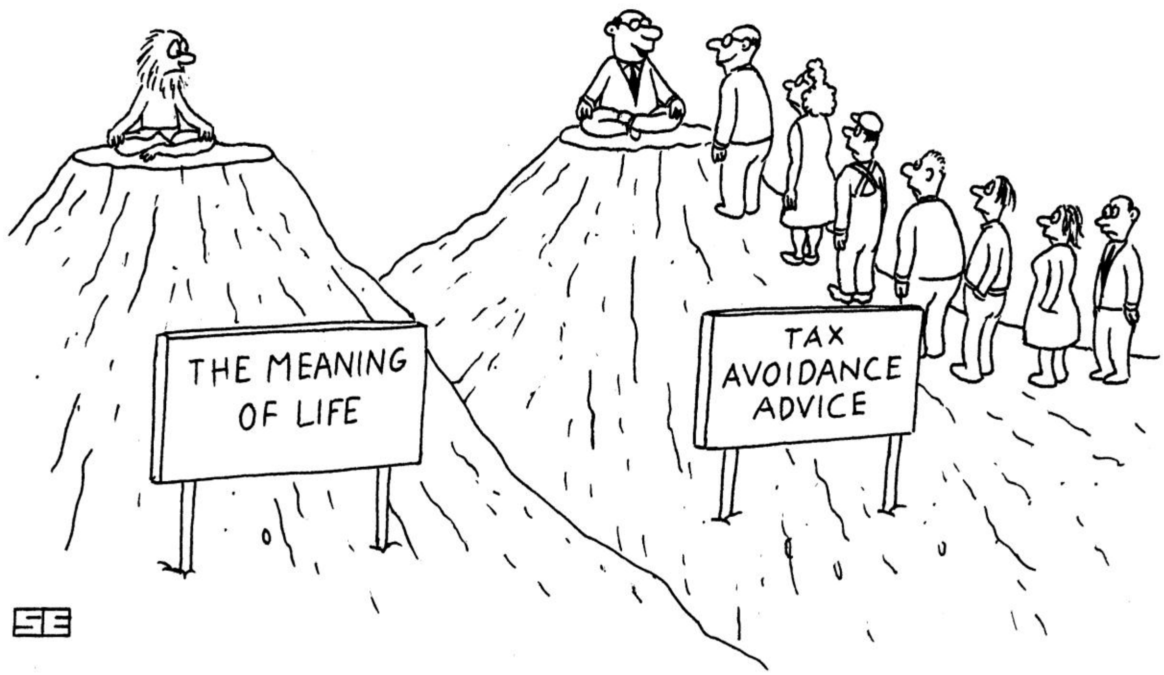
The Tax Avoidance Tale: Where and Why does the Money go?



Student: Monika Aleksiejute,

MSc International Business and Politics

Supervisor: Duncan Wigan,

Department of Business and Politics

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Abstract

Tax avoidance, as a legal arrangement of one's financial affairs to minimize tax liability, often involves the use of tax havens, or secrecy jurisdictions, to shelter or boost profits. It is estimated that 50 per cent of world trade takes place through tax haven states (ChristianAid, 2008). This paper is an attempt to unravel the tax avoidance phenomenon with an emphasis on the actors involved – the States and the Multinational Corporations.

Liberalization of trade, development of technology and increasing mobility of capital are several factors that have increased the cross-border economic activity as well as incorporated many remote corners of the world into the global production processes. How is it so then that the countries, participating in the global value creation, are not reaping the fruits in the form of wealth accrual from these activities? This paper makes an important distinction between the global value and wealth chains and why they do not take the same path in the production process. The argument is that the multinational companies navigate the different jurisdictions and place their revenue generating activities according to the favourability of the accounting policies and taxation regulations in place. The mismatch thus occurs between where the value is created and where the wealth accumulates. Additionally, the decentralization and evolution of the multinational firm is touched upon paying particular attention to intrafirm transactions, currently making up 60 per cent of all world trade (ibid). On the other side, the taxation systems have remained largely nationally oriented, alluding to the inability of the current international business taxation architecture to appropriately address the challenges of the knowledge economy.

Keywords: knowledge economy, tax avoidance, tax haven, multinational corporation, Google, global value chain, global wealth chain, OECD

1. INTRODUCTION

A recent case between Turquoise Hill Netherlands, an Amsterdam based company with 3 employees, no office and no personal mailbox, and the country of Mongolia showcased the mismatch between the places where the value in the global value chain is created and where the wealth is funnelled to (Reuters Mongolia, 2013). The dual taxation agreement allowed the firm to channel income from activities in Mongolia through the Dutch subsidiary without paying any withholding tax in Mongolia (ibid). In 2011, Mongolia decided to cancel the double taxation avoidance agreement with the Netherlands as it was costing the country income from the very profitable gold and copper mines located in Mongolia. It took similar measures to withdraw from treaties with Luxembourg, Kuwait and United Arab Emirates – all in an effort to keep the profits from the income, generated from its soil (ibid). While these measures would seem as going against the spirit of trade liberalization, for the developing countries it means trying to contain the wealth where the value is being created. This case is an illustration how the use of tax havens by multinational companies creates a mismatch between the place of value creation and wealth during the global production process.

1.1 Context and problem formulation

As the eight wealthiest nations of the world, known by the abbreviation of the G8, met in Lough Erne in Northern Ireland for their annual meeting of 2013, their focus was on the three T's – Trade, Tax and Transparency (G8 Communique, 2013). These priorities were spelled out by David Cameron at the meeting of World Economic Leaders in Davos as part of the programme for Britain's presidency of G8 in 2013 (Inside Government, 2013). Tax matters, and tax avoidance in particular, has received overwhelming attention in the past year. Speaking at the World Economic Forum in Davos, Mr Cameron strongly attacked companies that avoid paying their fair share of tax and which indulge in corrupt business practices in poor countries (Guardian, 2013). "Companies need to wake up and smell the coffee, because the customers who buy from them have had enough," the prime minister said (ibid) with a clear reference to Starbucks, which had been identified as having paid corporation tax only once in the past 15 years of operation in the UK (House of Commons Committee of Public Accounts, 2012). Mr Osborne, UK Chancellor of the Exchequer reiterated the same level of commitment at the beginning of 2013: “we are determined to use our [g8] presidency to drive a serious debate on tax evasion and tax avoidance. This will include action to help developing countries collect tax that is due to them” (ChristianAid, 2013). The inspiration for this thesis stems from the desire to unravel the phenomenon of tax avoidance. This paper will look into the evolution of the corporate form as well as juxtapose it with the nationally oriented taxation systems. The reasons behind the inability of the current international business taxation architecture to deal with the challenges posed by the participants of the modern economy will also be addressed as part of an argument why the wealth and value in the same production process do not correspond.

Tax avoidance includes two actors – the multinational firm, which is looking for ways to increase its profits, and the nation state, which is seeking to attract foreign investment onto its shores to collect additional revenue in the form of taxes. Therefore, the dilemma facing the regulators and institutions working to tackle tax avoidance is twofold: firstly, how to ensure that multinational companies pay their fair share of tax, and secondly, ensuring that countries do not engage in harmful tax competition, which minimizes the welfare of all parties involved. The ‘fair share’ of tax is a hotly disputed issue, envisioned quite differently by the profit seeking firms and the politicians, discussing these issues with their electorate. By seeking to attract businesses, the state acts as the participant of the marketplace, looking to draft laws that would benefit its interests the most, i.e. generate the most revenue. At the same time, jurisdictions work hard to ensure the additional economic activity results in increased revenues. The taxation systems put in place by various jurisdictions attract multinational businesses to establish in one or another country, and the jurisdictions hold on tightly to the ability to draft their own laws. Ability to write and implement taxation laws is seen as a manifestation of the national sovereignty (Palan, 2002). The taxation systems are therefore truly national in nature, and agreements with other countries exist in the form of bilateral treaties. The multinational firm, on the other end of the transaction, deserves detailed attention as well. As the economy becomes global, so do the businesses. The firm is no longer limited by geography and is able to assemble its products by buying and selling from distant parts of the world. Due to liberalization of trade the multinational businesses are decentralized, and have their legal, financial and accounting homes in different jurisdictions.

