*Projekt finansowany w ramach umowy 857/P–DUN/2016 ze środków Ministra Nauki i Szkolnictwa Wyższego przeznaczonych na działalność upowszechniającą naukę.*

Nazwa zadania:
Stworzenie anglojęzycznej wersji publikacji

Zeszyty Naukowe
Wyższej Szkoły Bankowej w Poznaniu
2017, t. 72, nr 1

**Jan Rymarczyk**

WSB University in Poznań
Faculty of Finance and Banking
e-mail: jan.rymarczyk@ue.wroc.pl
phone: +48 607 911 596

# Income Taxation and Tax Optimization in Transnational Corporations

***Abstract.*** *One of the basic aims of the transnational corporation's (TC) financial activity is maximization of profits after tax, that is minimization of taxes. Because profits after tax in particular countries vary, then tax optimization poses a challenge. If the TC runs its activity in the form of a "permanent establishment" or a subsidiary, they are subject to two different tax systems, i.e. that of the host country and home country. Bilateral agreements on double tax avoidance enable tax payments only in one country. Avoidance of double tax remittances can take place in the form of tax credit, i.e. deduction from home tax, the tax paid abroad or in the form of exclusion, i.e. exemption of foreign income from home-country tax.*

***Keywords:*** *transnational corporation, tax neutrality, corporate income tax, withholding tax, value added tax, double taxation, exclusion method, tax credit method*

## Introduction

From a microeconomic point of view taxes are an instrument of a state's economic, financial and social policy, and a basic source of its income. However, for companies or individuals tax is an expense – tax types and tax levels affect basic economic decisions of transnational corporations. Operating globally they have to take into consideration different tax systems in particular countries including their home country's tax system, which is of essential relevance because, generally, it is the home country where the transnational corporation's tax burden is located. It is common knowledge that low taxes or tax reliefs are not a basic criterion when

it comes to choosing the country by a transnational corporation for its investment operations. The majority of direct foreign investment (DFI) takes place in highly developed countries where, generally speaking, taxes are high. However, with more or less comparable other criteria investors will certainly prefer countries with lower tax burdens. Also when some other factors of investment location e.g. infrastructure, availability of low skilled labor force, social capital and so on, are not fully in line with the transnational corporations' criteria they may take investment decisions if their calculations show that they will receive compensation through tax reliefs. That is why generally developing countries use, as an incentive for foreign investors, convenient tax solutions and compete with one another in this area. From the point of view of the tax criterion the TCs will also prefer those countries whose taxation systems are in compliance with the principles formulated long ago by Adam Smith in his work *The Wealth of Nations* i.e. taxes are equal, transparent, simple, convenient and efficient [RPC 2015].

As practice shows a commonly used method of tax avoidance or its significant reduction is the establishment or subsidiaries in tax havens. The ability to take advantage of tax arbitrage or different forms of "getting away with" taxes, especially when it comes to income transfers from the subsidiary's countries to the home country of the corporation affects significantly their income level, and is decisive in terms of further expansion and competitive advantage. The essential thing here is the application of transfer pricing, selection of appropriate forms of financing subsidiaries, "thin capitalization" i.e. financing subsidiaries through the parent company's credits, creation of reinvoicing centers, central cash deposits and offshore companies in tax havens [Rymarczyk 2013]. The lowering of the TCs' taxes is conducive to their governments' activities by establishing bilateral or unilateral agreements on double taxation avoidance or taking unilateral decisions in this respect.

Tax management or rather tax planning or tax optimization is a question of not only top priority in the TCs' overall international strategy, but also it is a difficult issue that involves highly qualified, and often, international staff. They have to monitor, on an ongoing basis, the existing tax systems in particular countries because they are often subject to change, especially in less economically viable systems. Moreover, different forms of tax avoidance affect the budgets of particular countries, which leads to various restrictive actions taken by their tax offices. Managers responsible for taxes in the TCs have to know very well the tax legislation of the country of their investment, and international tax legislation in order not to come into conflict with them, which may result in not only substantial financial losses, but also corporate image losses. As a result they often make use of tax advisory services of domestic and international tax agencies or the like.

