Taxation and Development

Effects of Dutch tax policy on taxation of multinationals in developing countries

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Taxation is essential for development finance and good governance

This thesis analyses effects of Dutch corporate tax policy on developing countries. Developing countries need sustainable sources of finance for public expenditures and investments. Therefore they need to enhance domestic revenue mobilization. However, developing countries are faced with various challenges to raise tax revenues, such as insufficient administrative capacity and corporate tax avoidance. Some of these challenges have an international character and tax avoidance strategies often involve Special Purpose Entities (SPEs) in donor countries. As a consequence, the tax policy of donor countries can affect revenue mobilization in developing countries by creating or restricting tax avoidance opportunities. Dutch tax policy is particularly relevant, because multinationals use Dutch SPEs on a very large scale.

Tax revenues are increasingly being recognized as a key source of financing for development. Private external flows, such as Foreign Direct Investment (FDI), migrant remittances, and trade, can enhance investment and economic growth. However, private flows do not contribute directly to the financing of public services, such as education, health care, sanitation, and basic infrastructure, which are essential for social development. Therefore public sector financing remains essential. Tax revenues in developing countries without large government income from oil, diamonds, or other natural resources are often between 15% and 25% of Gross Domestic Product (GDP), much lower than in high income countries. In low income and lower middle income countries, Official Development Assistance (ODA) from donors is still a substantial source of public finance, but it is not a reliable or sustainable source. This implies that developing countries need to strengthen domestic revenue mobilization.

From a developmental perspective, taxes are not only a source of revenue; a more comprehensive analytical framework takes into account four main purposes of taxation. The first purpose, revenue generation, is also an instrument for macroeconomic policy. A second purpose is redistribution, through progressive taxation and limiting tax incidence on people with lower ability-to-pay. Redistribution is important because development has increasingly become an issue of inequality, also at the national level. A third purpose is representation; taxation is a catalyst for the establishment of governments that are more responsive and accountable towards their own citizens. Development aid has no such effect and fosters accountability to external donors instead. A fourth purpose of taxation is re-pricing, which refers to minimising market distortions and providing tax incentives to address externalities. Different types of taxes have different properties. Taxes on personal and corporate income tend to have the strongest positive effect on governance, but provide a relatively strong disincentive to economic activity.

Taxation of multinationals is difficult because of international tax avoidance

Corporate taxes are an important revenue component in developing countries. In middle income countries, corporate taxes typically generate between 10% and 30% of total tax revenue. This contrasts with high income countries, where corporate taxes are generally not a major source of revenue. The importance of corporate tax revenues for developing countries implies that potential threats to these revenues, such as tax avoidance by multinationals, are highly relevant in the context of financing for development.

For developing countries, taxing multinational enterprises involves various challenges and constraints. A major domestic constraint is weak administrative capacity. Furthermore, many countries lose revenues due to tax competition, often at the regional level, and poorly targeted tax incentives for foreign investors. At the international level, tax avoidance and evasion due to transfer mispricing is a major challenge. Transfer mispricing involves the manipulation of prices for trade between affiliates of the same multinational, usually to shift profits to low-tax jurisdictions. Moreover, multinationals shift profits through royalty payments for the use of trademarks and other intellectual property and through interest payments, by financing subsidiaries in high-tax countries with a larger proportion of debt. These issues have been relatively well covered in existing research.

This thesis mainly focuses on avoidance of withholding taxes, an issue that has received limited attention so far. Withholding taxes are levied on dividend, interest, or royalty payments to foreign entities. They play an important role in corporate taxation for several reasons. Withholding taxes are relatively easy to collect and can be a substantial source of revenues. In Kenya and Zambia, for instance, withholding taxes accounted for approximately 5% of total tax revenues in 2007. Furthermore, withholding taxes can have the effect of shifting tax payments towards the host country of foreign investment, which is beneficial for capital-importing developing countries. Withholding taxes also prevent non-taxation of income paid to foreign security holders and can serve as a backstop measure against profit shifting.