Embeddedness in the knowledge economy requires flexibility and innovation – value creation then becomes an iterative process where the suppliers as well as competitors could be involved (Helper et al, 2010). Products created are also much more complex and sometimes lack any physical form. The inputs that go into the production process require intangible inputs, as well as tangible ones. The customer is also becoming more demanding, requiring quality products at affordable prices. The company that is able to innovative and satisfy the demands of the modern consumer by assembling products regardless of geographies is a decentered firm. This modern multinational company presents challenges to the states whose rules of taxation and accounting are national in their very nature. This represents a new power dynamic between the state and the firm, where the businesses are mobile and flexible yet the taxation systems are national. This dissonance leads to inability of the jurisdiction to appropriately address the transactions happening within its borders as it loses control of capital. This is imperative for the creation of global wealth in the global production process, where the value inputs do not necessarily correspond to the wealth accruing from this process.

As tax avoidance is the focus of this thesis, the firm and state interaction will be analyzed through the lens of International Business Taxation (further – IB taxation). I will show that the existing IB taxation set-up is not equipped to address the challenges of the modern businesses. The firms increasingly rely on intangible inputs in their value creation process, and the product itself lacks physical substance. The principles of IB taxation, which were created to address manufacturing businesses rather than services, are rather obsolete. When the intangibles are introduced, appropriate mechanisms to evaluate them do not exist. Fundamentally, the dissonance between the existing set-up of taxation and the business embedded in the knowledge economy lead to tax avoidance. Multinationals move funds across jurisdictions depending on where the most favourable conditions can be found thus creating a wealth chain, separate from the global value creation chain. This paper will argue that that not only the value and wealth creation is asymmetric, but that the movement of wealth is motivated by the tax differentials of various jurisdictions.

Throughout this year, calls were made by the leaders of the G8 to task the OECD, the leading body of leadership in the area of international business taxation, to develop a common template for country-by-country reporting to tax authorities by major multinational companies (G8 Communique, 2013). This step represents a fundamental shift in addressing the separate entity approach, which is engrained in the current international business taxation set-up. Another important action point by the G8 was the commitment to developing an automatic information exchange mechanism (ibid). This step is another prerequisite to making the framework of international business taxation more efficient as secrecy is seen as the major factor contributing to tax avoidance practices. As acknowledged by the leaders of the world – International Business Taxation architecture in its current form is not equipped to deal with the challenges raised by the multinational business practices of the knowledge economy (OECD BEPS, 2012).

1.2 Research question

In this paper I will analyze the role of the IB taxation architecture in the wealth movement across the value chain and the interaction between the state and the firm facilitated by different tax regulations in various countries. The research question has been formulated in the following manner:

> *How do the taxation systems of various jurisdictions influence the wealth distribution in the global value chains?*

To answer this question, several sub-questions will be analyzed. *Firstly, how does the existing IB taxation architecture facilitate tax avoidance especially when intangibles are introduced? Secondly, how does the evolution of the corporate form and the national character of taxation systems impact the state-firm relationship with regards to tax avoidance?*

1.3 Research focus area

The purpose of this section is to familiarize the reader with the research object of the thesis as well as give reasons for the specific choice. As outlined before, the thesis will be analyzing the area of tax avoidance and will aim to analyze the multiple roles played by actors involved in the tax avoidance phenomenon, namely the states and the firms. Analytically, I will aim to show that the current set-up of IB taxation is not up to par with the modern business environment. As a consequence, through navigating the different regulations pertaining to taxation, multinational companies divert the wealth, created through the value creation process, to locations offering most favourable treatment in the form of taxation. This thesis will analyze the impact that different tax regulations of various jurisdictions have on the wealth accumulation in certain places of the world. The topic of choice is complex and a lot of details need to be analyzed to get to the core of the issue while. With an aim to answer research questions comprehensively a case study of Google has been chosen. Google representatives were recently summoned to a hearing by the UK Public Accounts Committee in 2012 and again in 2013 to provide answers about their tax planning operations. The case of Google allows me to represent several important angles. Firstly, the scope of the firms' operations globally exemplify a true multinational company of the 21st century. Google operates through 40 offices around the world and thus allows to take an in depth look into the reasons for the choices of locating their subsidiaries. With the focus on IB taxation of this paper, particular emphasis is paid to differentials in taxation and legislative codes in different countries of operation. Secondly, Google is an epitome of a truly knowledge based firm. Knowledge "is recognized as the driver of productivity and economic growth, leading to a new focus on the role of information, technology and learning in economic performance" (OECD, 1996, p. 5). Stemming from that the *knowledge-based economies* are "economies which are directly based on the production, distribution and use of knowledge and information" (ibid, p. 7). The knowledge based economy of which we are part of, differs from the preceding agricultural and industrial eras in that the knowledge society relies on the technology of knowledge generation, information processing, and symbol communication (Castells, 2000). Google's products are mostly based on intangible inputs, and largely, intangible outputs, relying on the importance of patents and intellectual property rights. Therefore, the choice of Google for the case study stems from the desire to juxtapose the current IB taxation set-up with the international decentered firm, truly at the core of the knowledge economy. A recent report by the OECD bluntly states that "current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy" (OECD BEPS 2012, p. 7). The case analysis of Google will allow analyzing the importance of taxation regulations of various jurisdictions and show how the differentials influence the routes that money flows take inside the multinational firm. Fundamentally, it will show how the decentered multinational firm employing mobile capital transcends the nationally oriented taxation systems at various points of production.

1.4 Theoretical framing and method

In order to answer the research question and sub-questions several strands of literature will be reviewed. Firstly, as I aim to analyze the tax strategies employed by Google, analysis of their operations is necessary. As the global value chain theory is positioned well to analyze the operations of multinational operations by tracking the inputs into the production process at various points of production, the choice of this literature is most suitable for this thesis. A critical outlook is taken on the global value chain literature as the primary purpose of the thesis is to track distribution of both wealth and value created along the chain. As a point of clarification it should be noted that the global value chains refer to the inputs into the production process at different points of this process. It could refer to design, marketing or more material inputs to create a final product. The global wealth chains on the other hand track the distribution of wealth in the global value chain, i.e. how much value the same actors involved in the value creation process are able to attribute for themselves. Whereas the global value chain literature acknowledges the gaps between the wealth and value created in the chain, it deals with how the value is created on the firm level, thus failing to explain the distribution of wealth that accrues to different countries from participating in global production processes. Moreover, the global value chain literature does not consider the impact of legislative background, and most importantly taxation rules as significant factors influencing the formation of global value chains.

In order to understand how the wealth accrues and travels in the global value chains, another strand of literature needs to be brought in. The wealth distribution aspect will be explained through the analysis of the offshore literature. The global value chain literature does not take into account the legislative environment and particularly the tax codes of different countries as factors, influencing the location decisions of the MNCs and it is a huge blind spot in light of this thesis. I will argue that the legislative environment and the different forms of taxation in countries of MNCs' operations have a definitive impact on the location of their subsidiaries. Moreover, the use of tax haven countries has a major impact on the wealth distribution in the countries of operation. For this reason, analysis of offshore literature is complementary to the global value chain literature to explain how value is created in the global value chains, and how the money flows inside the same value chain. Offshore literature is paramount in explaining why the value and wealth in the global value creation process is mismatched.

1.5 Thesis structure

This section will outline the chapter design of this thesis. The current chapter serves to set the stage for further research by outlining the research questions and the research focus area, as well as the theoretical framing and method. Chapter 2 will focus on methodological assumptions, reflect on the philosophy of science choice and research design and methods employed. Chapter 3 will serve as a review of global value chain and offshore literature. There I will also present the case of bringing the two theoretical endeavours together for the purpose of this thesis. It will also aim to showcase why the current set-up of IB taxation is not fit to appropriately administer the multinational businesses. Chapter 4 will be devoted to analyze the relationship between the state and the firm, analyze the decentering of the multinational firm as well as repercussions of the nationally focused taxation strategies of jurisdictions on the wealth movement in the value chain. Chapter 5 will analyze the main concepts in IB taxation and serve as groundwork for the case analysis of Google in Chapter 6. In this chapter I will show that the existing set-up of IB taxation is ill-equipped to address the decentered operations of the multinational companies. Moreso, IB taxation architecture falters when the intangibles are introduced into the production process. Chapter 6 will be devoted to a thorough case analysis of Google, placing a focus on their tax planning operations. Chapter 7 will present a conclusion and reflections on the findings of this paper.