The focus of this paper is on basic and general principles as regards financial systems, not on the analysis of the systems in particular countries. Besides, such

an analysis would be impossible due to its large variations and the scope of this paper, whose aim is to present ways of imposing tax on the TCs and what they do to optimize taxes.

## 1. Tax neutrality as a fundamental principle of the tax system

Tax neutrality is one of the most fundamental principles that should characterize different tax systems according to classic and liberal views on that matter. Neutral tax is such tax that does not cause distortions in natural capital flow to the most effective places and forms of its allocation. It merely depletes cash flow. From the TC's point of view one can distinguish two types of tax neutrality [Butler 2012]:

– domestic tax neutrality, which means that the TC's income from foreign and domestic operations are equally taxed by tax authorities of its home country. It is the so called capital export neutrality.

– foreign tax neutrality, also known as capital import neutrality, where taxes imposed on foreign corporations' activities in a given country are the same as the ones imposed on local companies.

Tax neutrality can only be found in an ideal tax system model. In practice what is possible is only some kind of approximation towards it by tax authorities.

There are substantial differences in tax systems and tax rates among particular countries. In a given country corporate income tax for local and foreign business entities is generally identical. It is, however, different from country to country, e.g. in Germany it is 33%, in Poland 19%, and only 13% in Ireland. Even within the same tax jurisdiction there appear tax differences. They are connected with:

– different types of assets – income from active business operations are taxed according to a different tax rate or at a different time than income from passive investment, and losses from one of these types of activity cannot be offset with the profits from the other one;

– differentiation of financial instruments – there are different tax rates for income from debt securities (e.g. bonds), from equities (e.g. shares) and hybrid securities, e.g. preferred shares, or pre-emptive rights and warrants. Different tax rates refer to payments related to these financial instruments treated as not only income by their owners, but also expenses by their issuers. For example, the issuer of debt securities can deduct interest paid on debt securities from income tax, but paid dividends cannot be deducted;

– different organizational types of business activity abroad. In the first place there are differences in taxes as it comes to the TC's foreign branches and foreign subsidiaries, which will be discussed later in this paper.

Generally speaking, there is a lack of tax neutrality, the consequence of which is the fact that the TC's decision regarding the place, type of investment and its organizational form is affected, to a large extent, by the existing tax differences and not by its possibly highest economic and social efficiency.

## 2. Types of taxes and tax systems

The TC's income comes from two or more than two countries, thus they are subject to, at least, two different tax jurisdictions. There are two basic tax systems. The first one is a worldwide taxation system based on the principle of the taxpayer's residence. The other one is a territorial taxation system based on the principle of the source of income. Particular countries use one of them or both of them. The application of worldwide taxation means that a given country imposes tax on all of the resident's income i.e. the income from domestic and international sources, the so-called residence principle. The income from foreign subsidiaries is taxed according to the tax rates of their home countries only after they are transferred to the parent company. If their income has been taxed earlier in the country of their location then it means that they are double taxed unless there is a mechanism preventing this situation, which practically takes place. This system can be found in eight OECD countries (Chile, Greece, Ireland, Israel, South Korea, Mexico, Poland and USA). It is believed that this kind of system is not favorable for the TCs based in countries with a high income tax rate (see USA), because this tax rate is used for imposing tax not only on domestic income but also on the one transferred from abroad, where it is lower. This state of affairs makes the TCs delay their transfers, i.e. "parking" abroad and investing in specially designed pro-tax-avoidance financial instruments, establishing holding companies in tax havens, and relocating headquarters to countries with a low income tax rate and using territorial taxation.

Territorial taxation is about imposing tax on only the income generated in a given country by both residents and non-residents (the so-called source principle). In other words, it is imposed no matter where the taxpayer is located or no matter what operations the taxpayer has conducted, if the income is made in the country that uses this system. From among the 34 OECD countries 26 use this system (Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Italy, Japan, Luxembourg, Holland, New Zealand, Norway, Portugal, Slovakia, Slovenia, Spain, Switzerland, Turkey, Great Britain). Yet some countries use territorial taxation for residents and worldwide taxation for non-residents.

