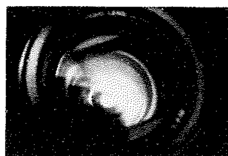

IN FOCUS 6.4

Corporate taxation drives US FDI in Europe

What are the preferred foreign locations for US MNEs to invest abroad? Countries with cultural ties rank highly as hosts for US inward FDI stock, including the UK (second) and Canada (fourth). However, some other top destinations may be more surprising. The largest share of outward FDI stock from the USA goes to the Netherlands (14.5%), with Luxembourg in third place (8.6%) and Ireland fifth (4.6%). These countries are also important sources for FDI stock in the USA, the Netherlands is third and Luxembourg seventh. While the Netherlands is an important trading nation and home to some large MNEs (such as *Unilever*, *Shell* and *Philips*), there must be something else going on here.

An important motivation for these investments is corporate taxation. For example, the corporate tax rate in Ireland is 12.5%, much lower than in Germany (30.0%) and France (33.0%). The UK lowered its corporate tax rate continuously from 30.0% in 2008 to 19.0%, while Italy sharply reduced its tax rate from 31.4% to 14.0% in 2017. Other countries, such as Luxembourg and the Netherlands, grant generous exemptions for some types of operations, notably corporate headquarters. Ireland even allows legal constructions, known as 'double Irish', which enable firms to collect profits in their Irish subsidiary and then route those profits out of Ireland through a second Irish subsidiary with tax residency in a tax haven such as Bermuda or the Isle of Man. In consequence, Ireland, the Netherlands and Luxembourg have become preferred locations for incorporating global companies and for European headquarters.

A business strategy that has become very controversial in the USA is 'tax inversion' acquisitions. US companies merging with a foreign company can move their place of registration (and hence where they have to pay corporate tax) out of the USA. For example, when two of the largest suppliers of chip-making equipment, *Applied Materials* (USA) and *Tokyo Electron* (Japan) merged in 2013, they set up a holding company in the Netherlands. The existing companies became US and Japanese affiliates of the Dutch holding company through share swaps.

Tax avoidance strategies also became very controversial in Europe. Some companies channel their profits from countries of their operation to their European headquarters, thereby avoiding taxes in those countries. For example, affiliates in the UK may pay a licence fee to the European headquarters in Ireland and thereby minimize their tax payments in the UK. According to one study, *McDonald's* channelled its Europe-wide profits to *McD Europe Franchising Sàrl* in Luxembourg, a company with 13 employees that in 2009 to 2013 reported a turnover of €3.7 billion and paid just €16 million in tax. Totally legally! Another loophole in international tax treaties is that warehouses often do not trigger a tax residency, which has been used by online retailer *Amazon* to channel €15 billion of sales through Luxembourg, where it pays no tax. An investigation by news agency *Reuters* found that three-quarters of the 50 largest US technology companies used tax avoidance strategies to channel their profits into locations with lower corporate tax, including *Google*, *Apple*, *Adobe* and *eBay*, with the 'double Irish' subsidiary structure particularly popular among firms delivering services through the internet. Since the EU does not harmonize corporate tax rules to allow for tax competition, and lacks rules preventing the transfer of profits through transfer pricing or excessive license fees, this creates quite substantive distortions. However, the EU has strict rules on state aid, which explicitly forbid member countries from giving selective tax benefits to some countries, and the EU Competition Commissioner in several cases has intervened and requested that companies pay back tax concessions they negotiated.

Why have US companies in particular been in the firing line of the critics? In the USA, companies only have to pay tax on their profits when the profits are repatriated to the USA. Hence they can lower their tax burden by exploiting international differences. In contrast, many European countries tax global profits (while allowing for double taxation), which means that European MNEs have fewer incentives to channel profits between subsidiaries, but they may still choose to register their corporate headquarters in a low-tax country.

Governments promise to tighten regulation, but that turns out to be difficult in practice. The OECD issued new guidelines, while the Obama government in the USA initiated new laws to tax non-repatriated profits and to prevent 'tax inversion'. UK politicians have also been vocal in the debate, yet they are reluctant to take firm action. On the one hand, action would

require coordination on taxation in the EU, which the UK government dislikes. On the other hand, rich individuals find UK taxation regimes very favourable; action against companies evading taxes in the UK by locating outside would certainly trigger others to respond in kind and demand the UK to be less welcoming to tycoons around the world moving their money into London. The bottom line is that many of the tax loopholes that politicians complain about in fact have been deliberately created by politicians trying to attract foreign investors!

Corporate tax avoidance strategies also have implications for the interpretation of FDI data: a large volume of investment does not necessary imply a large operation in the country. Keep this in mind when you review Figures 6.4 and 6.5 or other FDI data provided by UNCTAD.

Sources: (1) J. Smith, 2013, Adobe gets creative with Ireland's tax rules, *Financial Times*, September 13; (2) UNCTAD, 2014, *World Investment Report 2014*, Geneva: UNCTAD (pp. 79–80); (3) *Reuters*, 2014, OECD unveils proposals to curb corporate tax avoidance, September 16; (4) J. Drucker, 2014, Double Irish's slow death leaves Google executives calm, *Bloomberg*, October 15; (5) P. Lewis, 2015, Obama will propose mandatory tax on US companies' earning held overseas, *The Guardian*, February 1; (6) D. Robinson, 2015, McDonald's avoided €1 billion in taxes, says report, *Financial Times*, February 26; (7) KPMG, no date, Corporate tax rates table, www.kpmg.com (accessed July 2018); (8) J. Nebus, Irish-Dutch sandwiches, corporate inversions and arm's length transactions, *AIB Insights*, 16(2): 14–18; (9) *The Economist*, 2017, Raining on Amazon, October 7; (10) A. Slangen, M. Babij & R. Valboni, Disaggregating the corporate headquarters, *JMS*, in press.

Others are concerned that the transfer of capital or jobs may be detrimental to the home economy and thus oppose some forms of FDI. On the one hand, efficiency considerations suggest that in many cases relocation of labour-intensive parts of the value chain may actually enhance competitiveness and thus benefit the company and the home country in the long run. On the other hand, a relocation of production may often be opposed by trade unions fearing that people may lose their jobs and will not be able to find equivalent job opportunities locally. Yet, it is rare for governments to publicly intervene to dissuade MNEs not to establish production overseas. A rare exception happened in 2010 when *Renault* announced its intention to relocate production of the Clio to Turkey. French government ministers issued strong statements condemning the action, and – with reference to the state's 15% equity stake in *Renault* – put pressure on *Renault* to cancel its plans.[37] Yet later *Renault* invested in a new engine and engine part facility with its Turkey JV partner.

Paradoxically, the main argument for restricting FDI to a particular destination country is that it might help the economy of the other country. For example, the USA has tight bans on FDI and many other forms of business with several countries considered hostile, such as Iran, Sudan and Cuba. From the late 1990s until 2012, many countries banned investment in Myanmar, which induced firms to pursue low-profile, non-equity strategies of engagement in the country.[38] The merits of such boycotts are controversial. With one exception, there is little evidence that an investment ban actually induces political change in another country. That exception is the apartheid regime in South Africa, whose downfall was widely attributed to persistent pressure and boycotts from most of its potential trading partners.

LEARNING OBJECTIVE

8 Participate in three leading debates on FDI

DEBATES AND EXTENSIONS

MNEs are widely regarded as the embodiment of globalization. Not surprisingly, they have stimulated a lot of debates. At the heart of these debates is the trust that people have in foreigners and foreign firms making decisions that are important to