2. METHODOLOGY

In this chapter I will outline the mixed method data collection approach by discussing the philosophy of science choice position. The philosophical stance informs the way information is gathered and knowledge is created.

2.1 Reflections on philosophy of science

This thesis is associated with the ontological stance of subjectivism, as it believes that social phenomenon and concepts are created from the perceptions and consequential actions of the social actors concerned with this existence (Saunders et al, 2009). Even if the actors that will be at the centre of this thesis, such as the states and the multinational firms, do exist externally to the knowledge of actors interested in their existence, it is the views and conceptions about these actors and their roles in tax avoidance that would shape the debate we are to carry out in this paper. For example, the state is usually regarded as a regulator in tax avoidance, but in this paper its role as the supplier of laws and regulations to the multinational corporation will be at the focus point. Furthermore, the interaction between the state and the firm will be analyzed through the lens of IB taxation, with an aim to show the mismatch between the actors and the very IB taxation architecture as of today. Remenyi *et al*. (cited in Saunders et al, p. 111) stress that subjectivist ontology allows to analyze "the details of the situation to understand the reality or perhaps a reality working behind them". It is these details that shape the situation and understanding of tax avoidance, as a phenomenon including two sides – the state and the firm.

The aim of this thesis is to explain and understand the phenomenon of tax avoidance as well as draw inferences to a broader set of implications and changes in the roles of states and firms. In order to achieve these multiple purposes, the thesis is grounded in the hermeneutical tradition. Hermeneutics, which means interpretation, stems from analysis of texts in the study of culture and aims to "reconstruct the relationship of individual units of meaning to a meaningful context" (Delanty, 1997, p. 43). In its essence the hermeneutical tradition stands for the subordination of explanation to interpretation, which cannot be minimized to mere observation (ibid). However, the strand cultivated by Weber emphasizes the importance of social sciences *combining* explanation with understanding. The positivist tradition, on the other hand, is based on observation of data by experiments: ”the kind of laws positivism seeks to uncover are causal laws and have the power of explanation” (Delanty, 1997, p. 12). As I seek to *explain* the phenomenon of tax avoidance, I also seek to *understand* how different actors involved contribute to shaping this phenomenon. By explaining the tax avoidance structures used by Google, I aim to understand how the mismatch between where the value is created and where the wealth from this process is siphoned to occurs. In this sense, hermeneutics allows me to achieve these dual purposes, where the positivist tradition does not.

Interpretivist tradition is chosen as it is based on the understanding that “a strategy is required that respects the differences between people and the objects of the natural sciences and therefore requires the social scientist to grasp the subjective meaning of social action” (Bryman, 2001, pp. 12–13). As scientific concepts and rules are very different from those found in social everyday life, therefore an external position to analyzing those events cannot be taken, as argued by positivism (Winch, cited in Delanty, 1997). The laws of the society are fundamentally different from the laws of the natural world and a method which allows to analyze content as well as physical relations needs to be applied (Fay, 1996). Positivism argues for the unity of sciences and the same study methods to be applied to both the natural and social sciences. However, the study methods applied in positivism would not allow to fully comprehend the objects of this study paper - an analysis of facts (or funds involved in tax avoidance) would not portray the full picture without understanding the role that different jurisdictions and their tax codes play in contributing to the phenomenon. The relationship between the state and the firm is approached through the lens of IB taxation, thus understanding the state as the supplier of regulations. Interpretivism allows to take into account the multiple roles that actors can play, and how this contributes to shaping the phenomenon being studied. This thesis will aim to grasp the relationships between different actors involved in the phenomenon of tax avoidance, as well as the context in which these actors interact, therefore the strategy facilitated by interpretivism is considered to be most suitable.

Moreover, hermeneutics allows to interpret the multilayered realities of meaning and dualistic roles played by actors (Delanty, 1997). The role of the state is traditionally that of a regulator upon the citizens and businesses within its borders, however, in the case of tax avoidance, the state takes up a role of a supplier of legislation. The context in which this happens and what forms the relationship between the state and the firm is as important as the interaction between them. The analysis of content as well as context is strongly linked to the study of history and its implications on the phenomenon being studied, which is another important aspect of analysis in this paper.

2.2 Methodological approach

The research questions and sub-questions, as well as the philosophy of science choice are the main determinants of the methodological approach of this thesis. Due to the variety of angles in the research question, the thesis will take an <u>exploratory</u> as well as <u>explanatory</u> approach. In order to answer the complex question of the significance of tax planning strategies in the affairs of Google, the set-up of International Business Taxation needs to be explored. This part of the thesis is crucial in that it sets the stage for the case study, where understanding of main language and terms is necessary to draw implications on the relationship between the state and the firm, i.e explain those implications in a real-life context. As I approach the relationship between the state and the firm through as that between the buyer and the supplier, I make us of the explorative method. Possibility to view the relationship between the state and the firm through this lens invites new insights into this relationship, which is an indication of an exploratory approach (Robson, 2002, cited in Saunders et al, 2009).

The thesis is carried out using the approach of induction. This method aims to draw implications or conclusions from objects we have examined to those objects we have not yet examined. This method is useful for this study as the area of study is novel and no single theory allows to test its assumptions in real life. Instead, by taking a real life case of tax architecture of Google I will draw inferences on theory and the interaction between the state and the firm. By way of inductive reasoning I will argue that what we observe in the case of Google exemplifies a larger phenomenon and explains the asymmetry between the flows of inputs and distribution of wealth in the global value chains. Moreover, as no one strand of literature would allow me to test the influence of IB taxation on the interaction between the state and the firm, I mesh the theory on global value chains with the offshore literature. By doing this, I aim to set the groundwork for the later case study of Google. By analyzing the operations of Google's subsidiaries and their interactions I aim to find out the role played by different taxation laws of different countries. As I interpret the quantitative data, I draw on the knowledge of history, legislative background of different countries, which is crucial to interpret the motives of Google. As I narrow it down to the case of Google, I aim to take a detailed look into its operations as I see Google as a representative of a broader phenomenon taking place in many multinational companies. Through the inductive analysis my goal is to show that International Business Taxation plays a crucial role in the relationship between the state and the multinational firm. The inductive method of reasoning, paired with a mixed methods analysis while mostly relying on the qualitative analysis of the quantitative data, allows to draw generalizations about the tax avoidance phenomenon onto the broader subject of value creation and wealth distribution mismatch.

2.3 Research methods

As it was already mentioned earlier, the empirical part of this thesis will analyze the case of Google. The research will be carried out through the analysis of both primary and secondary data. A focus will be placed on the financial accounts, from where quantitative data will be extracted and analyzed (primary data). Interpretation of the financial accounts will be supplemented by the interpretation of the historic and law making background of different countries (secondary data).

Research will be carried out through the analysis of Google's operation in a certain region, as it allows to combine "an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence" (Robson 2002, cited in Saunders et al, 2009, p.178). An in depth analysis of the Google's tax accounts allows to observe and analyze the phenomenon not considered in depth before. Through the case analysis the context can be highlighted, which influences on the outcomes of the phenomenon being studied (ibid).

The use of the mixed method allows to explore the quantitative information in the real-world context which is in line with my choice of philosophy of science (Saunders et al, 2009). To comprehend the tax planning activities of Google it is necessary to look into their financial data and reports, which is quantitative data. Some calculations are made to arrive at the data necessary for the purpose of this thesis. A qualitative method is employed when the numbers from the accounts are interpreted and put into the context of larger operations of Google. The tax planning operations are also assessed in the context of several countries of operations. The qualitative method of interpretation is applied when analyzing and explaining the different legislative systems of the United States, Ireland, Netherlands, the United Kingdom as well as Bermuda. In this sense, the hard facts are put into the real life context – what those legislative rules and tax codes mean in the specific case of Google and how they impact on the goals that Google is trying to achieve with its tax planning operations globally.

