group based in high tax countries. The receiving companies are then able to reduce their tax bill where they are by offsetting the higher interest payments from their profits.

Conversely, the repayments they pass back to the internal finance company benefit from the low tax rate on income that those companies enjoy. By creating a more-or-less artificial financing structure, multinational companies are able to benefit twice over. A similar process is enacted with insurance, with companies setting up what are known as captive insurance companies. Some companies are so enamoured of this technique that they use internal finance companies to load up parts of the group with huge amounts of debt. This is process called ‘thin capitalisation’.

Moreover, unless there is regulation in place to stop it, multinationals may 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. 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.

**Tangible Assets**
• Multinational companies can choose to exploit the differences in tax reliefs offered by two countries on investment in tangible assets in order to gain twice the amount of relief on the same assets. Known as ‘double-dipping’ tax arbitrage, it can result in assets being owned far away from where they are actually used.

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, the company, would own these in the country in which they are used. But when companies choose to try and reduce their tax bill little is that simple. Assets are frequently legally owned in locations far removed from those where they are actually used.

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.

This incentivises companies to invest, which is great as long as they are committed to paying deferred tax at a later date and as long country rules on reliefs are not being over-exploited.

Tax reliefs can be exploited for further gain 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 choose to manipulate 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, a company 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. That company then can leases the asset to a territory where the lessee company (part of the same group) gets the relief on the capital cost of the expenditure, but no tax relief on the rentals paid.
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 the tax-relief transactions often taking many years (maybe 25 years) to reverse, no one cares much since they will no longer be in their jobs by the time any reversal of the effect takes place.

**Employees**

- Multinational companies can choose to employ managers in a low tax regime country or tax haven far away from where their services are used. This can both reduce the employees' individual tax bills and benefit the company by allowing them to make charges for ‘management services’ which are deducted from their profits elsewhere.

The senior management of a multinational, may well 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.

From this practice, managers can obtain a favourable tax treatment for their earnings if they are employed in a location that 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.

**Intellectual property**

- Multinational companies can choose to register patents and copyrights on things like their brand and logo to low tax regime countries or tax havens. The group’s companies based in higher tax regime countries then pay a fee for the use of these items every time they make sales. These transactions, which do not appear in a group’s accounts, shift profits to where they will be taxed less.

Intellectual property rights are intangible assets that are notoriously difficult to value or price. Multinational companies can choose to exploit this difficulty by
registering these rights in low tax regime countries or tax havens for tax reasons. Keeping intellectual property, which comprises patents (on which royalties are paid) and copyrights (on which licence fees are paid) in countries separate from a group’s principal trading territories both somewhat artificially increases the number of international transactions a group has – which are left out of their accounts – and maximises the opportunities for relocating profit to low tax areas.

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.

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.