

## GLOBAL CAPITAL FLOWS AND TAXATION: IMPACTS ON FOREIGN DIRECT INVESTMENT

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### **Abstract:**

*In an era where organizations are driven to establish global footprints and pursue economies of scale, the subject of global expansion has garnered significant attention in the literature. As articulated by Mohs (2016), globalization encompasses a range of interconnected objectives, including but not limited to expansion, diversification, and brand establishment. Moreover, these objectives are intrinsically linked to the expectation of generating profits from the targeted global expansion. In this dynamic landscape, globalization is a subject of continuous study within controlled environments. The advent of new technologies and advanced communication methods has empowered companies of varying sizes, from small privately held enterprises to large multinational corporations, to venture into international markets. These opportunities manifest through international trade or foreign direct investment (FDI) and inevitably encounter the tax policies of foreign nations. Foreign Direct Investment (FDI) can be categorized into two major forms: greenfield investments and acquisitions. Greenfield investments involve the establishment of entirely new operations in foreign countries, whereas acquisitions and mergers entail the acquisition of existing local businesses. This study refrains from distinguishing between partial or complete foreign investment, treating all forms with equal consideration. This research endeavors to investigate the intricate interplay between global expansion strategies and the tax policies of foreign countries, shedding light on the strategic choices made by businesses in pursuit of their global objectives. By exploring the dynamics of international market entry modes, this study aims to provide valuable insights into the decision-making processes of companies looking to expand beyond their domestic borders.*

**Keywords:** Global Expansion, Foreign Direct Investment (FDI), International Market Entry, Tax Policies, Acquisition Strategies

### **Introduction**

As organizations have strived to create global footprints and search for economies of scale, there has been a great deal of literature devoted to global expansion. As discussed in Mohs (2016) globalization includes a loosely connected set of objectives which include but are not exclusively limited to expansion, diversification, and brand establishment. Additionally, these objectives are expected to be covered with profits generated from the targeted global expansion. To the extent that globalism is dynamic, it is often studied and in a contained environment. With new forms of technology and communication, companies ranging from small privately held companies to large multinational companies are enabled to expand abroad. These opportunities are executed in the form of international trade or foreign direct investment and are exposed to foreign countries tax policies. The two major categories of Foreign Direct Investment (FDI) are investment by use of greenfield investments and acquisition. Greenfield investment is the method of establishing a whole operation in a foreign country, where Acquisitions and mergers require purchasing existing local operation. For the purposes of this study no distinction is made between partial or complete foreign investment.

### **Foreign Direct Investment**

FDI is generally defined as the ownership and control of foreign assets. There are a variety of reasons for multinational enterprises to participate in foreign direct investment. Some of these reasons include but are not limited to, increasing sales and profits, entering rapidly emerging markets, reducing costs, gaining a foothold in economic blocs, protecting foreign and domestic markets and acquiring technological and managerial know-how (Doupnik and Perera, 2015).

In 2008 the Organization of Economic Cooperation and Development (OECD, 2018a) argued that virtually all governments are interested in attracting FDI as a means of generating new jobs, bringing in modern technologies and generally to promote growth and employment. As discussed in Mohs (2016) it is clear that the economic benefits derived are sufficient to entice countries to offer competitive tax environments to attract foreign direct investment. As a result, some countries appear more appealing for foreign direct investment than others. In general, "foreign direct investment is attracted to countries offering: access to markets and profit opportunities; a predictable and nondiscriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labor markets; and well-developed infrastructure" (OECD, 2008b).

### **Income Attribution**

FDI is an investment made by an enterprise that has a primary resident in one country that establishes a longterm interest in another country. In order to be considered an FDI the enterprise must establish a significant degree of influence on the management of the foreign enterprise, which is 10% or more of the voting power (OECD, 2008a). This is separate from the 50% ownership that is required to establish control.

Income attributed to the investor from the FDIs can arise from distributed or undistributed profits generated by the enterprise leading Multinational enterprises (MNE) to formulate global tax strategies to maximize their ROI, by affectedly shifting profits from high to low tax countries generating more cash available for reinvesting in the enterprise or to pay an investor dividend. Most of the income from foreign subsidiaries of U.S. MNE are deferred until reparation, allowing United States parent entities to potentially avoid the income tax indefinitely with a well-executed global strategy.

U.S. MNE shift income to lower tax jurisdictions and expense to higher tax jurisdictions through allocation of debt with interest stripping, transfer pricing, contract manufacturing and special purpose entities. These international tax strategies have been around since the inception of the United States Tax Code due in part to a distinctive feature relating to the taxation of worldwide income (Mohs, Goldberg, Butler & Heath, 2016).