3. LITERATURE REVIEW

In this chapter I will analyze the global value chain literature in conjunction with the literature on tax havens. Bringing together the two strands of literature is necessary to address the parallel processes taking place during the value creation process that neither literature takes up on its own. The global production of goods tracked by the global value chain tradition does not take into account the money flows taking place in during the value creation process. The ability to track the money flows are crucial to understand the distribution of gains from the value creation processes. The money flows, or the flows of gains (wealth) in the value chain are in a major way influenced by the accounting and taxation rules, in place at different jurisdictions. The offshore literature thus allows to analyze this financialization of global production and the flows of gains in the value chain. However, the offshore literature is not concerned with the global production processes or the inputs that go into this production process. Therefore, by bringing these two sets of literature together I will show that legal infrastructure (especially business taxation and accounting rules) at different points of production could help explain the misalignment between the inputs and outputs from the production process.

In the first part of this chapter I will review the global value chain (GVC) literature, its main definitions and origins. Through the critique of GVC literature I will argue that accounting rules, legal regulations and codes enforced by the states constitute a crucial element in global supply chains. Secondly, I will discuss the offshore literature (or tax haven literature) and how it enhances the understanding of the money flows during the global production process. With financialization of firm activities secondary actions that the firms are involved in determine the outcomes in gain distribution throughout the value chain. Finally, I will aim to show how by bringing these two sets of literatures together we can see a more holistic view of the gain distributions in the value chain.

3.1 Global Value Chains as a way to analyze the dispersed production processes

The Global Value Chain literature has been growing at a steady pace since the early 1990’s as part of a framework introduced by the development scholars Gereffi and Korzeniewicz called the 'global commodity chains' (GCC). Global commodity research is "an endeavor to explain the social and organizational structure of the global economy and its dynamic by examining the commodity chains of a specific product or service" (Lee, 2010, p. 2987). It is a convenient way of analysis of inputs into the production process and could be defined as "the process by which technology is combined with material and labour inputs, and then processed inputs are assembled, marketed, and distributed" (Kogut, 1985 cited in Gereffi et al, 2005, p. 79). The GCC concept itself emanates from the world-system's tradition formulated by Hopkins and Wallerstein in the 1970s (Bair, 2005 and Lee, 2010). The world-system's tradition did not see the global economy's development as a sequential process whereby national markets evolve in the direction of expanded foreign trade but rather as something they called the 'commodity chains', where the different economies are tied together in a process of global production (Bair, 2005). However, the world-system's approach is a broader attempt, encompassing not only the trace of inputs into the production process, but also analyzing the broader questions of the structure of society in the capitalist era, such as the division of labour or exploitation (Van der Pijl, 2009). The GCC concept is primarily concerned with capturing the emerging patterns of post war industrialization, characterized by the disaggregation and spatial spread of production activities, which are then functionally reintegrated by multinationals into a coherent production process (Lee, 2010). In this regard, the GCC concept allows to analyze the processes of production taking place within one or several companies as part of the same production chain. In light of this thesis, the GCC concept is a good framework to look into the globally dispersed multinational corporation and trace the inputs at various points of production. This holistic view of the production process is a breakthrough from previous way of analysis, which focused on relationships between and within the firm as a rather disintegrated process. The framework of the global commodity chains is relevant in this thesis as it allows taking a systemic look into the trade and supply patterns in a globalized production process by bringing the fragmented production processes to one coherent picture (Gereffi et al, 2005).

In the 2000's GCC scholars moved to the term Global Value Chains (GVC) as the term 'commodity' was deemed too narrow for the service driven modern economy. GCC had a connotation with a uniform, undifferentiated good, easily interchangeable with others and as a result of this approach GCC focused on export oriented industries, such as automobiles, apparel or footwear (Lee, 2010). The notion of interchangeable goods was no longer accurate as the world saw the emergence of internet based firms, spanning all continents, basing their production processes on intangible inputs and producing goods lacking physical substance. These products were far from uniform, and often protected by patents or intellectual property rights to preserve their uniqueness. The switch to 'value' from 'commodity' was also influenced by the aim to become more industry neutral and make the research more fitting to the modern knowledge economy, where the inputs in the production processes are more sophisticated as are the firms involved in these processes –creating value, rather than a commodity (ibid). In this thesis, I will use the term GVC, as it seems to be more fitting to the analysis of the knowledge based economies and firms. Moving away from the term commodity allows to take a look into the value creation in the broadest sense, rather than a movement or production of commodity. The GVC is also more reflective of the financialization, in which a growing number of firms is involved as a supplement to their production processes (Milberg, 2008).

The value chain process could describe a full range of activities that companies perform to bring a product from its conception to final use (globalvaluechains.org, 2011 cited in Gereffi and Fernandez-Stark, 2011). These value creation activities include design, production, marketing, distribution and support to the final consumer. The GVC methodology deals with activities within a single firm or divided among different firms (ibid). Fundamentally "the GVC framework allows one to understand how global industries are organized by examining the structure and dynamics of different actors involved in a given industry" (ibid, p. 2). The GVC methodology is also comprehensive in going beyond the inputs into the production process, it can also trace the shifting patterns of production, link geographically dispersed activities and actors, and determine the roles these actors play in developed and developing countries (ibid). Fundamentally, the GVC framework focuses on the sequences of value added within an industry, from conception to production and end use. It could go as deep as examining job descriptions, technologies, standards, regulations, products, processes, and markets in specific industries and places, thus providing a holistic view of global industries both from the top down and the bottom up (ibid). It is very important to note that while the GVC framework is well positioned to trace the inputs into the value creation process, it is not designed to analyze the movement of money, or wealth, in the value chain. Moreover, as will be observed the GVC framework largely neglects the impact of the institutional framework and does not take into account the variety of regulations, in the form of tax codes or laws, that attract the multinational businesses to a particular jurisdiction for either ease of production or the appeal of regulations. This is a crucial blind spot for the analysis of this thesis, as I aim to trace not only the value creation process by the way of inputs, I also aim to show that the wealth accrued at certain nodes of production does not match the inputs at that production point. For this reason, another strand of offshore literature will be brought in.

3.2 Focus on the firm level to explain distribution of gains

The GVC framework is a great method of analysis to track the inputs into the production process at various points of production. However, the aim of this thesis is to show that the tax codes of different jurisdictions have major influence in altering the wealth, or gains that accrue during that production process. Kaplinsky (2000) poses a question why there has been little correspondence between the geographical spread of economic activity and the spreading of gains from participating in the global product markets. He argues that if those who had lost from globalization were confined to non-participants in the global production process the cure would be simple – working to include those outsiders into the production chain (ibid). This section will thus be an insight into how the GVC literature explains the differentials between the inputs and outputs from participation in the global value creation process.

A distinct feature of the value chains literature is its focus on the organizational linkages inside or between firms participating in the production process (Lee, 2010). The governance of global value chains has received the most theoretical and empirical attention to date (Gibbon et al, 2008). Governance was defined by Gereffi (1994, cited in Lee, 2010, 2990) as “authority and power relationships that determine how financial, material, and human resources are allocated and flow within a chain”. It seems then that looking deeper into the models of governance of GVCs would allow us to analyze what determines the financial allocation and flows within a chain. Several models to tipify the power relationships in the value chain were produced. The first one is the buyer versus the producer driven value chain paradigm, which highlights the importance of coordination across firm boundaries (Gereffi et al, 2005). The buyer driven value chains are governed by lead firms as buyers that utilize many independent suppliers (Lee, 2010). The producer driven chains are driven by vertically integrated large enterprises, that control the production system, through direct ownership or tightly knit alliances (ibid). However, only firms are considered to be productive actors, participating in the value chain of activities. Several groups of productive actors are distinguished in literature: an integrated firm, the retailer, the lead firm, a turn-key and a component supplier (Sturgeon, 2001). This scheme allows us to measure power between firms, analyze how that power emerges, depending on the industry and other firm specific factors. The country level is not touched upon in the buyer versus producer typology; the country is not considered to be one of the productive actors. The second distinction with regards to governance typifies five value chain governance types, depending on the role and power symmetry between the producers and buyers in the value chain (ibid). The parameters influencing the relationship and type of a relationship between a buyer and a producer are the complexity of transactions, codifiability of information, and capability of suppliers (ibid). All these parameters seem to have major influence on how much influence a certain subsidiary will be able to exert on the network, its ability to upgrade in the value creation process and similar firm-level parameters. However, going back to the definition of governance which stresses the allocation of resources in the value chain, it seems that neither of the governance paradigms described above touch upon the institutional environment that the chain operates in. The laws of incorporation, accounting rules and taxation systems of various jurisdictions where production nodes are located have major impact on the distribution of gains in the global value creation process. However, the GVC framework is not aiming to analyze the macro factors on the governance of value chains.