Dutch corporate tax policy facilitates certain tax avoidance structures

A central element of Dutch corporate tax policy that facilitates tax avoidance by multinationals is the unique network of bilateral tax treaties. As of end 2012, the Netherlands had concluded tax treaties with 6 low income countries and 41 middle income countries outside the European Union (EU). Some of these tax treaties strongly reduce the treaty partners' standard withholding tax rates, or eliminate them, for payments to Dutch entities. Moreover, anti-abuse provisions that protect tax revenues in the partner country are present in only four of the 47 treaties and limited to dividends. The Netherlands itself has a dividend withholding tax of 15%, but this is often reduced to 0% or 5% for intra-firm dividends under a tax treaty or the EU Parent-Subsidiary Directive. There exists no Dutch withholding tax on interest or royalty payments. This combination of tax policy elements makes the Netherlands attractive for conduit structures that involve dividend, interest or royalty payments passing through a Dutch SPE to benefit from withholding tax reductions under Dutch tax treaties.

Another relevant aspect of Dutch tax policy is the special tax treatment of certain entities, resulting in low effective tax rates. Between 1997 and 2010, approximately 90 SPEs benefitted from the Group Financing Activities (GFA) regime, a low-tax facility for intra-group interest and royalty income that has been phased out. In 2006, the Dutch government adopted a new low-tax facility for interest income to replace the GFA regime, but this facility never entered into force because it was incompatible with EU legislation. Currently some SPEs benefit from advance pricing agreements with the Dutch tax authority, often referred to as tax rulings, that specify small taxable margins on net interest, royalty, or trading income, even though actual margins can be higher. Such special tax treatment facilitates avoidance of corporate income tax in other countries through profit shifting.

This thesis focuses on negative and unintended effects of Dutch tax policy and does not contain a complete assessment of all effects, which materialize through different pathways. Dutch tax treaties stimulate foreign investments by Dutch multinationals and facilitate borrowing by developing country firms from Dutch banks and institutional investors. Dutch tax policy can therefore generate a positive volume effect, increasing investment in developing countries. At the same time, the reduced withholding taxes on payments to Dutch firms and creditors cause a negative rate effect, intentionally reducing revenues for a given

level of investment. These intended positive and negative effects are relatively well understood and therefore not investigated here.

From a developing country perspective, negative rate effects of conduit structures are usually unintended. Conduit structures can reduce withholding taxes on payments to entities in third countries passing through a Dutch SPE. Furthermore, conduit structures and special tax treatment of Dutch SPEs provide incentives to increase borrowing or transfer intellectual property to the Netherlands. This may influence the composition of a firm's assets and liabilities and negatively affect the tax base in developing countries. The present research focuses on these unintended rate and composition effects. The balance between positive and negative effects differs per developing country.

Dutch tax and development policy have been incoherent

The aims of donor countries' development policy can be supported or hindered by policies in other areas, such as tax policy. The concept of Policy Coherence for Development (PCD) refers to the absence of policy effects contrary to development aims as well as to the creation of synergies between different government departments to achieve development aims. Most PCD initiatives focus on the effects of trade policy. Since 2009, the EU's PCD agenda also includes tax governance. This mainly provides for technical assistance to strengthen tax systems in developing countries, but does not consider effects of corporate tax policies in EU member states.

In the Netherlands, the Ministry of Foreign Affairs aims to promote PCD and recognises the relevance of Dutch corporate tax policy in this regard. Over the past decade, the Ministry has paid considerable attention to both domestic and international constraints for domestic resource mobilization in developing countries, including transfer mispricing and excessive use of tax incentives. This implies that unintended negative effects of Dutch tax policy on developing countries are incoherent with development policy and can thus be considered adverse effects. However, the use of Dutch SPEs in tax avoidance strategies of multinationals had largely escaped attention from policy makers and the broader public until 2007. The approval of a new low-tax regime in 2006 that could obviously be used to shift profits out of developing countries provides clear evidence of the policy incoherence. The causes of policy incoherence are structural and political in nature, because the interests of developing countries inherently conflict with special interests of various large multinationals and Dutch service providers.

