



A study of tax minimization strategies in multinational companies

With focus on The Coca-Cola Company and IKEA

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Summary

In this thesis we study how multinational companies are using various strategies in order to minimize their total tax burden. We use theory and relevant literature to describe some of the strategies available, and we also confirm that these strategies are in fact being used on a global scale.

By studying two of the largest companies in the world, respectively The Coca-Cola Company and IKEA, we are able to see how some of these strategies are used in real life. By studying these two companies, we find that both show signs indicating an aggressive use of tax minimization strategies. The lack of transparency and the complicated organizational structures we have found are both clear indications that aggressive tax planning is being used. By locating the concentrate operation in a tax haven, we believe that The Coca-Cola Company is able to keep massive amounts of income outside of the United States, free of tax. This strategy is possible by having the parent located in Delaware, a high secrecy jurisdiction known for offering easy access to tax havens. Tax havens and high secrecy jurisdictions are also common denominators for IKEA's corporate structure, which includes both a foundation and holding companies located in tax havens such as the Netherlands, The Netherlands Antilles and Luxembourg. By funnelling royalty payments through shell companies and into holding companies in tax havens, as well as shifting profits away from high tax jurisdictions by using aggressive transfer pricing and internal debt; we believe that the companies are able to save massive amounts of taxes.

The problem of companies being able to avoid taxes is the result of a malfunctioning global tax system, where various loopholes are easy to exploit. The lack of a common understanding between all jurisdictions, where some deviate from the others in order to increase income, is a problem that needs to be solved. As we describe in the last chapter of our thesis, several actions have been and are to be taken in order to prevent companies from dodging taxes. Most countries are now on board for a new global transparency agreement, and there is reason to believe that we will see changes in the near future, hopefully increasing the total amount of tax paid at a global scale.

Foreword

This thesis was written as a part of the Master of Science degree in Financial Economics at the Norwegian School of Economics and Business Administration, and the Master in International Business at EGADE Business School.

The subject was inspired by the class FIE441 – Taxes and Business Strategy at NHH. Alongside the growing media attention and today's globalisation, we felt that this was a subject that would lead to a huge learning outcome.

We hope that this thesis will contribute to the growing awareness of how multinational companies are using strategies in order to reduce tax obligations, as well as how this can be regulated.

We would like to use this opportunity to thank our advisors, Professor Guttorm Schjelderup and Professor Alejandro Ibarra Yunez for providing us with marvellous comments and feedbacks.

This thesis marks the end of our studies, and we are forever grateful to everybody who has made this a remarkable and unforgettable time.

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1. Introduction

Today we observe a growing media attention regarding multinational companies and their tax minimization strategies. Large multinational companies such as GE, Apple and Starbucks, have been confronted and asked to justify their company structures and their effective tax rates, based on suspicions of aggressive use of tax planning.

The recent financial crises, followed by recession in several economies worldwide, have increased awareness of actors who fail to contribute to society in the form of paying their taxes. When companies dodge taxes, the remaining companies, as well as the households, pay the price in the form of increased taxes and reduced welfare. Thus, this problem affects everyone.

We will in this chapter study multinational corporations (MNCs) and describe the various tax minimization strategies available to them. By studying relevant literature and empirical analyses, we hope to confirm that companies worldwide are in fact using these strategies.

By studying two MNCs, respectively The Coca-Cola Company and IKEA, we hope to get a better view of how the strategies are being used by a company in a real life setting. We hope to be able to confirm that the two companies are in fact using some of the strategies explained, and we might also be able to estimate the effect of these various actions.

We chose to study these exact companies because of their respective sizes and positions internationally, and the suspicions aimed at them regarding their low tax payments. While IKEA is mentioned frequently in the media regarding their business structure, Coca-Cola has somehow been able to fly under the radar, and has succeeded in not drawing to much attention towards its tax planning regime. This made us curious, and we wanted to put the companies under the loop to see what we could find.

The thesis starts by explaining MNCs and how they are built up. We then move on to international tax systems and the regulations in relevant jurisdictions, before explaining the various strategies and analysing relevant literature to see if these are being used. The two companies are then analysed thoroughly, before we end the thesis by looking at various government actions aimed to prevent tax minimization.

2. Multinational companies and capital structure

This chapter will focus on how multinational companies (MNCs) set their capital structure, which will be highly relevant when we are to analyse The Coca-Cola Company and IKEA.

Firms issue a collection of securities to raise capital from investors. The composition of the securities constitutes the firm's capital structure. The most common securities are equity and debt¹. If a firm chooses to have a composition solely based on equity, the firm is said to be unlevered. If a firm chooses to have a combination of equity and debt, the amount of debt determines the company's leverage. A MNC will have to find an optimal capital structure at corporate level, taking into account the various jurisdictions in which it operates, and their laws and regulations. We will start by explaining what signifies a MNC.

2.1 Multinational companies (MNCs)

There are several definitions of a MNC, which include factors such as ownership, management, strategy or structure. A simple definition is that a company is multinational when it operates and sells goods and services in more than one country². Due to the increased mobility of capital that has been observed over the last decades, the number of MNCs has increased through this very same timeline. There are several operational upsides in changing a company's status to become a MNC, such as: Increased revenue potential, cheaper labour (i.e. lower costs) and cheaper raw material. This thesis will however focus on advantages linked to the capital structure of the MNC.

¹ Berk & DeMarzo, 2011

² Shapiro & Sarin, 2010

2.2 Capital structure in MNCs

A MNC chooses a capital structure that maximizes the company's global profit. Since a subsidiary can either be financed with equity or debt, the management chooses a capital structure taking into consideration certain trade-offs between the sources. Jurisdictions are practicing different laws of how to tax different sources of financing.

2.2.1 Tax efficient financial structure³

MNCs have distinctive features that a regular one-jurisdiction company doesn't have. It faces international tax-rate-differences, which gives it the ability to shift debt across affiliates (both external and internal) and use internal debt for tax reasons⁴. The following model will show how a MNC maximize worldwide profit.

E_i	Equity	$b_i^I \equiv \frac{D_i^I}{K_i}$	Internal leverage
$D_i^{I/E}$	Internal/ External debt	$b_i \equiv b_i^E + b_i^I$	Leverage ratio in affiliate i
$b_i^E \equiv \frac{D_i^E}{K_i}$	External leverage	$\sum_i r * D_i^I = \sum_i b_i^I * r * K_i = 0$	Internal lending constraint is equal to zero

Figure 2.1

There are costs associated when affiliates are undertaking both external and internal debt. The external debt has a U-shaped cost function, $C^E(b_i^E)$ whereas the internal debt cost function can be written as $C^I(b_i^I)$. On the parent level, the bankruptcy costs depend on firm-wide leverage $b_f = \frac{\sum_i D_i^E}{\sum_i K_i}$. Note that there is not an overall parent-level cost on internal debt as figure 3.1 shows that $\sum_i r * D_i^I = \sum_i b_i^I * r * K_i = 0$. The cost function for the firm wide leverage is $C_f(b_f)$ Møen, Schindler, Schjelderup and Tropina (2011) define the economic profit in affiliate i , π_i^e , as:

³ This paragraph is based on Møen et al. 2011 and Debt shifting and ownership structure. Dirk Schindler and Guttorm Schjelderup (2012) in a lecture given by Guttorm Schjelderup and Dirk Schindler in the course Taxes and Business Strategies (FIE441) at NHH – Norwegian School of Economics, spring 2013.

⁴ Since a one-jurisdiction company doesn't face different tax rates, there is no tax gains by shifting internal debt

$$\pi_i^e = F(K_i, L_i) - w * L_i - [r + C^E(b_i^E) + C^I(b_i^I)] * K_i \quad (2.1)$$

And the taxable profit in affiliate i , π_i^t as:

$$\pi_i^t = F(K_i, L_i) - w * L_i - r * [D_i^E + D_i^I] - [C^E(b_i^E) + C^I(b_i^I)] * K_i \quad (2.2)$$

The after tax profit in affiliate i , π_i , is the affiliate's economic profit minus the taxes of the taxable profit. Since a firm is interested in optimizing its worldwide profit it will maximize this by choosing the leverage, which gives the optimal capital structure. Dividing with respect to external debt and the internal debt gives⁵:

$$\frac{\partial L}{\partial D_i^E} = t_i * r = (1 - t_i) * \frac{\partial C^E(b_i^E)}{\partial b_i^E} + \frac{\partial C_f(b_f)}{b_f} * \frac{1}{\sum_i K_i} > 0 \text{ and,}$$

$$\frac{\partial L}{\partial D_i^I} = (t_i - \lambda) * r = (1 - t_i) * \frac{\partial C^I(b_i^I)}{\partial b_i^I}$$

There are certain implications attached to the formulas above. Due to the tax benefit, the internal bank is located in the lowest-tax affiliate. The external leverage and the financial structure are affected by tax rates, cost of capital, bankruptcy costs on the affiliate and the parent level. The external debt is not affected by the company's internal bank or the internal debt-to-asset ratio. The internal leverage is affected by the affiliate's corporate tax rate, cost of capital, concealment costs and the tax rate in the group's internal bank.

2.2.2 Debt versus the share price

As discussed, MNCs can use internal debt in order to avoid tax obligations by utilizing differences in international tax rates. As tax obligations decrease, earnings increase.

John P. Kennedy, partner at Deloitte Tax LLP, speaking at a conference in Philadelphia Nov. 3rd 2010, gave the following example to show the CFO's and other option holding managers incentive to rig the company's capital structure favouring tax avoidance;

⁵ Møen et al. 2011

For a hypothetical company that has 1,000 shares outstanding, has pretax income of \$5,000 and trades at 20 times earnings, cutting just 2 percentage points off the rate could drive the share price up \$2.⁶

Minority owners will benefit from holding shares in borrowing affiliates due to its tax savings (Schindler and Schjelderup (2012)). Since parts of the tax engineered profit fall on the minority owners and not the parent company, wholly owned affiliates use more internal debt than affiliates with minority owners (Schindler and Schjelderup (2012)). For wholly owned affiliates in emerging markets of multinationals, their debt-to-asset ratio increases by 27 percentage points given a 10% increase in its corporate tax rate.⁷ The same review does not find any evidence of debt shifting for partially owned affiliates. It goes to say that affiliates with minority owners are also less tax sensitive and that wholly owned subsidiaries have a 5 percentage points higher leverage ratio of internal debt compared to non-majority owned.⁸ Schindler and Schjelderup (2012) present the worldwide profits of a MNC with minority owners with the formula:

$$\Pi = \sum_i^n (1 - J_i)(\pi_i - t_i * \pi_i^t) \quad (2.3)$$

Where J_i is the minority shareholders contribution.

Although it relies on linear profit sharing rules, it shows how the minority ownership in country i reduces the profit income in country i for the MNC.

⁶ Drucker, 2010

⁷ Weichenrieder, A.J., 2010

⁸ Büttner, 2007

2.3 Tax efficient capital structures in Multinationals

2.3.1 Debt tax shield effects

Møen, Schindler, Schjeldrup and Tropina (2011) shows that there are three debt tax shield effects that MNCs can use. They define the drivers behind the total debt to asset ratio, b_i , of an affiliate with the formula below⁹.

$$b_i = \beta_0 + \beta_1 \cdot t_i + \beta_2 \cdot \sum_{j \neq i} p_j (t_i - t_j) + \beta_3 \cdot (t_i - t_1), \forall i > 1 \quad (2.4)$$

The following paragraphs will explain each driver and the three mechanism of this formula.

The standard debt tax shield

$$b_i^{\text{Standard debt tax shield}} = \beta_0 + \beta_1 \cdot t_i$$

$$\beta_0 = \frac{\mu \cdot b^*}{\mu + \gamma}, \beta_1 = \frac{r}{\mu + \gamma}$$

t_i	Corporate tax rate of affiliate i
μ	Positive constant
γ	Positive constant
r	Rental cost of capital
b^*	Optimal external debt to asset ratio in absence of taxation in each affiliate

Figure 2.2

In chapter 2 we elaborate the effects of the standard debt tax shield. We can see that the size of the tax shield is affected by the corporate tax rate in affiliate i and will increase along with the tax shield until the FOC = 0 when $b_i^i > 0$.

External debt shifting mechanism

$$\beta_2 \cdot \sum_{j \neq i} p_j (t_i - t_j)$$

$$\beta_2 = \frac{\gamma \cdot r}{(\mu + \gamma)\mu}$$

p_j	Share of real capital employed in affiliate j in total real capital in the MNC
$t_i - t_j$	Corporate tax difference for affiliate j and the affiliates under parent company

Figure 2.3

MNCs will allocate external debt in those affiliates that produce the highest absolute tax savings hence those with the highest effective corporate tax rate¹⁰ relatively to the affiliate

⁹ Møen et al. 2011

with the lowest effective corporate tax rate. Other effects of leverage are the decreased level of free cash flow¹¹ forcing managers to run the firm as efficiently increasing the productivity.¹²

Internal debt shifting mechanism

$$\beta_3 \cdot (t_i - t_1)$$

$$\beta_3 = \frac{r}{\eta}$$

η	Positive constant
t_1	Corporate tax rate of holding, parent or affiliate with the lowest tax rate

Figure 2.4

The internal debt shifting mechanism affects the total debt-to-asset ratio through internal debt. MNCs can exploit this by maximizing the tax rate gap between the affiliates and the company's internal bank (i.e. locate the internal bank in the jurisdiction with the lowest tax rate). By doing so, company i deducts a higher level of interest payments than company/internal bank 1 has in taxable payments provided that $t_i \neq t_1$. The MNC will therefore have incentives to increase the debt-to-asset ratios in the high tax affiliates.¹³

2.4 Minority ownership structure

In regard of the two companies in this thesis, there is one main difference in the ownership structure that is not directly associated with holding, royalty and interest conduit structures. The Coca-Cola Company (KO) has minority owners, meaning they are on the stock exchange and could be bought by anybody.

A minority ownership is when:

- Joint ventures or diversified investors hold shares in the company.

¹⁰ Formula standard debt shield proves that corporate tax rates affect tax savings

¹¹ As the debt-to-asset ratio increases we assume that interest payments increases as well implying that the access to free cash flow decreases

¹²Berk, J. & DeMarzo, 2011

¹³ Møen et al. 2011

- The multinational fully controls its affiliates (Total share of minority owners < 50%)

2.4.1 Tax-efficient structure with minority shareholding

We assume that there are no overall bankruptcy costs on parent level ($C_f = 0$), the sum of minority shares in affiliate i is given by J_i , market entry costs $C_i^M(J_i)$ which are decreasing with minority shares $\frac{\partial C_i^M}{\partial J_i} < 0$ and $\frac{\partial^2 C_i^M}{\partial J_i^2} < 0$.

Setting up the economic profit in affiliate i :

$$\pi_i^e = F(K_i, L_i) - w_i \times L_i - K_i[r + C^E(b_i^E) + C^I(b_i^I)] - C_i^M(J_i) \quad (2.5)$$

Production factors are real capital - K_i and labor - L_i . The production function: $x_i = F(K_i, L_i)$ (with decreasing marginal productivities in each factor). External debt cost function (agency costs) is given by $C^E(b_i^E)$ and internal debt cost function (concealment costs) $C^I(b_i^I)$. The wage rate is set by w_i and the rental cost of capital per unit, r .

Taxable profit in affiliate i :

$$\pi_i^t = F(K_i, L_i) - w_i \times L_i - K_i[r(b_i^E + b_i^I) + C^E(b_i^E) + C^I(b_i^I)] - C_i^M(J_i) \quad (2.6)$$

2.4.2 Profit maximizing financial structure

$$\Pi p = \sum_{i=1}^n (1 - J_i)(\pi_i^e - t_i \pi_i^t) \quad (2.7)$$

where π_i^e is the economic profit in subsidiary i , π_i^t the taxable profit, and t_i the corporate tax rate in country i .

2.4.3 Optimal capital structure

$$\max \Pi_{D_i^E, D_i^I} p = \sum (1 - J_i) \{ (1 - t_i) [F(K_i, L_i) - w_i \times L_i - C_i^M(J_i)] - K_i [r(1 - t_i) [b_i^E + b_i^I] + (1 - t_i) (C^E(b_i^E) + C^I(b_i^I))] \} \quad (2.8)$$

$$s. t. \sum_i r * K_i * b_i^I = 0 \quad (2.9)$$

$$s. t. b_i^a = \frac{D_i^a}{K_i}, \quad a = \{E, I\} \quad (2.10)$$

The first order conditions to the maximization problem above lead to

$$\frac{\partial C^I(b_i^I)}{\partial b_i^I} = \frac{r*[t_i(1-J_i)-\lambda]}{(1-J_i)(1-t_i)} \geq 0 \quad (2.11)$$

$$\frac{\partial C^E(b_i^E)}{\partial b_i^E} = \frac{t_i * r}{1-t_i} > 0 \quad (2.12)$$

From the first order condition for internal debt we can see how minority ownership affects the leverage structure

$$\frac{\partial b_i^I}{\partial J_i} = - \frac{t_i * r}{\partial^2 C^I(b_i^I)(1-J_i)^2(1-t_i)} < 0 \quad (2.13)$$

We conclude with this equation that minority ownership reduces the incentive to use internal debt as a tax minimizing strategy.

3. Tax systems and tax codes

The taxation rules the MNC meet in its various jurisdictions is the key driver for its tax avoidance strategies. Companies might face taxes on income, input, output or assets, but we will in this thesis keep focus on the income tax. Income tax is levied on corporate profits, and may in certain countries include withholding tax on interest, dividends and royalties from securities owned by a non-resident. MNCs set up their tax avoidance strategies based on the different taxes they are facing, and these strategies are continuously changing, along with changes in international taxation rules and changes in the company's operations.

We will now take a look at some of the different international tax systems a MNC might be facing, give a brief summary of the tax codes in Norway, Sweden and the United States, before looking at specific rules for certain types of firms and closed jurisdictions such as tax havens and "shell corporations".

3.1 International tax systems

The two most common systems for taxing MNCs, by dividing its taxable income among its tax jurisdictions, are Separate Accounting (SA) and Formula Apportionment (FA)¹⁴.

SA is the most commonly used method, where each subsidiary's tax liability is calculated based on the laws of the jurisdiction, and all internal transactions are measured using the arms-length principle. The FA method allocates the total tax burden of the MNC among its affiliates based on the affiliates weighted portion of different variables, such as the MNCs total assets, sales or total wage expenses. We can use the following formula to better explain the FA method:

$$\pi = (1 - t_1)(\pi_1 + \pi_2) \left(\frac{K_1}{K_1 + K_2} \right) + (1 - t_2)(\pi_1 + \pi_2) \left(\frac{K_2}{K_1 + K_2} \right) \quad (3.1)$$

¹⁴ Schjeldrup, 2013

The latter is by many seen as a superior method because it divides the tax liabilities based on the actual activity in the affiliate. This means that it will be impossible for the MNC to evade taxes in any jurisdiction in which there is activity, minimizing or even eliminating the incentives for shifting profits to low tax countries through abusive transfer pricing. Still, the OECD makes use of the SA-system, giving the MNCs good incentives to continue shifting profits to low-tax countries.

3.1.1 Double taxation problem

When a company is engaged in operations in several jurisdictions, each jurisdiction as well as the company will have interests as to where each affiliate is to be taxed. In certain cases, in the lack of tax treaties and a common understanding of the fiscal situation of the multinational, a situation called double taxation might arise. OECD defines double taxation as "the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods". The double taxation problem has a harmful effect on the international exchange of goods and services, and on the movement of capital, technology and persons, and it is a common understanding that this obstacle needs to be removed. In 1992, OECD released "The OECD Model Convention on Income and on Capital. The model has been updated several times in order to address new tax issues, and aims to clarify, standardize and confirm the fiscal situation of multinationals, with the intent of removing the problem of double taxation. The OECD Model is voluntary, and aims to create mutual agreement over tax related issues across jurisdictions.

In order to eliminate double taxation, the model suggests the use of the exemption method and credit method. We will use the description of the corporate income tax system by Huizinga et.al. to explain these two systems.¹⁵

We consider a MNC headquartered in country p with a foreign subsidiary in country i . Interest income is tax deductible, and dividends to the parent company are taxed in at least one country. The subsidiary's profits are first taxed in country i at a rate of t_i . The

¹⁵ Huizinga et al. 2006

subsidiary then pays its profits as a dividend to the parent company, which might release a withholding tax from the subsidiary country equal to w_i^e . The corporate and withholding tax in the subsidiary country combined, will now equal:

$$t_i + w_i^e - t_i w_i^e. \quad (3.2)$$

The parent country might tax the income generated abroad, depending on the tax regime in this country, which might lead to double taxation. If the parent company follows a territorial or source-based tax system, the tax paid in the subsidiary will be exempted from taxation. The parent can also operate a worldwide or residence-based tax system, giving the parent a foreign tax credit on the tax paid in country i . The OECD model gives the companies an option between an exemption or a foreign tax credit. The latter will however be limited in order to prevent the domestic tax liability on foreign source income from becoming negative.

Another possibility is an indirect credit regime, where the parent will pay no additional tax if its tax rate t_p is equal to t_i . If $t_p < t_i$, the parent will have an unused foreign tax credit, while $t_p > t_i$ will mean that the parent will have to pay a tax rate in the parent country equal to the difference between t_p and t_i . With an indirect tax system, the effective tax rate on income from country i will equal $\max[t_p, t_i + w_i^e - t_i w_i^e]$.

3.2 International tax codes

In order for us to get a better view of how the MNCs can exploit local taxation laws, we will look at how tax authorities in Norway, Sweden and in the United States treat foreign income, and if there exists any favourable tax treaties with tax havens. The list of tax havens we have used is based on the list made by Ethical Consumer,¹⁶ and on the Financial Secrecy Index, developed by The Tax Justice Network.¹⁷

¹⁶ Ethical Consumer; 2012

¹⁷ Tax Justice Network; 2013

3.2.1 Norway, Sweden and USA

The countries most relevant in this thesis are Norway, Sweden and USA. By looking at the laws in these three jurisdictions, the trend is that both domestic and foreign income is taxed by the tax authorities following the global income principle, while foreign citizens are taxed on income made in each jurisdiction, following the source principle. A noticeable difference is that the United States taxes foreign income when it is repatriated. This might give MNCs incentives to keep income abroad, away from US tax authorities. We will see more of this later on. All countries practice various forms of thin-cap rules, and Sweden stands out by inducing a withholding tax on dividends paid to foreign companies.¹⁸

Norway has tax treaties with close to all listed tax havens, Sweden is lacking quite a few, while the United States barely has any tax treaties. With this in mind, we might expect that the use of tax havens will be a more central part of the tax minimization strategy for IKEA than for Coca-Cola in Norway. We might further expect that tax havens will be aggressively used by The Coca-Cola Company, due to the lack of tax treaties in the US.

3.3 Subsidiaries and Branches

When operating abroad, an important consideration for the MNC will be the choice between setting up its operation as a branch or as a wholly owned foreign subsidiary, two structures with different advantages and disadvantages in a tax perspective. The differences between these two types of entities will be central in the analysis of the business structure of Coca Cola, and their reasoning for choosing as they have when setting up foreign affiliates.

Mark Northeast, a senior tax consultant at KPMG Melbourne, defines a branch as: *"a part, division, or section of an entity that is set apart to undertake certain responsibilities or tasks."*¹⁹ As the name suggests, a branch can be considered an extension of a company, whose main objective is to carry on business and generate revenue in a foreign country.

¹⁸ Information is taken from Deloitte's tax reviews, as well as from local tax laws presented by Finansdepartementet (Norway), Skatteverket (Sweden) and IRS (USA)

¹⁹ Northeast, 1991

A subsidiary differs from a branch in the fact that it is a separate legal and corporate entity, where more than 50% of its share capital is owned by the parent company. A subsidiary has its own board of directors and can act by itself, and will also face taxes in its home country on its worldwide income.²⁰ As a shareholder, the parent company might face taxes on profits received from a subsidiary in the form of dividends, while this procedure will only be a mere internal rearrangement of funds in the use of a branch.

A clear advantage of using a branch will be that any losses should be available for use in the jurisdiction of the parent company, thus decreasing profits and tax costs at the corporate level. If the foreign affiliate is located in a low tax country, and running a profit, a subsidiary will be beneficial being that the company will be able to take advantage of the low tax rate, whereas a branch's profit will be taxed at a higher rate in the jurisdiction of the parent company.

3.4 Tax havens & other secrecy jurisdictions

A tax haven can be described as a state with low or zero income tax. The expression is relative, being that the relative differences in tax rates and tax codes between countries are the variables deciding if a country is reckoned a tax haven or not. Thus, a country might be a tax haven in some relations, whilst not in other.²¹ Tax Justice Network defines a tax haven as: *"any country or territory that promotes laws with the intent that they may be used to avoid or evade taxes which may be due in another country under that other country's laws"*.²² In the article "Harmful Tax Competition" from 1998,²³ The OECD presents four key factors identifying tax havens:

1. No or only nominal taxes
2. Lack of effective exchange of information

²⁰ Invest Brussels; 2012

²¹ Zimmer, 2009

²² Murphy et al. 2012

²³ OECD, 1998

3. Lack of transparency

4. No substantial activity

In other words, a low or zero tax-rate is not the only attractive variable for a MNC looking to minimize its total tax burden. A high level of secrecy, causing an inefficient flow of information to the MNCs home country, will be beneficial for a tax-dodger in the sense that it will allow the company to hide relevant information from tax authorities. Such information might be regarding income, assets, cash flow, business structures and ownership structures, special agreements such as trusts, and other types of information, making it impossible for tax authorities to tax the company on its actual operations. Many countries will be able to offer such secrecy to "offshore corporations", or corporations located outside the country, making them what we call secrecy jurisdictions. All countries have a certain degree of secrecy in order to prevent the leakage of sensitive information, usually with regards to personal information in the health sector, for lawyers and other sectors where sensitive information is treated. What separates tax havens and secrecy jurisdictions from other countries is the level of secrecy in sectors such as in the financial sector, where information regarding MNCs will be hard or impossible for tax authorities to obtain without signed agreements and tax treaties. Many tax havens, such as The Cayman Islands and Belize, offer special secrecy agreements for offshore corporations or International Business Companies (IBCs), positioning themselves as attractive locations for MNCs trying to avoid taxes.

As we can see from the factors presented by the OECD, tax havens are not only the tropical islands we immediately think of, with zero tax rates and small office buildings housing thousands of foreign companies, such as the Cayman Islands, Bahamas or Bermuda. A tax heaven might also be a country with a developed economy, a diversified industrial base, and a normal tax system, but with certain beneficial laws or exceptions for various activities or for certain types of companies.²⁴ In addition to the four factors mentioned above, another key driver for a country operating as a tax haven is a diverse selection of beneficial tax treaties with other countries, allowing companies to use the country as a "shell-country", where they can set up pro-forma shell-corporations, with the sole function of channelling funds from one location to another, tax free.