Kaplinsky (2000) outlines several other parameters that allow certain subsidiaries attribute a larger portion of value than other in the same value chain - ability to innovate and create barriers to entry. These barriers create rent opportunities that a subsidiary can charge on its production. The ability to innovate is linked with creation of competitive advantage and ability to crowd out competition. The roles of governments in this case is seen as assisting producers in realizing where the competitive advantages lie, or helping them to enter the profitable chains of production. However, the focus on firm level upgrading or focus on innovation by certain subsidiaries should only be able to explain the gain distribution between subsidiaries, not countries. Moreover, why then certain subsidiaries, located in resource rich jurisdictions are not able to extract as much value from participating in the production process?

Moving on to the macro level, the GVC scholars argue that the unequal distribution of gains in the value chains depends largely on "the country's ability to upgrade its mix of coriperipheral economic activities" (Gereffi and Korzeniewicz, 1994 cited in Lee, 2010, p. 2989). In their original article Gereffi and Korzeniewicz (1994) argue that the distribution of wealth is different among the nodes in the commodity chain because of ability to create monopoly and thus crowd out competition from other countries. They extend their argument through analysis of core and peripheral countries – as innovation is taking place in the core countries, the competitive pressures are transferred to peripheral areas of the world economy (ibid). In another attempt to explain the distinction between the 'poor and rich countries' the role of relative value of commodities produced in each geographical area is emphasized (Applebaum et al, cited in Gereffi and Korzeniewicz, 1994). While these arguments largely explain the location of production facilities, and the concentration of activities in certain countries, it does little to explain why certain countries, whose specialism in the production process is certainly in high value creating activities, do not enjoy the corresponding accrual of wealth.

Institutional environment is one of the most understudied aspects of the GVC tradition and calls for a more inclusive approach of the external environment, the governmental policy and even the regional economics have been made (Bair, 2005). This deficiency in GVC literature is the crucial claim of this thesis – the legislative infrastructure of the state needs to be considered to address the money flows in the value chain affecting the distribution of gains in the value creation process. As will be seen from the case analysis of Google, the United States, the United Kingdom and even Ireland, being countries with specialization in innovation and potentially having the ability to crowd out competition from peripheral countries, do not enjoy the benefits of wealth attribution reciprocal to the role they play in the value creation process.

Therefore, while GVC analysis is useful in tracing the inputs at various points of production and explaining why certain production nodes are located in particular jurisdictions, the larger picture of wealth attribution is not successfully explained. It is the core argument of this thesis, that in order to explain the movement of wealth and the attribution of gains in global value chains, institutional aspects need to be brought into the picture. More specifically, the laws and regulations in the area of taxation seem to be the determining factor attracting corporations to establish their subsidiaries in certain jurisdictions. Furthermore, the financialization of the global value creation process needs to be explained to grasp the role of money and financial activities in the global value creation process.

3.3 Financialization of the global value chains

Milberg (2008, p. 5) talks of financialization as a process during which the ”non-financial firms have increasingly used finance rather than production as both a source and a use of their funds”. This new focus is not only the provision of financial services but also ”the increase in the share of assets of the firm that are financial and the increased use of firm profits to raise shareholder returns” (ibid). The focus on the financial side of business is inspired by increasing attention to shareholder value and growing profitability of financial investments versus other investments. Pairing the rise of financialization of firms' activities with increasing globalization of production (or vertical disintegration of the value chain) leads to increasingly shifting distribution of activities as well as gains in the value chain. Many manufacturing firms actually do no manufacturing at all, having outsourced main production processes, yet they are able to appropriate much of the value created in the chain by exerting control over the subsidiaries (ibid). The countries hosting the manufacturing processes enjoy much lesser benefits, due to continued pressure on lowering the price of input products into production (ibid). The headquarters of MNCs engage in the most profitable nodes of the production process, further leading to asymmetries in gain appropriation. Whereas the literature on financialization of production activities touches upon the asymmetrical distribution of profits in the value chain, it fails to address the profit shifting and transfer pricing schemes employed by multinationals. These schemes allow to capitalize on the synergies stemming from embedded production networks and intra-trade activities within the firm. The financialization of activities of non-financial firms is one important aspect of global value chains, yet the financial motivation of firms is another one. The motivation to position revenue generating activities in very particular parts of the world could also be considered financialization as it largely impacts on the money flows in the global value creation process. The differentials between international business taxation systems allow the financially motivated multinational to use it to their advantage, which results in asymmetrical distribution of gains throughout the value chain. While the GVC literature has not considered the implications of globalized production for the money flows the financialization school of thought has also neglected an important aspect of financial motivation, which leads firms to locate their activities in certain spots around the world. For this reason, one needs to supplement the framework of GVC, and particularly a highly financialized GVC, with a strand of literature which would deal with the motivation of multinational businesses shifting wealth in a particular direction during the global value creation process. For this reason, the offshore literature will be analyzed in the next section.

3.4 Offshore literature: movement in the global wealth chains

In this section I will take upon the analysis of tax haven states and how their role is contributing to shaping the global wealth chains. The chains of wealth that I refer to are the parallel process taking place in the global value creation process. Ideally, the place of value inputs should be symmetrical to the wealth accruing in the same spot. For example, a firm, or a subsidiary of a firm, located in a mineral rich country, employing local staff should be amassing a corresponding amount of wealth from the economic activity in that part of the world. The economic activity should be generating profit where it is taking place. While the GVC methodology analyzed above is well equipped to analyze the global value creation process, it also acknowledged that the accrual of wealth and value in the global production process is not symmetrical (Kaplinsky, 2000). This section will explain how the wealth is moved along the value chain principally in the direction of tax haven countries, which lure mobile capital with attractive legislative environment and particularly tax laws.

Tax haven activity and the tax planning schemes of multinational corporations are getting a lot of attention in light of the recent tax avoidance scandals including the well-known company names. Starbucks, Google and Amazon were all summoned to testify about their tax operations before a UK House of Commons Committee of Public Accounts at the end of 2012 and once again in 2013 (UK House of Commons Committee of Public Accounts report, 2012 and 2013). The executives of the companies were questioned why the tax bill paid in the UK, was not in line of what the politicians would have expected by looking at size of operations these companies run in the UK, or the amount of profits that are derived from these markets. Schmidt of Google was explicit in saying that he is most proud of the tax optimization strategies of Google while emphasizing that Google always acts in accordance with the letter of the law in the countries it operates (ibid). Furthermore, stressing the capitalist spirit and enhancement of the shareholder value he admitted that Bermuda plays a key role in the network of Google's operations.