The tax treaty policy of the Dutch Ministry of Finance published in 2011 reaffirms the importance of PCD. It interprets policy coherence as an imperative to strengthen tax compliance in and information sharing with developing countries. It also mentions that the Netherlands is willing to allow relatively high withholding taxes in treaties with developing countries and committed to include anti-abuse provisions if requested. These principles reflect increasing attention for coherence between Dutch tax and development policy, but do not yet address existing adverse effects.

Multinationals use Dutch SPEs for treaty shopping, avoiding dividend withholding tax

Some multinationals avoid withholding taxes by diverting FDI through a conduit country with favourable tax treaties; this is called tax treaty shopping. Host countries of foreign investment generally disapprove of treaty shopping, because it breaches the principle of reciprocity. Passing on equity investments is the largest activity of Dutch SPEs and accounts for up to 50% of their combined balance sheets.

This research analyses the effect of tax treaties and other structural determinants on FDI routed through the Netherlands. It uses anonymised micro data on large Dutch SPE, covering approximately 90% of total Dutch SPE assets. Excluding the major emerging

economies Brazil, Russia, India, China, South Africa and Mexico, 37 low and middle income countries had a tax treaty with the Netherlands in 2007. At the aggregate level, out of the combined €582 billion inward FDI stock in these countries, €53 billion or approximately 9% was held via Dutch SPEs. For the group of developing countries that did not have a tax treaty with the Netherlands, the proportion was 6%, thus a third lower.

Econometric analysis at the level of country pairs confirms that the share of diverted FDI is higher if the home and host country both have a tax treaty with the Netherlands, and lower if there exists a direct treaty between the home and host country. Bilateral investment treaties and gravity effects also contribute to FDI diversion. European headquarters or home and host country corruption do not have a significant effect. As tax benefits differ between treaties, the analysis also takes into account bilateral dividend withholding tax rates and home and host country tax systems. The results show that FDI diversion is partly driven by specific corporate structures that reduce the total tax on distributed foreign profits by taking advantage of Dutch tax treaties. It can therefore be concluded that FDI diversion partly results from tax treaty shopping.

On average, the possibility to avoid dividend withholding tax causes a few additional percent of bilateral FDI stock to be routed through the Netherlands. Macro data show that a few individual host countries are affected more strongly. For example, the Philippines has a tax treaty with the Netherlands that provides for a 10% withholding tax on dividends to Dutch parents, whereas the applicable rate to many other countries is 15%. This is one of the reasons why FDI via the Netherlands amounted to 27% of total inward FDI stock in the Philippines in 2010. Other developing countries with a special Dutch tax treaty and a large share of diverted FDI include Ghana (20%), Ukraine (15%), and Indonesia (10%).

In theory, FDI diversion influences tax revenues via both a volume and a rate effect. However, studies analysing the volume effect of tax treaties on bilateral FDI have produced mixed results. For all developing countries combined, a significant positive volume effect is even more uncertain than for an individual country, because of competition for foreign investments. It can therefore be concluded that the rate effect is dominant. In 2007, Dutch SPEs received more than €5 billion of dividends from developing countries, of which they passed on almost €3 billion to foreign parents. These figures imply that even a small rate effect, for example a 3% lower withholding tax on these dividend flows, can substantially reduce tax revenues.

Dutch SPEs also facilitate avoidance of interest withholding tax, increasing leverage

Some multinationals also channel interest payments through Dutch SPEs to avoid withholding taxes. Anonymised micro data show that in 2007, Dutch SPEs had onlent more than €450 billion to foreign affiliates. The sources of these funds were roughly €250 billion of debt securities issued by the SPEs, €150 billion of intra-group loans, and €50 billion of third party loans. The onlending activities account for more than 25% of Dutch SPEs' combined balance sheets and are often combined with holding activities.