Among the most burdensome taxes that the TCs pay are: corporate income tax (CIT), withholding tax, and value-added tax (VAT). Apart from them the TCs

may pay a number of other taxes depending on the country of their business activity, including taxes imposed by local authorities. The latter may also be equally important as the above-mentioned ones. For example, in Switzerland each canton imposes their taxes which are much higher than the country's maximum corporate income tax. To that is added a relatively small municipal tax.

Income tax or corporate income tax is a tax directly charging income from active business operations i.e. production or service provision. Rates of income tax vary from country to country being the source of tax arbitrage for the TCs. In tax havens they are at zero percent or several percentage points. The highest rates are found in such countries as the United Arab Emirates – 55%, Japan – 42%, the Democratic Republic of the Congo – 40%, the US – 35%, the Netherlands and France – over 34%, Belgium – a little below 34%, Germany – 33%.

Table 1. Corporate income tax in selected countries

| Country | Tax rate (%) |
|---|---|
| United Arab Emirates | 55.00 |
| Japan | 42.00 |
| Democratic Republic of the Congo | 40.00 |
| USA | 35.00 |
| Holland | 34.50 |
| France | 34.43 |
| Belgium | 33.99 |
| Germany | 33.00 |
| Spain | 30.00 |
| Italy | 27.50 |
| Sweden | 26.30 |
| Denmark | 25.00 |
| Poland | 19.00 |
| Czech Republic | 19.00 |
| Chile | 17.00 |
| Ireland | 12.50 |

Source: Price Waterhouse Coopers 2015.

Yet, one should take into account that the definition of taxable income varies from country to country. Generally everywhere before income tax the following are deducted: wage costs, equipment costs, depreciation costs, advertising and insurance costs.

Tax on passive income is an indirect tax imposed on the taxpayer who does not directly generate this income [Eun, Resnick, Sabherwal 2012]. It is imposed on dividends, income from royalties i.e.. patents, licenses, publication rights, interest (bonds, loans), management fees, and lease fees. It is deducted from the payments transferred by the company to the taxpayer, i.e. corporation or indi-

vidual and handed over to local tax authorities. In this way the tax authorities are sure to receive due tax on passive income within their tax jurisdiction. The rate of this tax is set generally on the basis of bilateral tax agreements between countries and varies depending on the type of passive income. For example, in the USA this tax imposed on income of the taxpayers having headquarters in Western European countries with which the US has signed bilateral agreements on tax avoidance is generally zero. However, it is 30% for countries with which the US hasn't signed such agreements. And income from direct investment is taxed lower than that from an investment portfolio.

Value added tax is an indirect tax imposed in most countries on domestic sales and exports, and imports of commodities and services. Within one country VAT rates may be different depending on the type of activity and volume of turnover. In the European Union, despite the advanced process of the tax harmonization, its rates vary significantly from country to country. The lowest rate can be found in Luxembourg – 15%, the highest in Hungary – 27%, and in Poland – 23% [Wikipedia 2015]. As it comes to exports of goods and intra-Community supply of goods[1] the rate is zero percent. Generally speaking when it comes to exports of goods the countries apply a zero rate of VAT, i.e. the exporter receives the whole VAT refund calculated in the purchasing price of an exported good. One can observe a certain tendency, namely, wherever income tax rates are relatively low, rates of VAT are relatively high, which is aimed to offset tax revenue in the budget. It is commonly used in EU member states and Latin America. But e.g. the US uses sales tax charged on the consumer's end purchase.

## 3. Taxation and organizational form of TC's foreign activity

The basic forms of international business activity, i.e. internationalization of business, are direct exports, direct imports, branches, subsidiaries and joint ventures. In the case of direct exports practically all business activity is conducted in the country of the company's headquarters. Income generated as a result of this type of activity is taxed on the spot, and losses deducted from income. In this case there is no double taxation. Duties and other non-tariff payments, which can be treated as taxes, are basically incurred by the importer. Theoretically there may occur export customs duty, i.e. tax paid by the exporter, but imposed by the customs administration of their country, which in practice rarely takes place. Transit duties also relatively seldom occur and are typical of the transit of oil and gas

[1] Intra-Community supply of goods is movement of goods from one country to another.

through pipelines across the territories of several countries, and also are imposed on the exporter.