OECD (1998, p.20) defines tax havens as countries "that are able to finance their public services with no or nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence". It is these nominal tax rates that attract the MNCs to the secrecy jurisdictions. OECD differentiates between tax havens and harmful preferential tax regimes (PTRs) and has separate sets of recommendations how to identify and fight such practices. Several criteria identifying a regime as a tax haven or a harmful PTR overlap (for example, both are defined as offering low or nil taxation, both target mobile capital). The Tax Justice Network (2007) considers both tax havens and harmful PTRs as conforming with certain criteria ascribed to a tax haven. To conclude whether a country is a tax haven or not Tax Justice Network performs the reputation test whereby other jurisdictions can suggest that other countries are tax havens. The laws and rules, governing international business of the mentioned jurisdiction, are analyzed to conclude whether it portrays features of a tax haven (ibid). The IMF, on the other hand, only focuses on the Offshore Financial Centres (OFCs). OFCs are defined as zones "which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity" (IMF, 2000). While the attributes here are very similar to those identified by OECD pertaining to a tax haven (low taxation, light regulation and secrecy), the distinction of the OFC is the specialization in financial and banking services. OFCs range from financial centres, such as Hong Kong or Singapore with well-developed architecture and financial markets, to

Caribbean centers ”where value added is limited to the provision of professional infrastructure” (ibid). The Financial Stability Forum (2000, cited in Tax Justice Network, 2007) identifies several more characteristics of OFCs: no withholding taxes, flexible use of trusts and other special corporate vehicles, this providing a more detailed list of attributes constituting a tax haven. An important dimension of tax havens can be extracted from this definition – the benefit of secrecy, which is a crucial point in itself, adding to the attractiveness of the services rendered in the secrecy jurisdictions. The services only cater to the mobile capital, and thus the domestic firms are excluded thus creating unequal competition terms. The crucial point in the tax haven business is that it “creates the legal instruments by which individuals and companies can reduce, or completely sever, their “connecting factor” to their country of origin. They do so knowing that individuals and companies have an incentive to sever their connecting factor: to avoid taxation” (Palan et al, 2010, p.81). It can thus be extracted that tax haven states attract the mobile capital of the multinational firms by offering them attractive tax rates or other beneficial regulations, allowing them to minimize the amount of tax paid in other jurisdictions. The ability to sever the “connecting factor” to a jurisdiction where the taxes would otherwise be paid (i.e. the wealth would accrue from participating in value creation) alter the wealth distribution in the global value creation process. Fundamentally, tax haven states thus amass amounts of funds without creating the actual economic value, as the value is created in other jurisdictions.

The role of tax haven states is critical in understanding how the money flows inside the multinational corporation and why the value and wealth is not posted in the same location.

Tax Justice Network finds 69 countries fitting into the description of a tax haven (Tax Justice Network, 2007). These identified countries are involved in one or another form of tax competition with other jurisdictions. Tax competition is understood as a process where jurisdictions use fiscal incentives (such as tax breaks and subsidies) to attract investment (Tax Justice Glossary, 2006). Testifying to the viability of this strategy are the numbers illustrating the amounts of money that that are accrued in offshore jurisdictions. Calculations show that “half of the global stock of money goes through offshore” (Cassard, 1994 cited in Palan et al, 2010). Bank of International Settlements’ data suggest that Cayman-registered banks have accumulated more than USD 1.5 trillion in deposits, Luxembourg registered mutual funds have amassed more than USD 2.3 trillion assets, and Swiss private banks manage about USD 4 trillion of assets (Sullivan, 2007). What is more, approximately 30% of all FDI is invested or passes through tax havens (Palan et al, 2010). This is primarily done for tax reasons: to take advantage of more favourable conditions, avoid the withholding taxes or take advantage of tax credits (ibid). On the other side of the picture we have the countries which lose out the money which is diverted to the tax haven regimes. USA could be losing USD 100 billion a year due to the use of tax havens, while estimates for the UK vary, the figure could be as high as £18 billion (Levin and Murphy cited in ActionAid, 2011). The effects of tax avoidance are especially striking in the case of developing countries - according to OECD, developing countries lose almost three times more to tax havens than all the aid they receive each year – and amount that would be sufficient to reach the Millennium Development goals (ActionAid, 2011). All these figures go to show that the value creation points and the points where the gains are posted do not correspond as the money is shifted to the tax haven states.

The use of "brass-plaque" companies, or subsidiaries of companies, established in the tax haven states allow the multinational companies to reduce their tax bill. More than that, it allows the companies to divert the flows of money to jurisdictions, which offer more favourable treatment in the form of lower or non-existing taxes. A case study by the Centre for Research on Multinational Corporations (Reuters, 2013) found that use of the Dutch tax system by multinational corporations causes 1 billion US dollars in annual lost tax revenue in 28 developing countries. Estimates show that there are around 12,000 of these shell companies in the Netherlands, known as the special purpose institutions. Around 10 trillion US dollars in dividends, royalties and interest were channelled through them (ibid). However these 12,000 companies create only 13,000 jobs in the Dutch economy and generate roughly 3 billion euros in annual income. This amounts to less than half per cent of annual the Dutch GDP, showcasing that the actual value created and the wealth diverted from other jurisdictions do not correspond due to the fact that the Netherlands is only used as a shell (research by Amsterdam University's Centre for Economic Research, cited in Reuters, 2013). The value created elsewhere is diverted to the Netherlands because of its extensive network of double taxation avoidance treaties, allowing to funnel the funds further where they will be subject to even lower tax rates.

To conclude, paired with the literature on global value chains, offshore literature allows to take a holistic look in the global production process: both the movement of goods, i.e. inputs into the production process as well as the movement of money, i.e. distribution of gains or wealth along the chain. The institutional environment in the form of tax codes and regulations is a strong impetus for multinational corporations, disposing with mobile capital to shift the wealth from the production process to those jurisdictions offering most favourable treatment. The next chapter will be an analysis of the different roles played by the jurisdictions and multinational firms in tax avoidance. The development of roles of the actors involved as well as the evolution of actors contributes to the core understanding of the differences between value and wealth in the global value chain.

4. TAX HAVENS AND MULTINATIONAL CORPORATIONS: TWO SIDES TO TAX AVOIDANCE

This chapter will focus on two sides in the tax avoidance story: the Multinational Corporation (MNC) and the State. Firstly I will look at the emergence of the tax haven state. Tax havens as a concept did not evolve overnight nor were they a creation of one country. The variety of attributes that could be assigned to tax havens is not clear cut and open for change. This fractured development at different parts of the world is indicative of the way jurisdictions have chosen to deal with taxation matters. International business taxation is seen as an expression of state sovereignty and the national character of taxation is pervasive. This national scope of taxation is in clear contrast with the evolution of the multinational corporation which I will tackle in the second part of this chapter. Increasing role of mobile capital as well as use of intangibles allows MNCs to transcend country borders. The corporation is not limited by national borders and moves across jurisdictions rather seamlessly. This chapter will tackle the research sub-questions regarding the evolution of the corporate form and the national character of taxation system. It will be seen that the national focus of taxation systems is in stark contrast with the global playground of the MNC. This affects the power relationship between states and firms and contributes to the inability to appropriately tax the mobile MNCs. Looking into the relationship between the state and the firm will help understand the reasons behind the misalignment of wealth and value in the value chain. By juxtaposing the decentered multinational firm with the nationally oriented taxation systems I will show how this adds to the inability of the state to control the capital and the wealth retained in its borders.

4.1 Fractured development of tax havens

This section gives background information on the evolution of tax havens. I will argue that the way in which tax havens emerged – multiple jurisdictions came up with the attributes of the modern tax haven state – could be considered fractured. Fractured here refers to the nature which is uneven and stems from many sources. Attributes of the tax haven state were rolled out by different jurisdictions which attests to the fractured nature of the phenomenon. Tax havens facilitate tax avoidance, which is a legal method of diminishing the tax obligations. Tax havens are involved in tax competition with other jurisdictions seeking to attract mobile capital. The inability to pinpoint to the exact features of a tax haven makes this concept fluid and prone to change. Moreover, the nature of competition between jurisdictions is a key cause for the national character of taxation systems, to be discussed in the following sub-section.

Tax avoidance is defined as the arrangement of one's financial affairs to minimize tax liability within the law (Oxford Dictionary, 2013). It is important to note that tax avoidance is not tax evasion, which is illegal non-payment or underpayment of tax. It is believed that tax avoidance contributes to the tax gap, which refers to the difference between what the taxpayers should pay and what they actually pay on a timely basis (HRMC, 2013). US Senate report estimates that the USA could be losing USD 100 billion a year due to the use of tax havens (Levin, cited in ActionAid, 2011). Estimates for the UK vary, but the figure could be as high as GBP 18 billion annually (Murphy, 2011, cited in ActionAid, 2011). Fundamentally, it also leads to the misalignment of wealth, as the countries which anticipated the increased revenue end up seeing this income siphoned away to other jurisdictions with more favourable regimes.

