The Blame Game: Multinational Taxation in an Era of Knowledge

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Introduction

U.S.-based companies such as Google, McDonalds, Starbucks, Apple, and Microsoft are being attacked by European politicians for not paying their fair share of taxes.[1] For example, in March 2014 Google was hit by a French tax assessment of perhaps as much as a billion euros according to press reports at the time. In November 2014, U.K. lawmakers accused Google, Amazon, and Starbucks of using convoluted accounting methods to reduce their tax liabilities.

Indeed, the feeling that U.S. multinationals—especially digital giants—are 'getting away with something' has fueled a concerted effort by developed countries to rewrite the global tax system. This so-called BEPS project (for Base Erosion and Profit Shifting), organized by the OECD, is in the process of issuing a series of guidelines for how countries can revamp their tax codes to best capture "stateless income."

Foreign-controlled companies in many knowledge industries pay lower U.S. taxes, measured as a share of receipts, than their domestic rivals.

However, these accusations of tax avoidance are, in reality, not as clear-cut as they seem. Certainly some companies are taking advantage of legal but blatant loopholes that make no economic sense. Eliminating such loopholes is an important part of the BEPS project that we support.

But while European politicians who complain about knowledge-based American companies not paying enough taxes in Europe have a point, they are also being hypocritical. Our analysis shows that the low taxes paid by some American companies in Europe—especially in industries that depend heavily on intellectual capital—may not be out of line with international norms. Indeed, some foreign companies operating in the United States—once again, in industries that depend heavily on intellectual capital—pay low U.S. taxes compared to their American counterparts.

To show this, PPI used Internal Revenue Statistics from 2011—the last year available—to compare taxes paid by foreign-controlled companies in the United States with active companies in the same industry. We found that for the entire infor-

mation sector, active companies paid 1.5% of revenue in federal income taxes, while foreign-controlled companies paid 0.9%, roughly 40% less. More specifically, we found that domestic companies paid significantly higher federal income taxes than foreign-controlled companies in industries such as information services (including web search), telecom, motion pictures, securities trading, electronic markets, publishing, electronic markets, computer and electronics manufacturing—all industries where intellectual capital is important.

The IRS data does not allow us to pinpoint the reasons why foreign companies in knowledge industries pay lower taxes in the United States than their domestic rivals. However, we can infer that foreign companies are able to arrange the location of their intangible capital in a way that reduces their taxes.

These comparisons are just at the federal level. In addition, many state and local governments offer incentives or "preferential regimes" to in order to attract foreign investment. These help foreign companies across a wide range of industries, including manufacturing. These strategies adopted at the state and local level are directly comparable to the way that some of the most economically successful European countries, such as Ireland, have been able to build major tech employment bases with low tax rates.

Looking out to the future, the principles of the BEPS project, if adopted, would force companies that depend on intellectual capital to book a great deal of their income in the countries where they perform their R&D and product development. For Google and Apple, that would mean paying their taxes to the United States rather than Europe. Indeed, it's possible that the taxes of American companies operating in Europe might not go up that much unless they moved more of their R&D to that continent.

Federal Taxes and Foreign Firms

The principal accusation against certain high-profile U.S. multinationals operating in Europe is that they pay too little corporate income tax there. So it's worth taking a look at the amount of corporate tax paid by foreign companies operating in the United States.

Each year, the Internal Revenue Service publishes income, balance sheet, and tax statistics on foreign-controlled domestic corporations—that is, domestic companies or subsidiaries where a single foreign entity owns more than half. PPI analyzed the data for 2011, the latest year for which figures are available. We found that across all industries, federal corporate income taxes, after credits, claimed 0.8% of domestic revenues for both U.S. corporations and for foreign-controlled domestic corporations. Thus, overall, there is no difference in federal taxes.

However, when we broke down our analysis by industry, an intriguing pattern emerged. Figure 1 shows sectors where U.S. companies paid significantly higher federal income taxes than foreign-controlled domestic corporations, and where

In the information sector, foreign-controlled companies paid only 0.9% of receipts in federal income taxes in 2011, 40% below the average.

the reverse was true. In addition, Figure 2 shows selected industries where U.S-based corporations paid much higher taxes, on average, than their foreign-controlled counterparts.