²⁴ Dijk et al. - The Netherlands: A Tax Haven? - SOMO-Report 2006

3.5 Shell-states

Shell-states usually differ from other states in that they possess a high number of favourable tax treaties with other countries. The shell-states usually have favourable tax legislations with little or no withholding tax, and their tax treaties often reduce or remove withholding tax from income generated in other countries. This makes for a perfect money-laundering location, where the flow of income from a company's foreign affiliates can run through and into other countries, untaxed. In chapter 4 we will describe some of the well-known strategies used by MNCs to exploit tax treaties, also referred to as treaty shopping. The Somo-Report argues that the Netherlands is one of the biggest shell-states in the world, while Luxembourg, Belgium, Ireland, The City of London, Hong Kong and Delaware, and several others, are also commonly referred to as locations used in such tax schemes. In *The Tax Free Tour*²⁵, a documentary about the increasing avoidance of taxes, it is assumed that as much as €11 trillion is routed through shell-corporations in the Netherlands each year, only for fiscal reasons. These countries all have large financial sectors with experienced people advising multinationals in their strategic planning, and are ruled by a high degree of secrecy and low transparency.²⁶ We will discuss more on the role of the different parties in chapter 4.6.

3.6 Private foundations

Certain countries have implemented strict rules and bylaws that a private foundation must follow. This is partly done to prevent individuals and companies from using foundations as their private bank accounts. In the United States the IRS has written the following rule²⁷:

“A private foundation that is not a private operating foundation must pay out, as qualifying distributions, its minimum investment return. This is generally 5% of the total fair market value of its non-charitable assets, subject to further adjustments as explained” -Part X. Minimum Investment Return

²⁵ Meerman, 2013

²⁶ Tax Justice Network - Tax us if you can; 2012

²⁷ Treasury Internal Revenue Service, Instructions for Form 990-PF (2013)

The IRS also writes that the intent is to ensure that a tax-exempt organization does not serve a private interest, but a public one. If an individual or group benefit substantially, the organization risks its tax-exempt status.²⁸ Such rules does not apply in Norway or Sweden, making private foundations attractive for fiscal reasons, something we will see when analysing IKEA.

3.7 Tax Evasion, Tax Avoidance and Tax Planning

Finnerty, Merks, Petriccione & Russo describe that from a tax authority's point of view, one might use these terms interchangeably, thinking that a dollar or euro lost in revenue due to tax evasion is the same as a dollar or euro lost in revenue due to tax avoidance. There is however a significant difference, being that Tax Evasion is illegal, while Tax Avoidance and Tax Planning is perfectly legal.²⁹

3.7.1 Tax Evasion

*"Tax Evasion is considered an illegal practice where a person, organization or corporation intentionally avoids paying his/her/its true tax liability. Those caught evading taxes are generally subject to criminal charges and substantial penalties"*³⁰

What is defined as legal or illegal practice varies between countries. Differences in taxation laws may lead to something being legal in one country while illegal in another country (Finnerty et al., 2007). Because of these differences, we cannot identify an illegal transaction from an international point of view, which makes the "war" on tax evasion even more difficult.

In 1987, the OECD gave the following definition of tax evasion in its report *International Tax Avoidance and Evasion*:

²⁸ IRS: compliance Guide for 501 (c) (3) Private Foundations

²⁹ Finnerty et al., 2007

³⁰ Investopedia; Definition of Tax Haven

"The term "tax evasion" covers: an action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax."

In other words, tax evasion can be generally defined as the direct violation of a tax provision³¹

3.7.2 Tax Avoidance and Tax Planning

Finnerty et al. (2007) points out that for most states, the difficulty is not so much to define tax evasion, but rather to distinguish tax evasion from tax avoidance and tax planning. They state the fact that taxpayers are free to arrange their affairs as they wish in order to save taxes.

The dividing line between Tax Evasion and Tax Avoidance & Tax Planning is not entirely clear. If a multinational corporation sets up a factory in a low-tax country instead of a high tax country, with the sole purpose of minimizing tax costs, the multinational is engaged in tax avoidance. If a Norwegian citizen sets up a secret bank account in a tax haven, and does not report the interest income to the government, he/she is engaged in tax evasion. The multinational is avoiding taxes in a perfectly legal way by performing tax planning, whereas the Norwegian citizen is evading taxes and might end up facing criminal charges for his/her actions.

However, there are numerous activities, particularly performed by corporations that are referred to as avoidance but could just as likely be referred to as evasion. Among these activities is so called transfer pricing, where firms charge low prices for sales to low-tax affiliates, but pay high prices for purchases from them. If the arms-length principle (see chapter 5.1.2) is not followed, this may be regarded as evasion, but due to the difficulties of finding an accurate price, and being able to find evidence to prove that mispricing has taken place, such cases rarely go to, or hold up, in court.³²

³¹ Finnerty et al., 2007

³² Gravelle, 2013

4. Tax minimization strategies

We have so far in this thesis explained the theories behind the corporate structure of both domestic firms and MNCs, and described how MNCs can use either subsidiaries or branches when doing business abroad. We have summarized the tax rules in various jurisdictions, and looked at the special cases of tax havens, other high secrecy jurisdictions, shell-countries and private foundations. In this chapter, we will use this theory to present some of the various tax minimization strategies available to MNCs. As we mentioned in chapter 3.7, there is a fine line between what is considered as tax planning or tax avoidance and what is considered illegal tax evasion. In the documentary "The Tax Free Tour", the difference between the two is described as the debt of a prison wall. Some of the strategies explained in this chapter are considered illegal, if they are used aggressively, and we have good reason to believe that these strategies are in fact being frequently used.

4.1 Transfer Pricing

4.1.1 Definition

In today's globalized world, transfer pricing has grown to be one of the most important parts of multinational enterprises tax-saving strategies. It includes terms and conditions regarding transactions between related parties, where the lack of the open market as a regulator, creates tax saving possibilities for the multinational enterprises, denying governments around the world huge amounts of tax income every year.

Transfer pricing occurs whenever two related firms trade tangible or intangible assets with each other. Transfer pricing is not illegal per se, and it is assumed that more than 60% of international trade happens within, rather than between multinational corporations.³³

In general, transfer pricing was introduced as a way of allocating costs between different affiliates and departments. The continuing increase in the globalization of markets and businesses, has made transfer pricing an important tool in management control, including

³³ Tax Justice Network; August 2012

cost allocation and performance management. Without accurate transfer prices, the multinational would not be able to separate the well performing areas of the firms from the poor performing ones.³⁴

4.1.2 Arms Length Principle

The arm's-length principle states that: "the transactions between affiliated firms must be made purely on commercial basis, both firms trying to maximize their advantage, and neither firm accommodating or favouring the other in any way".³⁵ In other words, the transfer price applied by an affiliate of a MNC, when dealing with a related affiliate, should not differ from the price used if the transaction was to take place on the open market between unrelated parties, thus using an arms length price means using the market price.

4.1.3 Incentives

For a multinational firm dealing with different tax rates in each of its affiliates, transfer pricing may be used as a tool to reduce its total tax payments and increase profits at the corporate level. We can imagine Coca Cola, producing its beverages in affiliate A and selling it in affiliate B. If the tax rate in affiliate A is higher than in affiliate B ($t_A > t_B$), Coca Cola will profit from shifting its profits away from the high-taxed affiliate (A) and into the low-taxed affiliate (B). By under-invoicing affiliate B using a low transfer price (LTP), profits in affiliate A will decrease and profits in affiliate B will increase, hence Coca Cola will reduce its total tax payments on corporate level. If, in contrast, the tax rate in affiliate A is lower than in affiliate B ($t_A < t_B$), Coca Cola will try to shift profits from the high-taxed affiliate (B) and into the low-taxed affiliate (A). Affiliate A will in this scenario over-invoice the beverages sold to affiliate B using a high transfer price (HTP), increasing profits in affiliate A while decreasing profits in affiliate B.

In the scenario described above, the government will have an easy job deciding the fair value of the traded goods, being that the goods are beverages sold all over the world on the free market. The tax saving possibilities for the MNCs occur when the traded assets are difficult to value, such as intangible assets, intellectual property, services, or other assets that are not

³⁴ Sandslätt; 2008

³⁵ Business Dictionary 2013

being traded on the free market. In the case of Coca Cola, such an intangible asset might be the syrup used in the making of the Coca Cola beverage, and the price the bottlers have to pay in order to use this syrup. It might also be different types of technology, patents, services or even knowledge.

4.1.4 Model

We will now take a look at how MNCs set their transfer prices, with the intent of saving as much as possible in tax payments. We will show how regulations from the government and tax authorities affects the MNCs use of transfer pricing, how minority ownership has an effect on the firms decisions, and also describe the arms length principle and the challenges the authorities face when dealing with suspicion of mispricing. In this section of the thesis, we will make use of the model developed by professor Guttorm Schjelderup with the Norwegian School of Economics and the Norwegian Center for Taxation (NoCeT). The model is described in the article "Multinationals and Transfer Pricing", and gives a perfectly good insight to the theories behind how the MNEs set their transfer prices.³⁶

The model describes a MNC with affiliates 1 and 2, located in country 1 and country 2. We assume that each of these two affiliates has monopolistic positions in their own market, and that the MNCs objective is to maximize its net global profits. We further assume that the MNC is able to practice systematic price discrimination between the two affiliates and their respective countries.

Firm 1 produces quantities Q_1 and Q_2 of product 1 and 2. Quantity Q_1 is sold in country 1 at a price of $P_1(Q_1)$, giving revenues equal to $R_1(Q_1) = P_1(Q_1)Q_1$.

Firm 2 imports Q_2 at a transfer price of p , and sells the product in Country 2 for $P_2(Q_2)$, earning Firm 2 revenues equal to $R_2(Q_2) = P_2(Q_2)Q_2$.

We assume a convex cost function where $\frac{\partial C}{\partial Q_i} > 0$ and $\frac{\partial^2 C}{\partial^2 Q_i} > 0$, and a concave profit

function where $\frac{\partial R}{\partial Q_i} > 0$ and $\frac{\partial^2 R}{\partial^2 Q_i} \leq 0$.

³⁶ Schjelderup, 2011

The profit functions for the two affiliates can now be written as:

$$\pi_1 = R_1(Q_1) - C(Q_1 + Q_2) + pQ_2$$

$$\pi_2 = R_2(Q_2) - pQ_2$$

In a situation without income taxes, the internal price of product Q_2 will not affect global profits, since the costs for Firm 2 will equal the income for Firm 1 when the product is sold internally. Thus, the MNC will not have any incentives to manipulate the internal price in order to shift profits. In this example, both firms are facing taxes in the country where they are located, giving tax rates of t_1 in Country 1 and t_2 in Country 2. We further assume that $t_1 < t_2$. The profits from the affiliates are repatriated to the parent company. As written earlier in this thesis (Tax Code section), the taxation of repatriated profits varies across countries. In Norway and Mexico, dividends are not subject to tax if they are sent to a corporate shareholder, being that they have already been taxed, cf. the global income principle. Dividends might be subject to tax when paid out to personal shareholders located in different countries with different taxation rules. For this reason, Schjelderup decides to investigate how the firm behaves by not taking into consideration personal dividend taxation in various countries, and rather look at how the firm maximizes profits after tax on a global level. The after tax profit for the MNC can now be written as follows:

$$\pi = (1 - t_1)\pi_1 + (1 - t_2)\pi_2$$

$$\pi = (1 - t_1)[R_1(Q_1) - C(Q_1 + Q_2) + pQ_2] + (1 - t_2)[R_2(Q_2) - pQ_2] \quad (4.1)$$

By derivating the after tax profit function with respect to the internal price p , we are able to find the first order condition (FOC)

$$\frac{\partial \pi}{\partial p} = (1 - t_1)[Q_2] + (1 - t_2)[-Q_2]$$

$$\frac{\partial \pi}{\partial p} = (t_2 - t_1)Q_2 \quad (4.2)$$

If we consider a situation where the tax rates in the two countries are equal ($t_1 = t_2$), FOC will equal zero, $\frac{\partial \pi}{\partial p} = 0$, and the optimal transfer price, p^* , will equal zero. There will be no

incentives for the MNC to manipulate its transfer price. In this model we assume $t_1 < t_2$, indicating that $FOC > 0$. In this situation, it will be optimal for the company to shift profit from the high tax country (country 2) to the low tax country (country 1), through the use of a high internal price. In order to minimize taxation for the company as a whole, it will be optimal to shift all profits to country 1, in other words by setting $\pi_2 = 0$.

The company needs to decide Q_1 , Q_2 and p in order to maximize global profits. The maximization problem can be perceived as a two-stage maximization procedure, finding the optimal transfer price p^* , and finding the optimal quantities of Q_1 and Q_2 when p^* is accounted for. The MNC wish to maximize global profits by minimizing profits in country 2. The optimal internal price will therefore give:

$$\pi_2 = (1 - t_2)[R_2(Q_2) - pQ_2] = 0$$

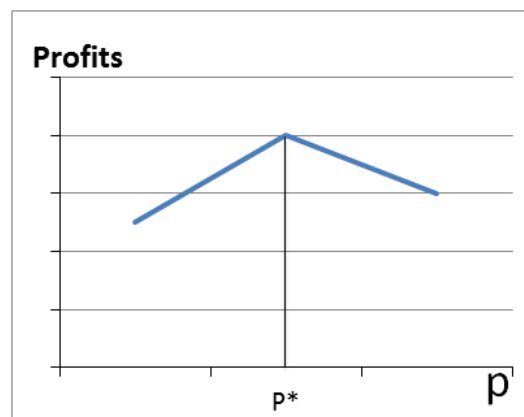


Figure 4.1

Most countries, amongst these Norway and the United States, do not allow losses in foreign controlled subsidiaries to be deducted against taxable income in the country of residence.³⁷

³⁸ A too high transfer price, causing a loss in country 2, will therefore not be deducted in country 1, and will only increase the total tax payments for the MNC, as shown in figure (4.78). With this in mind, the optimal transfer price will be equal to:

$$p^* = \frac{R_2(Q_2)}{Q_2} \tag{4.3}$$

³⁷ Regjeringen, 2006

³⁸ IRS, 2005

The next step in finding the optimal transfer price will be to insert the function for p^* into the profit function (4.1), and to maximize this. To maximize, we put $\pi_2 = 0$, which cancels out the second part of the profit function:

$$\pi = (1 - t_1)[R_1(Q_1) - C(Q_1 + Q_2) + pQ_2] + (1 - t_2)[R_2(Q_2) - pQ_2]$$

$$\pi = (1 - t_1)[R_1(Q_1) - C(Q_1 + Q_2) + pQ_2] + 0 \quad (4.4)$$

We then insert the optimal internal price: $p^* = \frac{R_2(Q_2)}{Q_2}$, giving us the following profit function:

$$\pi = (1 - t_1) \left[R_1(Q_1) - C(Q_1 + Q_2) + \frac{R_2(Q_2)}{Q_2} Q_2 \right] \quad (4.5)$$

We then derivate the profit function with respect to Q_1 and Q_2 , which gives us:

$$\frac{\partial \pi}{\partial Q_1} = (1 - t_1) \left[\frac{\partial R}{\partial Q_1} - \frac{\partial C}{\partial Q_1} \right] = 0$$

$$\frac{\partial \pi}{\partial Q_1} = (1 - t_1) [MR - MC] = 0 \quad (4.6)$$

And

$$\frac{\partial \pi}{\partial Q_2} = (1 - t_2) [MR - MC] = 0 \quad (4.7)$$

As we can see from our equations, the MNC sets its transfer price so that its marginal revenue equals its marginal cost, $MR_i = MC_i$, a common maximization strategy for a monopolist. Due to the lack of restrictions on transfer prices by local authorities, the MNC is able to operate as a monopolist, and shift all profits from the high tax country to the low tax country, minimizing its taxable income and its taxation.

4.1.5 Restricted Transfer Pricing

In certain cases, the MNC will face regulations on its internal pricing. In the example discussed above, the government in country 1 has the incentives of subjecting the transfer price, being that profits are shifted to country 2, reducing tax income for the government in country 1. In either way, when profit shifting occurs, there will always be incentives for either of the governments to question the transfer prices. In this example, Q_2 is produced in country 1, exported to country 2 and sold there. It will therefore be natural to assume that the market price of the product is public information, thus the government will be able to use this as a benchmark for setting the restricted transfer price. We can assume that the lowest possible price for the MNC, in a situation like this, will be to set its transfer price equal to its marginal costs, while the highest possible internal price will be the market price of the product.

4.1.6 Transfer-Pricing In Less Than Wholly Owned Foreign Subsidiaries

If the subsidiary located in country 2 is less than wholly owned, the MNC has to decide on an optimal transfer price, considering that a fraction of the profit in country 2 will have to be shared with the minority shareholders. For simplicity reasons, we do not add factors such as taxes or tariffs in this part of the thesis. If k equals the MNCs ownership in company 2, and we have that $0,5 < k < 1$, the profit function for the MNC will be:

$$\pi = \pi_1 + k\pi_2$$

$$\pi = [R_1(Q_1) - C(Q_1 + Q_2) + pQ_2] + k[R_2(Q_2) - pQ_2]$$

(4.8)

The MNC face the same two-way problem as described in the example of unrestricted transfer pricing, where they have to decide on an optimal transfer price p^* , Q_1 and Q_2 in order to maximize π . The FOC for the profit function derived with respect to p , gives us the following equation:

$$\frac{\partial \pi}{\partial p} = Q_2(1 - k) > 0. \tag{4.9}$$

With minority ownership, $k < 1$, and the company will have incentives of charging a high transfer price in order to shift profits from country 2 to country 1. In order to maximize profits, the MNC will set a transfer price so that $\pi_2 = 0$, giving us the following global profit function:

$$\pi = [R_1(Q_1) - C(Q_1 + Q_2) + R_2(Q_2)]$$

Minority ownership creates the same incentives as high tax rates, encouraging the MNC to shift profits away from the less than wholly owned foreign affiliate in order to avoid sharing profits. The MNC sets its transfer price equal to the way a monopolist would set its transfer price. Such profit shifting strategies should in the long run keep investors from holding shares in the foreign affiliate, being that the rewards for holding these shares should be just as high as the reward for alternative investments. With this in mind, we can ask ourselves why investors still decide to hold shares in foreign subsidiaries of MNCs? Viable reasons might be the trust in local tax authorities to prevent profit shifting from happening, in addition to the disciplinary reputational effect on stake for the MNCs.

4.1.7 Royalties

A royalty is defined as a compensation for the right to use an intangible asset, such as a patent, trademark, know-how, technology, etc.³⁹ The OECD Model Tax Convention explains that it is not a requirement that the compensated right is registered, still a royalty has to be regarded as a payment for the use or for the right to use a certain asset.⁴⁰ It is also stated in the OECD Model Art. 12-4 that the price of the royalties, agreed upon by the two related parties, shall follow the arms-length principle. The problem with royalties is the question of how to determine a fair price, or an arms-length price, on such an intangible asset as a trademark or a patent. Tax authorities will in most cases have a hard time arguing the arms-length price on such trades, giving the MNCs the possibility of shifting profits to low tax jurisdictions through the use of high royalty payments. The general principle behind the use of royalties is to compensate the party behind the research and development of the assets. A common tax avoidance strategy is to transfer the rights to the intangible asset to an

³⁹ Zimmer, 2009

⁴⁰ OECD Model Tax Convention; Art. 12-8

affiliate located in a low-tax jurisdiction or a tax haven, and maximize royalty payments from the "lenders" of the asset, located in high-tax jurisdictions. With this strategy, the MNCs will be able to transfer profits from high- to low-tax jurisdictions, and reduce their total tax payments on the corporate level.

4.2 Thin Capitalization

A company is thinly capitalized when it has a high degree of debt compared to equity. Tax jurisdictions often allow deductions of interest paid, leaving us reason to believe that there are incentives to “gear up”⁴¹ the firm. More debt most likely leads to higher interest payments, which again results in a greater value of the overall tax deduction of the firm⁴².

There are several factors that drive the decision whether or not to conduct a thin capitalization. In addition to bankruptcy- and agency-costs, other factors might be interest rates, corporate tax rates or the availability and trade off to the cost of equity in the various jurisdictions. By looking at the formula below that states the optimal capital structure one can also see that MNCs have a higher upside relatively to domestic firms and therefore also hold more incentives to increase debt. We stated in chapter 2 that there are two types of debts, external and internal. MNC’s advantage is that they can exploit different corporate tax rates by using internal debt⁴³ as they are per definition located in more than one country (see highlighted factors in formula).

$$\max \prod_{D_i^E, D_i^I} p = \sum \{ (1 - t_i) \cdot [F(K_i, L_i) - w_i \cdot L_i] - r \cdot K_i + t_i \cdot r \cdot [D_i^E + 1 \cdot D_i^I] - (1 - t_i)[C^E(b_i^E) + C^I(b_i^I)] \cdot K_i \} - C_f(b_f) - \lambda \sum_i r \cdot D_i^I$$

Formula explained: Production factors are real capital - K_i and labor - L_i . The production function: $x_i = F(K_i, L_i)$ (with decreasing marginal productivities in each factor). External debt cost function (agency costs) is given by $C^E(b_i^E)$ and internal debt cost function (concealment costs) $C^I(b_i^I)$. The wage rate is set by w_i and the rental cost of capital per unit,

⁴¹ Gearing refers to a company with a high D/A ratio

⁴² Not considering the PV(Bankruptcy costs) nor PV(Agency costs)

⁴³ Møen et al. 2011

r . D_i^I is the size of the internal debt whereas D_i^E the size of the external debt. t_i is the corporate tax rate.

To simplify the thin capitalization let us assume that the MNC's profit is only based on internal debt. Country A has a corporate tax rate of 33%, whereas country B is a tax haven and therefore has a corporate tax rate equal to 1%. The affiliate in country B lends \$100 to the affiliate in country A for a set interest equal to 15% over a 1-year period.

Action / Affiliate	A	B	A+B
B lends \$100 to A	+100	-100	0
A pays 15% in interests in year 1	-15	+15	0
B pays taxes on interest cf. country B's tax rate, 1%		-0,15	-0,15
A deducts interest paid cf. country A's tax rate, 33%	+5		+5
A pays B the money back in year 1	-100	+100	0
Net cash flow	-10	+14,85	+4,85

Figure 4.2

In addition creating a lower net income/decreased tax obligations for company A the group will also enjoy an arbitrage that generates an undiscounted \$4.85 for every \$100 dollar B lends to A⁴⁴. MNCs will therefore, without any form for thin capitalization rules, be more likely to have a higher D/A-ratio in high tax jurisdictions and locate the company's internal bank in a low tax jurisdiction or in a tax haven.

When shifting international debt, the affiliate in the high tax jurisdiction claims tax deduction on the interest expenses. *"There is evidence that multinationals excessively load those affiliates generating high net tax savings with external debt...to keep overall bankruptcy costs in check, the use of external debt in affiliates with low tax savings is reduced"*⁴⁵. In the eyes of the pecking theory we can say that if retained earnings is equal to zero, there exist no regulations on the internal debt shifting, and there is a positive taxable income, MNCs will choose internal debt as equity subsidy given perfect markets.

⁴⁴ We assume that both jurisdictions allows for tax deduction and tax interest rate equal to the corporate interest rate

⁴⁵ Ruf and Schindler, 2012

4.2.1 Thin cap rules

One challenge, as the example in the previous chapter illustrates, is that a MNC only needs one affiliate located in a country that is defined as a tax haven, or has a low corporate tax rate, to exploit the described example above. One might say that this is a jurisdictional prisoner's dilemma as more people would have been better off if we assume that it in terms will lead to higher governmental tax income and increased welfare if tax havens were non-existent. There are however, incentives for countries to operate as tax havens in terms of for example increased capital activity, by attracting more firms to the country, job creations and increased overall wage levels.

Governments have implemented thin capitalization rules as a countermeasure to this arbitrage possibility (TC-rules). Canada was the first country to introduce TC-rules (1971), Australia (1987) and the US (1989). Between the mid-nineties and 2005 a share of OECD-countries also had established TC-rules⁴⁶. The OECD supports thin capitalization rules and states that member countries are free to implement such rules, as long as the result leads to a determination of taxable basis that satisfies the arm's length principle⁴⁷. Büttner 2012 goes on and finds empirical analysis that shows thin-capitalization rules exert substantial effects on the tax-sensitivity of the capital structure. Büttner 2012 estimated that tax-sensitivity of internal debt is reduced by about a half if a country imposes a relatively strict thin-capitalization rule.

Thin capitalization rules are created to narrow the excessive debt financing and tax-revenue losses from international debt shifting.⁴⁸ There are in principle two approaches: Specific and non-specific thin capitalization rules.⁴⁹ Specific thin-capitalization rules restrict the interest deductibility for loans provided to a domestic corporation by a foreign parent or by other foreign affiliates of the controlling shareholder⁵⁰ whereas nonspecific thin capitalization

⁴⁶ Buettner et al. 2012

⁴⁷ More on the arm's length principle later on in Chapter 4.1.2

⁴⁸ Ruf and Schindler, 2012

⁴⁹ Dourado and Feria, 2008

⁵⁰ Buettner et al. 2012

rules restrict the use of debt in general.⁵¹ The mutual aim between the specific and the nonspecific is to curb excessive debt financing and tax-revenue losses from international debt shifting.⁵² We will take a further look at the different restrictions, such as the arm's length principle, controlled foreign company rules, earnings-stripping rules, bed and breakfasting, safe harbours and internal debt to asset ratio rules later on.

Møen, Schindler, Schjeldrup and Tropina (2011)⁵³ finds that an MNC's affiliate is more likely to possess a higher degree of external debt relatively to other affiliates with the same parent company if the affiliate is located in a high tax jurisdiction. If that particular jurisdiction lowers the tax levels, the bankruptcy costs for the group will increase hence making it less attractive carrying external debt for the respective affiliate. As part of the overall taxation strategy, the group will therefore allocate external debt with respect to the jurisdiction tax rate levels to minimize bankruptcy costs.

We can therefore say it is more attractive shifting both external and internal debt for multinationals compared to domestic firms, due to the fact that multinationals can exploit differences in tax rates.

4.2.2 Debt tax shield effects

Møen, Schindler, Schjeldrup and Tropina (2011) shows that there are three debt tax shield effects that MNCs can use. They define the drivers behind the total debt to asset ratio, b_i , of an affiliate with the formula below⁵⁴.

$$b_i = \beta_0 + \beta_1 \cdot t_i + \beta_2 \cdot \sum_{j \neq i} p_j (t_i - t_j) + \beta_3 \cdot (t_i - t_1), \forall i > 1$$

The following paragraphs will explain each driver and the three mechanism of this formula.

