

## **TAX AVOIDANCE METHODS OF MNES AND THEIR CHANGES**

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## **INTRODUCTION**

Multinational corporations play a vital role in the global economy and contribute to growth, innovation and employment in a number of ways. However, their operation often covers countries with different tax systems. This allows them to take advantage of the differences to reduce their overall tax liability. Although many forms of tax avoidance are not illegal, they also raise moral, equity and economic concerns. The simplest example of the latter is the lack of state tax revenues. This study examines the various tax avoidance methods used by multinational companies, the reasons for their use, and the consequences for the economy and societies by analyzing a few selected examples.

## **THEORETICAL BACKGROUND**

Multinational companies have developed several methods in the course of their activities. The common essence of these is the exploitation of legal loopholes so that the reduction of the tax base does not conflict with legislation. The authors summarize the most common and best-known methods below.

Basically, two directions can be distinguished in the tax avoidance strategies of multinational companies. One is the use of tax havens, the other can also be called the creation of tax havens. What is it about? Our world is globalized both economically and in terms of communication (Held et al., 1999). Local, regional events, happenings, and phenomena merge with the global ones (Kőműves et al. 2022), this is the phenomenon of global locality-local globality (Ehrlich, 1989; Teubner, 1997). McLuhan & Powers (1992) use the term global village for this phenomenon. This process, among many other changes, also resulted in easier cross-border capital movements and also advanced global communication revitalized offshore activities (Palan, 2017). Tax havens flourished and a significant proportion of well-capitalized, usually multinational companies registered in them. The other option is to take advantage of the fact that companies can assert their economic power anywhere on earth, often taking advantage of the local nature of states' jurisdiction. One of the consequences of this, which is useful for the companies involved, is that the jurisdiction of a country does not even extend to the company operating in the country if it is not registered there. This process of exploitation of rights is often facilitated by the states themselves through the competition for tax incentives to attract capital, even making exceptions to their own jurisdiction. That is why we can call this direction the creation of tax havens.

However, it is not only the states that can offer discounts and legal reliefs. Large international companies, using their capital power and even abusing it, are able to influence the laws of the target country themselves. The INCOTERMS standards or the Basel-III and Basel-IV criteria were not created by states, but by the economic actors of the market. However, they must also be applied in state law. On the one hand, because in case of non-compliance with such rules, a company practically excludes itself from the market. Therefore, all companies will operate in accordance with these rules, regardless of what the law of that country says. This phenomenon, i.e. customary law independent of the state (law without state), is not new, it is known as law living in legal history (Ehrlich, 1989; Teubner, 1997). On the other hand, it is necessary to integrate established customs into state law, because otherwise,

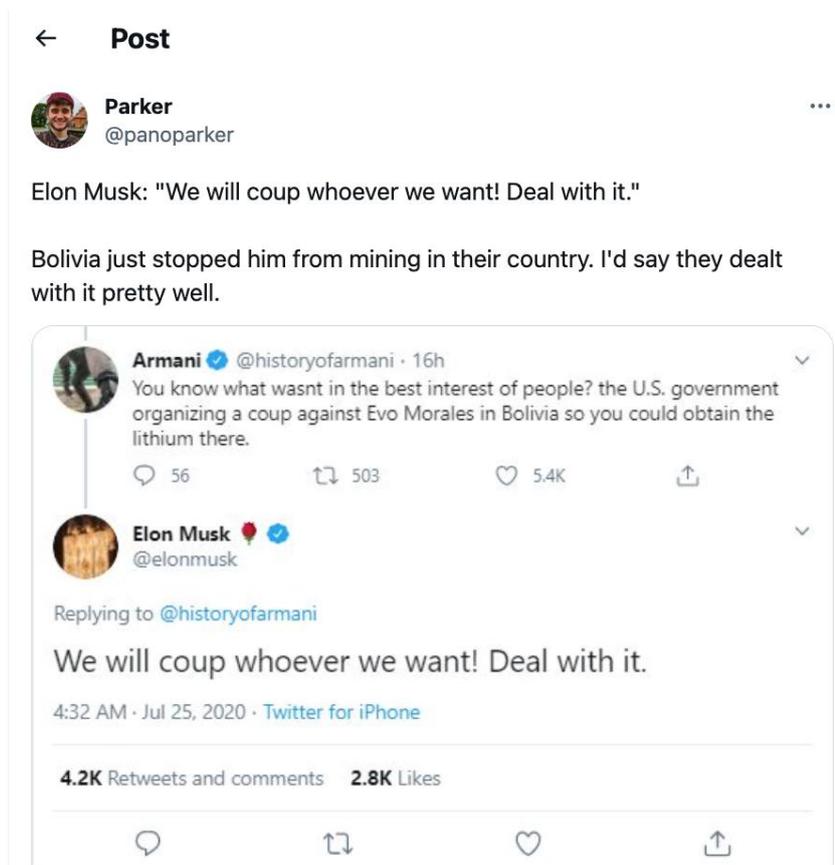
companies operating in state territory can completely remove themselves from state jurisdiction and settle all their disputes before an arbitration court.