Figure 1: US Federal Corporate Income Taxes: Foreign-Controlled Corporations vs. All Active Corporations

	Federal corporate income taxes as percent of receipts, 2011	
Major industries	All active corporations	Foreign-controlled corporations
Information*	1.5%	0.9%
Educational services	1.8%	1.4%
Finance and insurance	1.1%	0.9%
Manufacturing	0.8%	0.7%
Transportation and warehousing	0.5%	0.4%
Administrative support and waste management	0.5%	0.4%
All industries	**0.8%**	**0.8%**
Wholesale and retail trade	0.6%	0.6%
Utilities	0.2%	0.2%
Agriculture	0.4%	0.5%
Accommodation and food services	0.5%	0.6%
Construction	0.2%	0.4%
Arts, entertainment, and recreation	0.4%	0.7%
Mining	1.2%	1.7%
Professional, scientific, and technical services	0.6%	1.1%
Real estate	0.7%	1.7%
Health care and social assistance	0.4%	1.7%
Management of companies	2.3%	4.6%
Other services	0.3%	2.6%

Note: Industries ordered by difference between second and third columns. Thus, the information industry has the biggest gap between all active corporations and foreign-controlled corporations, measured by federal corporate income taxes as a percent of receipts.
**The information industry includes print publishing, motion pictures and sound recording, telecom, broadcasting, web search, and Internet firms generally.*
Source: Internal Revenue Service, Progressive Policy Institute

Figure 2: Selected Industries Where Foreign-controlled Corporations Pay Less Taxes as a Percent of Receipts

	Federal corporate income taxes as percent of receipts, 2011	
	All active corporations	Foreign controlled corporations
Electronic markets	1.7%	0.2%
Motion pictures and sound recording	1.9%	0.4%
Lessors of intangible assets	4.7%	3.3%
Securities	2.5%	1.2%
Computer and electronic product manufacturing	1.5%	0.6%
Other information service, including web search and internet publishing	2.3%	1.7%
Telecom	0.8%	0.2%
Publishing (including software)	1.8%	1.3%
Transportation equipment manufacturing	0.6%	0.2%

Source: Internal Revenue Service, Progressive Policy Institute

These charts report federal income taxes paid, including credits, as a share of receipts. We used receipts as the denominator rather than income for two reasons. First, we looked at receipts because the income reported by a corporation in any particular country depends on a variety of factors. In particular, the cross-border valuation of intangibles can greatly affect reported income. In that sense, looking at taxes as a share of receipts will give a better indicator. Second, since we are doing comparisons within industries rather than across industries, profit margins should be roughly of the same order of magnitude.

These results are consistent with a 2008 report from the Government Accountability Office. According to that report, 72 percent of foreign-controlled domestic corporations reported no tax liability for at least one year between 1998 and 2005. Over the same period, 55% of U.S.-controlled corporations reported no tax liability for at least one year. In general, the report noted that by most measures, foreign-controlled corporations reported lower tax liabilities than U.S.-controlled corporations.[2]

State and Local Tax Incentives

Just looking at the federal tax system, however, does not give the full impact of tax incentives on foreign companies. In particular, foreign manufacturers are often the beneficiaries of state and local tax incentives. In today's era of global manufacturing competition, multinationals are increasingly building factories

closer to their markets. In practice, that means U.S. manufacturers are concentrating on building and expanding their operations in other countries, while opening up few greenfield plants in the United States

By contrast, foreign companies see the United States as a place where they can expand in order to get closer to free-spending U.S. consumers. So in practice, if a state or locality wants to attract a high-profile company, it's more likely to be from outside the United States. Nevertheless, we do know that "incentives-based competition for FDI is a global phenomenon" and individual states are no slouches in this regard. In fact such activities are described by the OECD as "a mainstay of state governments' activity."[3]

Foreign manufacturers are often the beneficiaries of state and local tax incentives.