⁵¹ Ruf and Schindler, 2012

⁵² Ruf and Schindler, 2012

⁵³ Møen et al. 2011

⁵⁴ Møen et al. 2011

The standard debt tax shield

$$b_i^{\text{Standard debt tax shield}} = \beta_0 + \beta_1 \cdot t_i$$

$$\beta_0 = \frac{\mu \cdot b^*}{\mu + \gamma}, \beta_1 = \frac{r}{\mu + \gamma}$$

t_i	Corporate tax rate of affiliate i
μ	Positive constant
γ	Positive constant
r	Rental cost of capital
b^*	Optimal external debt to asset ratio in absence of taxation in each affiliate

Figure 4.3

In chapter 2 we elaborate the effects of the standard debt tax shield. We can see that the size of the tax shield is affected by the corporate tax rate in affiliate i and will increase along with the tax shield until the FOC = 0 when $b_i^i > 0$.

External debt shifting mechanism

$$\beta_2 \cdot \sum_{j \neq i} p_j (t_i - t_j)$$

$$\beta_2 = \frac{\gamma \cdot r}{(\mu + \gamma)\mu}$$

p_j	Share of real capital employed in affiliate j in total real capital in the MNC
$t_i - t_j$	Corporate tax difference for affiliate j and the affiliates under parent company

Figure 4.4

As mentioned in chapter 4.2.1 we explained that MNCs will allocate external debt in those affiliates that produce the highest absolute tax savings hence those with the highest effective corporate tax rate⁵⁵ relatively to the affiliate with the lowest effective corporate tax rate maximizing the difference illustrated in figure 4.2. Other effects of leverage are the decreased level of free cash flow⁵⁶ forcing managers to run the firm as efficiently increasing its productivity.⁵⁷

⁵⁵ Formula standard debt shield proves that corporate tax rates affect tax savings

⁵⁶ As the debt-to-asset ratio increases we assume that interest payments increases as well implying that the access to free cash flow decreases

⁵⁷Berk, J. & DeMarzo (2011)

Internal debt shifting mechanism

$$\beta_3 \cdot (t_i - t_1)$$

$$\beta_3 = \frac{r}{\eta}$$

η	Positive constant
t_1	Corporate tax rate of holding, parent or affiliate with the lowest tax rate

Figure 4.5

The internal debt shifting mechanism affects the total debt-to-asset ratio through internal debt. MNCs can exploit this by maximizing the gap between the affiliates and the company's internal bank (i.e. locate the internal bank with the jurisdiction with the lowest tax rate). By doing so, company i deduct a higher level of interest payments than company/internal bank 1 has in taxable payments provided that $t_i \neq t_1$. The MNC will therefore have incentives to increase the debt-to-asset ratios in the high tax affiliates.⁵⁸

4.3 Other tax minimization strategies

We will here explain two tax minimization strategies that are frequently used by large MNCs. We will first explain the scheme based on various articles, and then draw a figure that is solely based on its explanation.

4.3.1 Double Irish arrangement

The U.S. parent company establishes an S1, Irish affiliate and enters into a legal agreement which gives S1 rights to sell its intangible assets and do marketing on the parent company's behalf with financial back up provided by the parent company⁵⁹. The headquarters and management of the Irish S1 is located in a Tax Haven. Since most national legislations states that a company is subject to the corporate tax rulings where its management resides, the company will be subject to a corporate tax rate of 0%. The reason why S1 is incorporated in Ireland and not only in the Tax Haven is due to EU dividend policies which make it possible for EU companies to freely transfer money within the EU⁶⁰.

⁵⁸ Møen et al. 2011

⁵⁹ Schjelderup, 2013

⁶⁰ Darby, 2007

The S1 then lends the rights to its subsidiary, S2, which now bears the rights to sell and further distribute the right to international affiliates. Since the operating affiliates are lending the group's brand or intangible assets directly from S2, they are subject to pay for this in the form of royalties to S2⁶¹. These payments to S2 are tax-deductible, meaning they will end up being subject to marginal tax obligations. S2 is also subject to pay S1 for the rights and will funnel the royalties received from the operating affiliates, tax free, to S1.

A double Irish arrangement is illustrated in figure 4.6⁶²

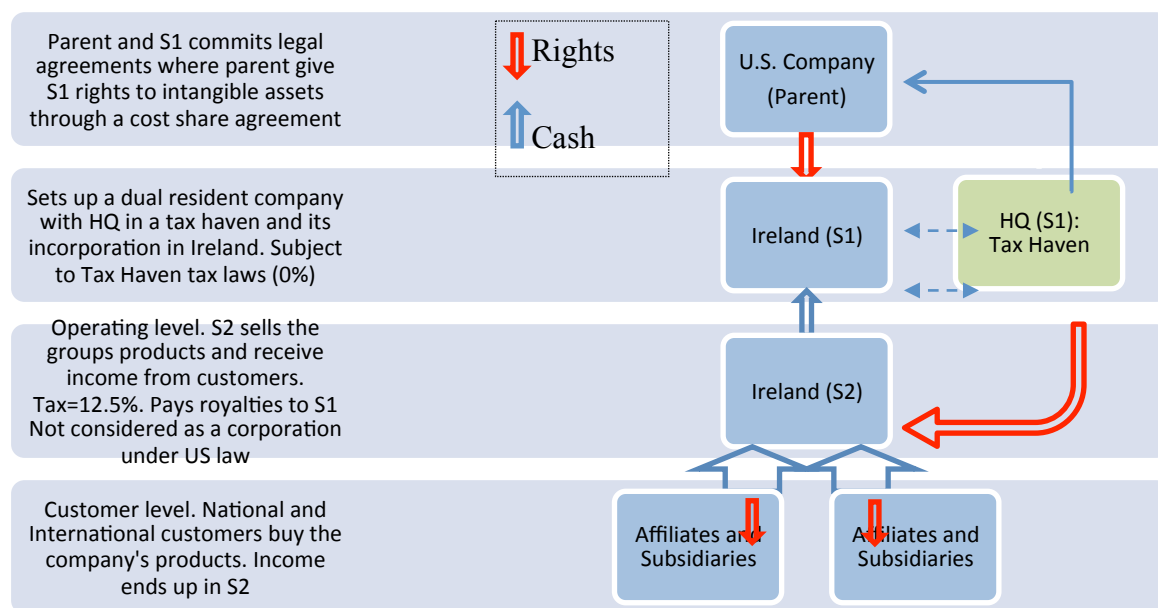


Figure 4.6

Summing up:

- The operating affiliate reduces its profit paying royalties (tax deductible) to S2.
- The Irish S2 receives the royalties from the operating affiliate which is not subject to tax obligations. The royalties are funnelled to the dual resident firm, S1, once again, tax free.
- S1's income and fortune is subject to the tax haven's tax policies which often is a synonym of 0.

⁶¹ Lowder, 2011

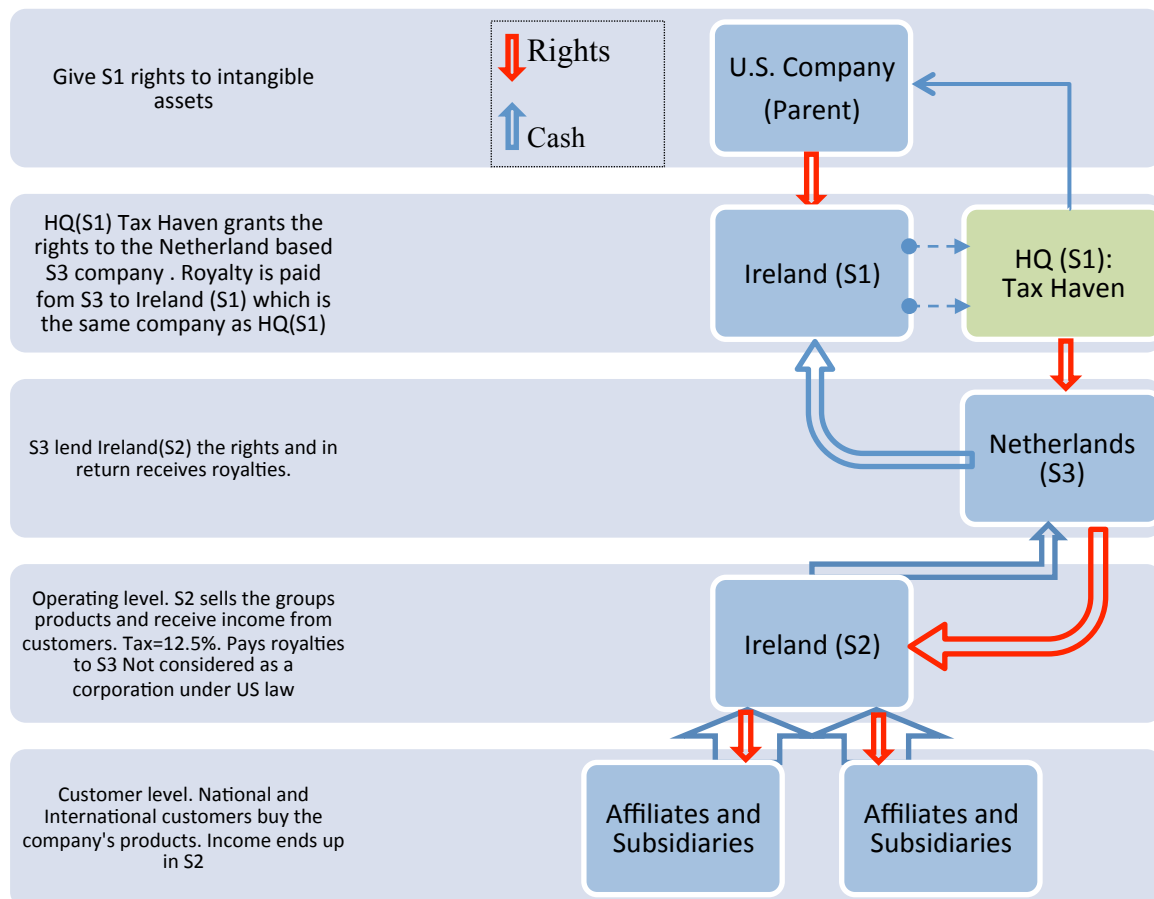
⁶² Based on this thesis's chapter 5.3

- U.S. parent and S1 have an “Advanced Pricing Agreement” (APA) which makes it possible for US firms to operate like this (APA approved by U.S. tax authorities in 2006).

4.3.2 The Dutch Sandwich

This scheme exploits the agreement between Ireland and other EU countries to further reduce their tax burdens. This structure resembles the double Irish as we saw in the previous paragraph. However, the ploy converts the double Irish into a Dutch Sandwich. The system is granting the rights from the tax haven and has the Netherlands (S3) affiliate funnelling the money between S1 and S2, which further reduces the group’s tax burdens.⁶³ The Irish tax system does not demand tax from money being moved around in Europe, implying that the funnelled money is tax-free. Incentives for this occur when the costs of tax obligations in Ireland exceed the fee of what the company located in the Netherlands requires for funnelling the money.

⁶³ Darby, 2007

Figure 4.7⁶⁴

4.3.3 The Delaware Loophole

Delaware is currently one of the most attractive tax havens in the world, and is in fact housing nearly half of all public corporations in the United States.⁶⁵ What makes this location so attractive is the easiness of establishing shell corporations (see 4.3.6) and the high degree of secrecy it allows. The companies can use these shell corporations to shift profits from other locations, in the form of royalty-payments or other revenues, to Delaware where it is not taxed. Estimations reckon that The Delaware Loophole has reduced taxes paid to other states by a massive USD \$9,5 billion over the last decade. The Coca-Cola Company is one of the many companies located in Delaware, and there is reason to believe that this is for fiscal reasons.

⁶⁴ Lowder, 2011

⁶⁵ Wayne, 2012

4.3.4 How to get the money back home

If an American profitable company has chosen a scheme like previously described (The double Irish and the Dutch sandwich) it will find itself with assets located in a tax haven. If it chooses to transfer the money back home, crossing the U.S. border, the IRS would classify it as income tax.⁶⁶ Strategies used by U.S. companies in order to avoid these obligations follow:

“U.S. companies overall use various repatriation strategies to avoid about \$25 billion a year in federal income taxes.”- Edward D. Kleinbard (Professor in law at the University of Southern California)⁶⁷

The Killer B

One of the strategies frequently used in order to get the cash back to the U.S. is called the Killer B. This manoeuvre stems from the Internal Revenue Code section 368(a)(1)(B) which deals with tax-free reorganizations⁶⁸. A U.S. company is able to sell shares to its offshore subsidiary. By doing this it will bring the cash back to the U.S, completely cash free. The foreign subsidiary can use the stock to make further acquisitions, which may on the bottom line benefit the parent. It is necessary to mention that the IRS has been increasingly thwarted this tactic since 2006⁶⁹.

⁶⁶ Lowder, 2011

⁶⁷ Quote given in Drucker 2010.

⁶⁸ Drucker, 2010

⁶⁹ Lowder, 2011

The Deadly D

The name of this manoeuvre stems from a section of U.S. tax laws. A U.S. company can receive money tax-free from its subsidiary by acquiring a company in which the ownerships get transferred to the subsidiary. By doing so, the U.S. parent can pull cash from its subsidiary limited to the purchasing price of the acquired company

The Outbound F

If a U.S. firm chooses to run this strategy it will first acquire another U.S. company with a large future cash transfer stated as a clause. The acquired firm will then be registered as a subsidiary in another country, borrow money from the previously existing sister subsidiary, and use this money to uphold the clause. Although it is a company located “offshore”, the foreign cash is not treated as dividend, but as a non-taxable payment due to the status between the parent and of the acquired company during the payment commitment.

4.3.5 Trust Company

The purpose behind a trust company can be an eventual transfer of assets to a beneficial party, management and administration on behalf of a person or a business entity. It doesn't own the company asset, but may possess legal obligation to control assets on behalf of other parties. See double Irish figure for an illustration.

4.3.6 Shell Corporations

A shell company is characterized as an entity with no active or operational businesses.⁷⁰ These entities have typically none or only a handful of employees. It may be formed ahead of commencing operations in order to obtain financing. Shell companies are making investigation troublesome for governments, individuals, courtrooms, master students and other outsiders as it often does not leave paper trail, has no phone number, e-mail or physical

⁷⁰ Garner, 1999

addresses as well as no company logo or contact person. Shell corporations aren't illegal or illegitimate, but can act as a tax minimization tool for legitimate businesses.

4.4 Indicators

It might be difficult for governments to audit MNCs thoroughly as some trust companies and shell corporations might legally withhold information⁷¹. In the following chapter we will look at indicators that are typical for subsidiaries or affiliates that large MNCs use for tax minimization. It is, however, important to emphasize that the following in this chapter are only observations from openly public information and does not necessary mean that the company uses tax avoidance strategies.

4.4.1 Ratios

As mentioned, shifting profits to low-tax jurisdiction to avoid tax obligations is a strategy. We have discussed several strategies that MNCs are using in order to minimize its worldwide tax burden such as transfer pricing and thin capitalization. The common feature is that it decreases the profit margin. In other words, tax obligations.

If we were to explore ratios to find certain deviations in the financial statements to different affiliates of a MNC, we believe to find differences both in the overall net income to gross profit-ratio as well as the net income to EBIT-ratio. Below is a brief financial statement layout that explains the different posts a MNC can increase with respect to which tax avoidance strategy it follows.

Revenue	Income from goods and/or services sold
Cost of goods sold	If a company uses transfer pricing as a tax avoidance strategy it is likely that this post is higher in high-tax jurisdictions to obtain a lower gross profit
Interest income	This post is likely to be relatively high if a company is located in a low-tax jurisdiction indicating thin capitalisation and internal debt shifting in high-tax affiliates.

⁷¹ Company bylaws might state that it is not allowed to provide foreign governments with company information

Interest expense	Visa versa: High tax affiliates can lower its EBT if this post is high due to for example if the MNC is using thin capitalisation and interest payment to lower its pre-tax earnings.
Earnings before tax (EBT)	Regardless the strategy, this post has been proven to be high in low-tax jurisdictions (effective tax rate) and low in high-tax jurisdictions (effective tax rate) as the tax rate is multiplied with this post and deducted from the company's net income. ⁷²

Figure 4.8

Grubert (2012) finds that companies with lower effective foreign tax rates have both higher foreign profit margins and lower domestic profit margins. This proves that MNCs are, intentionally (or subconsciously), shifting profits away from high-tax jurisdictions. Later we will compare Coca Cola and Ikea's profit margins with respect to the corporate tax rate.

4.4.2 Transparency

It is very typical for companies that commit to tax avoidance strategies to choose an ownership- and capital-structure that makes it difficult for outsiders to fully get the overall picture of the MNC. Although choosing a structure with limited transparency may be an indicator of tax engineering, there are other incentives as well. It might also be individuals or groups that wish to be anonymous. Either way, a structure of trust companies, shell-corporations, royalties, shell-countries, tax havens etc. within the same MNC does have a sceptic tone to it. However, we can't say if it is for tax purposes or not.

4.5 Moral hazard

During a hearing in the British Parliament in London in November 2012, representatives from Google, Amazon and Starbucks were asked about their low tax payments in the United Kingdom. The three representatives agreed that they have obligations; not only towards their shareholders, but also to the society, and that these obligations include paying their fair share of taxes. During 14 years of trading in the United Kingdom, Starbucks has paid a total of £1,6 million in corporation tax, even though their sales, their income statements, and the fact that they continue to operate in the area, suggest that their profits, and accordingly their total

⁷² Grubert, 2012

tax payments, should be much higher.⁷³ As a member of society, a society from which the companies derive huge benefits, one should expect the companies to participate in the same way as the normal workingman or -women, and pay their taxes. The moral hazard of the whole tax planning game is obvious. However, if you were given the chance to do an hour of work in order to pay half the tax you normally pay, would you not have taken it, done the work and increased your wealth? The fact is that the possibilities are there because of inefficient and non-cooperative global tax systems, and that companies, most of them with the sole purpose of making as much money as possible, will take advantage of them as much as they can. So who is responsible for these tax holes?

4.6 The actors

The accountants and auditors play a vital role in the tax avoidance game, in the fact that the big accounting firms, often referred to as the big four (EY, PWC, Deloitte & PWC), offer strategic planning advices to the MNCs. They use their expertise to help the firm achieve what they refer to as "neutral taxation" or "tax optimization", which in common English means zero tax. They can offer a huge, global network, and when the OECD identified states with unacceptable tax regulations (tax havens) in 1998, KPMG were present in 30 of 35. KPMG is managed from an office in the shell-country Switzerland, while PWCs operations are hidden in a London-based office with a claimed income of zero.⁷⁴

Because of the expertise of these people, they often end up playing a double role in the tax dodging game, where they offer services to MNCs while at the same time advising the tax authorities on how to "improve" the tax system. "The Tax Free Tour" actually points out that the new chairman of the tax authorities in the United Kingdom is a former senior partner in KPMG, and that the same is the case for Australia. This indicates that the large companies, employing the people with the highest expertise on tax matters, are actually working on the laws saying how they should be regulated, meaning that at the end of the day, the big firms are not accountable to anybody but themselves.

⁷³ Meerman, 2013

⁷⁴ Skjult; Tax Justice Network & Changemaker - used throughout this section

The MNCs are using lawyers when making large transactions, and when signing agreements within the firm or with governments regarding tax related issues. The lawyers are obliged to report any suspicious activity and any sign of money laundering, but Økokrim in Norway have criticized the low number of reports, indicating that illegalities are not being reported and that the lawyers are playing a role in these scams.

In order for the MNCs to be able to operate in tax havens, they need to have banks in these havens to deal with the money transfers. The banks often locate themselves in tax havens close to where they carry out their main operation, and we find that many South American banks locate themselves in the Cayman Islands, whereas Bermuda and Bahamas are attractive locations for banks from the United States. It is estimated that \$21,000 bn. is located in tax havens, and that the world's 50 largest banks hold \$12,100 billion of these.⁷⁵

The accountants, lawyers and bankers are nicknamed "the pin-stripe mafia" by Richard Murphy in "The Tax Free Tour", and he explains that there is a large degree of fear ruling the environment, and that this is the reason why so much illegal activity is left unreported. A whistle-blower will face the risk of losing his/her job, of destroying her profession and of being sued.

In addition to "the pin-stripe mafia", the MNCs, various other organizations and the governments, both in tax havens and in other states, are responsible for the tax holes. The MNCs and various organizations with big investments are the ones creating the need for such tax avoidance strategies, while the governments are the ones responsible for the rules in their jurisdiction. The tax havens are preventing sustainable development and a fair allocation of resources on a global basis, and the different governments are the ones best suited to put a stop to this.

In Kenya, and in many other African countries, companies are given a 10-year tax break when commencing trade. What happens after 10 years is that the company either leaves, or restructures its ownership, which initiates a new 10-year tax break. This is an example of harmful tax-codes, which are easily exploited and should be revised. We will talk more about possible solutions and taxation for the future in Chapter 10.

⁷⁵ Henry; 2012

5. Analysis of relevant literature

In the previous chapter we explained the different tax minimization strategies available to MNCs. A natural step in this thesis will now be to try and find out if the MNCs actually use these strategies. In this chapter we will make use of analyses and research regarding the use of aggressive tax planning, in order to see to what extent the different strategies are used.

5.1 Transfer pricing

There are two types of analysis possible when looking at internal prices. The first one is a direct analysis where we compare the market prices on a product or service with the internal prices used by the MNC, to check if the MNC is breaking the arms-length principle. The second one will be an indirect analysis through the use of regression, where the focus will be on different ratios, such as the profit margin, that are affected by the activity we are looking for.⁷⁶

5.1.1 Direct Analysis

Bernard et al. has studied the transfer prices used by U.S. based exporters during the 1990s, and finds significant differences in the deviation of prices, on the same products, exported to countries with different tax and tariff rates.⁷⁷ Swenson⁷⁸ and Clausing both find a strong correlation between different countries tax rates and the import prices to the U.S., on studies of transfer prices on goods imported to the U.S., respectively between 1981 - 1988 and 1997 - 1999. Clausing finds that a 1% lower tax rate in the exporting country will lead to a 1,8% lower transfer price, compared to the prices to non-related parties.⁷⁹

⁷⁶ Balsvik et al. 2009

⁷⁷ Bernard et al. 2006

⁷⁸ Swenson - 2000

⁷⁹ Clausing, 2003

5.1.2 Indirect Analysis

Klassen et al. studied geographic income shifting done by 191 U.S. multinational corporations in response to worldwide tax rate changes during 1984 - 1990. The analysis shows that after Ronald Reagan's tax reduction in 1986, pre-tax profitability for U.S.-multinationals grew by 10%.⁸⁰ Harris et al. studied the transfer-pricing practises of a pooled sample of American multinationals from 1984-1988, and found that MNCs with affiliates in tax havens had significantly lower U.S. tax liabilities than other comparable firms, proving that aggressive transfer pricing by the MNCs.⁸¹

Nordeng and Sanderud studied multinationals headquartered in Norway from 1999 - 2006, and found that Norwegian multinationals with affiliates in low tax jurisdictions reported lower profits than comparable domestic corporations during this period of time.⁸² They also found a tendency towards that profits are shifted to typical tax havens, such as Ireland, Switzerland and Singapore. In 2009, Balsvik et al. found empirical evidence that profit is being shifted both into Norway from high tax countries, and out of Norway and into low tax countries. The analysis was based on numbers from 1992 - 2005, and they assume that the total loss of tax revenue, due to the MNCs aggressive use of transfer pricing, might be as high as 30% of total possible tax income from foreign corporations. These results were tested and confirmed by Møen & Tropina in 2012, who found that foreign MNCs have 4,5 percentage points lower taxable profits than comparable Norwegian domestic firms. They also found that Norwegian MNCs have 2,5 percentage points lower taxable profits than comparable domestic firm, indicating that Norwegian firms are less aggressive in their transfer pricing than their foreign competitors.⁸³ Møen & Tropina assume that the loss of tax revenue might be as high as 40% of possible tax income.

The Swedish taxation law allows the authorities to correct transactions breaking the arms-length principle. The largest case regarding transfer pricing in Sweden took place in the 1980's, when Shell International Petroleum Company was accused of having over-invoiced

⁸⁰ Klassen et al. 1993

⁸¹ Harris et al. 1993

⁸² Nordeng & Sanderud, 2012

⁸³ Skjult - pages 60 - 63

its Swedish daughter, AB Svenska Shell, with up to 198 million SEK between 1976-1981.⁸⁴ In more recent years, Swedish AB Tetra Pak was in December 2010 found guilty by a court in Malmö, for having received only 3% contribution on research and development costs from its Swiss owner TPI, a contribution the court meant should have amounted to 7% following the transfer pricing principles by OECD.⁸⁵

5.2 Optimization of Capital Structure

5.2.1 Analysis of debt

Desai, Foley and Hines (2004) find that MNCs have a competitive advantage in comparison with domestic companies due to advantages related to the use of internal debt. By using U.S. data, MacKie-Mason (1990)⁸⁶ and Graham (1996)⁸⁷ shows evidence that tax benefits are one of the factors affecting the firm's financial structure.

Jarle Møen, Dirk Schindler, Guttorm Schjelderup and Julia Tropina (2011) find that if we were to observe a sudden 10% tax increase in MNCs with affiliates in no more than two countries, the leverage would increase by 7.4% in the high-tax country.⁸⁸ Huizinga, Laeven and Nicodème (2006)⁸⁹ find that an overall 10 percent tax increase in one country is found to increase the debt-to-asset ratio in that particular country by 2.44%, by using a sample of data from 33 European countries over the period from 1994-2003.

Torbjørn Hægeland (2003)⁹⁰ tried to find the relationship of the capital structure between affiliates and companies owned by foreigners and the equity share of Norwegian companies. The numbers, from 1998, show a significant negative correlation between foreign ownership and the equity share of the company. A Norwegian company that is wholly owned by foreign

⁸⁴ Arvidsson - p. 255 - 321

⁸⁵ Förvaltningsrätten i Malmö; Mål nr. 11615-11; Judgement of 30.12.2013

⁸⁶ Gordon et al. 1990

⁸⁷ Graham, 1996

⁸⁸ Møen et al. 2011

⁸⁹ Huizinga et al. 2006

⁹⁰ Hægeland, 2003

investors had a 7 percentage points lower equity to asset ratio compared to companies held solely by Norwegian investors.

