How multinationals circumvent anti tax-avoidance regulations

blogs.lse.ac.uk/businessreview/2020/09/29/how-multinationals-circumvent-anti-tax-avoidance-regulations/

September 29, 2020

Multinational tax avoidance has been a subject of political discussion in recent years, as there is growing evidence that multinational corporations (MNCs) pay little tax. The political pressure has been exacerbated by the revelations from Panama and Paradise papers in 2016 and 2017 that exposed details of some of the tax avoidance schemes to the public. Despite efforts to curb such practices, with countries around the world adopting various anti-tax avoidance measures and the Organisation for Economic Cooperation and Development (OECD) championing the Base Erosion and Profit Shifting (BEPS) initiative, the extent of profit shifting has been increasing over time. Hence, it is unclear how effective these measures are. Even less is known about how anti-tax avoidance measures affect business activities of multinational firms besides profit shifting activities.

Profit shifting generally takes three major forms: debt shifting, transfer pricing and patent reallocation. Allocating debt across different tax jurisdictions is one of the most popular methods that MNCs use to lower their overall tax burden. A subsidiary of an MNC can internally borrow money from its low-tax subsidiaries and reduce tax payments by paying interest on that debt. Interest is tax deductible; hence, it reduces firms' taxable income. When these payments flow from high-tax countries to low tax countries, this reduces firms' overall tax bill.

In this paper, we answer the question of how anti tax-avoidance regulations are affecting profit shifting of multinational firms. We consider the effects of a 2010 UK reform that targeted debt-shifting. We find that following the reform, multinationals reduce the amount of debt they hold *in the UK*. However, we also show that these firms

move the debt that they held in the UK to other high-tax countries. This debt reallocation is accompanied by real operations reallocations. Corporations affected by the reform moved a share of their total assets and employment away from the UK to where they locate their debt. Thus, this reform did not change their overall tax payment and did not limit profit shifting, as intended. Instead, our paper provides novel evidence on the ineffectiveness of such anti tax-avoidance regulations and on how multinationals circumvent them.

Before the recent corporate tax rate cuts, the UK, with its 30% corporate tax rate in 2008, was considered a high tax country, thus a preferred location for debt holdings for multinational corporations. In 2010, the UK introduced a "worldwide debt cap", an anti tax-avoidance reform that targeted firms with large debt holdings in the UK. The reform disallowed interest deductions on excess debt for companies that had over 75% of their total debt held in the UK. In this paper, we use the introduction of this reform to consider how MNCs respond to anti tax-avoidance regulations. We compare debt and real business operations of firms that crossed this 75% threshold to those with smaller debt holdings before and after the reform.

We show that corporations affected by the reform reduced their debt in the UK by 74% after the reform. We also show that at the same time, their debt holdings increased abroad, especially in countries with high corporate tax rates. This is consistent with shifting debt for tax-minimisation purposes. We show that this also led to the reallocation of real operations. Multinationals affected by the reform reduced total assets, fixed assets and employment in their UK subsidiaries by 7.5%, 11.4% and 3.9% respectively. At the same time, they substantially increased their real operations in their non-UK subsidiaries, especially in those to which they moved debt.

More extremely, we also find that MNCs adjusted their organisational structures to offset the impact of the UK anti-tax avoidance measure. In particular, affected corporations reduced the percentage of UK subsidiaries that were included in the calculation of the UK debt. They also increased the percentage of subsidiaries in countries with a higher tax rate than that in the UK, while reducing that in countries with a lower tax rate. Taken together, these results show that the worldwide debt cap affected corporations beyond their financing patterns, yielding real reallocation of subsidiaries, assets and employment across borders. This suggests that the unilateral introduction of tax avoidance regulations may hurt the size of operations and employment in a country that introduces them.

We also find that multinationals with headquarters outside of the UK have more flexibility than their UK counterparts in circumventing the UK anti tax-avoidance policy. We find larger effects for foreign MNCs, both in terms of debt reallocation and real operations reallocation. We find that because the UK headquartered multinationals did not react as strongly to the reform, the worldwide debt cap actually raised the UK tax payment from domestic multinational corporations, but not from foreign ones. One implication of these findings is that the worldwide debt cap may have created a

competitive disadvantage for domestic multinationals. Our analysis suggests that international cooperation in matters of anti tax-avoidance policies is crucial to avoid such unintended consequences.

This paper is the very first examination of the effectiveness of the "worldwide approach" as a new anti tax-avoidance measure. Many countries have standalone rules that limit multinationals' borrowing, but the evidence on their effectiveness is mixed. The worldwide approach is considered more difficult to circumvent, thus has been recommended by policymakers and academics to complement existing rules. In December 2017 the US passed the Tax Cuts and Jobs Act in which similar limits on net interest expense deductions of MNCs were put into effect. It is likely that more countries will adopt the worldwide approach to tackle corporations' tax avoidance in the near future. Therefore, our findings have important implications for the current policy debate.

Notes:

- *This blog post is based on the author's 2020 working paper "Real Responses to Anti-tax Avoidance: Evidence from the UK Worldwide Debt Cap", with Yaxuan Qi and Jing Xing, presented at the European Economic Association's annual congress, August 2020.*
- *The post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
- *Featured image by Liv Hema on Unsplash*
- *When you leave a comment, you're agreeing to our Comment Policy*

Katarzyna A Bilicka is an assistant professor of economics at Utah State University's Jon M. Huntsman School of Business and an international research fellow at the Oxford University Centre for Business Taxation (CBT). Twitter: @KatarzynaBilic1