States typically dangle a variety of incentives, including infrastructure improvements, free or below-market price land, low-cost housing, among others. These incentives tend to depress the taxes paid by foreign companies in United States. Unfortunately, there is no central database that allows us to assess the size of these tax breaks. Moreover, there is no incentive for either government or industry to provide easy access to the tax records of foreign companies.

The size of these incentives packages can vary considerably across states and industry, partially reflecting the nature and size of the industry in question. In 2013, the group *Good Jobs First,* created a database of the largest economic development packages within the United States. Eighteen of the top 100 went to foreign controlled firms. The sectors covered ranged from automobiles, to chemical to mining. Figure 3 below shows the largest packages offered to foreign firms based on this data.[4]

Figure 3: Large Subsidy Packages Offered to Foreign Companies Or Their U.S. Subsidiaries

	Company	State	Dollars	Year
1	Royal Dutch Shell	PA	$1,650,000,000	2012
2	Nissan	MS	$1,250,000,000	2000
3	ThyssenKrupp	AL	$1,073,000,000	2007
4	Volkswagen	TN	$554,000,000	2008
5	Bayer CropScience	AL	$429,500,000	2013
6	Kia (controlled by Hyundai)	GA	$410,000,000	2006
7	Toyota	MS	$354,000,000	2007
8	Kvaerner	PA	$350,000,000	1997
9	Areva	ID	$276,000,000	2008
10	Volkswagen	TN	$263,300,000	2014
11	Sasol Ltd.	LA	$257,000,000	2013
12	Orascom Construction Industries	IA	$251,000,000	2012
13	Triple Five	MN	$250,000,000	2013

14	Diamond-Star Motors (now Mitsubishi Motors)	IL	$249,300,000	1985
15	Mercedes-Benz	AL	$238,000,000	1993
16	Hyundai	AL	$234,600,000	2002
17	Samsung	TX	$233,400,000	2006
18	Nissan	TN	$230,000,000	2005
19	Wacker Chemie	TN	$210,500,000	2009
20	LG Chem-Compact Power	MI	$198,000,000	2009
21	Zurich Reinsurance Centre Holdings	CT	$190,000,000	1997
22	Shintech	LA	$187,200,000	
23	Teck Resources	AK	$180,000,000	1990
24	AstraZeneca	DE	$178,000,000	1999
25	Airbus (EADS)	AL	$158,500,000	2012
26	Honda	AL	$158,000,000	1999
27	Shintech	LA	$153,381,115	2009
28	Hankook Tire	TN	$150,600,000	2013
29	BMW	SC	$150,000,000	1992
30	Swiss Bank Corp. (now UBS)	CT	$150,000,000	1994
31	Toyota	KY	$147,000,000	1985
32	Toyota	KY	$146,500,000	2013
33	Honda	IN	$141,500,000	2006
34	Toyota	TX	$133,000,000	2003
35	Yokohama Rubber/Yokohama Tire	MS	$130,000,000	2013
36	ICAP North America	NJ	$127,107,428	2002
37	Mazda Motor	MI	$125,000,000	1984
38	Michelin	SC	$123,300,000	2012
39	Hynix Semiconductor (previously Hyundai)	OR	$121,000,000	1995
40	Mercedes/DaimlerChrysler (now Daimler)	AL	$119,300,000	2000
41	Severstal	MI	$119,000,000	2005
42	Subaru of America, Inc.	NJ	$117,832,868	2014
43	DHL Worldwide Express	OH	$114,700,000	2004
44	fortu PowerCell, Inc.	MI	$112,600,000	2010
45	Triple Five	MN	$108,000,000	1988
46	BMW	SC	$103,500,000	2002
47	MacMillan Bloedel (bought by Weyerhaeuser)	KY	$103,000,000	1995
48	Panasonic	NJ	$102,400,000	2011

Note: Whether firms are labelled as foreign or not was decided based on their status at the time of the package. Source: Goodjobsfirst.org, March 2015 data

Sometimes even the largest deals do not have the anticipated effect. For example, in 2007 Alabama offered ThyssenKrup, a German steelmaker, a huge tax incentive package to locate a steel plant in Mobile County. The deal included a variety of tax abatements and grants, which were increased again in 2011, making the total value of the tax abatements more than $600 million over 20 years.

