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## **Moving pieces**

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## Moving pieces

Global companies have plenty of latitude to minimise their tax bills

IT WAS as if America had swallowed Sweden. Since George Bush signed into law a one-off tax amnesty in 2004 that slashed corporate-tax rates from 35% to just over 5%, American companies have repatriated close to \$350 billion in previously untaxed foreign profits, according to estimates by JPMorgan, a bank—just shy of Sweden's annual output. Pfizer, a drugs company, alone brought home an eye-popping \$38 billion. Well over \$150 billion of American companies' foreign profits still sit offshore.

Companies the world over are increasingly global. They are also facing ever fiercer competition at home and abroad, which makes them increasingly sensitive to costs—including the costs of regulation and tax. That is good for OFCs, often the low-cost middlemen of international financial transactions.

The way companies use OFCs has changed over the years. A few decades ago, before the telecoms revolution made it easy to shuffle money around the globe, companies used OFCs primarily because they had less onerous financial rules. The links between banks in Cayman and those in America, for instance, are rooted in a long-standing American rule barring banks from paying interest on commercial chequing accounts. To get around this, many American banks set up “sweep accounts” that electronically funnel money to Cayman for an interest-earning overnight stay before being swept back home. “Cayman takes advantage of a legitimate loophole—and the financial system is none the weaker for it,” says one regulator in Europe.

Luxembourg got established as a financial centre four decades ago partly because it had looser lending rules than other European countries such as Germany, says Fernand Grulms of the Luxembourg Bankers Association. A Luxembourg subsidiary of a German bank could make over twice as many loans for the same amount of equity as its parent. Scandinavian banks were drawn to Luxembourg because they could deal in foreign currency there, which at the time was prohibited at home.

Regulation still matters. In Europe many countries, including Germany, France and Italy, until recently did not allow onshore hedge funds, says Tom Whelan of Greenwich Alternative Investments. That gave offshore hedge funds a chance to establish

themselves. In America three-quarters of onshore hedge funds have offshore clones, mainly because hedge funds with foreign investors, who are not required to pay taxes on their hedge-fund investments in America, would still need to file America's unwieldy tax returns if they invested onshore.

These days the main attraction of OFCs for companies is the prospect of lower tax bills. Because of fierce global competition, being as tax efficient as possible is just as important as keeping down labour costs and overheads, which often entails a different kind of offshoring.

In extreme cases companies have moved their headquarters to a tax haven to slash tax bills. In America new rules were introduced a few years ago to stop such “corporate inversions”, and have recently been tightened further. But a clutch of British insurers, including Hiscox and Omega Underwriting, have recently moved to Bermuda to minimise tax.

Most companies have gone for a half-way house, staying put but using OFCs to cut their tax bills. To understand how this is done, a quick tax tutorial is in order.

Broadly speaking, countries opt for one of two kinds of tax system. The first taxes companies and people on their worldwide income, irrespective of where it was earned. This method is used by America, Britain and Japan, among many others. To avoid double taxation, a company receives a credit for the taxes it pays to foreign governments up to the amount it would have paid had it remained at home.

The second, simpler method, called the “territorial” or “exemption” system, taxes only profits earned in the home country. This system is used by the vast majority of OECD countries, including France, Canada and Switzerland. For example, France would tax Total, the energy company, on the profits it earns in France but not on those it earns in Venezuela or Kazakhstan.

For companies taxed under the worldwide system, the most straightforward way to use OFCs to minimise taxes is to send money offshore and keep it there, as Pfizer did. This is because countries that tax companies on worldwide profits do not present the tax bill for foreign profits until these have been repatriated.

There are four other main ways in which companies can use OFCs to avoid tax, regardless of where they are based and what tax regime they fall under. The first three do not worry the taxman; the fourth gives him sleepless nights.

The first of the less worrying sort involves moving a physical business—such as a manufacturing plant—to a tax haven and then attributing as much profit to it as possible. Ireland is a prime example of this strategy in action. The second is setting up a company in a tax haven to tap its favourable tax-treaty network. Mr Owens of the OECD notes that the vast majority of foreign direct investment in India over the past decade has been

channelled through nearby Mauritius because of its tax treaty with India. Cyprus's tax treaty with Russia makes it a favourite for companies investing in that country.

A third involves companies setting up in OFCs that are “tax neutral”—that is, the main attraction is avoiding extra layers of tax rather than avoiding tax bills. For example, an American mortgage-lender might sell a chunk of its mortgages, and the mortgage payments that go with it, to a Cayman company. This company would not make any profits; it would simply repackage the streams of mortgage payments into bonds and sell these to investors. In Cayman it would not be taxed, but onshore it might have been.