Direct imports mean looking at a foreign business transaction from the buyer's perspective. As in the case of direct exports similarly the importer's income is subject to taxation in their country, and losses are treated as the costs of business activity. Moreover, the importer pays duties and incurs non-tariff burdens (import taxes, variable levies, consular fees, handling charges, stamp duties) in favor of the budget of their country. Tariff and non-tariff fees can be included by the exporter and importer as tax deductible expenses.

The TC can run foreign activity in the form of a branch, i.e. a unit being its integral part (direct branch operations). The branch is not a legal entity and the TC's headquarters is fully accountable for its liabilities. The branch is subject to the jurisdiction of the country of origin. That is why the possibility of interfering by local authorities in its functioning is definitely lower than in the case of a subsidiary. Since its capabilities to run operations are by definition lower than that of the subsidiary, the TC rather seldom uses this form, if so then at an initial stage of its business operations abroad. The branch is often used as a center for international advertising, warehousing goods, collecting orders, repairs, after-sales service and the like.

Under certain circumstances its profits may be double taxed, i.e. in the host country, and in the home country. It is so if the branch meets the requirements of the permanent establishment, i.e. if we deal with its permanent and physical presence in the host country (e.g. in the form of office or department store), and if it runs basic business operations (e.g. it manufactures goods or takes decisions about accepting or declining orders). In this case its income is taxed in the host country according to the territorial taxation principle, and in the home country according to the residence principle (worldwide taxation) [Sercu 2009: 708-709]. Since there is no transfer of dividends, interest, and royalties, there is no withholding tax. Thus the income of the branch is double taxed (unless there is an agreement or decision on double taxation avoidance).

The most common organizational form of the TC's foreign activity is a wholly-owned subsidiary. It is a legal entity and, as a separate entity, is subject to the host country's jurisdiction. As a result it is taxed with corporate income tax according to this country's existing tax rate which is in line with the source principal of taxation. Moreover, what is taxed is profits transferred in the form of dividends and royalties to the TC's headquarters, who owns the subsidiary. The headquarters adds the transferred profits to the domestic ones and according to the residence principal pays corporate income tax on them unless there is an agreement on double taxation avoidance with the country hosting the subsidiary. It means that the subsidiary's income is triple taxed.

Joint ventures are taxed, as is the subsidiary, i.e. income from business operations conducted by partners from different countries (usually from two) within the same enterprise based on the signed agreement. Of course this involves the joint venture's foreign partner's income.

## 4. Ways of double taxation avoidance

There is no doubt that double or triple taxation would affect negatively the tendency to undertake direct foreign investment. That is why countries use different forms of exemption from multiple taxation. They may be of unilateral character, i.e. result from the principles of a given country's jurisdiction, or they may result from bilateral or multilateral agreements between countries. The most common type of agreements are bilateral agreements based on the OECD Convention. It specifies two methods of double taxation avoidance, namely exclusion method and tax credit method.

The former one, also known as capital import neutrality, is based on the assumption that one should neither penalize nor award, in terms of taxation, a business entity only because it is owned by a foreign corporation. The assumption is that income or assets taxed in the country of the source of income or location are exempt from taxation in the country of the taxpayer's residence. It may, however, be included while calculating tax on the remaining income or assets.

On the other hand, the capital export neutrality method is based on the assumption that the tax authorities of the country of investment origin should not create tax incentives for investment in the country with relatively low tax. In other words, corporate income tax imposed on the business entity located abroad should be the same as if it was located in its owner's country. As a result, tax paid in the country of income origin or location of assets is deducted from the tax collected by the tax authorities of the taxpayer's country.

Unused tax credit may be used, however, in two cases. The first case is when the TC paid, in the past, domestic tax on foreign income exceeding tax credit. It is the so-called carry back principle.

The other case is when in the near future the TC has to pay domestic tax on foreign income higher than tax credit, it may eliminate the differences by taking advantage of excess tax credit from the past, i.e. making use of the carry forward principle. The application of either principle is limited in time by appropriate tax laws.