Clearly these tax incentives helped make the plant more profitable, and persuaded ThyssenKrupp to invest more than $5 billion. However, despite the tax incentives, the plant was not successful. In 2014, it was sold to ArcelorMittal and Nippon Steel & Sumitomo Metal Corp for $1.5 billion.

The BEPS Principles

The final issue is whether U.S. multinationals should be paying that much tax in Europe, even if all loopholes were closed. The OECD's BEPS project is rolling out a new set of international tax principles designed specifically for the digital age. In particular, the new principles require that intangibles be valued at "arms-length" prices for the purposes of assessing international prices.[5]

That's just a fancy way of saying that if the BEPS principles are implemented as currently written, knowledge-based companies such as Google, whose value is mainly based on its search and advertising algorithms, will end up booking more profits in the country where most of their research and development is done—namely, the United States. Meanwhile, income booked in Europe by U.S. knowledge-based multinationals will likely fall. Ironically, the apparent mother lode of multinational income that European politicians covet will vanish if the BEPS reforms go through.

European criticisms of taxes paid by American-based companies in knowledge-based industries are in part unfair.

Of course, that's not the end of the story. If the United States maintains its extremely high corporate tax rate, U.S-based multinationals might take the obvious step of moving more of their R&D to other countries with lower rates. That could boost European tax revenues—but then the United States could counter by lowering its corporate tax rate, or implementing preferential tax treatment of intellectual property. Forecasting long-term tax policy is not easy—but we do know that under the BEPS principles, the country where the value is created will account for the bulk of the taxes.

Tax Policy in The Future, Without Hypocrisy

Our analysis shows that on average, foreign companies operating in the United States in knowledge-based industries pay lower U.S. federal income taxes relative to their revenues than their American counterparts. Moreover, foreign companies are often offered lower state and local taxes in order to relocate. From that perspective, European criticisms of the taxes paid by American-based companies in knowledge-based industries are in part unfair, although there are clearly loopholes that need to be closed.

As governments move towards implementing new structures for taxing knowledge-based multinationals, on a broader scale, they are going to have to decide whether they want more immediate tax revenue or more growth. As we noted in a recent paper, the BEPS principles by themselves are likely to sharply boost taxes on intangible investments, in a way that is self-defeating and directly harmful to growth.

One solution is for developed countries to implement "patent boxes" or "IP boxes" that offer companies low and preferential tax rates for profits generated by investments in intellectual property. Indeed, some of the European countries that have been most vociferous about U.S. multinationals have already themselves implemented such "patent boxes" or "IP boxes" that offer their own companies low and preferential tax rates for profits generated by investments in intellectual property. We have already suggested that the United States also implement such an IP box. [6]

The United States needs to move aggressively on tax reform that enhances growth and encourages investment in intangibles while promoting fairness. Assigning blame is less important than making sure we have a tax system which raises revenues without getting in the way of growth.

Endnotes

[1] For example, see Mark Thompson, "Apple, Starbucks Face New Tax-Dodging Probe," CNN, June 11, 2014.

[2] U.S. Government Accountability Office, Tax Administration: Comparison of the Reported Tax Liabilities of Foreign and U.S. Controlled Corporations 1998-2005, (GAO-08-957), July 2008, http://www.gao.gov/products/GAO-08-957.

[3] Charles Oman, "Policy Competition for Foreign Direct Investment", *A Study of Competition among Governments to Attract FDI*, OECD Development Centre Studies, 2000.

[4] It is worth noting again that there is a lack of data with regard to earlier deals, so it is likely these figures underestimate the total number of deals.

[5] For a description of the BEPS process, see Michael Mandel , 2015, "Taxing intangibles: The Law of Unintended Consequences," Progressive Policy Institute Policy Brief, http://www.progressivepolicy.org/issues/economy/taxing-intangibles-the-law-of-unintended-consequences.

[6] Michael Mandel, "Should the US Consider a Patent Box," 2015, http://www.progressivepolicy.org/blog/should-the-us-consider-a-patent-box.

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