### **Funding Foreign Direct Investment**

The FDI can be funded with equity investment which would include includes stock, capital contributions and later the reinvestment of earnings. The investments can also be funded with debt instruments such as bonds, loans, promissory notes, trade credit and other accounts payable/ receivable. The type of financing of an FDI is influenced by many factors and may result in the shift from one type of funding to another type of funding. In the United States(U.S.) MNE"s are taxed on the repatriation of their earnings, a natural shift from debt financing of the initial investment to equity financing of the reinvested earning can occur as a tax reduction strategy. The parent can deduct the debt expense in the beginning and then defer the income tax from its subsidiary until repatriation. In a recent OECD report,earnings reinvested in the first half of 2017 by U.S. MNE parents in their foreign affiliates represents 54% of total earnings reinvested by OECD parents (OECD, 2017a), illustrating how common this practice is today. Another method which is commonly used to finance FDI is transfer pricing policy.

### **Transfer Pricing**

Transfer prices are broadly defined as the amounts charged for goods and services exchanged between divisions or units of the same company. To properly reflect income, prices of goods and services sold by related companies should be the same as the prices that would be paid by unrelated parties. This is referred to as an arm's length transaction. By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases, income can be shifted (Gravelle, 2015). Payment for services or expenses, like interest payments or

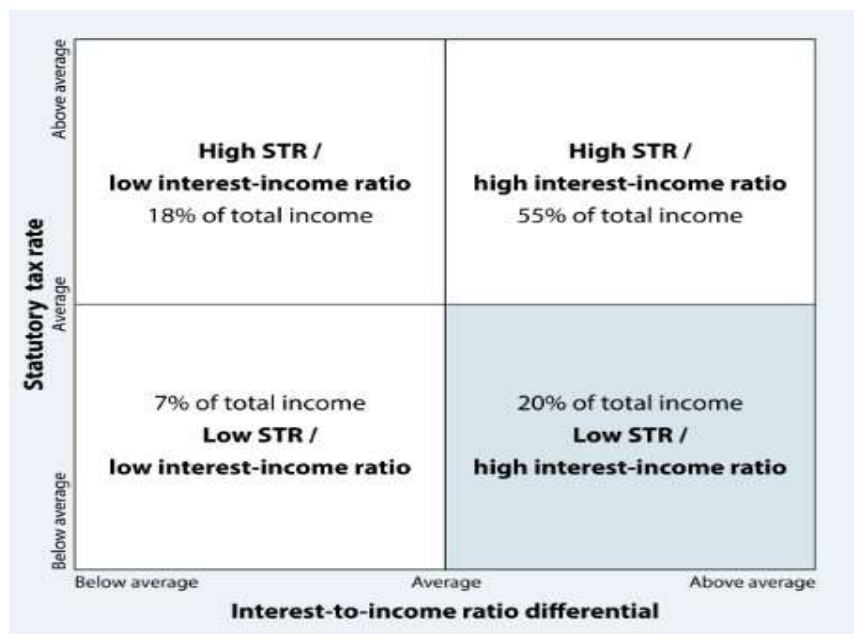
payments for the purchase or use of property, can be adjusted in order to reach a desired tax result similar to transfer pricing (Mohs, Goldberg, & Buitrago, 2017). Transfer pricing for intellectual property, or intangibles can be manipulated much easier since they usually don't have anything comparable, making it almost impossible to know what a royalty would be paid in an arms-length price.

It is a well known common practice for technology and drug companies to do research and development in the U.S. to deduct the expense. Then license that patent to an affiliate in a tax haven at less than true value, paying little to no taxes on the profits.

To explain further, investments in intangibles is favorably treated in the U.S. because costs, other than capital equipment and buildings, are expensed for research and development, which is also eligible for a tax credit. Overall these treatments tend to produce an effective low, zero, or negative tax rate for overall investment in intangibles. Hence a significant incentive to make these investments in the United States. On average, the benefit of tax deductions or credits when making the investment tend to offset the future taxes and therefore the return on investment. However, for those investments that tend to be successful, it is advantageous to shift profits to a low-tax jurisdiction, so that there are tax savings on investment and little or no tax on returns.