What the small and large actors of the economy have in common is that they all strive for a balance between the performance provided and the tax paid. If they remain within the framework provided by law, we are talking about tax optimization. If they cross these limits, they are already committing a violation of the law, tax avoidance (Nótáros, 2014). There is often a very thin line between the two solutions, not always clear even for professionals. Who can say whether a multi-company that bases its tax strategy on local differences in tax legislation and taxation falls into the category of fair play or fraud?

There are also more aggressive methods that can only be used by large companies. They are often capable of covert or open political intervention. A good example of this is the case of the so-called banana republics. The name comes from the beginning of the 20th century. In the 1880s, the Boston Fruit Company, which later became the United Fruit Company and then Chiquita, began importing bananas from Jamaica and launched a successful campaign to promote them in the United States (Stromberg, 2016). To meet the growing demand, the company invested a significant amount in the expansion and modernization of the production areas. It is therefore understandable that they tried to block any process that was contrary to their interests. For example, the Cuyamel Fruit Company supported the coup in Honduras in 1911 (Cohen, 2013), which saw its president replaced by someone more aligned with US interests.

Another well-known example is the 1954 CIA plot on behalf of the United Fruit Company against Guatemalan President Jacobo Árbenz (Jones, 2019). This coup ended the first real period of democracy in Guatemala. The method is still used today. In Bolivia in 2019, a military coup removed the democratically elected president, Evo Morales, from power. According to unofficial news, the campaign was also financed with significant financial support by the company Tesla (Rocha, 2021). The goal was to secure sovereignty over Bolivia's lithium. Musk, the head of Tesla, responded to the accusations with a Twitter message that outraged many, which he later deleted (Figure 1): "We will coup, whoever we want! Deal with it" (Parker, 2020).

Figure 9. Twitter post of Elon Musk



Source: (Parker, 2020)

Smaller economic operators do not have the opportunity to do so. On the other hand, it is because they try to avoid paying taxes by taking advantage of legal loopholes and legal vacuums. The literature describes many factors on tax morale (Torgler, 2007; Mayowan, 2019; OECD, 2019) and the factors influencing it: digitalization and e-taxation (Pulungan and Imani, 2022), the tax control system (Slemrod, 2018), or the so-called institutional trap (Do, 2004). After getting to know the somewhat extreme, but, as you can see, still existing and applied interest enforcement method, we will now review the less aggressive options.

### **Transfer pricing (transfer of profits across borders)**

Transfer pricing is a strategy often used by multinational companies. Its essence is the manipulation of the price of transactions between subsidiaries located in different countries. By setting the price of goods, services or intellectual property, companies can shift their profits from high-tax countries to low-tax countries. The Organization

for Economic Co-operation and Development (OECD) has developed guidelines to ensure that transfer prices reflect market conditions, preventing abusive practices. However, these guidelines are complicated. They are difficult to comply with and open to manipulation (OECD, 2010).

### **Exploiting treaties on the avoidance of double taxation**

Conventions on the avoidance of double taxation are bilateral agreements concluded between countries. Their purpose is to prevent the same income from being taxed twice. The original purpose of these treaties was to encourage cross-border investments, but they also facilitated tax planning strategies that could reduce the tax base payable in a country. Multinational companies often take advantage of these contracts. Transactions are structured to minimize tax liabilities. Cross-border payments are routed through jurisdictions with favorable tax rates or treaty provisions, thereby reducing withholding tax (UN, 2018).

