Taxation of Multinational Corporations
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Abstract

Multinational taxation is an area of research that encompasses academics in accounting, finance and economics. In particular, researchers are interested in determining whether taxation alters where multinational corporations (MNCs) operate their businesses. A review of the literature on foreign direct investment provides clear support for taxes influencing MNCs’ location decisions. In addition, MNCs appear to organize themselves in a manner to increase the amount of their profits invested in relatively lightly taxed jurisdictions. By altering the location and the character of income across jurisdictions, MNCs are able to reduce their tax burdens. The natural extension of these lines of research, then, is determining the welfare consequences of MNCs’ sensitivity to taxation.

This review aggregates the large body of international tax literature succinctly in one location. Very little of what is incorporated in this piece is novel. Rather, it borrows heavily from those researchers who have focused their careers on understanding taxation in the multinational context. Unfortunately, because the research in this area is dominated by work involving U.S. data, the review is also quite U.S.-centric. However, many countries’ multinational tax rules are quite similar. This is primarily attributable to the conformity generated in tax
treaties based on the model treaty outlined by the Organization for Economic Cooperation and Development (OECD). So, although there is variation in specific tax rules across jurisdictions, the basic tax rules are very homogeneous.
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Multinational taxation is an area of research that encompasses academics in accounting, finance and economics. Over the years, these researchers have endeavored to understand the role of taxation on multinational corporation (“MNC”) behavior. In particular, researchers are interested in determining whether taxation alters where MNCs’ operate their businesses. A review of the literature on foreign direct investment provides clear support for taxes influencing MNCs’ location decisions. In addition, MNCs appear to organize themselves in a manner to increase the amount of their profits invested in relatively lightly taxed jurisdictions. By altering the location and the character of income across jurisdictions, MNCs are able to reduce their tax burdens. The natural extension of these lines of research, then, is determining the welfare consequences of MNCs’ sensitivity to taxation. Ceteris paribus, investors are better off if an MNC can lower its worldwide tax burden. Yet, the revenue consequences to the jurisdictions involved are far less clear.

The central problem of multinational taxation is that there are at least two jurisdictions that can claim the right to tax the firm’s income. Firms that only operate within the confines of one jurisdiction face one
set of statutory tax rates. Firms that operate in several jurisdictions are not only subject to several sets of tax rates but also several sets of tax regulations. The interplay between rules and rates leads to a multitude of potential tax obligations facing these firms. As the income of multinational corporations faces overlapping tax claims, MNCs have developed various avenues for tax avoidance which complicates tax collection by the tax authorities. Such tax-avoiding behavior may reduce tax revenue and could distort international financial flows and the international allocation of investment by MNCs. An important policy question is to what extent these incentives for tax avoidance actually affect the behavior of MNCs and reduces tax revenue.

Governments also have been known to use the tax system to both attract foreign investment and acquire leverage over MNCs’ that they believe are unfairly escaping taxation in their jurisdiction. Hence, there are often competing incentives that lead to conflicting objectives between an MNC’s home country and the countries where they do business. Further, many countries are broadly defined to be tax havens. A tax haven can be any country that reduces its statutory tax rates to attract foreign investment. Not only does a relatively low tax rate potentially attract investment, it also likely increases the incentives for a firm operating in a nearby high-tax jurisdiction to shift its profits out of the high-tax jurisdiction into its low-tax neighbor. Many legislators argue that havens are bad for the U.S. But if a U.S. MNC reduces its foreign tax burden, then, as described below, it is effectively increasing its domestic tax burden. Furthermore, the U.S. and the U.K. are known to be particularly astute in pursuing taxpayers who appear to be aggressively undertaking income shifting to low-tax jurisdictions.

Eventually, much of the discussion herein will (hopefully) become obsolete as countries continue to conform their tax regimes. As discussed in detail below, there are two basic tax regimes facing multinational firms: a territorial system, and a worldwide system. Under a territorial system, profits are subject to taxation based on where they are earned regardless of where the ultimate owner (or parent) of the firm resides. Worldwide taxation, on the other hand, subjects all profits to taxation in the parent’s home country. At the writing of the review, the U.S. is the sole member of the G7 with a worldwide system of
taxation and corporate tax rate in excess of 30%. Both Japan and the U.K. adopted territorial tax systems in 2009. Now, over three quarters of the member nations of the Organization for Economic Coordination and Development (OECD) have adopted a territorial system of taxation. The fact that U.S. MNCs not only face a worldwide system of taxation but also a very high statutory tax rate leads many to believe that U.S. firms are at a relative disadvantage as compared to their non-U.S.-domiciled competitors.

The role of this review is to aggregate the large body of international tax literature succinctly in one location. Very little of what is incorporated in this piece is novel. Rather, it borrows heavily from those researchers who have focused their careers on understanding taxation in the multinational context. Unfortunately, because the research in this area is dominated by work involving U.S. data, the review is also quite U.S.-centric.

However, many countries’ multinational tax rules are quite similar. This is primarily attributable to the conformity generated in tax treaties based on the model treaty outlined by the Organization for Economic Cooperation and Development (OECD). So, although there is variation in specific tax rules across jurisdictions, the basic tax rules are very homogeneous.

Much of the prior non-U.S. research used the cross-sectional variation in countries’ tax rates to garner variation in other jurisdictions’ dividend taxation systems to study the role of shareholder level taxes on payout policy and share prices (e.g., Lasfer 2008). However, there has been a recent uptick in studies involving non-U.S. corporate data. Because of the availability of Bureau van Dijk’s Orbis, Amadeus and the Bundesbanks’ datasets, researchers have begun to investigate the role of cross-border taxation on merger and acquisition activity (e.g., Huizinga and Vogel 2009) as well as intra-firm capital structure (e.g., Huizinga et al. 2008). I look forward to reading more of this work in the future.

I begin by outlining all of the (relatively) picky details of taxing multinational firms in Section 2. My focus, due to the limits of my knowledge, is on the U.S. tax regime. As the very notion of multinational implies more than one regime, the consequences of other
Introduction

jurisdictions’ tax regimes are also important but, for simplicity, are presumed to merely be different than that of the U.S. In Section 3 of this review, I will discuss the theory and the related research on the role of taxation on foreign direct investment and remittances of profits into the home country. The incentives to undertake income shifting and/or transfer pricing will be described in Section 4. Then, in Section 5, I will address some of the non-tax considerations (including financial accounting) of foreign investment decisions. I discuss some current developments in the multinational tax policy in Section 6. Section 7 concludes.


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