In 2005, Han-Suck Song did an analysis on different determinants of the capital structure of Swedish firms based on about 6000 companies and panel data from 1992 to 2000. According to Han-Suck Song (2005), the non-debt tax shield⁹¹ has a significant positive effect on the short-term debt ratio as well as a negative correlation with the long-term debt ratio (Swedish short-term debt amounts to almost 50%).

5.2.2 Analysis of internal debt

Desai, Foley and Hines (2004) investigate the allocation of debt in American MNCs. Their study concludes that if the MNC experience an increase of 10% in the corporate tax rate level, the respective affiliate in that particular country will increase their leverage by 2.5%. The internal debt has a higher elasticity (i.e. it is more sensitive) than the external debt, with respectively 0.35 to 0.19. Further on, Desai, Foley and Hines (2004) states that MNCs use internal debt selective when it is cheaper than external or there is a possibility for an arbitrage.

Gertner, Scharfstein and Stein (1994) compares internal versus external debt financing and concludes that these do not have the same characteristics. MNC's internal interest costs are equal to zero, which supports the argument of Stonehill and Stitzel (1969), which is that equity and internal debt should be treated equally.

Büttner and Wamser (2007) found that the use of internal debt decreases as MNCs open up for minority ownership.

⁹¹ When total debt is decomposed into short-term and long-term debts

5.3 Use of indirect company structures, trusts and tax havens

Desai et al. finds that large international firms, typically with extensive intra-firm trade and high R&D costs, are more likely to use tax havens than others.⁹² Mintz & Weichenrieder did research on the use of holding companies in 2010, and found that MNCs from most countries in the world make use of advanced financial structures,⁹³ indicating that size is an important factor for the MNCs choice of financial structure.

Janský & Prats studied more than 1500 MNCs operating in India, and reported that in 2010, the companies with links to tax havens reported 1,5% less profits, paid 17,4% less in taxes per unit of assets and 30,3% less in taxes per unit of profit than the other firms.⁹⁴ Dyreng & Lindsey finds that U.S. multinationals with affiliates in at least one tax haven have a tax burden on worldwide income that is approximately 1,5% lower than firms with no ties to tax havens.⁹⁵

Despite the two previous researches, Møen et al. finds that most MNCs use direct structures instead of indirect structures.⁹⁶ This might question the effect of such indirect structures, or might again indicate that size is the key driver for creating such financial structures, and that the strategy is not suitable for smaller firms.

Publish What You Pay found that ten of the worlds most powerful oil, gas and mining companies own 6038 subsidiaries, and that one third of these are based in secrecy jurisdictions,⁹⁷ while the Norwegian newspaper, Aftenposten, found that 10% of the companies on the Oslo Stock Exchange had offices in tax havens.⁹⁸ This gives a clear

⁹²Desai et al. 2006

⁹³ Weichenrieder & Mintz,; 2010

⁹⁴ Janský et al.; 2013

⁹⁵ Dyreng & Lyndsey; July 2009

⁹⁶ Møen et al.; 2011

⁹⁷ Publish What You Pay; September 2011

⁹⁸ Gustavsen, Øyvind; Aftenposten 18. Oct. 2011

indication that such structures are common in Norway as well, but due to the lack of research we are not able to draw any conclusions that this is purely for fiscal reasons.

As expected, we were not able to find any research regarding the use of trusts in tax haven subsidiaries. This information is well hidden by the companies and the trusts, and little research has been done on this field.

5.4 Conclusion

On the basis of the literature presented in this chapter, we can, with a high level of certainty, conclude that both transfer pricing- and thin capitalization-strategies are being frequently used by MNCs both in Norway, Sweden and in the U.S. There is reason to believe that Norwegian MNCs are less aggressive in their transfer pricing, compared to their foreign competitors, something we might be able to see in our analysis of Coca-Cola Enterprises Norge.

The use of indirect financial structures is not clear due to lack of research, and it will therefore be interesting to see if we can find that such structures are being used by the two companies we are studying. The research we have presented states a wide usage of tax havens on a global basis, indicating that we might find an extensive use of such tax havens as well as other high secrecy jurisdictions, when analysing TCCC and IKEA.

6. Analysis: The Coca-Cola Company

We will now use The Coca-Cola Company (TCCC) as an example, and analyse how a multinational company uses the different strategies we have explained in order to minimize its tax burden. By doing so, we hope to gain a better understanding of how the different strategies work in real life, and of how the global tax system is exploited by one of the largest MNCs in the world.

Since TCCC is listed on the New York Stock Exchange (NYSE), we are fortunate enough to get access to the company's financial statements and some information regarding their ownerships and other activities. Still, we have to inform that any information about the tax strategies used by TCCC, as well as information regarding most of their foreign operations, is well hidden within the walls of the company. We have throughout this thesis only been using public information and assumptions based on the theory presented, as well as the Orbis Database.⁹⁹

6.1 Coca Cola at a glance

In general, TCCC's business can be divided into two main operations:

1. Concentrate Production
2. Bottling Investments Operation

The cornerstone of TCCC's operation is the production and sale of the Coca-Cola syrup, internally referred to as "Merchandise 7X". The company generates revenue by selling concentrate and syrup to authorized bottling and canning operations (bottlers), who then produce it into finished beverages for further distribution and sales. The bottlers are either company-owned or -controlled by TCCC through its bottling investment operation, or they operate as independent bottling partners. All bottlers have separate contracts (Bottler's Agreements) containing authorization to prepare, package, distribute and sell specified

⁹⁹ A database drifted by Bureau Van Dijk, containing information on 120 million private companies.

products under strict regulations from TCCC, where TCCC normally has complete flexibility to determine both prices and terms.¹⁰⁰

6.2 Coca Cola and taxes

TCCC's annual report states: "*Our annual tax rate is based on our income, statutory tax rates and tax planning opportunities available to us in the various jurisdictions in which we operate*".¹⁰¹ In other words, the company confirms that tax planning is a central part of their operations, and that opportunities to avoid taxes are taken advantage of.

In the fiscal year of 2013, Coca Cola reported \$2,851 million in taxes on taxable income of \$11,477 million, showing an effective tax rate of 24,8%, significantly lower than the U.S. tax-rate of 35%.

	2013
Net Revenues	46 854
Operating Costs	36 626
Operating Income	10 228
Financial Operations	1 249
Income Before Tax	11 477
Tax	2 851
Net Income	8 626

(In \$ mill.)

Figure: 6.1

We have to remember that Coca-Cola is dealing with income and taxes in all existing countries in the world, except for two. They are therefore also dealing with as many tax rates - most of them lower than the U.S. tax rate, as well as tax rules, serving a valid reason for why the effective tax rate is lower than 35%. But this does not tell the whole story. The number reported as total income tax for the company includes both current and deferred tax. The deferred tax is an unreliable source of income for the government, being that the tax might be paid next year, or never. The interesting number is therefore the one telling how

¹⁰⁰ Information is found in TCCCs 2013 Annual Report Form 10-K

¹⁰¹ Coca Cola Co.; Annual Report Form 10-K released on the 27.2.14

much tax the company actually paid, signifying money out of the company's accounts and into the hands of the government. The general rule in taxation is that profits from one year, are taxed in the following year. This might not be the same for every tax jurisdiction in the world, but in the long run, the total tax payments in one year seen in comparison to the taxable income from the previous year, will give the net effective tax rate for the company. For 2012, the effective tax rate will therefore be found by dividing the actual amount of tax paid in 2013 (2162) by the pre-tax income for 2012 (11 890). By using this rule, the effective tax rates from 2008 - 2012 are as follows:

Year	2013	2012	2011	2010	2009	2008
Pre Tax Income		11 809	11 458	14 207	8 946	7 506
Actual Tax Paid	2 162	981	1 612	1 766	1 534	1 942
Effective Tax Rate		18,3 %	8,6 %	11,3 %	19,7 %	20,4 %

(In \$ mill.)

Figure 6.2

As we can see from the numbers, the effective tax rates for the previous five years vary a lot, but are all well below what we can expect for a U.S. company. We will in the following part of this chapter try to figure out how TCCC is able to achieve such low effective tax rates. We also believe that TCCC is able to keep some of its income of its U.S. books, and therefore completely free of tax, by using advanced financial structures, including the use of tax havens and trusts. We will start by looking at the company's corporate structure. We will look at its ownerships in various affiliates, and try to figure out how The Coca-Cola Company is put together.

6.3 Corporate structure

Being that TCCC's business operation is clearly divided into two parts, concentrate production and bottling investments, we would expect the corporate structure to be so as well. This is however not the case. Studying the ownership structures of TCCC leads you into a maze of multiple-company ownerships, where you, more often than not, end up with a loose thread in the form of a company in a high-secrecy jurisdiction. Our guess is that this advanced corporate structure is created for fiscal reasons. A quick search for "coca cola" in the Orbis database leaves you with 2590 companies spread out across the globe. TCCC also

operates under several different names, in jurisdictions with a high level of secrecy. This means that you would have to be an insider in order to reveal the actual structure of the firm. We have used the information available to us, including the Orbis database, and will now present our theory of how some of the company is put together:

6.3.1 Concentrate/Syrup Production

All production of the Coca-Cola concentrate is controlled and performed directly by TCCC and its subsidiaries, and all revenue created by this activity falls to TCCC. As of December 31st 2013, TCCC had 10 concentrate-manufacturing facilities in North America, and 17 outside of North America.

We have been able to locate three of these facilities:

Atlantic Industries (Egypt)
Atlantic Industries (Ireland)
Pacific Refreshments PTE LTD (Singapore)

All three are subsidiaries of the Cayman Islands based Atlantic Industries, located in the well-known Uglan House in George Town. The information gives us reason to believe that the whole concentrate operation has been located in a tax haven, being kept away from the United States and its tax authorities. When investigating Atlantic Industries further, we find that the company has affiliates in Australia, Belgium, Denmark, Dominica, Great Britain, Hong Kong, India, Liechtenstein, Pakistan, and in the US. The spread locations of the affiliates give us further reason to believe that this is the concentrate-manufacturing operation, positioned to distribute concentrates worldwide.

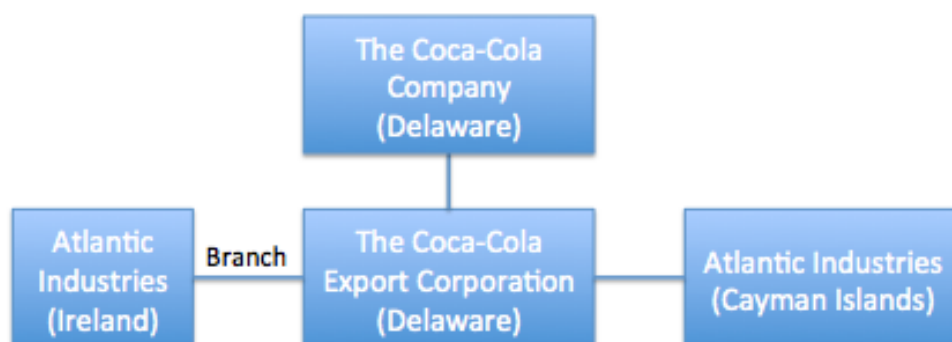


Figure 6.3

Atlantic Industries is a wholly owned subsidiary of The Coca-Cola Export Corporation, daughter of TCCC. The Coca-Cola Export Corporation operates in Ireland through their branch, coincidentally also named Atlantic Industries. By using this structure, TCCC will be able to either keep portions of the earnings from the concentrate operation off the US-books, or tax portions of the income at a favourable rate in Ireland. As we mentioned in chapter 3.3, one of the advantages of setting up a branch in a foreign subsidiary, is that losses may be added directly to the parent company. TCCC might be able to allocate costs to the affiliate in Ireland, run a deficit and use this deficit to reduce taxes on parent level. With this in mind, we believe that revenue from the concentrate operation is sent through Atlantic Industries in Cayman Islands, while costs are allocated to the branch in Ireland. The structure might be an example of a Killer B, or a similar setup as the ones explained in 4.3.3, used in order to route foreign income back to the parent company free of tax.

6.3.2 Bottling investments

Occasionally, TCCC make investments in bottling operations in order to increase control of the Coca-Cola operations and in order to increase profits. The bottling-investment segment has become an increasingly more central part of TCCC's strategy, and as of 31.12.13, TCCC had the following ownership in some of the largest Coca-Cola bottlers:

Bottler	Ownership
Coca-Cola FEMSA, S.A.B. De C.V.	28,00 % ¹
Coca-Cola HBC AG	23,15 %
Coca-Cola Amatil Limited	29,00 % ²
Coca-Cola Enterprises (CCE)	0% ³
Arca Continental S.A.B de C.V.	8,60 % ⁴

¹ Owned through The Inmex Corporation (US based subsidiary)

² Owned through Coca Cola Hldings Overseas Ltd.(Delaware, US).

³ TCCC acquired CCE in 2010, separated the North American business into a new company called Coca-Cola Refreshments Inc., and transferred the Norwegian and Swedish bottling operations to New CCE which was then listed on the NYSE

⁴ Shares owned directly by TCCC?

Figure 6.4

As mentioned earlier, and as we can see from this list, TCCC prefers indirect ownership, and usually through advanced corporate structures. A good example of this is the ownership in Coca-Cola HBC AG.

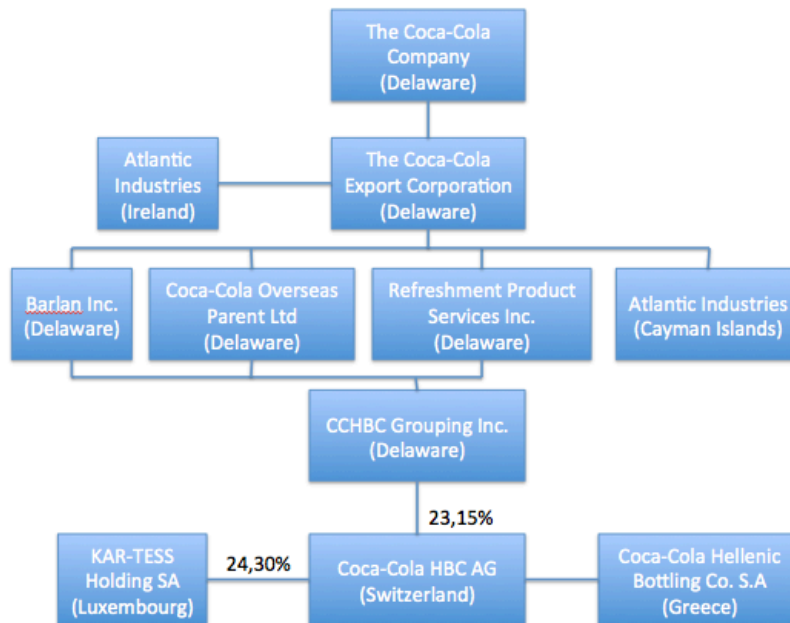


Figure 6.5

Coca-Cola HBC AG is the world's second largest independent Coca-Cola bottler, and operates in 27 countries in Europe and in Nigeria. As we can see, the ownership of the 23,15% is through an advanced structure of companies. Barlan Inc., Overseas Parent, Refreshment Product, and Atlantic Industries shared the ownership of HBC AG until April 2013, when these holdings were consolidated to CCHBC Grouping. In the same month, a shareholders' agreement between KAR-TESS Holding and TCCC's affiliates, limiting the total ownership of HBC AG for the two parties to 44%, was terminated.¹⁰² This is clear from the combined ownership share of 47,45%. KAR-TESS Holding SA is owned through a structure going from Luxembourg to Cyprus, British Virgin Islands and Bahamas before ending up in Switzerland, a structure that smells of secrecy and possible tax avoidance. A theory is that Coca-Cola may have used KAR-TESS as a trust company, being able to control a larger number of shares while looking like a minority owner. The termination of the shareholder's agreement might indicate that we can expect a change in the ownership of Coca-Cola HBC AG in the near future. Something worth mentioning is that in the SEC-filing regarding HBC AG, all seven corporations, from CCHBC Grouping to TCCC, are represented and signed for by the same person. This indicates that these companies' main activity is to function as holding companies, with little or no activity apart from this.

¹⁰² The Coca-Cola Company, SEC-filing 13G of Feb. 14th 2014

6.4 The use of subsidiaries in tax havens

As we have seen, TCCC has affiliates in several of the locations regarded as tax havens, and they seem to play a central role in the company's operations. When TCCC acquired Coca-Cola Enterprises in 2010, affiliates in British Virgin Islands, the United States Virgin Islands and the Cayman Islands were transferred to TCCC.¹⁰³ Switzerland, Luxembourg, Ireland, Hong Kong and Singapore are examples of locations from where TCCC holds several of its subsidiaries. When explaining how MNCs use offshore subsidiaries to avoid taxes, Senator Carl Levin explains that: "*Many are little more than a post office box set up to allow corporations to move profits to the low- or no-tax havens rather than reporting that income to the United States.*" By running the company from Delaware,¹⁰⁴ TCCC is able to set up shell-corporations, as described in chapter 3.5, and subsidiaries in tax havens, purely for fiscal reasons. As we saw in part 4.3.3, the Delaware Loophole is reckoned as a popular tax minimization strategy, where the scheme is that royalties and other revenues from foreign subsidiaries are paid to Delaware, free of tax. The fact that TCCC and many of its closest daughter companies are located in Delaware, states the fact that the use of tax havens is an important part of the company's tax minimization strategies. By running the company from Delaware, the company will be able to reduce its taxes, and the low transparency will make this hard for tax authorities to figure out.

Atlantic Industries is currently one of more than twelve thousand companies located in the Uglund House in the Cayman Islands. The Uglund House is known as one of the many office buildings in George Town, where companies such as TCCC locate their subsidiaries in order to stay away from US-taxation.¹⁰⁵ We believe that most of the revenue from selling the Coca-Cola concentrates ends up in the Cayman Islands, while costs are allocated to the branch in Ireland, reducing the total tax burden at corporate level as explained in chapter 3.3. There is no income or corporation tax in the Cayman Islands;¹⁰⁶ therefore, as long as the foreign earnings remain off the books in the U.S., these earnings will be free of tax for the

¹⁰³ The Coca-Cola Company, SEC-filing 13G of Feb. 14th 2014

¹⁰⁴ Coca Cola, 1919

¹⁰⁵ Evans, 2004

¹⁰⁶ Cayman Islands Information & Knowledge Portal

company. The criteria for keeping such earnings of the books in the home country, is the so-called indefinite reversal criteria, saying that the undistributed earnings must be invested by the foreign subsidiary indefinitely.¹⁰⁷ Having a look at the annual reports from The Coca-Cola Company, the amount of foreign earnings that fulfil the indefinite reversal criteria is absolutely breath taking:

Year (20-xx)	03	04	05	06	07	08	09	10	11	12	13
Undistributed Foreign Earnings (bn)	8,2	9,8	5,1	7,7	11,9	14,1	19	20,8	23,5	26,9	30,6
Growth		19 %	-48 %	51 %	55 %	18 %	35 %	9 %	13 %	14 %	14 %

Figure 6.6

As we can see from our findings, The Coca-Cola Company has been able to keep massive amounts of earnings off its books in the United States, adding up to \$30,6 bn. in 2013. The company repatriated \$6,1 bn. during the Jobs Creation Act in 2005, paying an effective interest rate of 5,25%¹⁰⁸. Since then, there have been no reports of repatriated earnings, meaning that the rest of the undistributed earnings have been "left" abroad, as a foreign cash reserve, something we can see by the growth since 2005. For U.S. tax authorities, this means a huge loss in important tax income. As we described earlier regarding efficient tax structures, we assume that all costs have been allocated to affiliates facing higher tax rates, being that it would be inefficient to allocate any costs to an affiliate located in a tax haven, unless it is a branch such as Atlantic Industries in Ireland. This means that if the tax system in the United States was working as it should, all of these earnings would have been taxed at a rate of 35%, adding a massive \$10,71 bn. in tax income over the past ten years. In others words: due to a dysfunctional tax system, the United States has lost \$10,71 bn. in tax income from TCCC over the past ten years. And this is just from one company. Imagine the total amount of earnings from all the other American multinational companies, never making it to the American books, thus never being taxed by the American authorities.

The reason why we wrote that the undistributed earnings have been "left" abroad is that this is in most situations not the case. The fact is that a lot of this cash is deposited in various banks around the world, so it is actually circulating through the economy as we speak, not

¹⁰⁷ From Coca-Colas Annual 10-K form of 2013

¹⁰⁸ The Coca-Cola Company, Annual Report 10-k Form of 2006

stuck in a foreign bank account like many people assume. The undistributed earnings cannot be used to finance business operations, but still, with this cash reserve TCCC will be able to lend money and issue bonds at a very low tax rate, meaning that the cash is still very much useful. The companies also find ways to bring that cash back home, as shown in chapter 4.3.3. TCCC amounts their cash reserve held by foreign companies to \$18,3 bn. as of December 31st 2013.¹⁰⁹ This shows that \$12,3 bn. of the \$30,6 bn. in undistributed foreign earnings have already been put to use by the company. The phrase that profit is trapped or left abroad, with no use to the company or to the economy, is wrong, and we will elaborate more on this in chapter 10.

6.5 Internal pricing

We will now check if we can find any signs to prove that TCCC is manipulating their transfer prices, i.e. that the company's transfer prices differ from the market price, breaking the arms-length principle. Our major challenge in doing so is the lack of information available to us. The main products that TCCC is selling internally are the concentrates and syrups, used by bottlers to produce the different beverages. Optimally, we would have performed a direct analysis of the internal prices used by TCCC on these products, compared to the market prices. Since these products are not traded in the open market, a direct analysis is not possible to perform, and in the absence of these prices, we will have to perform an indirect analysis of the company. By using the Orbis-database, we are able to find information and income statements from various Coca-Cola companies worldwide. When looking for irregularities in the transfer prices, we will be checking the profit margins of the various affiliates, in connection to the tax rates in the countries in which the various affiliates are operating. The profit margin is defined as gross income divided by total sales, and as described in chapter 4.4, this is one of the ratios that might indicate the use of tax minimization strategies. It is natural to assume that if TCCC is in fact manipulating its transfer prices, we will be able to see this in the form of high profit margins in countries with low tax rates, and low profit margins in countries with high tax rates. In other words, we will see signs that TCCC is shifting profits from high-tax affiliates to low-tax affiliates, as described in our theory chapter.

¹⁰⁹ TCCC; 2013 Annual Report on form 10-k; p. 63

Country	Company	Profit Margin	Tax rate
Korea	COCA-COLA KOREA INC.	-12,3	24,20 %
Slovenia	COCA-COLA HBC SLOVENSKA REPUBLIKA, S.R. O.	-12,1	17,00 %
Poland	COCA - COLA HBC POLSKA SP. Z O.O.	-5,7	19,00 %
Norway	COCA-COLA ENTERPRISES NORGE AS	-3,6	27,00 %
Great Britain	COCA-COLA BEVERAGES LTD	-3,2	21,00 %
Ireland	COCA-COLA HBC IRELAND LIMITED	-2,0	12,50 %
Philippines	COCA COLA BOTTLERS PHILIPPINES, INC.	-1,7	30,00 %
Germany	COCA-COLA ERFRISCHUNGSGETRAENKE AKTIENGESELL	-0,4	29,58 %
Italy	COCA - COLA HBC ITALIA S.R.L.	-0,2	31,40 %
Russia	LIMITED LIABILITY COMPANY COCA-COLA HBC EURASIA	-0,1	20,00 %
Croatia	COCA-COLA HBC HRVATSKA D.O.O.	0,2	20,00 %
Austria	COCA-COLA HELLENIC PROCUREMENT GMBH	0,4	25,00 %
China	COCA-COLA BOTTLERS MANUFACTURING (DONGGUAN)	0,9	25,00 %
Hungary	COCA-COLA HBC MAGYARORSZAG KORLATOLT	1,0	19,00 %
Denmark	COCA-COLA TAPPERIERNE A/S	1,9	24,50 %
Lithuania	UAB COCA-COLA HBC LIETUVA	2,9	15,00 %
Czech Republic	COCA-COLA HBC CESKA REPUBLIKA, S.R.O.	3,5	19,00 %
Greece	COCA - COLA HELLENIC BOTTLING COMPANY S.A.	3,5	26,00 %
Switzerland	COCA-COLA HBC AG	3,7	8,50 %
France	COCA-COLA ENTREPRISE	3,9	33,33 %
India	HINDUSTAN COCA-COLA BEVERAGES PRIVATE LIMITED	4,2	33,99 %
Japan	COCA-COLA WEST CO., LTD.	4,3	35,64 %
Australia	COCA-COLA AMATIL LIMITED	4,8	30,00 %
Spain	EQUATORIAL COCA COLA BOTTLING COMPANY SL	5,6	30,00 %
Malaysia	F&N BEVERAGES MARKETING SDN BHD	6,4	25,00 %
Belgium	COCA - COLA ENTERPRISES BELGIUM	6,6	33,99 %
Singapore	COCA-COLA SINGAPORE BEVERAGES PTE. LTD.	6,8	17,00 %
Serbia	COCA-COLA HELLENIC BOTTLING COMPANY-SRBIJA	7,3	15,00 %
Thailand	COCA-COLA (THAILAND) LTD	7,3	20,00 %
Argentina	EMBOTELLADORA DEL ATLANTICO S.A.	8,6	35,00 %
Romania	COCA-COLA HBC ROMANIA SRL	8,6	16,00 %
United States	COCA-COLA ENTERPRISES, INC.	9,8	35,00 %
Mexico	COCA-COLA FEMSA S.A.B. DE C.V.	11,0	30,00 %
Brazil	SPAL INDUSTRIA BRASILEIRA DE BEBIDAS S/A.	13,9	25,00 %
Netherlands	COCA-COLA ENTERPRISES NEDERLAND B.V.	14,0	25,00 %
Bulgaria	COCA COLA HELLENIC BOTTLING COMPANY BULGARIA AD	14,2	10,00 %
Great Britain	COCA-COLA ENTERPRISES LIMITED	14,4	21,00 %
Sweden	COCA-COLA ENTERPRISES SVERIGE AB	14,6	22,00 %
New Zealand	COCA-COLA HOLDINGS NZ LIMITED	15,6	28,00 %
Colombia	COCA COLA SERVICIOS DE COLOMBIA S A	23,3	25,00 %
United States	COCA-COLA COMPANY (THE)	24,5	35,00 %
United States	COCA-COLA EXPORT CORPORATION, THE	26,3	35,00 %
Luxembourg	COCA-COLA ENTERPRISES LUXEMBOURG SARL	70,9	5,76 %

Figure 6.7

Tax rates are taken from KPMG's "Corporate tax rates table".¹¹⁰

Switzerland: Corporate tax rate of 17,92%, but lowered to 8,50% due to the Swiss "Mixed company" laws. (KPMG, 2011)¹¹¹

Luxembourg: Corporate tax rate of 29,22%, lowered to 5,84% because of an 80% reduction on qualifying IP-income (KPMG, 2013)¹¹²

In Figure 6.7 the companies are sorted by profit margin, from the lowest to the highest. In order for us to have a clear proof that Coca Cola is shifting profits through manipulating their transfer prices, we would have to see a clear decrease in tax rates along with the increase in profit margins. As we can see from the table this is not the case, and we can therefore not make a conclusion regarding Coca Cola and their possible profit shifting.