### The taxman's nightmare

The strategy that gives the taxman nightmares involves shifting profits from high-tax to low-tax jurisdictions. This is done either by transferring a company's financial risk (and its potential future profits) to an OFC, or by exploiting the ambiguities of transfer-pricing rules which govern how multinationals divide up their profits among the countries they operate in.

An example of a risk-transfer scheme would be a company set up in Luxembourg to finance the research and development of a drug in high-tax Germany. Such a manoeuvre could cut both ways. If the drug were a success, profits would be booked in Luxembourg and taxed at a low rate. But if the drug bombed, the company would lose out on the higher tax losses it would have been able to book had it kept everything in Germany.

Financing companies of this type can be set up to pay for all sorts of initiatives that can later be credited with boosting profits to be taxed offshore—a big advertising campaign, investment in technology and the like. Companies can also structure loans between subsidiaries in high- and low-tax countries to achieve the same end.

Another way to minimise taxes is to shift the risk of joint ventures or other transactions offshore. Companies based in the BVI, for instance, are now the second-largest investors in mainland China after Hong Kong, says Robert Briant, a partner at Conyers Dill & Pearman, a law firm based in Bermuda. Many of these investments involve joint ventures.

The second big stick in the corporate treasurer's tax-avoidance armoury is transfer pricing. Companies have a lot of latitude in setting the price that subsidiaries charge each other for goods and services. This can shift profits away from high-tax countries by attributing higher expenses and lower profits to them. This is no small matter for tax authorities: an astonishing 60% of international trade takes place within multinational firms.

The question of where a company creates value, and thus where its profits should be taxed, is tricky at the best of times. Companies are increasingly managed on regional or even global lines, not national ones. It makes little sense to have a separate risk or research division each for France, Germany and Italy, for instance. And a large and

growing chunk of the value companies create comes in the form of intangible assets such as patents or brands. These are hard to value as well as exceedingly mobile.

Most countries calculate transfer prices on the basis of what two independent companies would pay on the open market. But many services and intangible assets, say a unique patent or a global brand, do not have a market price, so it is hard to estimate what they are worth. That leaves ample room for quibbling—and, say the tax authorities, manipulation.

These schemes have deprived the taxman of a lot of revenue. A government report published in 2004 found that 61% of American companies paid no federal income tax during the boom years of 1996-2000. Much of this was thanks to moving profits—rather than actual business—to tax havens, reckons Martin Sullivan, editor of *Tax Analysts*. He looked at Internal Revenue Service data from 1998 to 2000 and found that profits before tax of subsidiaries of American companies during this period grew by \$64 billion, or 45%, to \$208 billion, with over half of this increase coming from low-tax countries, particularly Bermuda, the Bahamas, Denmark and Cayman. The average effective tax rate on the foreign profits of American multinationals during this period dropped from 24.2% to 20.8%.

Transfer pricing in particular is coming under increasing scrutiny. Mark Everson, the IRS Commissioner, told a group of senators last August that the challenges posed to the agency by transfer-pricing manipulation “are acute and ever growing. Offshore abuses are a real problem.” A study by Andrew Bernard of the Tuck School of Business at Dartmouth, Bradford Jensen of the Institute for International Economics and **Peter Schott of Yale School of Management** conservatively estimates that the IRS loses at least \$5.5 billion and maybe as much as \$30 billion from the manipulation of transfer pricing each year.

Such numbers have made tax authorities in America, Canada and Britain more belligerent. Late last year Merck, a drugs company, disclosed that it is facing four disputes with American and Canadian tax authorities that could cost it \$5.6 billion in additional taxes and interest. Another drugs-maker, GlaxoSmithKline, last autumn settled a 16-year transfer-pricing dispute with the IRS for over \$3 billion.

Some believe that the best way out for companies is to assign transfer prices according to a formula based on the number of people and amount of property they have in each country. But in practice this does not really make things easier, says Peter Merrill of PricewaterhouseCoopers. For a start, there is no common tax base in a common currency across countries, so there is no coherent pool of taxable profits to allocate by such a formula. Intangible property would still have to be valued. And the formula would probably not work for companies involved in a range of different businesses such as Toyota, which apart from making cars is also involved in businesses such as housing, financial services and biotechnology.

The real problem is that globalisation has rendered the current system of taxing multinationals archaic. Taxation is based on national boundaries, but companies operate across continents and can easily shift money and physical assets around. Until tax systems reflect that reality, the difficulties will persist.