As a result, these investments can be subject to negative tax rates, or subsidies, which can be significant (Gravelle, 2015). Earnings stripping, a potential by-product of transfer pricing, is when either debt is associated with related firms or unrelated debt is not subject to tax by the recipient. This is seen when a parent may lend to its subsidiary or an unrelated foreign borrower not subject to tax in the parent company home country lends to the subsidiary. OECD data from 2013 confirms this practice of concentrating debt in high tax countries. Illustrated in figure 1, high-interest income in high-tax jurisdictions made up 55% total interest payments, an increase from 45% in 2011. Total interest income in low-tax countries was only 7%, down from 10% in 2011 (OECD, 2017b).

**Figure 1**



With no allocation rule in place to address deferral, a U.S. parent can operate its subsidiary with all equity finance in a low-tax jurisdiction and take all of the interest on the overall firm's debt as a deduction (Gravelle, 2015). In an effort to limit the scope of earnings stripping in either case, the U. S. and most trade partners have thin capitalization

rules. IRC 163(j)) applies to a corporation with a debt-to-equity ratio above 1.5 to 1 and with net interest exceeding 50% of adjusted taxable income (generally taxable income plus interest and depreciation). Interest more than the 50% limit paid to a related corporation is not deductible if the corporation is not subject to U.S. income tax.

When rights to an intangible is set up in a low-tax country to shift profits they may not be suitable for manufacturing. Adding to the complexity of the issue is that the desired manufacturing location is in a high tax country. MNE have resolved to contract with a firm in the preferred location which becomes a contract manufacturer, who will produce the item for cost plus a fixed markup. Subpart F taxes on a current basis certain profits from sales income, so the arrangement must be structured to qualify as an exception from this rule (Gravelle, 2015).

Special Purpose Entities (SPE) are entities with little or no physical presence or employment in the host country but that provide important services to the MNE in the form of financing or of holding assets and liabilities. Resident SPEs in Luxembourg, the Netherlands, Hungary, Iceland, the United Kingdom and Austria account for 25% or more of their inward FDI(OECD, 2017a).

### **Tax Havens**

As Outlined in Tax Havens: How Globalization Really Works, tax havens are “places or countries that have sufficient autonomy to write their own tax, finance, and other laws and regulations. They all take advantage of this autonomy to create legislation designed to assist non-resident persons or corporations to avoid the regulatory obligations imposed on them in the places where those non-resident people undertake the substance of their economic transaction” (Palan, Murphy, & Chavagneux, 2010). Others use a very simple definition of a tax haven as any country that offers no or lower taxes than the home country of the MNE.

With no set definition of a tax haven there are more than 10 different list of tax havens with eight countries appearing on all list: Bahamas, Bermuda, Cayman Islands, Guernsey, Jersey, Malta, Netherlands and Luxembourg (Palan et al., 2010). The congressional research service combined many published lists consolidating them to the most common 50 countries by geographical location in the table below (Gravelle, 2015);

**Table 1. Countries Listed on Various Tax Haven Lists**

Caribbean/West Indies	Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, <sup>a,e</sup> British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, <sup>a</sup> Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands <sup>a,e</sup>
Central America	Belize, Costa Rica, <sup>b,c</sup> Panama
Coast of East Asia	Hong Kong, <sup>b,e</sup> Macau, <sup>a,b,e</sup> Singapore <sup>b</sup>
Europe/Mediterranean	Andorra, <sup>a</sup> Channel Islands (Guernsey and Jersey), <sup>e</sup> Cyprus, <sup>e</sup> Gibraltar, Isle of Man, <sup>e</sup> Ireland, <sup>a,b,e</sup> Liechtenstein, Luxembourg, <sup>a,b,e</sup> Malta, <sup>e</sup> Monaco, <sup>a</sup> San Marino, <sup>a,e</sup> Switzerland <sup>a,b</sup>
Indian Ocean	Maldives, <sup>a,d</sup> Mauritius, <sup>a,c,e</sup> Seychelles <sup>a,e</sup>
Middle East	Bahrain, Jordan, <sup>a,b</sup> Lebanon <sup>a,b</sup>
North Atlantic	Bermuda <sup>e</sup>
Pacific, South Pacific	Cook Islands, Marshall Islands, <sup>a</sup> Samoa, Nauru, <sup>c</sup> Niue, <sup>a,c</sup> Tonga, <sup>a,c,d</sup> Vanuatu
West Africa	Liberia