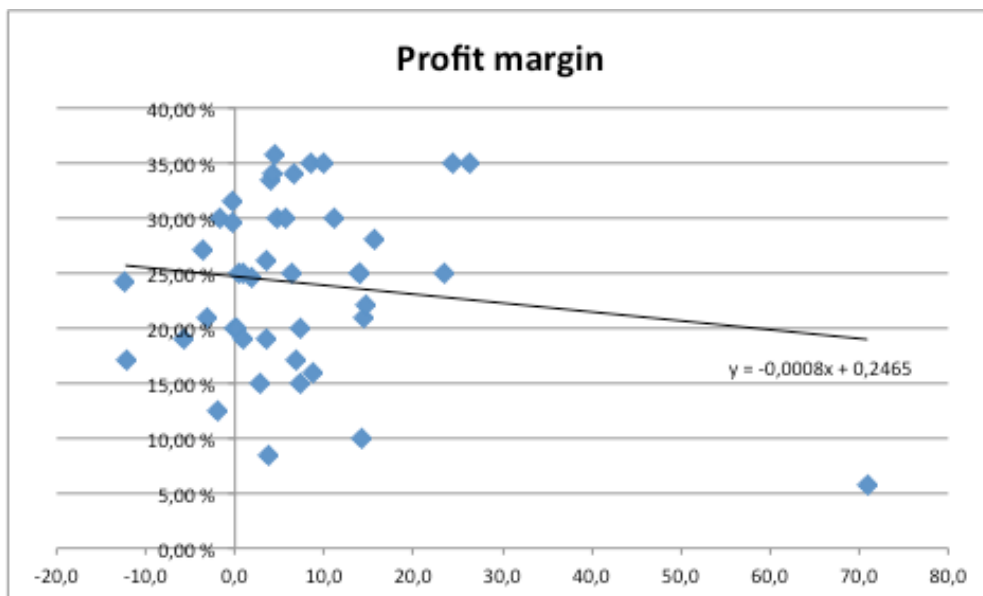


Figure 6.8

In Figure 6.8 we can see a slight trend towards increasing profit margins following the decrease in tax rates. It might be possible to prove this theory with a statistical analysis, using numbers from several Coca-Cola companies over a longer period of time, but we will not perform such an analysis in this thesis. According to Yahoo Finance, the average profit margin in the beverage and soft-drink industry is 11,80%,¹¹³ and as we can see from the

¹¹⁰ KPMG; Corporate Tax Rate Table of 2014

¹¹¹ KPMG; International Corporate Tax - IP Location Switzerland

¹¹² KPMG; Luxembourg - A Hub For Intellectual Property

¹¹³ Taken from Yahoo Fiance: <http://biz.yahoo.com/p/348conameu.html> 02.04.2014

chart, 10 out of the 43 companies operate with lower margins. It is also interesting to see that both TCCC and The Coca-Cola Export Corporation, along with CCE Luxembourg, are the three companies with the highest profit margins, being that the first two are two of the main companies located in the tax haven Delaware, and that the last one is located in Luxembourg, a country known for its favourable tax regime.

As we mentioned, the main possibility for profit shifting within TCCC is in the trading of concentrates and syrups. There are also possibilities in the production and sales of the bottles and cans produced by the company, and when the finished drinks are sold from bottlers to distributors. There are however big risks connected to manipulating these prices, especially when selling finished products, in that the actual arms-length prices are easier to measure and that any deviation from this price is illegal. A good example of this is the accusations towards TCCC made by a Cook Islands audit office. On January 28th 2013, New Zealand based Investigate Daily revealed that TCCC has been named in a Cook Island Audit Office investigation regarding a possible invoice scam. The possible scam includes Cook Island Trading Company (CITC), importer of Coca-Cola, and the Cook Island customs, with which CITC has allegedly had a hidden and very lucrative deal since 1980. During this period of time, CITC has been allowed to separate content and packaging on the products supplied by Coca Cola. By doing so, CITC has paid a normal 40% import tax on the content, but only a 10% tax on the packaging. In addition to this, by telling the customs that the actual can itself was worth nearly half the total value of the product, CITC has been able to save large amounts of tax costs.¹¹⁴ Another example is TCCC's operations in Vietnam, where the company has failed to achieve a profit ever since commencing operations in 1994, even though earnings have increased since the start up.¹¹⁵ Still, TCCC has decided to invest more money in the country. To us, this might be an indication that the company is actually making money in the country, but by using aggressive transfer pricing they are able to shift this profit away from the country and avoid local income tax.

¹¹⁴ Investigate Daily; 2013

¹¹⁵ Tuoi Tre News, 06/10/2013

6.6 Royalties

There is little or no information regarding TCCC's royalty charges for various patents, trademarks or trade secrets. What we do know is that the famous Coca-Cola syrup is being kept a trade secret. Holding an asset a trade secret instead of a patent has its advantages in that there is no application process or costs, it has immediate effect, and most importantly; it is not limited in time and therefore continues indefinitely as long as the secret is not revealed. The main risk is that there does not exist any exclusive rights for the use of the asset, and if anyone is able to copy it, anyone will be able to use or even patent it.¹¹⁶ As described in chapter 4.1.7 regarding royalties, the OECD Model Tax Convention does not require the compensated right to be registered, meaning that TCCC can charge a royalty for the use of its syrup. It will therefore be natural to assume that the company does so, but any information on the amount of royalties the various affiliates face is not available to us.

By using the Orbis-database, we know that TCCC is in possession of several patents. But without knowing anything about these patent, and about the possible royalty charges affiliates pay in order to use the connected assets, we do not want to speculate more around this aspect.

6.7 Thin Capitalization

TCCC might be able to reduce taxes by using debt, both internal and external, where interest payments will reduce taxable income. The use of internal debt is favourable, being that the interest payments never actually exits the company, and therefore is not seen as a cost but as a way of shifting profits from one affiliate to another. If TCCC uses internal debt aggressively in order to reduce taxes, we might be able to see this by comparing equity ratios to tax rates in various affiliates.

¹¹⁶ WIPO; Patents or Trade Secrets?

Country	Company	Equity ratio	Tax rate
Korea	COCA-COLA KOREA INC.	3,1	24,20 %
Italy	COCA - COLA HBC ITALIA S.R.L.	8,6	31,40 %
Ireland	COCA-COLA HBC IRELAND LIMITED	11,5	12,50 %
Netherlands	COCA-COLA ENTERPRISES NEDERLAND B.V.	20,4	25,00 %
Belgium	COCA - COLA ENTERPRISES BELGIUM	20,8	33,99 %
Malaysia	F&N BEVERAGES MARKETING SDN BHD	23,1	25,00 %
United States	COCA-COLA ENTERPRISES, INC.	23,9	35,00 %
Denmark	COCA-COLA TAPPERIERNE A/S	25,9	24,50 %
Australia	COCA-COLA AMATIL LIMITED	26,3	30,00 %
Thailand	COCA-COLA (THAILAND) LTD	31,4	20,00 %
Colombia	COCA COLA SERVICIOS DE COLOMBIA S A	35,0	25,00 %
Slovenia	COCA-COLA HBC SLOVENSKA REPUBLIKA, S.R. O.	35,1	17,00 %
Argentina	EMBOTELLADORA DEL ATLANTICO S.A.	36,3	35,00 %
China	COCA-COLA BOTTLERS MANUFACTURING	36,7	25,00 %
United States	COCA-COLA COMPANY (THE)	36,8	35,00 %
Switzerland	COCA-COLA HBC AG	41,2	8,50 %
Greece	COCA - COLA HELLENIC BOTTLING CO	41,5	26,00 %
Russia	COMPANY COCA-COLA HBC EURASIA	42,4	20,00 %
New Zealand	COCA-COLA HOLDINGS NZ LIMITED	43,4	28,00 %
Germany	COCA-COLA ERFRISCHUNGSGETRAENKE	44,5	29,58 %
Great Britain	COCA-COLA ENTERPRISES LIMITED	47,1	21,00 %
France	COCA-COLA ENTREPRISE	50,3	33,33 %
Luxembourg	COCA-COLA ENTERPRISES LUXEMBOURG SARL	50,3	5.76%
Norway	COCA-COLA ENTERPRISES NORGE AS	50,6	27,00 %
Spain	EQUATORIAL COCA COLA BOTTLING CO	51,3	30,00 %
Mexico	COCA-COLA FEMSA S.A.B. DE C.V.	54,1	30,00 %
Austria	COCA-COLA HELLENIC PROCUREMENT	57,3	25,00 %
Serbia	COCA-COLA HELLENIC BOTTLING CO-SRBIJA	61,2	15,00 %
Great Britain	COCA-COLA BEVERAGES LTD	62,1	21,00 %
Croatia	COCA-COLA HBC HRVATSKA D.O.O.	62,6	20,00 %
Hungary	COCA-COLA HBC MAGYARORSZAG	63,6	19,00 %
India	HINDUSTAN COCA-COLA BEVERAGES	63,8	33,99 %
Philippines	COCA COLA BOTTLERS PHILIPPINES, INC.	64,2	30,00 %
Poland	COCA - COLA HBC POLSKA SP. Z O.O.	64,4	19,00 %
Brazil	SPAL INDUSTRIA BRASILEIRA DE BEBIDAS	67,0	25,00 %
Japan	COCA-COLA WEST CO., LTD.	68,9	35,64 %
Sweden	COCA-COLA ENTERPRISES SVERIGE AB	69,0	22,00 %
Romania	COCA-COLA HBC ROMANIA SRL	70,4	16,00 %
Singapore	COCA-COLA SINGAPORE BEVERAGES PTE.	72,9	17,00 %
Lithuania	UAB COCA-COLA HBC LIETUVA	73,0	15,00 %
Czech Republic	COCA-COLA HBC CESKA REPUBLIKA, S.R.O.	73,8	19,00 %
Bulgaria	COCA COLA HELLENIC BOTTL CO BULGARIA	78,3	10,00 %
United States	COCA-COLA EXPORT CORPORATION	92,1	35,00 %

Figure 6.9

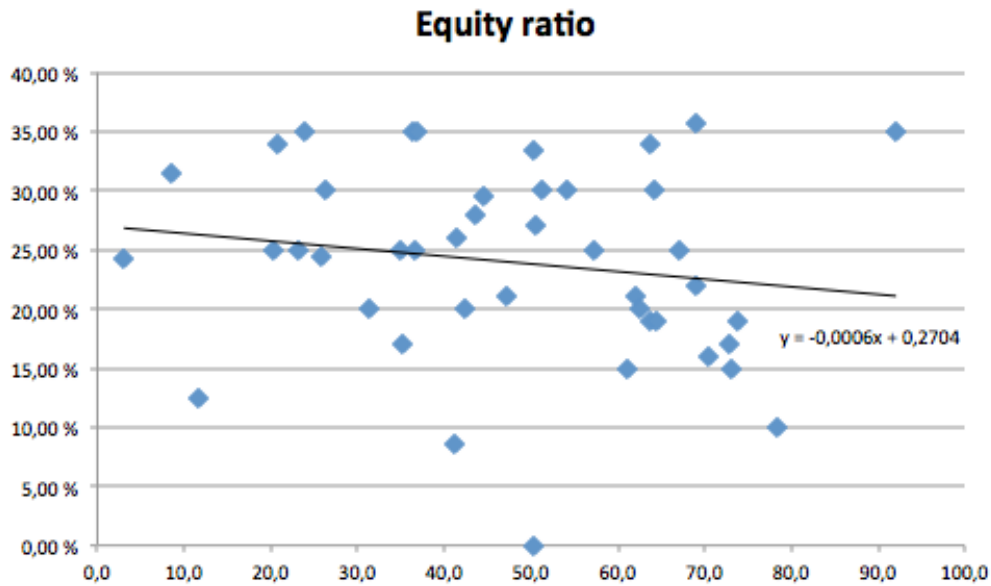


Figure 6.10

If the company is using internal debt to shift profits, we might be able to see this through a trend of low equity-ratios in countries with a high tax rate, and high equity-ratios in countries with low tax rates. As we can see from Figure 6.10, there is a slight trend pointing towards an increased level of equity in countries with low tax rates, indicating that TCCC is using debt as a profit-shifting device. We have to emphasise that we do not have any information regarding TCCCs use of internal debt, and as far as we know, no research has been done in this field. We are therefore not able to confirm any findings, and can only refer to the trend shown in Figure 6.10.

6.8 Optimal minority ownership structure

As shown in chapter 4.1.6, minority ownership is believed to have the same effect on profit shifting as tax rates, meaning that increased minority ownership gives the management incentives of shifting profits away from the affiliate and into a wholly owned affiliate. If this is the case, we would be able to see this in the form of higher profit margins in wholly owned subsidiaries compared to affiliates with minority owners. We will not analyse this any further, but would like to recommend others to test this theory.

6.9 Transparency

A factor that really increases our suspicion towards TCCC and their possible use of aggressive tax planning is the level of transparency related to financial information, business information and ownerships information. The high number of companies, many of them under various names, the complicated ownership structures and the lack of information regarding these ownerships, the lack of information regarding foreign owned subsidiaries and their finances. All of this just makes us more certain that TCCC is using aggressive tax planning in order to reduce tax payments.

6.10 Conclusion

Through this analysis, we have seen how TCCC tends to use complicated ownership structures, where tax havens seem to play important roles. We believe that the use of tax havens, trusts and complicated ownership structures, including shell companies, is part of TCCC's tax minimization strategies, and we believe that by running their concentrate operation through the Cayman Islands based Atlantic Industries, TCCC is able to channel big amounts of income through these countries at a zero or low tax rate. The fact that TCCC is located in Delaware increases the company's possibilities of shifting profits free of tax. We have shown how TCCC takes advantage of the American tax system, keeping a total of \$30,6 bn. of foreign income away from the U.S. books. This equals \$10,71 bn. in lost tax income for the U.S. government over the past 10 years. Further, we have discovered a slight indication that TCCC might be using transfer pricing and thin capitalization in order to avoid taxes. These findings are however unsure due to the lack of available information. However, the corporate structure of the company, with a base in Delaware and affiliates in several tax havens, provides a good platform for the use of such strategies. The lack of transparency in the company's finances and operational activities increases our suspicion that the company is using aggressive strategies in order to avoid taxes.

7. Analysis: Coca-Cola Enterprises Norge AS

We will in this chapter analyse Coca-Cola's operations in Norway, and see if we can find any signs of aggressive tax planning here. Since Coca-Cola Enterprises Norge AS is not listed on the stock market, the amount of available information is reduced compared to TCCC. We are therefore restricted to public general information, such as general income statements, balance sheets and cash-flow statements. This information, both regarding Coca-Cola and the various comparable firms, is taken from Proff.no, and our analysis is based on the theory previously presented in this thesis.

7.1 Introduction

Coca Cola Enterprises Norge AS (CCEN) is a daughter company of the US-based Coca-Cola Enterprises Inc., and is responsible for the production, sales and distribution of the Coca Cola Company's products in Norway, and has been since 1997.¹¹⁷ With a relatively high tax rate of 27%, Norway is one of the countries where we would expect companies to use their strategies in order to minimize taxable income, and we would like to see if, and if so, how this is done.

The company ran a deficit in 2012, for the first time since 2002, meaning that the effective tax rate was negative. The effective tax rates from the previous six years are as follows:

Year	2012	2011	2010	2009	2008	2007
Pre Tax Income	-89 880	120 748	67 911	185 235	226 634	201 211
Tax	-24 161	35 155	21 069	53 542	66 526	58 360
Tax Rate	-26,88 %	29,1 %	31,0 %	28,9 %	29,4 %	29,0 %

Figure 7.1

Because of the lack of information, we are not able to find out how much tax the company actually paid in this period. Keeping in mind that this is a domestic affiliate operating in a country with a highly developed tax system, we assume that the actual amount of tax paid does not deviate much from these numbers.

¹¹⁷ Information taken from Coca-Cola Norge's homepage

Considering the location and the developed Norwegian tax system, the tax saving possibilities for the parent occurs in the structural and operational part of the affiliate, starting with the corporate structure.

7.2 Corporate Structure

CCEN is wholly owned by CCE Holdings Norge AS, both companies located at the same address in Lørenskog, Norway. CCE Holdings Norge AS is wholly owned by Coca Cola Enterprises Belgium SPRL. This company is according to Bloomberg a joint venture of Bottling Holdings (Netherlands) B.V. and Coca Cola Enterprises Luxembourg SARL, holding 77,33% and 22,67% each respectively.

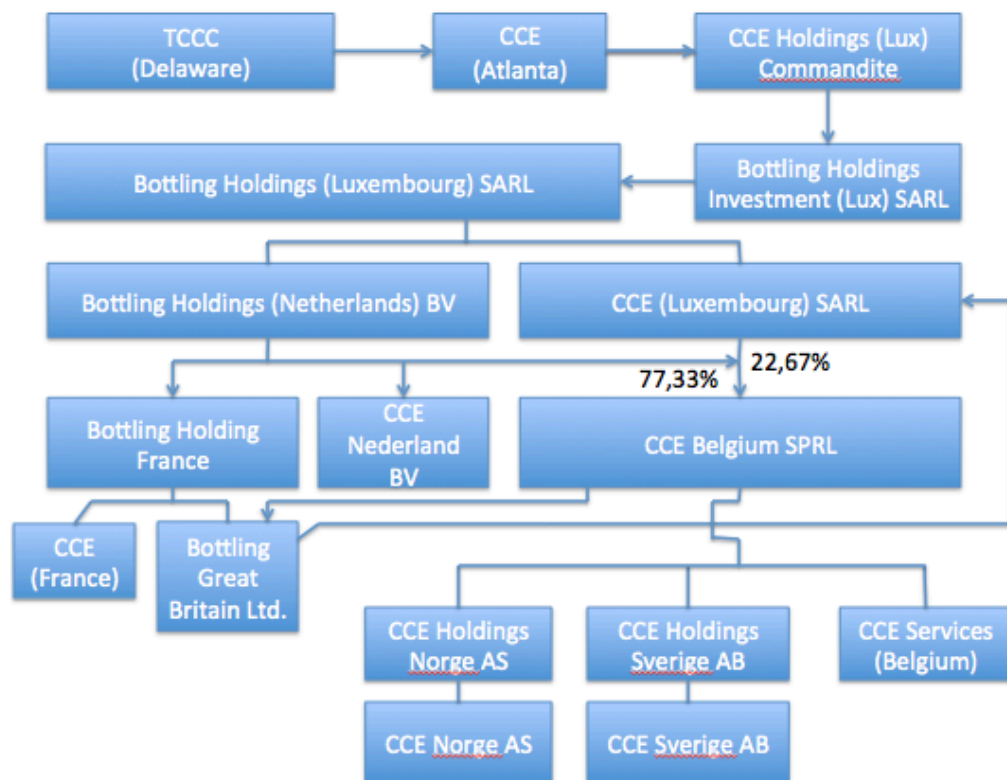


Figure 7.2

As we can see from the figure, the ownership continues through three companies located in Luxembourg, before ending up at the parent in Atlanta. This advanced corporate structure, with several affiliates located in high secrecy countries, might offer CCE a favourable tax position. Belgium is known for its many lucrative tax-treaties, while both Luxembourg and the Netherlands are known for offering tax saving possibilities to MNCs. With this in mind,

we believe that this advanced ownership structure is created for fiscal reasons, giving CCE possibilities of decreasing taxes on income made in Norway.

An important aspect of this corporate structure is that we do not know if TCCC has any direct or indirect ownership in CCE. In 2010, TCCC acquired "the old" CCE, separated the European segment and listed it on the NYSE as "new" CCE. TCCC does not have any ownership in new CCE according to their annual report 10-k form of 2013, so this is the information we will have to follow. With this in mind, it would be natural to assume that TCCC would put a high price on the goods sold to CCE, in order to maximize profits. However, TCCC has to consider that CCE is a listed company that needs to perform well in order to attract shareholders. There is also a need for bottlers to perform well if they are to continue to work for TCCC through the Bottler's Agreement. For the simplicity of our analyses, we will assume that TCCC trades goods with CCE at arm's length prices, and that CCE is responsible for deciding the transfer prices when trading internally with its different affiliates.

7.3 Internal pricing

CCEN is responsible for the production of Coca-Cola beverages in Norway, meaning that they will have to purchase concentrates, bottles and cans, and any other input that is needed to make the beverages according to the Bottler's Agreement signed with TCCC. This means that there will be internal trading between CCE and its affiliates, and CCEN, where CCE will set transfer prices in order to maximize profits on corporate level. We are not able to perform a direct analysis of these prices due to the lack of information, and will therefore perform an indirect analysis where we will compare CCEN's profit margin to the profit margins of comparable firms in the beverage-industry in Norway. We believe that CCE sells the input from an affiliate in a low-tax jurisdiction, and that it maximizes the internal prices in order to shift profits away from Norway and into the low-tax affiliate. If this is the case, we might be able to see this in the form of lower profit margins for CCEN compared to domestic firms in the same industry. As we already know from the previous analysis of Coca-Cola's international operations, the average profit margin for the beverage and soft drink industry is 11,80%, so this will be a good platform for comparison. We will compare CCEN with some of the largest beverage companies in Norway. A problem with this comparison is that several of these companies are also in the business of brewing and selling

beverages containing alcohol, an industry which has an average profit margin of 27,10%.¹¹⁸ It will therefore be natural to assume that the profit margins of the brewers will be higher than the profit margins for companies in the pure soft drink and beverage industry. Once again, the profit margin is defined as gross income divided by total sales, indicating the efficiency of the firm and the amount of profit the company gains compared to total sales.

Profit Margin					
Company	2012	2011	2010	2009	2008
Soft Drink Industry					
Coca-Cola Enterprises Norge	-3,6 %	5,0 %	2,9 %	7,8 %	9,3 %
Oskar Sylte Mineralvannsfabrikk	10,4 %	7,9 %	6,0 %	4,8 %	4,9 %
Roma Mineralvannfabrikk	5,8 %	4,5 %	0,8 %	6,4 %	5,3 %
Industry Average	11,8 %				
Soft Drink & Brewery Industry					
Aass Bryggeri AS	8,2 %	6,9 %	8,6 %	1,7 %	3,6 %
Grans Bryggeri	9,6 %	7,9 %	7,0 %	5,8 %	2,7 %
Hansa Borg Bryggerier	3,7 %	1,6 %	2,1 %	3,1 %	5,1 %
Ringnes AS	6,8 %	9,2 %	12,6 %	11,8 %	8,8 %
Industry Average	27,1 %				

Figure 7.3 ¹¹⁹

The figure indicates that the general Norwegian soft drink- and brewery-companies have a profit margin that is clearly below that of the average industry, and that this is also the case for CCEN. The profit margin for CCEN has been falling over the last five year, and it is the only company in this test with an operating deficit. The two other soft-drink companies have increased profitability during the past year. This is however not an ideal test, being that there are few comparable companies to Coca-Cola, and few companies that can match their position and size. Because of this, we cannot focus too much on these findings.

Looking at the income statement, we can see that the sales have increased for CCEN over the past year, and so have wages and depreciation. Other operating costs have increased a lot, something that could be a coincident related to actual operating matters, or it could be due to an increased use of tax minimization strategies by CCE, shifting profits away from

¹¹⁸ Average profit margin taken from: <http://biz.yahoo.com/p/346conameu.html>

¹¹⁹ Numbers and Income Statements found on proff.no

Norway. CCE reported that operating expenses at corporate level decreased by 1,5% in 2012 compared to 2011.¹²⁰ The increased operating costs in Norway does not represent the trend at corporate level, thus strengthening our theory that profit is being shifted out of Norway. Keeping in mind that Norway has just decreased their corporate tax rate by one percentage point, we might have expected a situation where the profit margin in this affiliate would have increased. However, these findings might not be related to tax avoidance at all, and might have their natural, operational explanations.

In 1000NOK	2012	2011	Change in %
Revenue	2 477 123	2 415 304	2,6 %
Cost of goods sold	1 292 202	1 247 118	3,6 %
Wages	709 423	677 574	4,7 %
Depreciation	231 139	156 552	47,6 %
Other operating costs	347 181	222 204	56,2 %
EBIT	-102 822	111 856	-191,9 %

Figure 7.4

Without seeing a clear trend over a period of time, it is hard to come to any conclusion regarding Coca-Cola Enterprises' use of internal prices to minimize taxes in their Norwegian affiliate. The findings we have made here can have their natural reasons, still, it is hard to imagine how the company can increase sales while at the same time turn a profit into a deficit, regarding their position in the market. This will be an interesting thing to look into for the years to come.

7.4 Pricing of royalties

As we have explained in chapter 4.1.7, royalties are paid in order to use a resource owned by someone else. In this example, the different affiliates pay a fee to TCCC in order to use their brand and concept.¹²¹ With a high degree of certainty, we can assume that these rights are owned by a Coca-Cola affiliate in a tax haven, probably in the Cayman Islands, thus this income will be sent to an affiliate in a tax haven and will be tax free for the company. With this in mind, it will be natural to assume that Coca Cola will set the royalty fees as high as

¹²⁰ Coca-Cola Enterprises Inc.; Annual Report on Form 10-k 2012

¹²¹ Zimmer; 2009 - Internasjonal inntektsskatterett,

possible in high tax affiliates, in order to move profit to a tax haven and reduce their overall tax burden. An increased use of royalty payments, in order to shift profits from Norway to a tax haven, might explain the increased operating costs causing the deficit in CCEN. There is however a lack of information when it comes to the various affiliates, and detailed income statements and internal payments are only available to insiders. We have, for this reason, decided not to speculate around the amount of royalties paid by CCEN, due to the fact that this would only be regarded as guessing and will not be very useful for our results in this thesis.

7.5 Thin Capitalization

The tax system in Norway makes it profitable for MNCs to increase interest payments from their foreign subsidiaries located here. By leveraging the Norwegian affiliates, the increased interest expenses will be eligible for deduction against taxable income, thus decreasing tax payment in the country. By comparing the level of debt in CCEN to the levels of debt in other companies in the same industry, we can analyse if CCEN has a lower equity ratio than what is normal. A finding like this might indicate that CCE is using thin-capitalization strategies in order to reduce taxable income in the Norwegian affiliate.