### **Tax havens**

Tax havens are jurisdictions where the tax rate is low or zero, and this is often combined with increased protection of bank secrecy. Multinational corporations set up subsidiaries in these havens, allowing them to channel their profits through entities that pay minimal or no taxes. This strategy can result in significant tax savings, but it has also provoked strong international criticism for facilitating tax evasion and undermining other countries' tax revenues. The lack of transparency in tax havens has prompted global efforts to exchange information and combat illicit financial flows (Zucman, 2016).

### **Tax havens: Creation of subsidiaries for minimum taxation**

Tax havens are jurisdictions with low or zero tax rates, often coupled with financial secrecy. Multinational corporations set up subsidiaries in these havens, allowing them to channel their profits through entities that pay minimal or no taxes. Although this strategy can result in significant tax savings, it has drawn international criticism for facilitating tax evasion and undermining other countries' tax revenues. The lack of transparency of tax haven practices has prompted global efforts to increase information exchange and combat illicit financial flows (Zucman, 2016).

### **Hybrid differences (taking advantage of tax differences)**

Hybrid differences arise from the different tax treatment of entities or financial assets in each jurisdiction. Multinational companies exploit these differences to achieve results such as double non-taxation or deduction without proper income recognition. For example, a payment may be treated as tax deductible in one jurisdiction but not recognized as taxable income in another. While some countries have implemented measures to offset hybrid mismatches, the complexity of international tax systems can make it challenging to manage all possible scenarios (PwC, 2019).

### **Reassignment of debt**

Multinational companies often use intercompany loans to redistribute profits. Inter-subsidary loans are charged at rates that reduce taxable income in high-tax countries and increase deductions in low-tax countries. This practice requires measures to limit excessive interest deductions and ensure that interest payments are reasonable and at arm's length. OECD Base Erosion and Profit Shifting (BEPS) Measure 4 addresses concerns about interest deductions and financial payments (OECD, 2016).

### **AN EXAMPLE OF THE PRACTICAL APPLICATION OF THE METHODS IS THE DOUBLE IRISH WITH A DUTCH SANDWICH**

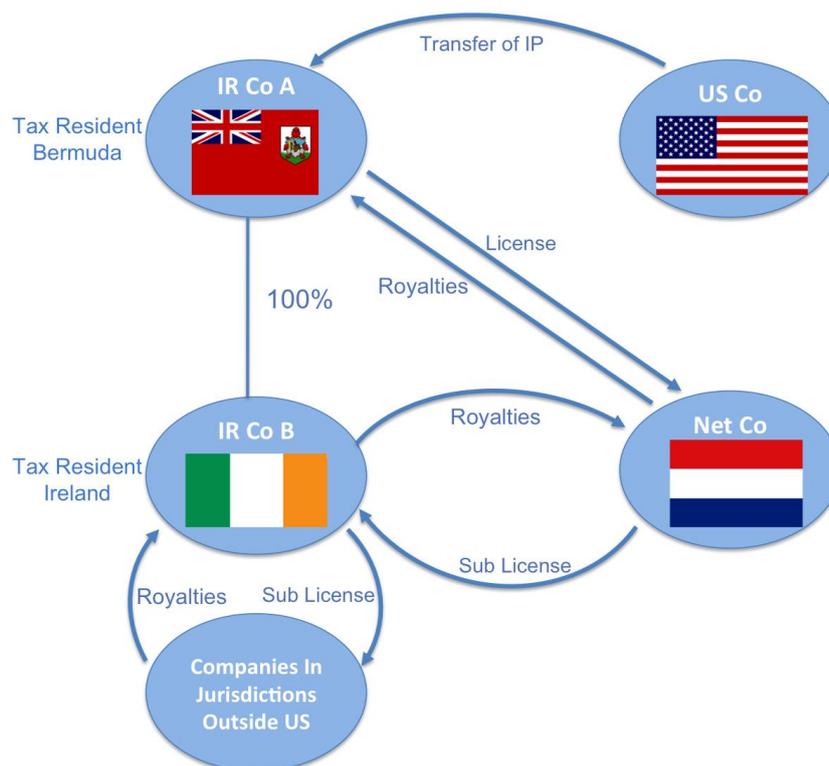
The essence of the methods described in the theoretical overview and similar tax base reduction solutions is to reduce transparency. One way of doing this is that the income is realized through several companies in several countries so that the remaining tax base at the end of the process is as small as possible. One such method became known as the "Double Irish with a Dutch Sandwich". The aim of this method is also to minimize the tax liability of multinational companies. This sophisticated tax avoidance strategy involves taking advantage of differences in tax regulations between jurisdictions, often resulting in significantly lower tax payments. This chapter examines the mechanism, history, consequences, and regulatory responses of the "Double Irish with a Dutch Sandwich".