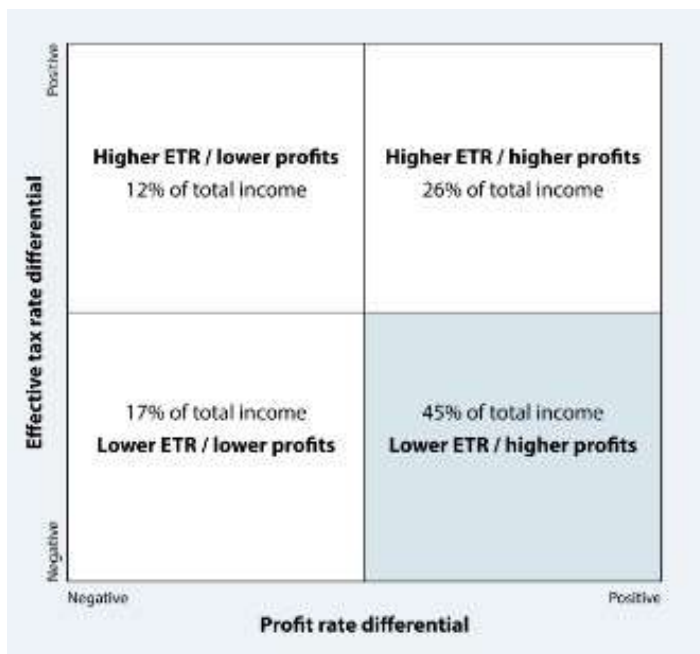
**Sources:** Organization for Economic Development and Cooperation (OECD), *Towards Global Tax Competition*, 2000; Dhammika Dharmapala and James R. Hines, "Which Countries Become Tax Havens?" *Journal of Public Economics*, Vol. 93, October 2009, pp. 1058-1068; Tax Justice Network, "Identifying Tax Havens and Offshore Finance Centers: [http://www.taxjustice.net/cms/upload/pdf/Identifying\\_Tax\\_Havens\\_Jul\\_07.pdf](http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf). The OECD's gray list is posted at <http://www.oecd.org/dataoecd/38/14/42497950.pdf>. The countries in Table 1 are the same as the countries, with the exception of Tonga, in a 2008 Government Accountability Office (GAO) Report, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09-157, December 2008.

As noted Desai et al. (2006) One type of tax haven has the characteristic of being a small island economy regarded as "dots" by with low populations and land masses below 23,000 square kilometers, where they offer little in terms of natural resource advantages with significantly lower rates of taxation and light-touch regulation. The location of tax havens are often characterized by countries with strong institutions and good governance (Dharmapala & Hines, 2009).

The use of these type of tax havens does not involve any movement of a firm's actual production, just intangible assets. Many technology companies such as Apple, Google and Amazon as well as pharmaceutical companies like Pfizer and Baer have been criticized for moving patents, trademarks, and other licenses to these types of countries. To demonstrate MNE use of tax havens OECD data from 2013 showed the shift of profits from high tax countries to affiliates in low tax countries. As illustrated in figure 2, an MNE with affiliates in low tax countries saw 45% of total income while high tax countries only saw 12% of total income (figure 2). The average profit rate in low tax countries for 2013 was 2.3 times as high as the MNE average profit rate, increase from 2 times in 2011 (OECD, 2017b). But large MNE must do effective tax planning to remain competitive in a global economy and increase shareholder value. To make debt financing and transfer pricing work a MNE move operations (tangible assets) to a foreign country that have a lower corporate tax rate. Countries with a lower tax rate than the U.S. 35%. Countries like Ireland, Poland or other eastern-bloc countries are considered opportunities for FDI for manufacturing and services. These lower tax jurisdictions appeal to MNE in a high tax country to use debt financing to fund the investment.

**Figure 2**





### Empirical Effects of Taxes

Many studies with results in similar ranges illustrating that taxes do influence FDI. One example calculates a mean value tax elasticity of -3.3, suggesting that a 1 percent reduction in the host country rate of tax on capital would increase total FDI inflows by 3.3 percent (De Mooij and Ederveen (2003; 2008). Other studies showing an FDI can vary between 0-5% with a change in the statutory tax rate confirming that taxes are not the only factor considered. With three common methods of calculating tax rates used in the literature each with their own pros and cons: statutory tax rates, average effective tax rates (AETRs), and marginal effective tax rates (METRs). Statutory tax rates have been widely viewed as unsatisfactory compared AETRs, but the most accessible since they are published. The advantage of AETR & METR is that they provide data on taxes actually paid, incorporating firms' tax minimizing strategies where statutory tax rates ignore tax-planning effects (Beck & Chaves, 2012).