Equity ratio	
Soft Drink Industry	2012
Coca-Cola Enterprises Norge	50,6 %
Oskar Sylte Mineralvannsfabrikk	49,1 %
Roma Mineralvannfabrikk	38,4 %
Soft Drink & Breweries	
Aass Bryggeri AS	58,9 %
Grans Bryggeri	54,8 %
Hansa Borg Bryggerier	34,5 %
Ringnes AS	16,3 %

Figure 7.5

As we can see from our findings, CCEN actually has a normal to higher equity ratio than what seems to be average in these industries. Compared to Ringnes AS, which is a subsidiary of the large MNC Carlsberg Group, CCEN has a much higher equity ratio, which reduces our suspicion that CCE is shifting profit out of Norway through the use of thin capitalization.

7.6 Conclusion

In our analysis of CCEN, we have been able to find an advanced ownership structure, where ownership is passed through multiple high-secrecy countries, such as Belgium, Netherlands and Luxembourg, before ending up at CCE in the United States. This business structure represents possibilities for tax avoidance, and by looking at the deficit from CCEN we believe that such tax avoidance might be taking place. However, we have not been able to see clear irregularities with regards to thin capitalization or internal pricing when comparing profit margins and equity ratios with other firms in the industry. A high increase in costs over the last year might be seen as a sign that the use of tax minimization strategies has increased, but this trend needs to be evaluated over time, and we cannot draw any conclusions on the basis of this information. The way we see it, the highly developed tax system in Norway might make the country a less attractive location for MNCs wishing to avoid taxes.

8. Analysis: IKEA

We will in this section try to see how one of the world largest furniture retailers, IKEA,¹²² takes advantage of the tax minimization strategies available. IKEA inherits a sophisticated organizational structure. Sophisticated in terms of that it is engineered to minimize their total tax obligations and to maintain family control of the company. We want to see to what extent that is true and if so, how does it correlate with the theory described, and our theoretical propositions.

We start by describing IKEA's general structure, before we in the next chapter go back to its roots and investigate to what degree IKEA can still be called Swedish, and to what extent it avoids Swedish taxation.

8.1 IKEA at a glance

In 1982, the founder wanted to develop an ownership structure that secures IKEA's independence and a long life¹²³. He therefore formed IKEA Group, which was and still is owned by a foundation in the Netherlands, Stichting INGKA Foundation¹²⁴. Today, using Orbis database and public information, there exists in total 3 groups that can be linked to the Stichting INGKA Foundation or the Ikea Group. Figure 8.2 illustrates how these groups interconnect.

Group name	Name of parent	Country of...	
		.. parent's company	..parent's first and only subsidiary
IKEA Group	<u>Stichting INGKA Foundation</u>	The Netherlands	The Netherlands
Inter IKEA Group	INTEROGO Foundation	Liechtenstein	Luxembourg
IKANO Group	ICAF <u>Antillen NV</u>	<u>Curaçao</u>	Luxembourg

Figure 8.1

¹²² Reuters, 2008

¹²³ Ikea, 2014a

¹²⁴ Ikea, 2014b

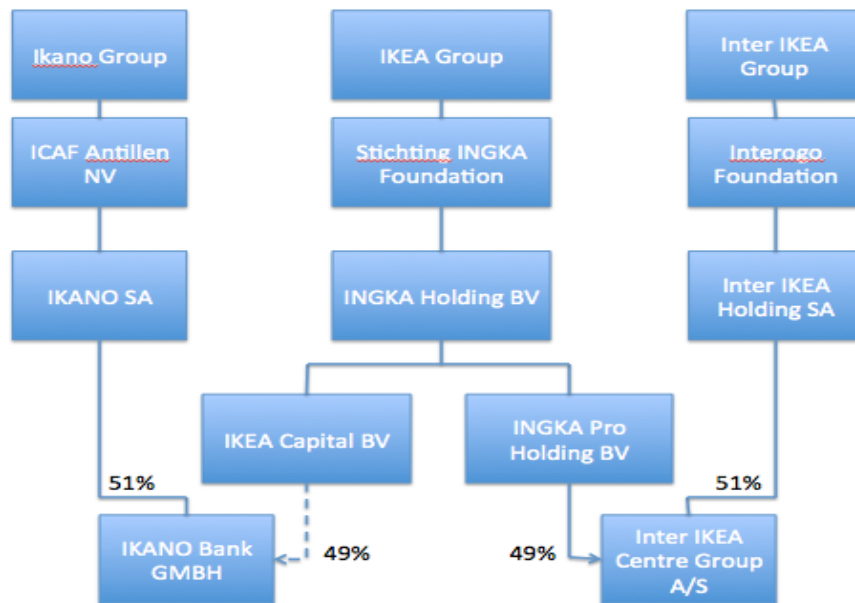


Figure 8.2

According to Inter Ikea Group's webpage, Inter IKEA Group and INGKA Group are independent from each other and have different owners. Ikea Group counts for 303 warehouses. The remaining 52 warehouses are owned by Inter Ikea Group, Ikano Group and various franchisees.¹²⁵ We will give a detailed briefing in the following chapters on how each of the three mentioned groups operate.

8.2 Ikea Group

Stichting INGKA Foundation is the final majority owner of 85%¹²⁶ of the Ikea worldwide warehouses, making it the largest franchisor. The Ikea Group is in charge of the entire supply chain, varying from its distribution centre and business development, to factoring and procurement. Each warehouse is owned by INGKA Holding B.V., which again is owned by Stichting INGKA Foundation. Each warehouse is either controlled by or ran by an Ikea hub in each Ikea-country, assisting with national staff and support functions. Next to the Stichting INGKA Foundation are the IKEA Foundation, which runs the charity side of the foundation, and the Stichting IMAS, which manages dividends from INGKA Holding BV.¹²⁷

¹²⁵ Inter Ikea Group, 2014a

¹²⁶ $303/355 = 85\%$

¹²⁷ Bloomberg, 2012a

8.2.1 Tax payments

There is little financial information available, other than what is to be found in Orbis. By looking at figure 8.3 we find that, in terms of U.S. dollars¹²⁸, the INGKA Holding B.V. revenues the last 6 years have been between \$30bn - \$38bn per annum.¹²⁹ By using the profit margin (%) we can compute the implicit EBT¹³⁰ by adjusting the formula:

$$\text{Profit Margin} = \frac{\text{EBT}}{\text{Operating Revenue}} \rightarrow \text{EBT} = \text{Profit Margin} * \text{Operating Revenue}$$

The effective tax rate is then calculated from the stated tax payments divided by the implicit earnings before tax (EBT).¹³¹ By accumulating the total tax payments from 2008 – 2013 and dividing it on accumulated earnings before tax from the same period, we find an average effective tax rate of 18% for INGKA Holding B.V. We also find an average profit margin¹³² in the same time span of 14%.

We can start by comparing the effective tax rate with the average effective tax rate of the largest U.S. and EU multinationals. In the time span from 2001- 2010, Avi-Yonah and Yaron Lahav (2011)¹³³ find that U.S. and EU multinationals have an effective tax rate of respectively 31% and 35%. These deviate 13 and 17 percentage points from INGKA Holding BV's effective tax rates¹³⁴.

In a PWC report on corporate income tax – a global analysis, however, the effective tax rate among EU and OECD countries was respectively 20.6% and 23.1% which is closer to INGKA Holding BV's implied effective tax rate in 2013 (2.6 and 5.1 percentage points).

¹²⁸ Ikea lists its revenue in terms of euros and has a steady revenue growth, currency adjusted. Since the Eurodollar fluctuates, the growth isn't that notable when listed in dollars.

¹²⁹ The Ikea fiscal year is from September – August

¹³⁰ The earnings before tax is not listed in Orbis under INGKA Holding B.V.

¹³¹ Neither the net income nor the effective tax rate is listed in Orbis under INGKA Holding B.V.

¹³² EBT on Operating Revenue

¹³³ Avi-Yonah, R. & Lahav, Y., 2011.

¹³⁴ The average numbers from Avi-Tonah, R. & Lahav (2011) are from the period 2001-2010. We compare these numbers to INGKA Holding BV effective tax rate in 2013.

INGKA Holding B.V. <i>Source: Orbis (2014)</i>	2013-08 milUSD	2012-08 milUSD	2008-08 milUSD
Operating Revenue	38 102	35 178	32 150
Sales	37 728	34 088	31 198
COGS	20 893	19 828	n.a.
Gross Profit	17 209	15 350	n.a.
Other operating expenses	11 901	10 959	28 240
Taxation	1 026	876	805
<i>Implicit Earnings Before Tax (EBT)*</i>	<i>5 416</i>	<i>4 930</i>	<i>4 172</i>
<i>Implicit Net Income**</i>	<i>4 390</i>	<i>4 053</i>	<i>3 367</i>
<i>Effective tax rate***</i>	<i>18.9%</i>	<i>17.8%</i>	<i>19.3%</i>
Profit Margin (%)	14,2	14,0	13,0
Gross Margin (%)	45.2	43.6	n.a.
Other operating expenses fraction of sales	31.5%	32.1%	90.5%

Assumptions:

*Profit margin multiplies by operating revenue

**EBT - taxation

***Taxation / (Taxation+Implicit Net Income)

Figure 8.3

8.2.2 Internal pricing

Since there are several Ikea Group-affiliates located in high secrecy jurisdictions, it will be difficult to jump to any conclusions on whether or not the Ikea Group actively uses transfer pricing. As mentioned, incentives to use transfer prices is to shift profits away from high-tax jurisdictions. By comparing the profit margin to the jurisdiction's corporate tax rate, one would believe to find a negative correlation between these if the case is that debt shifting is being used. Unfortunately, since public assessable information is limited, a significant correlation is difficult to derive.

INGKA Holding B.V. holds 89 subsidiaries according to Orbis. By searching individually on all 89, the total number of affiliates amounts to 571. We consider all of these as they most likely do business within the group. Of the 571 affiliates, only 75 provided satisfactory fiscal information for running the comparison of the affiliate's profit margin to the country's corporate tax rate.

The correlation between the profit margin and the country's tax rate of 13% of the group's affiliates¹³⁵ does not comply with the theory. With a correlation of only -0.02 we can't say if Ikea strategically is using transfer pricing as a tax minimizing strategy or not¹³⁶.

Country	Company	Profit Margin	Tax rate
GB	IKEASY LTD	-69,44 %	23,00 %
SK	SWEDWOOD SLOVAKIA, S.R.O.	-7,24 %	23,00 %
RO	IKEA ROMANIA SRL	-4,70 %	16,00 %
AT	SKANDIA LEBEN AG (AUSTRIA)	-3,64 %	25,00 %
IT	IKEA ITALIA RETAIL S.R.L.	-0,14 %	31,40 %
DK	IKEA A/S	3,66 %	25,00 %
LT	UAB IKEA INDUSTRY LIETUVA	3,86 %	15,00 %
AU	IKEA PTY LIMITED	3,94 %	30,00 %
FI	IKEA OY	4,19 %	24,50 %
FR	MEUBLES IKEA FRANCE	4,23 %	33,33 %
IE	IKEA IRELAND LIMITED	5,61 %	12,50 %
PL	SWEDWOOD POLAND SP. Z O.O.	6,15 %	19,00 %
NL	IKEA NEDERLAND B.V.	6,59 %	25,00 %
NO	IKEA AS	8,79 %	28,00 %
DK	INTER IKEA SYSTEMS A/S	15,87 %	25,00 %
SG	IKEA ASIA PACIFIC PTE LTD	23,70 %	17,00 %

Figure 8.4

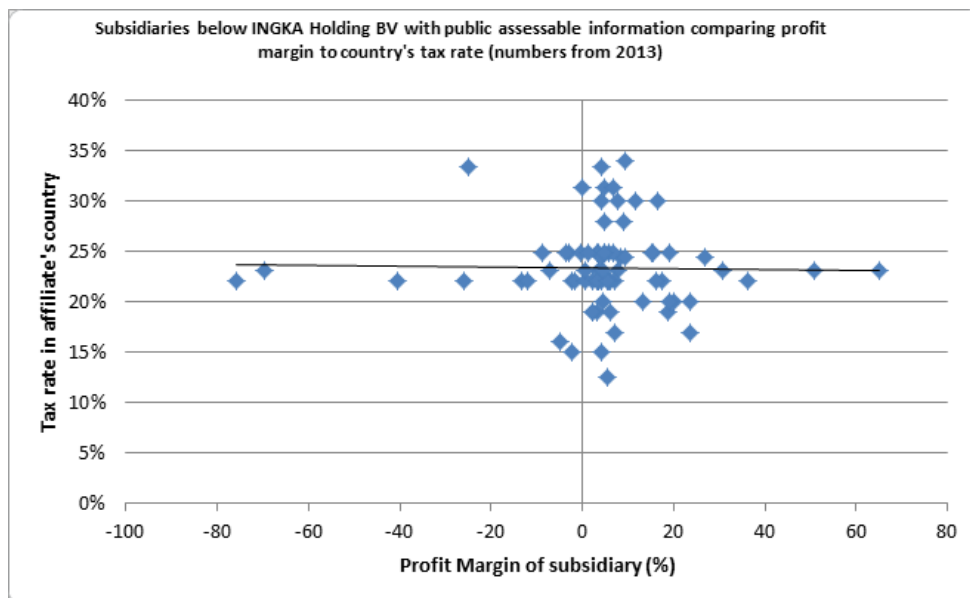


Figure 8.5

¹³⁵ $75/571 = 13\%$

¹³⁶ The full list of the affiliates with listed profit margin in Orbis is to be found in appendix x

Although we cannot conclude that Ikea uses transfer pricing as a strategy to reduce their tax obligations, certain suspicions arise. One of our questions regards the lack of transparency and the fact that the first Swedish registered company of the hierarchy in the Ikea Group is on the retail level.

We will now consider the profit margin for the top operating revenue affiliates under INGKA Holding B.V. and calculate the implicit profit margin for the rest of Ikea Group's operation. If the implicit profit margin is higher, relative to the profit margins listed below, we can suspect that profit is shifted away from these countries. The numbers are collected from Orbis. The requirement is that the affiliate is a subsidiary of INGKA Holding B.V. (and Stichting Ingka Foundation) and has publicized operating revenue and profit margin for 2013. We have not emphasized its industry as the purpose behind this exercise is to find the implicit profit margin which is independent the affiliate's industry.

Country	Company	Operating revenue mil USD 2013	% of INGKA Holding BV Op.rev.	Profit margin	Tax rate 2013
FR	MEUBLES IKEA FRANCE	3239	8,5 %	4,2 %	33,3 %
SE	IKEA AB	3008	7,9 %	3,8 %	22,0 %
NL	IKEA NEDERLAND B.V.	2228	5,8 %	6,6 %	25,0 %
IT	IKEA ITALIA RETAIL S.R.L.	2093	5,5 %	-0,1 %	31,4 %
GB	IKEA LIMITED	2032	5,3 %	3,6 %	23,0 %
BE	IKEA BELGIUM	949	2,5 %	9,3 %	34,0 %
AU	IKEA PTY LIMITED	625	1,6 %	3,9 %	30,0 %
DK	IKEA A/S	589	1,5 %	3,7 %	25,0 %
SE	IKEA OF SWEDEN AKTIEBOLAG	499	1,3 %	7,1 %	22,0 %
FI	IKEA OY	413	1,1 %	4,2 %	24,5 %
CZ	IKEA CESKA REPUBLIKA, S.R.O.	385	1,0 %	3,0 %	19,0 %
SE	IKEA COMPONENTS AB	240	0,6 %	2,4 %	22,0 %
IE	IKEA IRELAND LIMITED	138	0,4 %	5,6 %	12,5 %
IT	IKEA ITALIA PROPERTY S.R.L.	120	0,3 %	3,5 %	31,4 %
FR	DISTRIBUTION SERVICES IKEA FRANCE	120	0,3 %	4,6 %	33,3 %
FR	IKEA DEVELOPPEMENT SAS	119	0,3 %	51,9 %	33,3 %
SK	IKEA BRATISLAVA, S.R.O.	100	0,3 %	4,3 %	23,0 %
SE	IKEA INDUSTRY HULTSFRED AB	98	0,3 %	-12,1 %	22,0 %
LT	UAB IKEA INDUSTRY LIETUVA	96	0,3 %	3,9 %	15,0 %
GB	IKEA PROPERTIES INVESTMENTS LIMITED	94	0,2 %	50,9 %	23,0 %
Total fraction of INGKA Holding BV and weighted average profit margin and tax rate for group:			45,1 %	4,6 %	27,0 %

Figure 8.6

The figure above shows that 45.1% of INGKA Holding BV's operational revenue stems from the companies listed. These companies had a weighted average tax rate of 27% and a weighted average profit margin of 4.6%. From figure 8.4 we can see that the parent, INGKA Holding BV has a profit margin of 14.2% in the same period, which mean that the remaining 54.9%¹³⁷ must have an average profit margin that accounts for this.

Post	Operating revenue mil USD 31/08/2013	Percent	Profit margin
INGKA Holding BV (from figure 9.4)	38 102	100,0 %	14,2 %
Observed companies (in figure 9.7)	17 184	45,1 %	4,6 %
Remaining for INGKA Holding BV	20 918	54,9 %	22,1 %

Figure 8.7

Ikea has restricted the view/openness for the remaining 54.9% of its operational revenue. This part must account for a profit margin that is almost 5 times¹³⁸ as high, in order to add up to the parent's profit margin. Taking this into consideration, it might be a very clear indication of Ikea's profit shifting activities. The transfer pricing can take place anywhere within the supply chain.

8.2.3 Royalties

The Ikea concept is owned by Inter Ikea System B.V. Ikea's worldwide franchises marketer and seller. Inter Ikea System B.V. has set the franchise fee to 3%¹³⁹ of sales-revenue, meaning that for every dollar spent in any given Ikea store, three cents goes directly to Inter Ikea System B.V. in the Netherlands, which are then routed through or forwarded to Inter Ikea Holding SA in Luxembourg. Interogo Foundation in Lichtenstein own Inter Ikea Holding SA. The Interogo foundation's owner remains unknown, as they are protected by

¹³⁷ 100% - 45.1% = 54.9%

¹³⁸ 22.1% / 4.6% = 4.8

¹³⁹ Inter IKEA Group Annual Report 2012

the foundation's bylaws.¹⁴⁰ We will in chapter 8.3 look closer on exactly where the royalties end up.

The royalties are tax exempted. We will now show how much the Ikea group would have had to pay if they weren't. We collect the numbers from figure 8.4(INGKA Holding BV) and assume that the only change is that the franchise fee of 3% is added on the EBT (i.e. neither additional revenues nor costs except the tax difference)

INGKA Holding BV milUSD 2013	With franchise fee (figure 9.4)	Without franchise fee	Difference	Reduction in %
Sales	\$ 37 328	\$ 37 328	-	-
Franchise fee, 3% of sales	\$ 1 120	\$0	-\$1 120	-
EBT ¹⁴¹	\$ 5 416	\$6 536	+\$1 120	-17.1%
Taxation (18%) ¹⁴²	\$ 1 026	\$1 176	\$150	-12.8%

Figure 8.8

From Figure 8.8 we can see that the Ikea group reduced its EBT-post by 17.1% and that the franchise fee accounted for a reduction in tax obligations of \$150 million, or 12.8%.

8.2.4 Thin Capitalization

We will in this chapter do the same as we did when finding the implicit profit margin for those affiliates that do not have published fiscal information. We mentioned that affiliates with a high debt-to-asset ratio most likely would be located in a high tax jurisdiction, as the interests paid are tax deductible. Likewise, the low tax affiliate is more likely to be the group's internal bank. The theory described implies a negative correlation between the

¹⁴⁰ SVT, Uppdrag Granskning, 2011

¹⁴¹ Franchise fee fraction of total EBT without franchise fee.

¹⁴² By accumulating the total tax payments from 2008 – 2013 and dividing it on accumulated earnings before tax from the same period we find an average effective tax rate of 18% for INGKA Holding B.V. Decreased post: fraction of reduced tax compared to tax obligations without franchise fee.

country's tax rate and the equity-to-asset ratio (i.e. if a country has a high tax rate, the group fills this affiliate with debt). By using the same companies as in the previous section we get a correlation value of -0.25, which is an indication that the theory complies with those companies offering public fiscal information within the Ikea Group.

Company name	Country	Total assets mil USD 2013	Equity mil USD 2013	Equity to Asset Ratio	Tax rate
IKEA CESKA REPUBLIKA, S.R.O.	CZ	199	121	60,8 %	19,0 %
IKEA INDUSTRY HULTSFRED AB	SE	162	63	39,2 %	22,0 %
IKEA BRATISLAVA, S.R.O.	SK	72	21	28,8 %	23,0 %
IKEA PTY LIMITED	AU	641	168	26,3 %	30,0 %
DISTRIBUTION SERVICES IKEA FRANCE	FR	38	10	25,6 %	33,3 %
IKEA A/S	DK	318	78	24,6 %	25,0 %
IKEA ITALIA PROPERTY S.R.L.	IT	638	153	24,0 %	31,4 %
IKEA COMPONENTS AB	SE	42	10	23,7 %	22,0 %
UAB IKEA INDUSTRY LIETUVA	LT	115	25	22,0 %	15,0 %
IKEA OY	FI	86	18	20,8 %	24,5 %
IKEA DEVELOPPEMENT SAS	FR	697	135	19,3 %	33,3 %
IKEA LIMITED	GB	1 286	233	18,1 %	23,0 %
IKEA PROPERTIES INVESTMENTS LTD	GB	1 010	182	18,1 %	23,0 %
MEUBLES IKEA FRANCE	FR	677	118	17,4 %	33,3 %
IKEA OF SWEDEN AKTIEBOLAG	SE	214	37	17,1 %	22,0 %
IKEA IRELAND LIMITED	IE	125	21	16,9 %	12,5 %
IKEA AB	SE	978	134	13,7 %	22,0 %
IKEA ITALIA RETAIL S.R.L.	IT	938	121	12,9 %	31,4 %
IKEA BELGIUM	BE	361	37	10,4 %	34,0 %
IKEA NEDERLAND B.V.	NL	1 628	78	4,8 %	25,0 %
SUM, 45.1% of Ikea Group's companies		10 223	1 763	17,2 %	

Figure 8.9

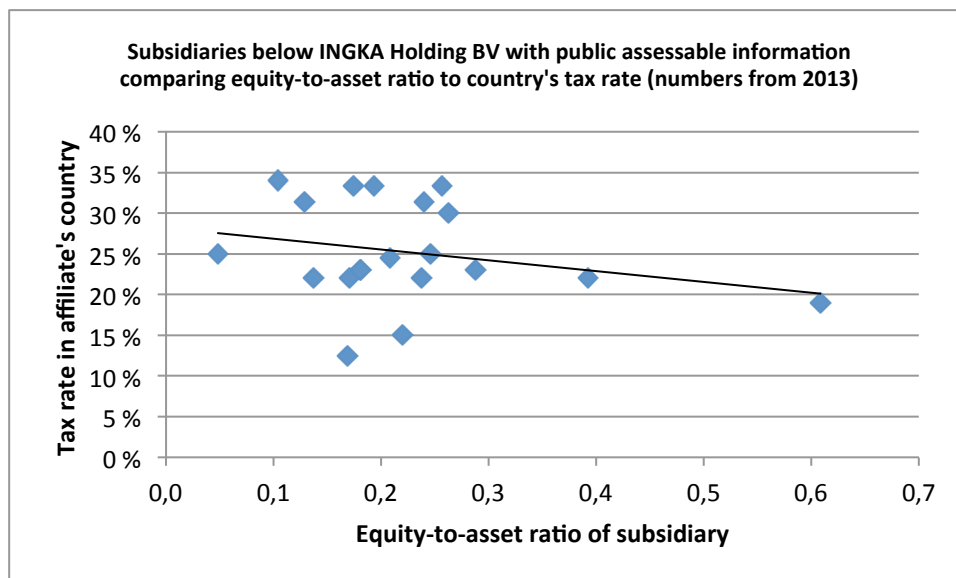


Figure 8.10

By comparing the affiliates listed in figure 8.9 to the home furnishing stores on yahoo finance¹⁴³ we find that:

Post	Equity-to-asset ratio
Home Furnishing Stores	13.9%
Ikea subsidiaries from figure 9.10	17.2%
Difference percentage points	3.3%

Figure 8.11

The Ikea subsidiaries listed in figure 8.9 have a 3.3 percentage point higher equity to asset ratio than the Home furnishing stores index on Yahoo finance. We can therefore not conclude whether or not Ikea actively uses thin capitalization as a tax minimization strategy. It is worthwhile to notice that INGKA Holding BV had an Equity-to-asset ratio in 2013 of 69.5%¹⁴⁴ which is substantial higher than its subsidiaries. However, we can't conclude anything solely based on these numbers as we need every subsidiary within the group's fiscal information to see whether or not the Ikea group shifts debt/profit.

¹⁴³ Franchise fee fraction of total EBT without franchise fee

8.2.5 Non-profit charity organization

As mentioned in the chapter introduction, the Stichting INGKA foundation is a non-profit charity organization, without tax obligations located in the Netherlands. We want to see how much it saves annually in taxes, after adjusting for charity, by having a legal entity as a charity organization. In chapter 4.6 we wrote about how the IRS has defined the consequences of being a private foundation in order to ensure that a tax-exempt organization serves public and not private interests. An organization generally has to pay out 5% of the fair market value of its non-charitable assets. With that in mind we will try to estimate a market value on Stichting INGKA foundation and compare 5% of the market value with what they give away today.

Since Ikea is not listed on the stock market we use Yahoo Finance's industry centre to convert the P/E for the market capitalization. We use the earnings from INGKA Holding BV which is wholly owned by Stichting INGKA foundation to value Stichting INGKA foundation. As of 12th of May 2014 the average P/E on Home furnishing stores was 17.3.

Implicit net income 2013 INGKA Holding BV	\$4.39bn	Figure 9.4
P/E average Home furnishing stores	17,3	Yahoo finance 12 th of May 2014
Market capitalization INGKA Holding BV	\$76bn	4.39 * 17.3
5 % of market capitalization	\$3.8bn	-

Figure 8.12

With a market capitalization of \$76bn it makes it the 86th largest company in the world¹⁴⁵. This places the company just in front of the Norwegian oil company, Statoil. Compared to other foundations it is almost twice as large as the Bill & Melinda Gates foundation, which is \$40bn as of September 2013.¹⁴⁶

The IKEA Foundation gave away €101million¹⁴⁷ to charity in 2013, equalling \$133 million USD.