The very nature of legality, tells us that tax avoidance is not restricted to corporations or individuals (however this thesis has a focus on corporations rather than individuals and will proceed discussing only this segment). Tax avoidance also involves countries, who play a very active role. By providing a home to corporations, seeking to minimize their tax bill, states use tax competition as a form of state strategy. Tax competition then is the process where jurisdictions use fiscal incentives (such as tax breaks and subsidies) to attract investment (Tax Justice Glossary, 2006). Structural changes in the world economy, such as capital liberalization, technological change and financial innovation have greatly increased the volume and mobility of international capital (Palan et al, 2010). These changes have provided impetus for countries to compete in attracting this mobile capital to their soil - for as when the capital is mobile, the companies do not need to be registered, managed and operated all from one place. The Governments then could deploy their most prized sovereign possession - the right to write tax law to to attract non-residents. This presents a development strategy for some states, as they hope to collect more taxes or create more by attracting MNCs. Strange (1988, p. 564) has captured this phenomenon: "states are now engaged increasingly in a different competitive game: they are competing for world market shares as the surest means to greater wealth and greater economic security".

For some small states or remote islands, the choice of becoming a tax haven could be the one steady source of income to complement tourism. By carving out a niche in the financial world (offshore banking, captive insurance services) such countries rely on certain sectors to attract mobile capital into their domains. In this regard, offering certain sweeteners to MNCs becomes not *one of*, but *the one* strategy. For another set of players tax competition is a good way to supplement income by attracting MNCs. Dharmapala and Hines (2009) go on to show that there is actually a positive correlation between the probability of a state to become a tax haven and its governance. The better governed the country is, the more likely it is to become a tax haven and succeed in this strategy thereafter. Tax havens score very well on cross country indices of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and the control of corruption (ibid). The list of top 10 secrecy jurisdictions around the world shows us just how varied the tax haven world is: United States (State of Delaware), Luxembourg, Switzerland, Cayman Islands, the UK (City of London), Ireland, Bermuda, Singapore, Belgium and Hong Kong (Forbes, 2010).

The emergence of the modern tax haven state was not linear or straightforward, as several countries in different parts of the world came up with a selection of features that are ascribed to tax havens today. Delaware and New Jersey of the United States pioneered a central tenet of international business architecture - incorporation within incorporation, giving each subsidiary a separate legal entity status (Palan et al, 2010). Switzerland offered secrecy to corporations through their Banking Act of 1934, which included conveying banking secrets punishable by criminal law. The third element to the tax haven profile was added by Britain which introduced the notion of "virtual residency" (ibid). The connection between management and control of the company and its residence rather than the place of registration was emphasized, which is believed to be a crucial cornerstone in the legitimization of the tax haven concept (Picciotto, 1992). Three broad categories of tax havens could be identified. First and largest is the British Empire-based tax havens, consisting of the Crown Dependencies, Overseas Territories, Singapore and Hong Kong, centered at the City of London. The second grouping are the European tax havens, specializing as headquarter centers or financial affiliates. The third group is least uniform spanning from the likes of Panama and Dubai to new and emerging havens from transition economies and Africa (Palan et al, 2010). The broad categories inform us that the tax haven world is varied and non-uniform.

It is fair to say, that no state has developed the tax haven strategy fully, rather details were added as a response to special circumstances of their time (Palan et al, 2010). This fragmented process through which the modern tax haven state has emerged leads to difficulties identifying the secrecy jurisdictions. The OECD has named only 39 countries fitting into a definition of a tax haven (Tax Justice Network, 2007). The Financial Secrecy Index (2011), on the other hand, focuses on 73 jurisdictions which have set up laws and systems to provide legal and financial secrecy to others. This index measures the level of financial secrecy in both quantitative and qualitative terms. Financial secrecy refers to several tenets – bank secrecy, permission to create entities whose ownership or purpose is kept secret, and creation of barriers for information exchange (Financial Secrecy Index, 2011). This index is a much broader assessment of tax haven states. Among the ones not identified by OECD but considered to have features of a tax haven by the Financial secrecy Index are the US, UK, Switzerland, Singapore, the Netherlands or Ireland.

Tax havens as a concept did not develop overnight. It was not an invention of one country, but rather a mixture of developments that took place in different countries over a period of time. It is precisely this complexity of factors that make tax havens so hard to identify or define. Moreover, the nature in which tax havens evolved leads to the next section – the national focus of taxation systems. The nationally focused taxation systems present a stark difference to the multinational corporation, which operates across borders and escapes the borders of national sovereignty. This juxtaposition of the national versus the multinational/transnational presents irreconcilable challenges to the business taxation system.

4.2 National character of taxation systems and the role of OECD

The fractured development of the tax haven states leads to the argument developed in this section – the idiosyncratic nature of international business taxation in different jurisdictions. International business taxation is embedded in the desire of states to hold on to their national sovereignty. As they compete with one another to attract mobile capital, ability to draft their own tax law is crucial. This ability to write taxation laws is also seen as the embodiment their sovereignty. To avoid the perils of double taxation countries go into bilateral treaties with other jurisdictions. Yet even this cooperation is not able to match the multinational character of the MNC. Inability to control money flows in and out of country's borders adds to the decreased capacity of the state, which is able to employ reactionary measures at best to the changing business environment.

The implications of business becoming global, yet the taxation remaining nationally oriented signify a major discrepancy, allowing the decentered multinational firm go around the nationally focused taxation rules and pay less tax than their value creation processes would indicate. The problems are very much rooted in the way the IB taxation rules are implemented by countries. Countries chose to deal with matters of international taxation by way of bilateral treaties as they allow for minimal intrusion into the national law making practice of each nation state. This choice stems from the aim of nation states to preserve their law making sovereignty. While the law making ability is well preserved under this arrangement, other issues emerge. As every country is free to choose how to tax certain activities, what exemptions to which businesses and industries to extend, the international business taxation architecture becomes extremely complex. For the rules applicable to a subsidiary of the same company in India are not the same as the rules applicable to another subsidiary of the same company in the UK. Moreover, the bilateral treaties are not the same between every pair of countries, and some countries have a much wider web of bilateral agreements applicable to international businesses operating within their borders. The lack of uniformity between taxation practices of different jurisdictions makes the notion of business taxation being *international* quite inaccurate. For if the businesses are taxed in different countries, and the rules applicable at the different points of production process are embedded in the national legislation, the business taxation is merely a web of different national rules. This is an important point of departure for this thesis, as the heterogeneity of business taxation rules presents a unique opportunity for the multinational corporation (which by definition operates across borders) to pick and choose the most useful rules of different countries for activities it carries out inside the borders of that state. This poses a significant challenge to the nation state – willingness to preserve the national sovereignty hinders the capacity to control capital movement in and out of its borders. As countries engage in tax competition they have no control over the strategies of other jurisdictions, while the multinational businesses are able to mix and match the rules of different jurisdictions to come up with the most beneficial tax strategy.

The development of the Eurocurrency market in the 1960s, denoting a currency of one country on deposit in another country added a fundamental piece to the capacity of the state losing control over the capital flows. London played a central role in the evolution of the Eurocurrency market due to its expertise in international money matters and the ban on the foreigners to trade the pound sterling by the Bank of England (Moffett et al, 2011). The corporate finance literature sees Eurocurrency markets as an efficient and convenient money market device for holding excess corporate liquidity and as a major source of short-term bank loans (ibid). However the main characteristic of the Eurocurrency market is the lack of regulation at the source country or the country where the deposits are held (Palan et al, 2010). The virtual freedom from regulation leads to higher profit margins but more importantly to the inability of neither of the jurisdictions to control the capital. Technical advancements such as the invention of the jet airplane or fax machine made physical travel time as well as speed of doing businesses shorter and faster. This contributed to the ability of remote parts of the world to be included in the global value chains, as well as the global wealth chains. Yet with the arrival of these advancements each jurisdiction separately lost the immediate ability to control flows in and out of their borders. Evolution of the Eurocurrency market paired with technological advancements influence the decreased capacity of the state to control the money flows, coming in and out of its borders.