The International Monetary Fund first drew attention to this corporate tax tool (IMF, 2013). It is based on a loophole created by Joop Wijn (State Secretary of Dutch Economic Affairs). In the EU's tax law system, the Dutch regulations, unlike other member states, allowed the tax-free payment of royalties to many offshore tax

havens outside the EU. It was Joop Wijn who was convinced by American tax advisors to cancel the royalty tax liability (Frederik, 2017). Since the option applies to royalties, it was primarily suitable for eliminating income from intellectual products and patents. Thus, it was used most often by industrial, technological, medical companies, and pharmaceutical factories (Matoso, 2018). This deliberately created Dutch loophole is part of the "Dutch Sandwich" model.

The method is characterized by a multi-stage structure (Cohen, 2014), which includes subsidiaries in Ireland and the Netherlands. The goal is to channel the profit, taking advantage of the favorable tax rules in both countries, and ultimately achieving a low effective tax rate. The process can be summarized as follows (Figure 2):

Figure 10. Double Irish with a Dutch sandwich



Source: (Reynolds, 2019)

The multinational company using the method establishes two Irish subsidiaries. This is considered foreign in US tax law, but since the company is not managed in Ireland, but from, for example, Bermuda, Irish tax law also treats it as a foreign company. This makes it possible to transfer royalty income tax-free to a company within the EU. Irish tax relief is also due to lobbying (Drucker, 2013). The first subsidiary owns the intellectual property rights of the company's products, while the second subsidiary

carries out sales and licensing to other international organizations. The Dutch sandwich element is created with the involvement of a Dutch subsidiary between the Irish companies. This Dutch subsidiary facilitates payments between the first Irish subsidiary that owns the intellectual property and the second Irish subsidiary responsible for sales.

The Irish subsidiary that owns the intellectual property charges significant royalties to the Irish selling subsidiary. These royalty payments are deductible expenses for the Irish sales subsidiary, reducing its taxable income. The Dutch subsidiary acts as an intermediary in the payment of royalties. It may hold the funds for a short period of time and then transfer them to the Irish sales subsidiary (intra-group financing), often taking advantage of favorable tax treaties between the Netherlands and Ireland.

How does the process affect taxation? The Irish sales subsidiary, after paying royalties, records a lower taxable profit. However, the Irish corporate tax rate on royalty income is typically lower than the standard corporate tax rate in other countries.

## **APPLICATION AND CONSEQUENCES OF THE METHOD**

The "Double Irish with a Dutch Sandwich" method has brought tax evasion into the spotlight as it has been used by many large tech companies (such as Apple or Google) to minimize their tax liability. There has been a wide debate about the fairness and legality of such practices, as the consequences of this method of tax avoidance are manifold (Hebous, Ruf and Weichenrieder, 2010). Let's review the most important ones!

A very important consequence is the loss of government revenue. In the countries where these companies operate, government tax revenues are reduced. This is because the company transfers most of its profits to countries with low tax rates. The application of such strategies also increases tax competition between countries (global tax competition), as everyone wants to offer an attractive tax environment to multinational companies, thus motivating them to settle in the country (Palan, Murphy and Chavagneux, 2018). The situation is especially serious in developing countries, for which it is vital to attract foreign capital investors to the country (FDI), because their only competitive factor is cheap labor. Added to this is the fact that corruption is mostly widespread in these countries, so it is not difficult to find legal loopholes, or even intentionally create and exploit them. Ethical and social concerns

also arise: the experience that multinational companies take advantage of tax loopholes can lead to public outrage and damage the company's reputation and public trust. A decrease in trust in the institutional system can have political, economic and tax consequences.