¹⁴⁵ PWC, 2013

¹⁴⁶ Gatesfoundation, 2014

¹⁴⁷ Ikea Foundation, 2014

IKEA foundation charity post 2013	\$0.133bn
Royalty tax savings 2013 (figure 9.9)	\$0.150bn
5% of Stichting INGKA foundation market capitalization (figure 9.4)	\$3.8bn

Figure 8.13

As we can see the scheme handsomely reward the Stichting INGKA foundation in terms of tax exempts. The Ikea group saves roughly \$3.7bn, all else being equal, if the alternative was to use the U.S. as location for Stichting INGKA foundation instead of the Netherlands.¹⁴⁸ The overall scheme of using royalties also allows Ikea to save \$150 million annually (figure 8.14), making the net earnings between royalties and funds given to charity \$17 million each annum in Ikea's favor¹⁴⁹.

8.2.6 Chapter summary

It is a challenge to conclude whether or not Ikea is actively using transfer pricing, thin capitalization or other tax minimizing strategies due to the lack of information. However, looking at the numbers presented in this chapter and our analysis, we clearly see huge deviations in several factors. Profit margins, transparency, equity-to-asset ratios, royalties, the effective tax rate and the charity fund location, all indicates that Ikea do indeed exploit tax minimization opportunities, especially when looking at the parent of the group, Stichting INGKA foundation, which is a non-profit foundation. The fact that Ikea saves more alone on royalty payments then it gives away to charity makes it very difficult to argue to maintain a status as a charity organization when the overall scheme tips the bottom line in favour to the group.

¹⁴⁸ From figure 9.14: $\$3.8\text{bn} - \$0.133\text{bn} = \$3.667\text{bn}$

¹⁴⁹ From figure 9.14: $\$0.15\text{bn} - \$0.133\text{bn} = \$0.017\text{bn} = \17million

8.3 Inter IKEA Group

The Inter Ikea Group can be seen as the real Ikea, as it is the owner of the IKEA trademarks and the IKEA Concept¹⁵⁰ (i.e. intellectual property assets). The purpose of this group is, according to their webpage, to secure a continuous improvement and secure a long life of the Ikea concept.¹⁵¹ The group has Interogo foundation as its main global ultimate owner¹⁵² and inherits a sophisticated structure.

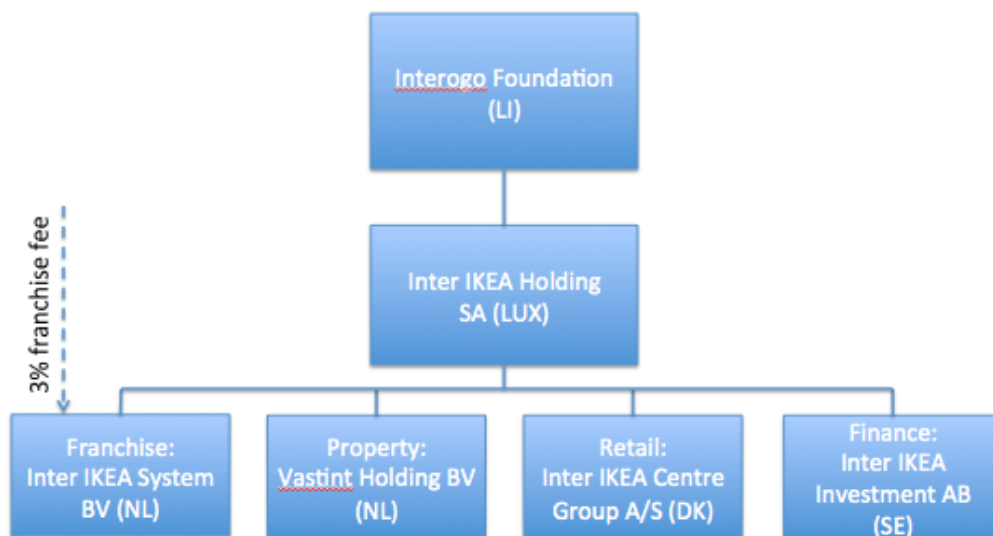


Figure 8.14

The Inter IKEA Group consists of four divisions, namely:

- The Franchise Division
- The Retail Centre Division
- The Property Division
- The Finance Division

¹⁵⁰ Inter Ikea Group, 2014b

¹⁵¹ Inter Ikea Group, 2014c

¹⁵² See attachment A

8.3.1 Tax payments

Inter Ikea Holding SA, which is the parent of the division, is hiding large parts of their financial statement. We have collected numbers from the annual report¹⁵³ and the remaining from Orbis. We have also derived the implied values between the numbers provided from our two sources. Unfortunately, the most recent figures are from 2011 and 2012. The result will still be relevant, even though the information is 2 years old. We use different EUR/USD ratios as this ratio has been quite volatile over the last 2 years.

INTER IKEA HOLDING SA	2012 <u>milUSD</u> EURUSD = 1.27	2011 <u>milUSD</u> EURUSD = 1.40
Operating revenue / Turnover (<i>annual report</i>)	\$3 378	\$3 404
<i>Franchise revenues (% of turnover)</i>	<i>\$1 023(30%)</i>	<i>\$1 070(31%)</i>
Implicit COGS	\$2 161	\$3 117
EBITDA (<i>annual report</i>)	\$1 217	\$287
Other operating expenses and depreciation	\$1 226	\$301
EBIT (<i>orbis</i>)	-\$9	-\$14
Financial revenue (<i>orbis</i>)	\$484	\$628
Taxation (<i>orbis</i>)	\$0,07	\$0,8
EBT	\$431,07	\$473,8
Net income (<i>orbis</i>)	\$431	\$473
Effective tax rate	0.01%	0.17%
Profit margin	12.8%	13.9%

Figure 8.15

The figure above shows that Inter Ikea Holding SA had an effective tax rate of 0.17% and 0.01%, respectively in 2011 and 2012. This is a remarkably low effective tax rate compared to the average EU multinationals from PWCs report on corporate income tax – a global analysis, which was 20.6%. 20.6% on its earnings before tax in 2012 makes \$89 million. We can assume that its financial revenues are exempted from tax payments (interests and dividends within the same group in EU aren't taxable income).

In addition, we notice that the franchise revenues that stems from Ikea's original core industry, its warehouses, in 2011 and 2012 only accounted for 31% and 30%. The remaining 70% of the revenues may origin from the other three divisions or other non-mentioned income sources in the franchise division.

¹⁵³ Inter Ikea Group, 2014d

8.3.2 Internal Pricing

As mentioned under the Ikea group chapter, finding any evidence to prove the use of transfer pricing will be difficult. Inter Ikea Holding SA has 8 direct subsidiaries and 59 indirect, making it 67 in total. Of the 8 direct subsidiaries, few of them have public fiscal information available in Orbis. This make an analysis equal to the one we did under the chapter of the Ikea group more or less useless due the low number of observations.

Country	Company	Profit Margin (2012)	Tax rate
SE	INTER IKEA INVESTMENTS AB	-25,94 %	22,00 %
DK	INTER IKEA CENTRE GROUP A/S	-0,54 %	25,00 %
NL	INTER IKEA SYSTEMS B.V.	na	25,00 %
NL	VASTINT HOLDING B.V.	na	25,00 %
LU	INTER IKEA HOLDING SA	12,80 %	28,80 %

Figure 8.16

Based on single observations we can see that the affiliate in Sweden has a negative profit margin of almost -26% in 2012. However, due to the lack of public information we find problems extending the profit margin analysis.

Ikea group and Inter Ikea group are two different legal entities. Although they write on their webpages that they are separate, they are co-owners in the Inter Ikea Centre Group A/S. Both Orbis and Inter Ikea's annual report from 2012 confirm this. To say exactly why this has been chosen is very difficult, but it certainly open up the possibility for internal pricing between the two groups.

8.3.3 Royalties

Inter Ikea System BV received \$1 120 million in royalties from the Ikea group in 2013¹⁵⁴. We can find the value of the trademark in Inter Ikea's annual report. We can read that the value for Inter IKEA System BV's intangible assets equalled €9,000million, (\$11,430 million) as of 31st of December 2012. €9 000mil was paid from Inter Ikea Systems SA to the

¹⁵⁴ Assuming 3% of INGKA Holding BV sales

Interogo foundation in January 2012.¹⁵⁵ Although the owner of the Ikea rights changed, Inter Ikea System SA still pays rents as the purchase was financed by¹⁵⁶:

IKEA Trademark value 2013	€ 9 000mil (\$11 430mil)
<i>Share premium issuance</i>	€ 3 600mil (\$4 572mil)
<i>Debt</i>	€ 5 400mil (\$6 858mil)

Figure 8.17

Both posts issued by Interogo foundation means that Inter Ikea System SA still has to pay rent and dividends to Interogo foundation, which will lower the group's tax obligations. Inter Ikea System BV affiliate administer/lend the trademark.

8.3.4 Thin capitalization

We can find the following numbers from the Orbis-database:

Inter Ikea System SA subsidiaries	Country ISO Code	Total assets mil USD 2012	Shareholders' funds mil USD 2012	Solvency ratio (Asset based) % 2012
INTER IKEA INVESTMENTS AB	SE	257	27	10.5%
INTER IKEA SYSTEMS B.V.*	NL	n.a.	n.a.	n.a.
VASTINT HOLDING B.V.	NL	487	407	83.4%
INTER IKEA CENTRE GROUP A/S	DK	3 160	924	29.0%

Figure 8.18

One indicator that strengthen the theory that Inter Ikea is actively using thin capitalization as a way to reduce tax obligations can be seen on the equity-to-asset ratio. The affiliates from Sweden and Denmark possess a relatively lower equity-to-asset ratio compared to the Vastint Holding BV, which is located in the Netherlands. The Netherlands is a very attractive jurisdiction for holding equity, as companies can commit private agreements with the tax authorities, dismissing them from tax payments.

¹⁵⁵ Bloomberg, 2012b

¹⁵⁶ Inter Ikea Group, 2012d

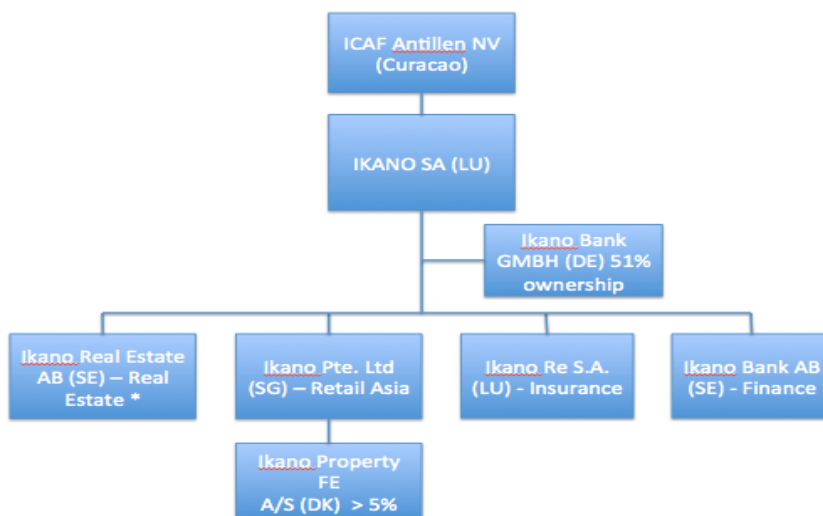
8.3.5 Chapter summary

The Inter Ikea group is substantially less transparent compared with the Ikea Group. There is very little public information available making it difficult to draw any conclusions. This in itself does however strengthen our research, as there is often a negative correlation between transparency and tax avoidance activity (low transparency = high tax avoidance activity). There seems to be strong indicators that Inter Ikea is using tax minimization strategies judging by the acquisition of the trademark, royalty arrangement and the equity-to-asset ratios and knowing that there is a company-link between the Inter Ikea group and the Ikea group.

8.4 IKANO Group

We weren't supposed to include the IKANO group in this thesis until we stumbled upon the company Ikano Bank GMBH located in Germany. As of 01.01.2014 this company was 49% owned by the Stichting INGKA Foundation under INGKA Holding BV, the parent in the Ikea group.¹⁵⁷ The rest and the majority, 51%, was as mentioned owned by the IKANO group.¹⁵⁸ Since IKANO also owns and operates IKEA stores in Singapore, Malaysia and Thailand and has a franchise agreement with the Inter IKEA System B.V.¹⁵⁹ There has also been done relatively little research of the group. We therefore find it to be a very interesting group in the Ikea sphere. Bloomberg states that Ikano is the banking arm of Ikea.¹⁶⁰

The group erupted from the Ikea Company in 1988. It was owned by the Kamprad family and became an independent group of companies. Today it owns and manages companies within 4 sectors: Finance, Insurance, Retail Asia and Real Estate, according to their webpage.¹⁶¹



¹⁵⁷ New figures in Orbis show that as of the Ikano Bank GMBH is now 100% owned by the IKANO group. This number changed in March 2014.

¹⁵⁸ We have attached the ownership structure in attachment A for both the Ikea group, the IKANO group and the inter ikea group.

¹⁵⁹ IKANO Group, 2012

¹⁶⁰ Bloomberg, 2014

¹⁶¹ Structure based on Orbis (attachment A)

Figure 8.19

*We couldn't find this Swedish located company mentioned in the Ikano - facts and figures 2012 brochure. We could however find a company named Ikano Real Estate Holding BV that is located in the Netherlands and probably own the Swedish company. The holding company has chosen not to show any fiscal information so we choose to ignore this company further on.

Ikano SA own 16 affiliates where 2 affiliates are either partly or wholly owned. Neither of the affiliates has listed its asset-value nor their net income in 2013.

The parent of the group, IKANO SA had in 2012 (according to Orbis) the following fiscal information:

IKANO SA	2012 milUSD EURUSD = 1.27
Operating revenue / Turnover (<i>orbis</i>)	\$1 163
Costs ¹⁶²	\$1 000
EBT ¹⁶³	\$163
Taxation (<i>orbis</i>)	\$47
Net income (<i>orbis</i>)	\$116
Effective tax rate ¹⁶⁴	28.8%
Profit margin (<i>orbis</i>)	14.0%

Figure 8.20

Compared to the two other groups, this is the group with the highest effective tax rate in the Ikea sphere (The effective tax rate is equal to the corporate tax rate in Luxembourg where it operates). Although it has a relatively high effective tax rate, it doesn't give us any value until we know what the costs are. Some of the costs are franchise fees to the Inter Ikea System BV, but we need more information than this.

¹⁶² Operating revenue minus EBT

¹⁶³ Profit margin times operating revenues

¹⁶⁴ Taxation divided on EBT

8.4.1 Internal pricing

We will try to find indicators of internal pricing within the group by comparing profit margins between those companies which offer this information in Orbis.

Company name	Country ISO Code	Total Assets 2012 milUSD	Profit margin % 2012	Equity-to-Asset Ratio 2012	Country Corporate Tax rate
IKANO SA	LU	\$8 171	13,98	32.1%	28.8%
IKANO BANK AB (PUBL), NORWAY BRANCH*	NO	\$507	9,84	9.7%	28.0%
IKANO BANKEN AB (PUBL)*	SE	\$498	10,01	9.7%	22.0%
IKANO PTE LTD	SG	\$474	14,45	37.9%	17.0%
IKANO FINANCIAL SERVICES LIMITED	GB	\$56	16,01	2.2%	23.0%
INTER FUND MANAGEMENT SA	LU	\$45	58,34	72.5%	28.8%

*These two companies are a branch.

Figure 8.21

The companies with the lowest profit margins are located in Norway and Sweden which is an indicator of internal pricing. We also observe that the affiliate with the highest margin is located in Luxembourg, which is as mentioned an attractive location for internal banks.

8.4.2 Thin capitalization

By looking at the equity-to-asset ratio we can see that the differences between the Norwegian and the Swedish affiliate compared to the affiliate located in Luxembourg are very large. Due to these huge differences, we suspect that Ikano are also actively avoiding tax obligations.

8.4.3 Tax havens

If we follow the company structure we reach the ICAF Antillen NV which is the owner of the group. This company is located in Curacao which forms part of the Kingdom of the Netherlands and is an associate member of the European Community. ICAF Antillen NV is registered at Curacao International Financial Services Association¹⁶⁵ together with over 100

¹⁶⁵CIFA – homepage, 2014

other companies. The only information available on the company is a name that we weren't able to link to the Ikea sphere. This is something that makes us believe that the Ikano group wants to hide something, increasing our beliefs that they are using tax minimization strategies.

8.4.4 Chapter summary

There is very little information on the Ikano group available. Combined with our intention to only write about the other two groups, we have chosen to limit this chapter to only a couple of pages. The reason why we felt the Ikano group was worth mentioning is due to the connection Ikano Bank GMBH has to the Ikea group, which we concluded actively minimizes its tax obligations. This led us to believe that the Ikano Bank GMBH affiliate was in the same boat as the Ikea group. Our suspicion increase when the Ikano and the Ikea group reorganized the ownership structure by changing the Ikano group ownership share from 51% before May 2014 to 100% after May 2014. Unfortunately, as mentioned, information is limited and we weren't able to investigate the restructure further.

8.5 Conclusion

Our analysis of the three groups shows signs of an active use of tax minimization strategies. We have discovered a structure that we find difficulties explaining the incentives for, other than for pure fiscal reasons. By combining the three groups, including the 8 largest directly majority-owned sub-affiliates by Operating Revenue, and colour those located in countries defined as tax havens in the SOMO report¹⁶⁶ red, we can clearly see that there is a high possibility that this setup is in fact a tax avoidance scheme (Figure 8.23).

The mutual factor between these three groups is that at least parts of the income is tax free using three different strategies:

¹⁶⁶ Dijk et al., 2006

Company	Reason to reduced tax	Estimated yearly savings made in this analysis (by only considering the factor to the left)
IKANO GROUP: ICAF Antillen NV	Located in Curacao	Uncertain
Inter IKEA Group: Interogo Foundation	Receives royalty payment which is exempted taxes	\$295 mill. USD
Ikea Group: Stichting INGKA Foundation	Formed as a private foundation	\$3 700 mill. USD

Figure 8.22

By looking at the different group's way of saving taxes, we can see that they are exploiting special legislations that would not have been possible outside tax havens. The strategic location, the low transparency, as well as the affiliates overall possibility of every tax avoidance schemes, it is very certain that the Ikea groups together are minimizing tax obligations. However, we were not able to provide solid proofs, but our conclusion is that they intentionally have chosen this structure to minimize tax burdens, saving huge amounts of money each year, as shown in figure 8.22.

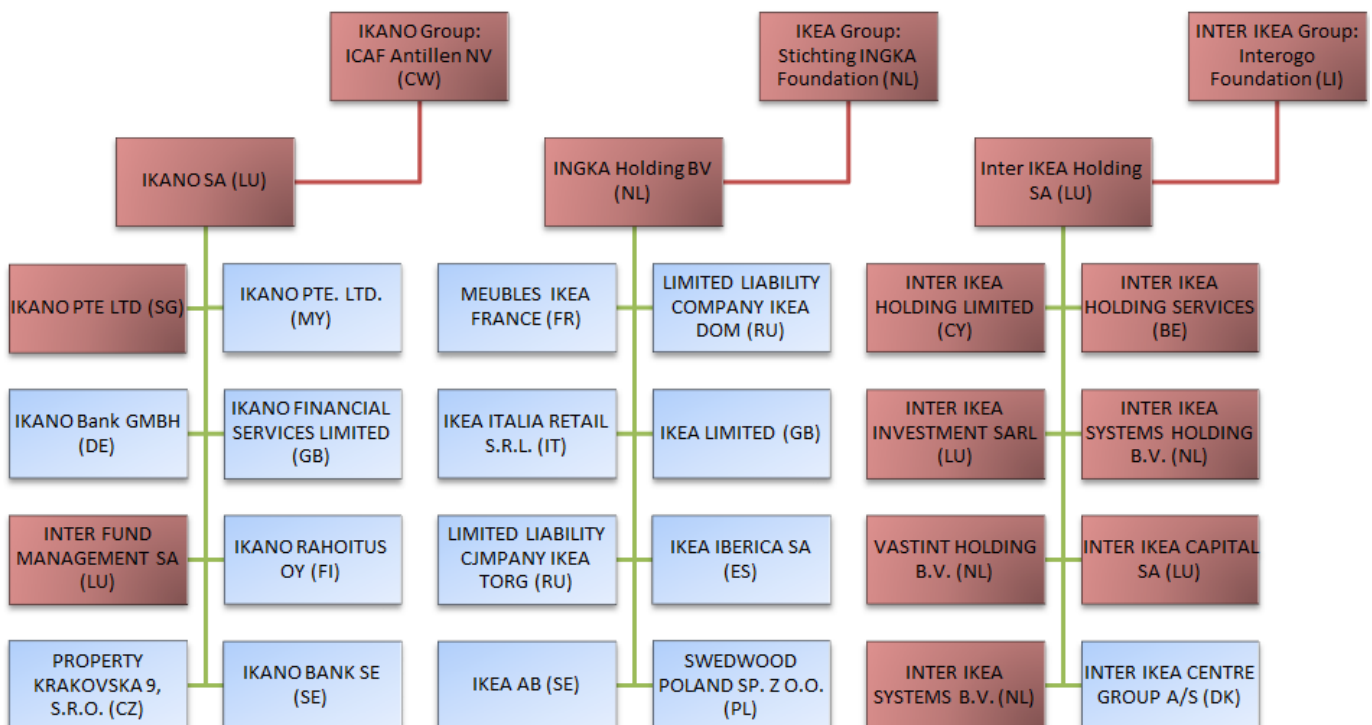


Figure 8.23

We can also conclude that Ikea can exploit the royalty legislations many tax havens have, as 7 of the total 8 affiliates in the Inter Ikea Group is located in a tax haven (marked with red). The two first levels in the three groups are also located in tax havens, making the Ikea sphere very likely to interfere in tax avoidance.

9. Analysis: IKEA and Sweden

We will go back to its origin, Sweden, and try to see if we can find indications of tax planning. This chapter, in addition to the rest of our analyses, will be limited to public information. We will use Orbis and proff.se to draw the corporate Swedish structure and attach this to the theory presented in the theoretical chapters.

9.1 Introduction

Ikea opened its first store in Stockholm, Sweden in 1958. The founder uses the word “Swedishness” to describe the success of how it has evolved into perhaps Sweden’s most well-known brand¹⁶⁷. By using the Orbis database, we can see that Ikea (naturally) has a high activity in Sweden. By using the key words Ikea, Inter Ikea and Ikano we were able to find 162 Swedish companies that corresponded. We will limit our research by focusing on the Stichting INGKA foundation’s affiliates.

INGKA Holding B.V. owns IKEA AB which is the warehouse coordinator in Sweden.¹⁶⁸ Sweden is a country where it is attractive to shift away profits, hence its tax rate of 22%. We expect findings that imply that the Ikea AB Company as a whole uses tax planning to minimize its tax obligations. There are 19 warehouses in Sweden, which work as branches¹⁶⁹. As the affiliates below Ikea AB in the hierarchy does not provide income statements, we use the statement from Ikea AB to investigate the level of tax planning.

Description, IKEA AB	2013-08 milUSD	2012-08 milUSD	2011-08 milUSD
Turnover	\$3 008	\$2 928	\$3 022
Pre Tax Income	\$115	\$187	\$123
Tax	\$34	\$38	\$29
Tax Rate	29.3%	20.3%	23.9%

Figure 9.1

¹⁶⁷ Ikea, 2014a

¹⁶⁸ Every country has a coordinator controlling the country’s warehouses

¹⁶⁹ Information from Orbis by searching on Ikea AB

Based on the income statements we can see that the effective tax rate does not deviate that much from the corporate tax rate in Sweden, 22%. Due to the big difference however between the turnover and the earnings before tax, we suspect that there is one or many accountant cost posts in the statement that minimizes the EBT, making the tax payment relatively smaller in terms of money and not percentage.

9.2 Corporate structure

Ikea AB is the Ikea-coordinator in Sweden and is wholly owned by INGKA Holding B.V. Ikea AB is the parent of 17 Swedish companies which all fall under the Stichting INGKA foundation umbrella.

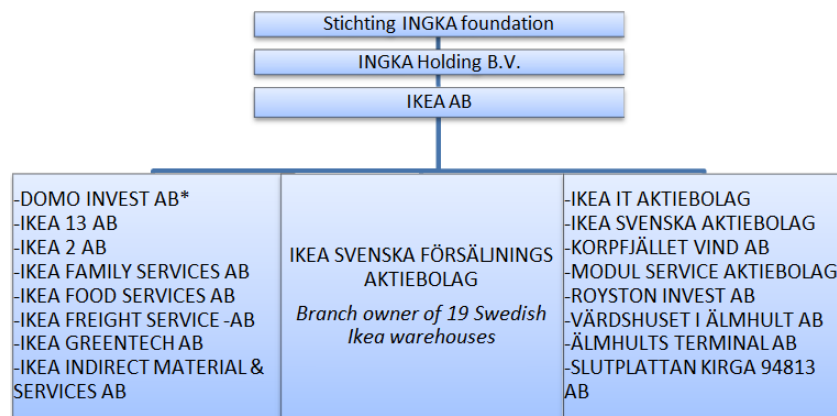


Figure 9.2

*Domo Invest AB holds two companies registered in Russia, Oao Domostroitel and Otkrytoe aktsionernow obshchestvo somostroitel.¹⁷⁰ The last of these companies had in 2013 1.988 employees registered. Most of its documentation is in Russian and we experience difficulties elaborating its functions in the corporate structure.

By the structure seen above we can see that the Stichting structure in Sweden aligns with the Ikea concept described in the previous chapter. In difference, there are also other Ikea groups located in Sweden, but we will continue focusing on this group.

¹⁷⁰ From orbis

9.3 Internal pricing

The affiliates under Ikea AB work as an independent unit that offers products and services to its group members. The warehouse's products and IT-sites stems from the Ikea Indirect Material & Services AB, Ikea Supply AG and Ikea IT AB, close companies inside the Ikea group located in Sweden.

There are incentives for the Ikea-group to sell products and services in low-tax jurisdictions to high-tax jurisdictions such as Sweden for the highest price possible. As we do not have information on internal sales available, we will use an indirect method comparing profit margins with similar domestic entities located in Sweden. As there are no incentives shifting profit for a group inside the same country, we believe to find lower profit margins at Ikea AB compared to the domestic ones.

The Ikea AB differs from the other two stores as they operate differently since Ikea relies on more internal control. Regardless, we have chosen to compare Ikea with the two companies as they are, in our eyes, the best that we have to proceed with this analysis.