Focussing on developing countries, securities data indicate that firms from Indonesia and Kazakhstan had issued by far the largest volume of debt securities via the Netherlands. In 2010, Dutch SPEs passed on €0.6 billion of interest payments from Indonesian firms to holders of debt securities. Due to the tax treaty between Indonesia and the Netherlands, most of these interest flows are free of withholding tax, whereas a rate of 10% to 20% applies to interest paid directly from Indonesia to external creditors in almost all other countries. For Kazakhstan, the Dutch treaty does not specify a lower rate than other tax treaties. Interest payments from developing countries passed on within the group are smaller than interest passed on to external creditors. Thus, the main rate effect of interest channelled through Dutch SPEs concerns a substantial reduction of Indonesian withholding tax revenues.

Debt financing via Dutch SPEs can have a composition effect as well. At the firm level, lower borrowing costs can lead to higher leverage. At the subsidiary level, firms may engage in debt shifting and use Dutch SPEs to pass on interest payments to lowly taxed affiliates, increasing the leverage of normal subsidiaries. An analysis of composition effects at the subsidiary level requires financial data that are not readily available from developing countries. Therefore the capital structure of EU-based multinationals and their EU subsidiaries is analysed instead.

Econometric analysis shows that at the firm level, debt issuance via Dutch SPEs is associated with significantly higher debt. Controlling for relevant firm characteristics, EU firms with a Dutch issuing SPE on average have a ten percentage points higher ratio of debt to equity capital plus debt. This large effect could result from differences in tax aggressiveness; firms with a more aggressive tax strategy may use more debt financing and are also more likely to avoid withholding taxes via Dutch SPEs. Other Dutch SPE types have no significant effect on firm leverage, which confirms the relevance of debt issuance.

At the subsidiary level, the analysis produces three important results. First, EU subsidiaries of larger multinationals are more leveraged. Second, the use of Dutch onlending SPEs is associated with higher subsidiary leverage, whereas the use of other Dutch SPE types is not. Third, in large firms, the sensitivity of subsidiary leverage to host country tax rate is relatively low. In combination, these results suggest that large firms are more likely to shift profits from EU subsidiaries to special lowly taxed affiliates and that this is partly facilitated by Dutch onlending SPEs.

Thus, both external debt and intra-group loans channelled through Dutch SPEs have composition effects. Regarding external debt, this implies an additional revenue loss for Indonesia. The composition effect of intra-group loans is relatively small; in 2007, Dutch SPEs passed on only €0.2 billion of interest payments from developing countries to low-tax affiliates.

Royalty structures involving Dutch SPEs facilitate income shifting

Advance pricing agreements between SPEs and the Dutch tax authority that specify an alternative tax base can facilitate profit shifting to the Netherlands through royalty payments or other types of transactions. In 2007, Dutch SPEs received approximately €0.3 billion of royalty income from developing countries that was not passed onwards. At least part of these flows involved profit shifting to the Netherlands. Royalty payments from developing countries passing through Dutch SPEs were only €0.1 billion and thus relatively small. For developing countries, royalty structures involving Dutch SPEs therefore mainly have a composition effect, reducing the host country tax base.

Adverse effects of Dutch tax policy differ per country and depend on tax treaties

It can be concluded that several aspects of Dutch corporate tax policy have negative revenue effects on developing countries. A key policy aspect concerns Dutch tax treaties with developing countries that specify relatively large reductions of withholding taxes. Due to differences among tax treaties and partner country withholding tax regimes, Dutch tax policy affects some developing countries more than others. The unintended effects on withholding tax rates and on the composition of firms' assets and liabilities can be considered adverse, because these effects are incoherent with the aims of Dutch development policy and against the interests of developing countries.

Tax avoidance strategies facilitated by Dutch corporate tax policy also have an impact on the redistribution, representation, and re-pricing roles of taxation. At the international level, tax avoidance leads to redistribution from developing countries to the Netherlands and other high income countries. Distributional effects at the national level

depend on the domestic tax systems of developing countries. Regarding representation, tax avoidance by multinationals can weaken broader taxpayer morale and hinder constructive revenue bargaining. Finally, an important re-pricing effect is the distortion of competition between large firms that can engage in international tax arbitrage and smaller firms that cannot, reducing market efficiency. These negative effects on broader economic development are difficult to quantify, but may be at least as important as the direct effect on public revenue mobilization.