According to the Tax Foundation the U.S. has the 2<sup>nd</sup> highest statutory corporate income tax rate at 39.1% which has not changed in over 7 years (appendix A). The METR is the 5<sup>th</sup> highest among the 43 nations at 34.8 percent it surveyed in 2017 (appendix B). If bonus depreciation were made permanent the METR would be 27.3 percent. The average METR among developed nations is 19.2 percent (Bazel & Mintz, 2017). Since 2010, the average OECD corporate income tax rate has fallen by more than 1 percentage point, with the biggest reductions in Japan (8.5 points), Spain (5 points), Finland (6 points), and the United Kingdom (10 points) (Bazel & Mintz, 2017).

OCED tracks the flow of FDI in and out of countries worldwide publishing that approximately 60% of global FDI inflows are to OCED countries. Noting that the first half of 2017 and 2016 the U.S. was the largest recipient of FDI inflows worldwide, even with such a high tax burden (appendix C). The next largest recipients of FDI in 2017 then Switzerland with one of the lowest tax rates followed by China with a more moderate tax rate. The U.S followed by Japan and Canada had the largest outflow of FDI in the first half of 2017 (OECD, 2017a).

### Non-Tax FDI Factors

When considering making an investment in a foreign country a MNE will assess whether their host country offers attractive risk/return opportunities, taking into account framework conditions (political/monetary/fiscal stability; legal protection; public governance), market characteristics (market size, availability/cost of labor, energy, state of infrastructure) and the prevalence of location-specific profits (Borga, 2015) (Gravelle, 2015). How a host country in the past and current levels of public expenditures on programs such as education has a direct impact on the quality

of the labor market. Implying that collecting tax is acceptable when they are used to finance public expenditures that strengthen host country(OECD, 2008b).

Tax incentive schemes are typically temporary in nature and are rarely enough to overcome an unfavorable economic or political environment. An MNE is looking to make a long-term investment, favoring a country that demonstrates convergence towards IFAB or other international standard setting organizations. The administration aspect of the account and tax systems are as important as the taxes themselves, leaves some with the viewpoint that the establishment of globally acceptable tax rules would be beneficial (Jeffrey, 2012).

Studies have shown inflation in the destination country has a statistically significant negative impact, indicating that countries with rising prices are less likely to attract FDI(Daude & Stein, 2001). Concluding that the exchange rate has no statistically significant impact on FDI flows, (Brouwer, Paap, & Viaene, 2008)&(Beck & Chaves, 2012).

### **Conclusion**

The U.S. and other OECD countries with relatively high effective tax rates are very successful in attracting FDI. Illustrating that taxes are only one aspect of a very complex decision. The importance of market size and employee talent has a large effect on attracting FDI in the U.S. in conjunction with the tax system structure (credits, deductions. Etc...). Highlighting the fact that a host country with low tax burden cannot compensate for a generally weak or unattractive FDI environment.

The U.S. remains one of the only countries with a worldwide tax system while other countries waive taxes on foreign business profit. This allows investors to compete on equal tax terms with other investors in foreign markets, with all investors in a given host country subject to host country tax alone. Many can argue that tax credits and treaties help level the playing field but with such a high statutory and marginal effective tax rate a U.S. is still at a large disadvantage. These companies are not free to move their money back to the parent (in the U.S.) to reinvest as easily as MNE with parents in a territorial system. This has resulted in the heavy reliance on the profit shifting methods described above.

Tax havens illustrate that MNE are always focused on the bottom line to either grow the business or reward the investors. With all countries looking to improve their economic situation there is always going to be a country with lower taxes for an MNE to invest in. A U.S. MNE is going to rely more on a tax haven not only to reduce their tax bill but more for the flexibility reinvesting or distributing their profits.

Tax havens are playing a critical role in keeping U.S. MNE competitive in this global economy and will continued to be used even with a significant reduction in the U.S. Tax rate or a switch to a territorial system. That is because taxes are only one of many factors that affect the FDI decision by MNE. The U.S. has a stable political climate, an educated workforce and a large consumer market which is very attractive to foreign companies.

Based on the evidence from empirical studies, investors are willing to pay for services to access a countries talent or market to a point. In theory the effect of the permanent as well as the proposed tax cuts would lead to an increase in FDI in the U.S. by foreign parents to a point. With the world-wide tax system in the U.S., a reduction in the tax rate may not have the same effect as it did in the studies. U.S. parents will continue to seek foreign investment and tax havensto move their profits globally without being taxed.

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