PROFIT MARGIN		
Company	2012	2011
Ikea AB (<i>'sept-aug</i>)	6.4%	4.1%
Mio AB	4.4%	4.2%
Chilli AB	-1.6%	3.6%
Industry average ¹⁷¹		7.8%

Figure 9.3

Judging by the table above, the difference isn't remarkable between the companies located in Sweden. The numbers would have been more valuable if we had access to the company's internal transactions, but since we are operating with public information we can't conclude anything by looking at these numbers alone. Comparing last year's available income statement with the latest one shows a higher increase in costs. With cost we mean everything between the revenue post and the EBITDA post which will with tax planning minimize taxes. We have made this "shortcut" due to the lack of information.

¹⁷¹ Yahoo Finance, 2014

IKEA AB, milUSD	2013-08	2012-08	Change in %
Revenue	\$3 008	\$2 928	2.7%
Costs ¹⁷²	\$2 858	\$2 703	5.7%
EBITDA	\$150	\$225	-33.3%
EBIT	\$112	\$188	-40.4%

Figure 9.4

The costs before EBITDA have increased by 3 percentage points relatively to the revenues. This might be explained by a Swedish market that may be a bit saturated compared to other developing countries, but we still think it's interesting to see how much the EBIT post is affected by those 3 percentage points. If the gap between changes in revenue and costs continues to grow it might be a sign that Ikea is expanding its costs in order to avoid taxes in their Swedish affiliates.

9.4 Royalty payments

Inter Ikea System BV receive 3% of the revenue from Ikea stores worldwide.¹⁷³ Also Sweden's Ikea AB is an entity under the Stichting Ingka foundation. Reporters question this arrangement as the founder is sitting on both sides, the giving and the receiving end. We will now see how the royalty arrangement affects the tax post.

IKEA AB, milUSD	2013-08 With FF	2013-08 Without FF	Changes in \$	Changes in %
Revenues	\$3 008	\$3 008	-	-
<i>Franchise fee, 3%</i>	\$90	0	-\$90	-100%
Remaining costs	\$2 768	\$2 768	-	-
Pre-tax income ¹⁷⁴	\$115	\$205	+\$90	78.3%
Taxation (29.3%) ¹⁷⁵	\$34	\$60	+\$26	76.5%
Net income	\$81	\$145	\$64	79.0%

Figure 9.5

¹⁷² Revenues minus EBITDA (not listed in Orbis database nor proff.se)

¹⁷³ Explained in chapter 8

¹⁷⁴ We assume that the royalty payment is constant in the absence from a franchise fee

¹⁷⁵ We use the same effective tax rate as calculated earlier for Ikea AB (2013) when calculating for the taxation for the royalty fee.

We can see that in absence of the franchise fee, Ikea AB would have to raise their tax payments with 76.5%, or \$26 million more, each year (after adjusting for inflation and company growth). This is lost tax revenues for the Swedish society which have to be covered from other sources. If we compare the tax payments to the size of the Swedish economy, using a USDSEK on 6.6116 (orbis) we see that:

Swedish National Budget ¹⁷⁶	2013 ¹⁷⁷ mSEK
National revenues	790.5
National Expenses	921.4
Budget balance	-130.9
Ikea AB's \$26mil	171.9
Adjusted balance	40

Figure 9.6

If we only consider one factor, all else equal, the Ikea AB's tax exemption due to the franchise fee alone would have turned a SEK130 million deficit into a surplus of SEK40 million for the Swedish government.

9.5 Thin capitalization

Since the interest payments are tax deductible in Sweden, the Ikea group has incentives to increase its debt-to-asset ratio filling the affiliate with internal (or external) debt. We will compare Ikea AB's equity-to-asset ratio to the same companies as earlier. If Ikea is using this strategy we expect to find a relatively lower equity-to-debt ratio in Ikea AB relatively to the benchmark companies we use.

Equity-to-asset Ratio		
Company	2012	2011
Ikea AB (<u>'sept-aug</u>)	15.9%	11.2%
Mio AB	45.9%	48.3%
Chilli AB	21.3%	22.5%

Figure 9.7

¹⁷⁶ Ekonomifakta, 2014

¹⁷⁷ Forecast by Ekonomifakta, 2014

As we see from the table above, the Ikea AB affiliate has a substantial lower equity-to-asset ratio than its two national competitors. This implies that Ikea AB has higher interest payments and thus, higher interest tax deduction, strengthening the argument that Ikea AB possesses a tax favourable financial and ownership structure.

9.6 Conclusion

We have seen how Ikea in Sweden has an ownership structure that has a coordinator with a low profit margin, high costs, franchise fees and a low equity-to-asset ratio. Although we face troubles making solid conclusions due to the limited information, we strongly suspect intentional tax planning with the mission to minimize tax payments.

We can with great certainty say that Ikea AB is removing \$90mil in gross profit from Sweden and transferring this to the Ikea-concept owner, which is the Luxembourg based Inter Ikea System BV. That being said, we have only been focusing on the Stichting Ingka foundation, which funds the Ikea group. For a more comprehensive analysis we recommend looking at the whole Swedish sphere considering the 162 Ikea related companies that as of today are located in Sweden.

10. Government actions

10.1 FATCA

The Foreign Account Tax Compliance Act (FATCA) is a set of new regulations intended to reduce tax evasion in the United States. FATCA was enacted in 2010, and requires American institutions, taxpayers and foreign corporations with U.S. ownership interests to report to the IRS information regarding financial accounts held abroad.¹⁷⁸ The regulations demand foreign financial institutions to report to American tax authorities any information regarding financial assets belonging to U.S. citizens.¹⁷⁹

As we have seen throughout this thesis, MNCs tend to shift profits from high tax countries, such as the United States, and into low tax countries where information is protected by a high level of secrecy in the finance sector. The problem for tax authorities in this situation is the lack of information and the low level of cooperation from some foreign financial institutions. The IRS, or any other tax authority for that matter, does not have the authority to collect taxes in regions outside of their jurisdiction, and they cannot demand any information from foreign institutions. FATCA introduces the right to levy withholding taxes of 30% on international payments made from the U.S., to financial institutions that do not cooperate in sharing information. By doing so, the intention is to put pressure on the various financial institutions in order to make them share important information, not to generate higher tax revenue.

The regulations introduce some challenges in creating systems for identification of the various companies and institutions, reporting and levying the 30% withholding tax. The FATCA-regulations therefore offer agreements to simplify these processes. In April of 2013, Norway signed such an agreement with the United States, agreeing that Norwegian institutions are to report to the Norwegian tax authorities, which will forward the information to the IRS.¹⁸⁰

¹⁷⁸ U.S. Department Of The Treasury; 2014

¹⁷⁹ KPMG - FATCA; 2014

¹⁸⁰ PWC; 2011-2014

The European Commission has also proposed a European FATCA, intended to extend the automatic exchange of information between member states of the EU to also apply to dividends, capital gains, other forms of financial income and account balances.¹⁸¹ An interesting question to ask is if we should consider the introduction of a Norwegian FATCA. As shown in chapter 5, research has shown that taxable profit is being shifted out of Norway as well, reducing tax income for the government. The question would in that case be if such an investment would be worth it, meaning if the additional tax income created by such regulations would be higher than the costs created?

The IRS has announced that 2014 and 2015 will be regarded as a transition period for FATCA, where institutions and agents acting in good faith will not be penalized for technical failures while getting the new regulations worked in.¹⁸²

10.1.1 Global Transparency

FATCA is a step in the right direction when it comes to increased transparency on a global scale. At the G20 meeting in Sydney in February 2014, the countries gave a green light for a global standard regarding automatic exchange of information, where implementation plans are supposed to be agreed upon on the next meeting, being held in September.¹⁸³ Their goal is to develop and integrate a global standard for automatic and smooth exchange of tax related information between countries.

On the 24th of March 2014, the member countries of the European Union agreed upon rules that will increase the amount of tax information exchanged by national authorities. This breakthrough came after five years of discussions, where Austria and Luxembourg objected to the proposed laws, fearing that it would hurt their financial sector. The two countries agreed upon the new legislations after the European Commission succeeded in negotiations with Switzerland, Liechtenstein, Andorra, San Marino and Monaco, five low-tax countries with similar financial sectors. The pressure provided by the FATCA regulations is also

¹⁸¹ KPMG; 2013

¹⁸² IRS; Notice 2014-33

¹⁸³ European Commission; February 2014

regarded as an important reason for why the countries decided to agree upon the new legislations. However, the rules agreed upon by the EU that are expected to be enforced in 2017, will probably never be enforced because of the global standard that OECD will discuss in September.¹⁸⁴ Still, the agreement is a step in the right direction, indicating that the EU is united in the work for a global standard for transparency, giving hope for the OECD standard.

A recent positive change in Norway was presented in the revised budget on the 14th of May 2014, saying that information on shareholders in Norwegian firms is to be constantly and automatically updated in a digital database.¹⁸⁵ The companies are currently responsible for updating their lists of shareholders, an inefficient and expensive practise where the information is stored in a closed database and access has to be requested,¹⁸⁶ thus making it easier for companies to hide ownership. It is not yet decided if the new database is to be open to the public or not.

10.2 ACE & CBIT

Tax systems following the general accounting principles allow deduction of interest against corporate income when determining taxable profits. This is the case for the three countries we have been looking at in this thesis, and is regarded as the natural way of treating interest in a tax perspective. However, this accounting principle creates an unbalanced relationship between debt and equity, giving companies incentives to increase the amount of debt for fiscal reasons. As we have seen in previous part of this thesis, the use of internal debt has grown to be one of the biggest tax minimization strategies used by MNCs, and causes huge losses for governments around the world.

Allowance for Corporate Equity (ACE) -system maintains the deductibility of interest payments, and introduces an additional deduction for equity. This creates neutrality between debt and equity, leaving capital income untaxed and thus removing the effects on investment behaviour. With the ACE-system, the corporations are only taxed on their operational

¹⁸⁴ Hirst; 24.3.2014

¹⁸⁵ Finansdepartementet; 2013-2014

¹⁸⁶ Dahl, Siri Gedde; 15.5.2014

revenue, meaning that total tax income for the government will decrease. This is solved by increasing corporate tax rates, or by increasing tax income from other parts of society. The system has been tested in several countries, showing various results.

The CBIT-system removes deductibility for interest payments, making return on both equity and debt taxable at the corporate tax rate. A clear disadvantage of this system is that it increases the cost of capital, thus affecting investment behaviour of the firms. But at the same time, the system favours equity and might decrease the use of leverage. Another advantage is that the system will not create a need to increase corporate tax rate or any other tax rate in order to maintain the total tax income at government level. The system might in fact allow for a decrease in the corporate tax rate, which might attract FDI and general investment in the jurisdiction. Simulated studies have shown that this system might lead to a fall in both investments and GDP, caused by the increased cost of capital.¹⁸⁷

10.3 BEPS – Base Erosion and Profit Shifting

In a European Commission MEMO¹⁸⁸ they focus on the “honest” citizens who have to carry a heavier tax burden when businesses engage in aggressive tax planning and tax avoidance schemes. The mobility of money grows along with the technology. So do the possibilities of shifting profit across borders. National tax laws have not been adapted in order to prevent loopholes that can be exploited by MNCs in order to avoid taxes. The G20 Finance Ministers requested something to be done about this. This was the trigger following the creation of the Action plan on Base Erosion and Profit Shifting (BEPS) launched by the OECD. This plan involves 15 actions that will equip governments with the international and domestic instruments to face this challenge. As of July 2013, the G20 Finance Ministers and Central Bank Governors endorsed this action plan fully. The BEPS action plan is scheduled in three phases ending up with the final phase in December 2015.¹⁸⁹

Some of the main principles are to improve the tax administration and tax collection in developing countries. The action plan also involves the re-establishment of the global

¹⁸⁷ Mooij et al. 2008

¹⁸⁸ European Commission; 05.12.13

¹⁸⁹ OECD, 2014

coherence of government income taxation with a goal to increase transparency, predictability and certainty and to make the information exchange among global tax authorities automatic. The OECD divides these main principles into 15 actions.¹⁹⁰

Overall it aims to end the use of shell companies, which are used to save profits offshore and to cancel schemes that shift profit offshore.¹⁹¹

10.4 A Look at Canada

Canada was at the forefront introducing thin capitalization rules way back in 1971.¹⁹² We will therefore see how the Canadian government has combatted international tax evasion and aggressive tax avoidance. First of all, the country has an extensive tax treaty network. Since 2006, the Canadian government has audited almost 8000 cases of aggressive tax planning rounding up to approximately CAD\$4.6bn in unpaid tax.¹⁹³ With initiative like BEPS and FATCA we believe that this will be reduced.

If countries worldwide commit to the BEPS and FATCA and their guidelines, we will observe an effect in increased tax payments. As of today there is a large amount of cash stacked in offshore companies, however, we lack information on the BEPS and FATCA effect as they have been implemented relatively recently.

Countries have great intentions fighting tax avoidance using tax havens and sophisticated schemes. We have described some regulations and actions taken by governments in this chapter, and it will be interesting to see their future effect.

¹⁹⁰ Freehills et al. 2013

¹⁹¹ OECD 2014

¹⁹² Ruf and Schindler, 2012

¹⁹³ Canada Revenue Agency, 2013

10.5 The Failed Tax Holiday

In 2004, the American government enacted a repatriation tax holiday, allowing companies to bring home foreign profits at a tax rate of 5,25%, instead of the normal 35%. This was done in an attempt to get money back into a struggling American economy, and to increase investments and spending. During this tax holiday, \$363 bn. went back to the United States according to the Internal Revenue Service,¹⁹⁴ and \$312 billion of these were eligible for the reduced tax rate.¹⁹⁵ The amount repatriated equalled 45% of registered profits held abroad, and Hewlett-Packard was one of the companies taking full advantage of the possibility, bringing home \$14,5 bn. of a total \$15 bn. held abroad.

There are mixed views on the effect of this tax holiday, and a report released by the U.S. Senate Permanent Subcommittee on Investigations and its chairman Carl Levin, states that the tax holiday did not produce the promised benefits of new jobs or increased research expenditures to spur economic growth.¹⁹⁶ The report found an increase in both executive pay and stock buy-backs among the 15 companies that repatriated the largest amounts during the tax holiday. These companies decreased their R&D spending's in the years after the tax break, and after repatriating a total of \$155 bn., these companies reduced their workforce by close to 21 000 jobs. The effects were the opposite of what was expected, and the fact is that because the MNCs now expect occasional tax breaks like this one, even more profit than before has been shifted offshore. The estimated costs for the U.S. Treasury were close to \$3,3 bn., and Levin strongly recommends not to introduce a new tax break, believing that it will only benefit a small group of corporations, creating a significant revenue loss, a failure to create jobs and more incentives for MNCs to move even more jobs and investments offshore.

¹⁹⁴ IRS; March 2012

¹⁹⁵ Coy & Drucker; March 17th 2011

¹⁹⁶ Levin, Carl; October 11th 2011

10.6 The progress

“No Results without cross-border cooperation”-European commission 2013

The European commission has launched several actions with the intention of reducing MNC's tax avoidance. In 2013 the European commission proposed extending the automatic information exchange between EU countries (MEMO/13/533)¹⁹⁷. The G20 Finance Ministers gave a green light in February 2014 to a new global standard that aims to fight tax evasion as well as improving global tax transparency.¹⁹⁸ This standard was developed by the OECD with support from the EU.

The EU has recently launched a policy on good governance internationally. Regardless, the European commission estimates that €1 trillion is being lost from public finances as a consequence of avoidance and evasion and says that more needs to be done in order to protect government revenues.¹⁹⁹

Among other, we find initiatives on the European commission webpage as:

- Digital taxation debate
- Fight VAT fraud with agreeing on new instruments
- Publish a new report on the VAT gap in the EU
- Increase company transparency

One obvious challenge is to get everyone on the same team. If only one country deviates from the norm, MNCs will still have the possibility to avoid EU, OECD and the European commission's actions.

¹⁹⁷ European commission; 12.06.13

¹⁹⁸ European commission; 23.02.13

¹⁹⁹ European commission; 15.05.12

10.7 New Rules to Stop Debt Shifting Through Shell-Companies

Ever since 1990, the EU's Parent-subsidiary Directive has existed in order to prevent the risk of double taxation within companies operating in different EU-countries. Some companies have however been able to find loopholes in the directive, giving them an advantageous "double non-taxation". By using certain types of internal debt, as described in chapter 4, the payments on these types of debt end up being treated as tax-deductible debt payments in one country and tax exempt dividends in another, meaning that the company ends up paying little or no tax on income made in certain subsidiaries. The European Commission has proposed a new law, stating that a company will have to pay taxes on incoming payments, if these payments have been deducted in the other country, aiming to prevent the use of such internal loans. The law will also work to prevent companies from creating subsidiaries in EU-countries solely to exploit local tax laws. The new directive is supposed to be implemented by December 2014.²⁰⁰ The leaders of the G-8 countries also addressed these problems when they met in Northern Ireland in June 2013. They created a declaration that included increased openness between both countries and companies, where information regarding ownership and location of income was to be known by each jurisdictions government.²⁰¹

As we have seen throughout this thesis, the use of shell-companies in tax havens and in high-secrecy jurisdictions has become a widely used tax minimization strategy, and is causing huge losses in tax income for various governments around the world. Companies are generally allowed to create foreign affiliates whenever and wherever they want, being that any restrictions from governments might reduce the companies overall willingness to invest. The main problem is the lack of transparency and openness in some jurisdictions, allowing shell-companies with no real business activity to exist. In order to solve this problem, global transparency standards needs to be implemented, and the activity in all existing subsidiaries needs to be measured and reported continuously. Technology might help to increase openness, and a global network of information exchange could make the job easier for tax authorities.²⁰² The most important thing is however to get all countries and jurisdictions on

²⁰⁰ European Commission; 25.11.13

²⁰¹ Lough Erne Declaration; 18.6.13

²⁰² The Economist; 10.5.14

board, and the development regarding the FATCA agreement has ignited new hope and proved that this might be possible.

11. Final Conclusion

In this thesis we have explained the various tax minimization strategies available to MNCs and the theories behind these, and we have shown empirical evidence that these strategies are in fact being frequently used internationally.

By analysing two large MNCs we have been able to see how some of these strategies are used in a real life setting. We have found that both The Coca-Cola Company and IKEA use several of the methods we described in chapter 4, where the use of tax havens, high secrecy jurisdictions and advanced corporate structures with shell companies are the most obvious strategies. We were able to find information on IKEA's use of royalty payments, and a strong indication of thin capitalization strategies, but we were lacking information to find any direct proof that the two companies use strategies involving transfer pricing. Our findings suggests that the two companies use several tax minimization strategies aggressively, and as we can see from the figure below, and from the information in the analysis, they are both ending up paying a low effective tax rate on their earnings.

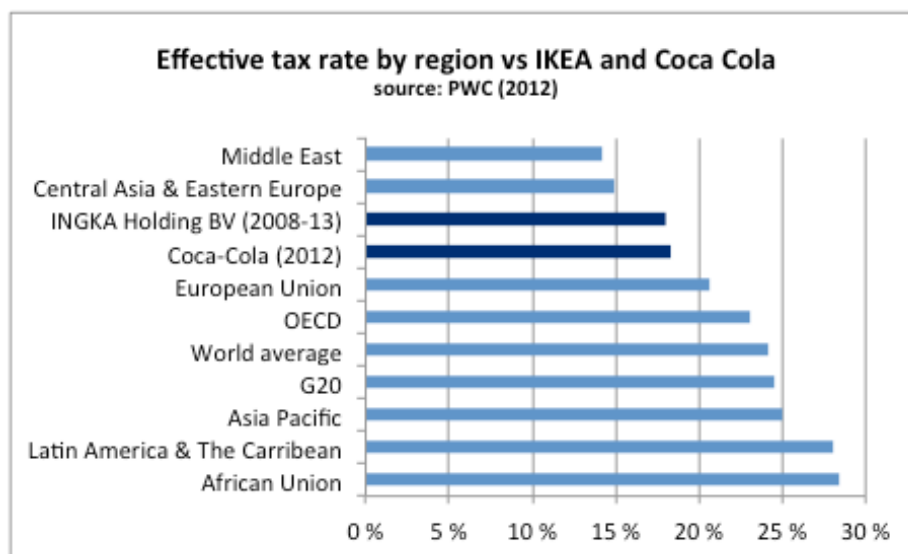


Figure 11.1

We have also been discussing the actors creating these loopholes for the MNCs, and the moral aspects of tax minimization. The fact that the employees of some of the big firms that are making money out of the tax loopholes, are actually the ones advising the tax authorities in the creation of new tax laws, is an obvious problem that needs to be dealt with. We have pointed out that a global consensus towards taxation, and a global agreement in dealing with

financial information to increase transparency is needed. Tax avoidance has been given increased attention in recent years, and it seems like changes are about to be made. FATCA, ACE, CBIT and BEPS are some of the actions aimed to prevent tax avoidance, and with all EU countries now on board for a new global transparency standard, we might be getting close to a solution.

12. Attachment

12.1 Attachment A

IKANO GROUP:

Level	ICAF ANTILLEN NV	Country [Ⓜ] ISO code	Direct (%)	Total (%)	Status	Source	Information date	Op. [Ⓜ]	
								Revenue [Ⓜ] (mil USD)*	No of [Ⓜ] employees
1.	IKANO SA	LU	100.00	100.00	UO+	VC	01.02.2014	1,163	3,036
1.1.	COMPAGNIE DES MINES ET METAUX SA	LU	100.00	100.00	UO+	VC	01.02.2014	n.a.	1
1.2.	IKANO B.V.	NL	100.00	100.00	UO	LN	01.07.2013	n.a.	n.a.
1.3.	IKANO CAPITAL SA	LU	100.00	100.00	UO+	VC	01.02.2014	0	2
1.3.1.	ANCHORGLADE LIMITED	IE	100.00	100.00	UO	RT	01.05.2013	n.a.	n.a.
1.3.2.	IKANO AG	CH	100.00	100.00	UO	OF	01.01.2014	n.a.	4
1.4.	IKANO FINANCIAL SERVICES LIMITED	GB	100.00	100.00	UO	RT	01.05.2013	56	227
1.5.	IKANO PROPERTIES, S.R.O.	CZ	100.00	100.00	UO	SH	01.10.2011	0	3
1.6.	IKANO PTE LTD	SG	100.00	100.00	UO	DP	01.02.2014	474	n.a.
1.6.1.	IKANO PROPERTY FE A/S	DK	>5.00	n.a.	-	KO	01.01.2014	n.a.	n.a.
1.6.1.1.	IKANO CORPORATION SDN BHD	MY	100.00	100.00	-	KO	01.01.2014	20	n.a.
1.7.	IKANO RAHOITUS OY	FI	100.00	100.00	UO	FI	01.09.2012	1	5
1.8.	PROPERTY KRAKOVSKA 9, S.R.O.	CZ	100.00	100.00	UO	SH	01.08.2012	<0,5	n.a.
1.9.	INTER FUND MANAGEMENT SA	LU	99.99	n.a.	UO+	VC	01.02.2014	45	18
1.10.	IKANO BANK GMBH	DE	51.00	n.a.	UO	VC	01.01.2014	n.a.	210
1.11.	DUTCH NORDIC INSURANCE COMPANY NV	CW	MO	n.a.	UO	WW	01.12.2010	n.a.	n.a.
1.12.	IKANO BANK SE	SE	MO	n.a.	UO	RS	01.12.2010	436	350
1.13.	IKANO FINANCE RUSSIA	RU	MO	n.a.	UO	WW	01.12.2010	n.a.	n.a.
1.14.	IKANO PTE. LTD.	MY	MO	n.a.	UO	WW	01.12.2010	139	394
1.15.	IKANO RE SA	LU	MO	n.a.	UO	WW	01.12.2010	5	n.a.
1.16.	DENDRO POLAND LTD SP. Z O.O.	PL	50.00	n.a.	-	IR	01.02.2013	131	450

IKEA GROUP:

Level	Subsidiary name	Country ISO code	Direct (%)	Total (%)	Status	Source	Information date	Op. Revenue (mil USD)*	No of employees
1.	INGKA HOLDING B.V.	NL	100.00	100.00	UO+	WW	01/2014	38,102	3
1.1.	IKEA CAPITAL B.V.	NL	100.00	100.00	UO	LN	06/2013	n.a.	4
1.1.1.	IKANO BANK GMBH	DE	49.00	n.a.	-	VC	01/2014	n.a.	210
1.2.	IKEA HOLDING GERMANY AG	CH	100.00	100.00	UO	OF	01/2014	n.a.	4
1.2.1.	IKEA HOLDING DEUTSCHLAND GMBH & CO.KG	DE	100.00	100.00	UO	VC	01/2014	n.a.	3
1.2.1.1.	AMIKO HANDELSGESELLSCHAFT FÜR KONSUMGÜTER MBH	DE	100.00	100.00	UO+	VC	01/2014	n.a.	n.a.
1.2.1.2.	IKEA INDIRECT MATERIAL & SERVICES GMBH	DE	100.00	100.00	UO+	VC	01/2014	n.a.	27
1.2.1.3.	IKEA TRADING SERVICES GMBH	DE	100.00	100.00	UO+	VC	01/2014	2	30
1.2.1.4.	IKEA EINRICHTUNGS-GMBH	DE	94.90	n.a.	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.	IKEA DEUTSCHLAND GMBH & CO. KG	DE	100.00	100.00	UO	VC	01/2014	n.a.	14,447
1.2.1.4.1.1.	IKEA CALL CENTER SERVICES GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	150
1.2.1.4.1.2.	IKEA-GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	2
1.2.1.4.1.3.	KLG INVEST GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	3
1.2.1.4.1.4.	KMP INVEST GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.5.	KMP LEASING GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.	IKEA VERWALTUNGS-GMBH	DE	94.60	n.a.	UO	VC	01/2014	366	34
1.2.1.4.1.6.1.	I.V. IMMOBILIEN SERVICE GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	2
1.2.1.4.1.6.2.	IKEA ENERGIE GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	4
1.2.1.4.1.6.2.1.	WINDFARM DIEMELSEE GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.2.1.1.	EBV WINDPARK 28 GMBH & CO. BETRIEBS-KG	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.2.2.	WINDFARM OBERENDE GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	2
1.2.1.4.1.6.2.3.	WINDFARM WINTERSPELT GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.2.4.	WINDFARM ZETTINGEN GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.2.5.	EBV WINDPARK 28 GMBH & CO. BETRIEBS-KG	DE	GP	n.a.	UO	VC	01/2014	n.a.	n.a.
1.2.1.4.1.6.3.	IKEA GRUNDBESITZ GMBH	DE	100.00	100.00	UO	VC	01/2014	n.a.	2
1.2.1.4.2.	IKEA DISTRIBUTION SERVICES GMBH	DE	94.00	n.a.	UO	VC	01/2014	217	1,210
1.3.	IKEA SERVICES B.V.	NL	100.00	100.00	UO	LN	03/2013	n.a.	90

Both tables are from Orbis

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