The occurrence of excess tax credit results in an effective tax rate being higher than a standard domestic tax rate. In order to eliminate this phenomenon, i.e. liquidate unused tax credit, one can apply two methods. The first one is about relocation of indirect costs. Increasing by the headquarters the burden of these costs for

a foreign branch located in the country with high taxes will result in lowering the taxes paid abroad, and eliminating their surplus over taxes due to be paid in the country. However, for a number of reasons the headquarters has limited possibilities to maneuver these costs. The other method is about applying transfer pricing; this, however, may end up in restrictions by the tax authorities, who may conclude that the prices of their services exceed market prices (arms-length principle). In this situation all of these costs or part of them will not be deducted from sales in either country. This will lead to taxes being higher than before the relocation of costs. One should also take into account the fact that the relocation of costs through transfer pricing may bring about a rise in import customs duty that the branch will have to pay.

### 4.1. Problems connected with the application of exclusion method in the case of the permanent establishment

The exclusion method is applied in both unilateral tax jurisdiction and international agreements on double taxation avoidance. The exclusion in unilateral agreements is not often full (it comprises e.g. 50%, 75% or 90% of a foreign branch's income [Sercu 2009: 718]. It is justified by the fact that certain expenses related to management of a foreign branch incurred by the headquarters are deducted from its domestic income. If they are estimated at 25%, the privilege of the exclusion will refer only to 75% of the foreign branch's income. In bilateral agreements the full exclusion most frequently occurs only if a foreign rate of taxation is similar to the domestic one. In other cases partial exclusion is justified by the pursuit of not creating large incentives to transfer income to countries with low taxes.

### 4.2. Double taxation avoidance in the case of a subsidiary

A subsidiary constitutes, in an economic sense, unity with the whole corporation. In the financial sphere it results in transferring to the mother company income generated by its subsidiary. However, the losses generated by the subsidiary fall fully on the very subsidiary – the parent company does not take any responsibility for it. Apart from that between the subsidiary and the parent company and the subsidiaries themselves there are different financial transfers going on. They are the result of transactions which sometimes are a hidden form of income transfer. The basic methods of income transfers are as follows:

– concluding sales transactions based on transfer pricing; it is one of the most common forms of income transfer between the TC's particular units,

– intra-corporate capital transactions, i.e. trading in shares, bonds and other securities, and granting loans,

– license fees, consulting fees, remuneration and the like (the so-called royalties and management fees), and lease fees.

The most common and the simplest form of income transfer from the subsidiary to the headquarters are dividends, i.e. part of its profit that is not reinvested. The dividends in the subsidiary's country are double taxed, first with income tax, and next with withholding tax the moment they are transferred to the headquarters. In the headquarters' country, however, they may be excluded from taxation by means of tax credit or exclusion methods, as is the income transferred from the "permanent establishment". It is worth noting that in many countries the application of indirect tax credit is permissible only if the headquarters has controlling interest on the subsidiary transferring dividends. In the US, for example, it is 25%. If the share is lower, the investment is treated as portfolio and it is not possible to deduct tax credit from the transferred dividends. If excess tax credit cannot be used by means of the already mentioned methods of "carry back" or "carry forward", or by combining the income of the low tax country based subsidiary with the income of the high tax country based company, the TC should consider the possibility of transfers being delayed until it becomes possible or separate payments according to their type. This method lies in dividing the subsidiary's income into the part transferred to the headquarters as royalties, interest or management fee, which are not taxed with income tax, but only with withholding tax, and the residual part as dividend, which is taxed higher i.e. with income tax and withholding tax.

### 4.3. Application of exclusion method

The exclusion of the subsidiary's foreign income from domestic taxation is applied basically to only dividends [Sercu 2009: 730]. Remittances in some other form such as royalties, management fees and lease payments are taxed much lower than the dividends because the only tax paid on them is the income tax paid abroad. That is why in the case of these forms of transfers what is rather applied is the tax credit system. If the exclusions occur, then they are much lower than in the case of dividends.

Tax planning by the TC consists in computing overall taxation of every form of remittances and selecting such a form which will guarantee the lowest taxation. As it comes to dividends the overall tax will be a sum of income tax and tax on dividends abroad possibly increased by the taxation of part of the income that was not excluded from taxation in the home country. However the other forms of remittances will be taxed with a withholding tax plus the home-country headquarters' tax less tax credit.