Google reportedly saved itself nearly \$3.3 billion in taxes in 2016 by transferring approximately \$17 billion from Europe through the Netherlands to an Irish-registered shell company in Bermuda (Kahn, 2018). According to Reuters, the company moved \$23 billion to Bermuda using this tax avoidance strategy in 2017 alone (Meijer, 2019). Under pressure from the EU, the Irish government closed the tax loophole of the "Double Irish" tax treaties in 2015 (Reynolds, 2019).

## **COUNTERMEASURES AND RESPONSES**

The importance of the issue is well demonstrated by the fact that the OECD report already estimated the amount of lost tax revenues at USD 240 bn in 2013 (OECD, 2013c). This fact alone justifies the need for countermeasures. On the one hand, these measures can be general anti avoidance rules (GAAR), which generally regulate tax avoidance. Another group of measures (specific anti avoidance rules, SAAR). They are targeted and regulated only in a certain area. Among other instruments, the clauses of double taxation agreements and other bilateral treaties play an important role. The tools described so far are considered legal tools. Another group of tools includes judicial tools (Ostwal and Vijayaraghavan, 2010). These are used by the courts in their jurisprudence. Another tool is the so-called "extended law". One example of this is the FCPA, which extends the jurisdiction of the United States beyond its borders (US Congress, 1977). The FCPA criminalizes any bribery that is subject to US jurisdiction at any point. Proceedings were initiated against Magyar Telekom, for example, citing this law (The US Department of Justice, 2011).

In response to concerns about aggressive tax planning, international organizations, regulatory bodies and governments have therefore taken steps to mitigate the effects of the Double Irish and other similar strategies (Fuest and Riedel, 2009; OECD, 2013b). Among these, the best known and most widely used solution is the OECD's Base Erosion and Profit Shifting (BEPS) initiative. This aims to tackle tax evasion through cooperation and reforms. The main methods include the modernization of international tax rules and the elimination of tax evasion loopholes.

Some countries have introduced specific measures themselves, such as Controlled Foreign Company (CFC) rules, against such practices. The French government has introduced a 3% tax on all digital services sold in the country. This type of tax is unique because it taxes the local revenues of big tech companies, not their profits. According to The New York Times (NYT, 2019), Great Britain, Spain, Austria, Canada, Denmark and Portugal have also announced that they will introduce a similar tax in the coming years.

More than 140 countries have already joined the OECD-led coalition, including Hungary (OECD, 2013a). The main goal of the cooperation is to prevent base erosion and profit shifting (BEPS) (OECD, 2013c). Accordingly, the OECD's program also deals with a wide area, in addition to transfer pricing, which is often a topic these days, or sales taxes, for example, the transparent regulation of the issue of locations also plays a very important role. The EU also launched a program partially similar to this program (Anti-Tax Avoidance Package), its elements are:

- Anti-Tax avoidance directive (PwC, 2019),
- Tax Treaty recommendation,
- revised administrative cooperation directive and
- communication on external strategy.

## **SUMMARY**

According to a study published in 2020 (Tørsløv, Wier and Zucman, 2022), more than a third of the profits of multinational companies go to tax havens. By legally paying the taxes avoided in this way, the tax revenues of the USA would increase by 10% and the tax revenues of the EU by 20%, while the income of the tax havens would be cut in half. The Double Irish with a Dutch Sandwich tax avoidance method is a good example of the complexity of international tax planning for multinational companies. While these strategies may be legally legal, they certainly raise ethical and fairness concerns. International organizations and governments are making ongoing efforts to eliminate such strategies and address them through reforms and increased transparency. These measures reflect the collective aspiration that companies contribute their fair share to the economy of the country in which they operate. In a world of globally connected economies, finding the balance between encouraging cross-border investment and fair distribution of tax burdens remains a difficult and complex task. As governments must constantly modify their tax policies and regulations, continuous cooperation between countries, organizations and

stakeholders is essential. The goal is to create a global tax system that minimizes the possibilities of aggressive tax avoidance by multinational companies.

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