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Profit Shifting and Earnings Management through Tax Haven Subsidiaries: an Exploratory Analysis of Multinational Companies

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Abstract

Borderless global trading activities provide opportunities for multinational companies (MNCs) to practice tax avoidance and tax evasion. MNCs with tax haven subsidiaries have higher tendency to shift profits to their subsidiaries. Therefore, this study observes the MNCs and their tax characteristics. Out of 60 MNCs, 56 companies have subsidiaries in tax haven. Analysis shows that MNCs with subsidiaries in tax haven territories, reported lesser profits and paid lesser taxes. The findings confirm that MNCs with tax haven advantage, engage in profit shifting more extensively than MNCs without tax haven links. Therefore, this study highlights on the need to further investigate on this issue to mitigate profit shifting.

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1. Introduction

Money laundering and terrorism financing has negative effect on the economy and financial market. Borderless trading activities attract money launderers because of loose regulations on anti-money laundering and its low risk of detection (FATF, 2006). This issue has been a hot issue discussed among academics, policy-makers and enforcement agencies, especially on international taxation. The Financial Action Task Force (FATF) has recognised misuse of the trade system as one of the main methods by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the formal economy (FATF, 2006). OECD

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(2013) also showed concern on the problem of tax evasion and profit shifting by multinational corporations (MNCs), as it results to large sum of illicit financial flows.

Malaysia has been in the top five list of developing countries with highest amount of illicit financial flows for three consecutive years (GFI, 2012, 2013, 2014). The amount of illicit financial flows has increased from US$ 285.24 billion (period 2001 to 2010) to US$ 370.38 billion (period of 2002 to 2011) and US$ 394.87 billion (period 2003 to 2012). In deriving to the amount of total illicit financial flows, GFI's adopted the aggregate of two methods; 1) trade mispricing and 2) hot money narrow through informal channels.

As of 2013, 362 of 500 Fortune companies are found to stash their cash in the tax haven countries through profit shifting in their subsidiaries located in the tax haven countries, resulting to owing huge number of taxes to the United States federal taxes (Phillips, Wamhoff, & Smith, 2014). Tax avoidance done by 30 companies with the most money offshore collectively around US$ 1.2 trillion and this tax loses is required to be balanced by higher individual taxes or cuts to public investments and public services. Hence, this leads to a burden to the whole nation. Profit-shifting strategies by multinational companies raise serious issues of fairness and compliance as current international tax system provide opportunities to exploit legal loopholes and enjoy tax-free earnings (Janský & Prats, 2013). Taxes being paid do not reflect the income that they have earned. Furthermore, having subsidiaries located in the tax haven countries is found to be one of the red flags of trade based money laundering (Henn, 2013; Henry, 2012).

Therefore, this study look into multinational companies listed in Bursa Malaysia, their tax haven subsidiaries and companies' tax characteristics. The findings will determine the tax characteristics of MNCs with tax haven subsidiaries to identify their profit-shifting strategies to evade and avoid taxes. This study provides insights into the profit-shifting strategies by MNCs operating in Malaysia, which eventually becomes eye-opener to the regulators to address this matter in minimizing the amount illicit financial flows. The following section discusses on previous literature related to this topic. Section 3 explains on research methodology adopted in this study. The findings and discussion are presented in section 4 and the final section concludes the study.

2. Literature Review

Trade based money laundering and terrorist financing (TBML) refers to the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illegal origins or finance their activities (FATF, 2006). Examples of how TBML may be carried out includes: misrepresentation of the price, quantity or quality of imports or exports; and money laundering through fictitious trade activities and/or through front companies (FATF, 2008). The techniques of trade based money laundering includes; 1) over and under invoicing of goods (trade mispricing), 2) multiple invoicing of goods, 3) over and under shipment of goods, 4) falsely described goods, and 5) complex trade approaches (Thanasegaran & Shanmugam, 2007).

Over and under invoicing of goods and services or trade mispricing is a major conduit through which profits of companies are shifted from developing countries to developed country banks and tax havens (Henn, 2013). Indeed, more than half of Malaysian illicit financial flows are attributed to this conduit (GFI, 2012, 2013, 2014). Trade mispricing it is done by misrepresenting the price of goods or services in order to transfer money between colluding importers and exporters (FATF, 2006; Mevel, Ofa, & Karingi, 2013). It occurs when the underlying trade involves transactions between related parties, such as trade transactions between international subsidiaries of a large parent company. It involves transactions between both related and unrelated parties; for example, a local company trading with an independent foreign supplier. As such, trade mispricing presents a channel through which legitimate profits are transferred abroad illegally (Hollingshead, 2010). The implication is of concern to many countries since it has negative impact on their national's economic growth.

According to the Organisation for Economic Co-operation and Development (OECD) transfer pricing best practice guidelines for MNCs and tax administrators, transshipment transactions should be based on an arm's length principle and it is known as transfer pricing. Transfer prices refer to prices at which an enterprise transfers physical and intangible goods or provides services to associated companies. It is significant because they determine the amount of taxable profits for associated companies operating in different tax jurisdictions. Hence, the implementation of transfer pricing guidelines on MNCs is an important mechanism that can facilitate and minimise conflicts between tax administrations and MNCs. However, there are companies which ignore the arm's length principle resulted to trade mispricing. Abnormal price involve during the transaction is highlighted as a red flag of