International Herald Tribune
TUESDAY, APRIL 25, 2006

Managing Globalization: Tax tightrope getting tangled

By Daniel Altman

Globalization has allowed many more businesses to expand outside their home countries than ever before and, as a result, taxes have become a knottier issue.

Though companies have often used their subsidiaries abroad to reduce their tax liabilities, both overseas and at home, that practice may not be so easy in newly popular destinations like China and India. Moreover, some are clamping down on such tax avoidance through their own legislation.

In the past decade, for almost any country you can name, international taxation has rapidly become more important in two ways: more domestically based companies have become multinational, and more foreign companies have set up shop in the country's territory. Though most developed countries have not had to change their tax rules, the job of collecting has gotten steadily bigger.

Ireland is a case in point. Its rapid economic growth - much aided by the investments of foreign businesses - has led to a reciprocal expansion in Irish companies' presence abroad. The number of them filing taxes for overseas income has grown from 560 in 1997 to 1,343 in 2003, the last year for which data are publicly available. They paid more than €2 billion, or $2.48 billion, in taxes in 2003, compared with €262 million in 1997.

That doesn't mean the job has gotten harder, though.

"The phenomenon that's sometimes called globalization is essentially both a higher-level and freer movement of investment, goods and services across national boundaries," said Joseph Isenbergh, a law professor at the University of Chicago. "That, in and of itself, has relatively little bearing on government's power to enforce their tax rules."

For example, Isenbergh said, "the United States Treasury has about the same access to the records and transactions of foreign subsidiaries of U.S. companies as it had 10 years ago."

Yet the ability of multinational companies from wealthy countries to shift money around the world, minimizing their tax liabilities, may be somewhat constrained by their involvement in today's fastest-growing economies.

In the recent past, it was a bonanza, Isenbergh said. Companies with many overseas subsidiaries were able to buy and sell goods and services between them at prices they chose themselves, using the transactions to shift income from high-tax to low-tax environments. In the United States, the additional ability to defer taxes by several years created "a possibly greater current tax advantage than the designers of these tax rules contemplated," he added.

But now, companies are investing in countries like China and India where the taxes are high, and requirements for reporting income are strict as well.

"Those are not low-tax environments - quite the contrary, they are high-tax environments," Isenbergh said.

He added that the type of tax regulation differed in those countries from those in Europe, giving Western companies "much less room to maneuver" in seeking to reduce taxes by shifting income to subsidiaries in lower-tax countries.

Indeed, Isenbergh said, developing countries like China, which have relatively less capacity to audit and account for businesses with intricate structures, would be more likely to use fixed formulas to calculate the tax liabilities of foreign businesses. That means not only that companies will probably have to pay more Chinese tax on their Chinese income but also that they will have a harder time avoiding taxes back in the United States and Europe.

In the meantime, some countries are stepping up own efforts to control tax avoidance through international outlets. Last year's finance acts in Britain explicitly focused on what Jan Marszewski, a spokesman for Her Majesty's Revenue and Customs, called a "double dip" - when a company claims a tax deduction twice for the same expense, in Britain and in the foreign country where it does business.

Companies were also prevented from claiming a tax relief for dividends received - a measure usually designed to eliminate double taxation - when those dividends were actually tax-deductible in the country of the payer. And the acts proscribed, for the first time, the practice of claiming deductions for payments of foreign taxes that had, in reality, been avoided.

The globalization of companies has also placed a premium on cooperation between the tax authorities across national boundaries, an issue on which the British government, despite the obvious international implications of its rule changes, was tight-lipped.

There are limits, however, to what foreign governments can offer, especially in developing countries. Tax evasion may be a risky proposition for a big multinational company, but it is still a widespread problem in China. Even after recent changes to China's economic statistics, some analysts still say that profits - including those of foreign companies - are underreported.

Still, even if avoiding taxes does become more difficult in lucrative markets like China and India, it is not likely to slow the pace of businesses' international expansion, Isenbergh said.

"With the overall gains of globalization," he said, "in terms of high returns on investment and physical capital being matched with highly productive human capital, the tax effects are likely to be overwhelmed by other effects."

E-mail: daltman@iht.com