It can be concluded from the above that the TC's headquarters receiving foreign profits in some other form rather than dividends can partially or completely avoid paying corporate income tax in the home country. This can be achieved also

if the remittances were transferred to the headquarters in the form of tax-deductible dividends to an offshore holding company located in a tax haven. After paying (or not paying at all) a very low tax this company transfers them as dividends to the parent company. Under an exclusion system the parent company will pay no tax. Of course, the tax authorities of different countries take various measures against methods of double taxation avoidance that are against the tax law or principles, and diminish their income. However, its efficiency is limited and, to a large extent, is dependent on the quality of tax law and qualifications, experience, efficiency and honesty of tax officers.

## Conclusions

One of the main aims of the TC's financial activity is maximization of after-tax profits, i.e. minimization of paid taxes. Because tax systems in particular countries differ, tax planning is challenging for managers and requires knowledge and experience. In particular they have to make decisions as to what type of foreign business activity to choose, where to locate costs and income, in what form and how to transfer it to the headquarters or between the TC's subsidiaries.

If exports or imports are the form of foreign activity, the tax issues are quite simple – all of the income is taxed in the exporter's or importer's country and there is no multiple taxation of income. However, the issue gets complicated in the case of FDI. In theory a permanent establishment may be double taxed, i.e. with host-country income tax and according to the principle of residence. In practice it is generally taxed in only one country on the basis of an unilateral agreement on double taxation avoidance or unilateral decision.

However theoretically, the subsidiary may be taxed with income tax in the host country, with withholding tax on dividends and with income tax in the home country of the TC. As in the case of a permanent establishment, it pays tax only in one country, based on bilateral agreements on double tax avoidance.

Double tax avoidance may take place in the form of tax credit or exclusion.

The TC tries to manage remittances in such a way as to reduce tax burdens. The common method used by the TC to reduce taxation is transfer pricing and creating offshore holding companies in tax havens. It is not always effective due to the restrictions of particular countries and the activity of international organizations "civilizing" the functioning of tax havens.

## References

Butler K.Ch., 2012, *Multinational Finance*, Chichester: John Willey.

Eun Ch.S., Resnick B.G., Sabherwal S., 2012, *International Finance*, New York: MacGraw-Hill Education.

Price Waterhouse Coopers Corporate Taxes, *Worldwide Summaries*, www.pwc.com, 2010 [access: 10.11.2015].
RPC, www.rpc.senate.gov/policy-papiers /territorial-vs.worwilde taxation [access: 8.11.2015].
Wikipedia, http://wikipedia.org/wiki.Podatek-od-tow. [access: 15.11.2015].
Rymarczyk J., 2012, *Biznes międzynarodowy*, Warszawa: PWE.
Sercu P., 2009, *International Finance. Theory into Practice*, Princeton – Oxford: Princeton University Press.

## Opodatkowanie dochodów i optymalizacja podatkowa w korporacjach transnarodowych

***Streszczenie.*** *Jednym z podstawowych celów działalności finansowej korporacji transnarodowej (KTN) jest maksymalizacja zysków po opodatkowaniu, czyli minimalizacja podatków. Ponieważ zyski po opodatkowaniu w poszczególnych krajach różnią się miedzy sobą, optymalizacja podatkowa stanowi dla nich duże wyzwanie. Jeśli KTN prowadzi działalność w formie „stałego oddziału" lub spółki córki, to podlegają one dwóm różnym systemom podatkowym, tj. kraju goszczącego i kraju pochodzenia. Bilateralne porozumienia o unikaniu podwójnego opodatkowania umożliwiają płacenie podatku tylko w jednym kraju. Uniknięcie podwójnego opodatkowania może nastąpić w formie kredytu podatkowego, tj. odliczenia od podatku krajowego podatków zapłaconych za granicą lub w formie wyłączenia, czyli zwolnienia dochodu zagranicznego od podatku krajowego.*

***Słowa kluczowe:*** *korporacja transnarodowa, neutralność podatkowa, podatek dochodowy, podatek potrącany, podatek od wartości dodanej, metoda wyłączenia, metoda kredytu podatkowego*