While the international business taxation is embedded in the desire to preserve national sovereignty, IB taxation regime also exists in the form of model conventions and bilateral agreements, informing and complementing the national tax laws (Rixen, 2008). At the beginning of the 20th century the basic principles of double tax avoidance were developed by the League of Nations, this task was later taken up by the OECD. The position of the OECD as a leader in international business taxation thought remained solid and "as the main multilateral forum, the OECD disseminates "soft law" in the form of a model convention and policy advice. On the basis of this, governments conclude bilateral tax treaties" (Rixen, 2008, p.6). A challenge to the multilateralism of the IB taxation stems from the limited OECD composition, as it is a group uniting 34 developed countries, referred to as the "rich club". The repercussions of the limited and rather monolithic membership pose a risk of misrepresentation of views, as the vast majority of countries cannot influence the rules that later apply to them. The debate is particularly significant in the case of developing nations, which host much of the economic activity that they could profit from, however are only mere observers when it comes to drafting the rules on how to tax the entities operating in their jurisdictions. While the OECD invites experts from other countries than its membership, the potential conflicts arising from a limited and rather similar group of countries disseminating solutions has to be kept in mind throughout the tax avoidance debate. OECD having a rather uniform membership base should be able to arrive at concrete solutions and proposals faster. However, the pace of change and adaptation to the developments occurring in business has been very slow. The resilience to change has been particularly evident adapting to the challenges raised by the firms embedded in the knowledge economy (Rixen, 2008). The states are only able to employ reactionary or afterthought measures at best to tackle the new challenges posed businesses (Rixen, 2008 and Desai and Hines, 2004. Moreover, the OECD has chosen an incremental way of reform to adapt to the changes in the business environment, causing the process to be slow and embedded in the interests of the limited group of countries represented in the institution.

International business taxation framework, governing transactions at different points of production is best seen as a network of national rules. The rules governing the transactions between the different parts of the same company differ in various jurisdictions, which provide opportunities for MNCs to mix and match those rules for the best deal. While the states might be able to anticipate the levels of production at a specific plant, they are unable to project how much capital will enter or leave the country. The money flows, motivated by differentials in tax policies are to a certain extent uncontrollable by the state. The effects are multiplied when and increased complexity of cross-border transactions is added to the picture. The use of intangible by the decentralized multinational company at are at the center of the global value chain, yet the jurisdictions in which MNCs operate are struggling between holding on to their right to write laws and upholding the wealth created in their jurisdictions. The next section will be an exploration of the multinational corporation and the changes in the corporate form, which allow the MNCs to bypass the nationally oriented taxation systems.

4.3 A decentered multinational corporation of the knowledge economy

A multinational is a firm that controls operations or income generating assets in more than one country (Jones, 2005) and is thus deploying various activities in different countries. This section will be an examination of the evolution of the multinational corporation. Increasing size and complexity of cross border transactions increases abilities as well as motivation of firms to move their operations across jurisdictions. The increasing use of intangibles in the value creation process leaves the state incapable to evaluate these transactions and accordingly tax them.

The MNC as a business actor has gained importance in the world economy over the years exemplified by exponential growth in international business activity in the 20th century (Forsgren, 2008). At the end of the 1960s there were approximately 7,000 registered multinationals (van Tulder and van der Zwart, 2006 cited in Forsgren, 2008). In the early

1990s the number had increased to 37,000 with at least 170,000 foreign affiliates while in 2005 the number of MNCs had almost doubled to 70,000 and the number of foreign affiliates has quadrupled (United Nations World Investment Report, 2005, cited in Forsgren, 2008). Between 1982 and 2006 the world's outflow of foreign direct investment increased from $28 billion to $1,216 billion, an increase well above 4000 percent. The exports of the world have increased by 565 percent and the world's production by 300 percent in the same timeframe (Jones, 2005). To top this impressive list of expansion it should be said that around 60 per cent of transactions globally are occurring inside MNCs as intrafirm transactions. The increased role of mobile capital in global trade presents novel challenges for jurisdictions across which these businesses operate. The removal of tax obstacles "together with other policies aimed at the liberalization of trade and investment, created an increased mobility of capital" (Quinn, 1997 cited in Rixen, 2008 p.117). Mobile capital is flexible, transcending the country borders as revenue generating activities could be placed in multiple jurisdictions, facilitated by expansion of technology and trade liberalization. The national character of taxation and rules implemented by separate jurisdictions is unable to grasp and adequately respond to this increased role of mobile capital.

Moreover, "the past decades have witnessed a constant increase in the level of sophistication in the structuring of cross-border transactions" (OECD, 2012b, p. 5). The MNCs not only grew in size and scope, but also in complexity of transactions. The value creation process places growing importance on knowledge as the source of wealth creation (Dunning, 2000). In the knowledge economy, success is increasingly based on the use of intangible assets such as knowledge, skills and innovative potential (ESRC, 2005). The intangibles, rather than physical resources are key to competitive advantage (ibid). The use of intangible inputs allows MNCs to fully exhaust the potential of operating in multiple markets, as the information, as well as production inputs can be easily transferred across jurisdictions. At the core of the competitiveness are the R&D processes, the IP rights and all intangible inputs or processes (Dunning, 2000). Being in a certain physical space to perform a particular transaction is much less or not even important in this type of economy. Due to the uniqueness of transactions, the margins earned are much higher than on replicable physical products. Moreso, the use of intangibles in the value creation process means that the nation states could be losing grip on these transactions due to their complexity and lack of physicality to perform simplistic check processes. To illustrate the growth of the knowledge intense sector, in the EU alone 756 thousand enterprises were active in this sector in 2008, these enterprises employed 34 million people as of 2010 in the EU-27 countries, representing 35 per cent of total employment on average in the EU (European Commission, 2011 and EC Competitiveness report, 2011). We are going to see a further shift towards a knowledge intense industry, as innovations presents the most attractive profitability margins for investors. The jurisdictions will have a decreased ability to verify the values of the intangible products or inputs into them, loosing ability to control the money flows between companies involved in the value creation process.

The work of OECD, and the report on hybrid mismatch arrangements (OECD, 2012b) deals with the exploitation of taxation differences of different countries by MNCs through the use of complex arrangements. Most importantly it serves as an example of how the decentered MNC activities, as well as a level of complexity and sophistication of the structures lead to tax avoidance and the misalignment between the wealth and value in the global value chains. Hybrid mismatch arrangements usually use one or more of these elements: hybrid entities (entities usually visible for tax purposes in one country and not visible in another country), dual residence entities (entities resident in two different countries for tax purposes), hybrid instruments (instruments which are treated differently for tax purposes in the countries involved, most often as debt in one country and as equity in another country), hybrid transfers (arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country) (ibid). These hybrid mismatch agreements aim to achieve double deduction for the same activity in several countries or generate fictional foreign tax credits. The MNCs through the network of subsidiaries located in different jurisdictions seek to minimize taxation in high tax jurisdictions. This is achieved by shifting gross profits through trading structures or reducing net profit by maximising deductions at the source level (OECD BEPS, 2012). Furthermore, the MNCs could be aiming to achieve low or no withholding tax at source as they shift the profit to a lower tax jurisdiction, and moreover, if the end location is chosen carefully, low can be achieved at the level of the recipient country (ibid). Eventually, through the aggregation of steps no taxation can be achieved at the ultimate parent level. It is precisely the disaggregation of the production process and value creation, which allows the multinational company to operate in multiple jurisdictions without decreasing their production effectiveness, instead achieving tax savings at various jurisdictions of operation.

Increasing importance of knowledge and intangible inputs into the production process alter the way economic activities are organized. Knowledge-based networks become the relevant dimension to understand the organization of economic activities – ”such networks typically cut across the legal boundaries of the firm ... inter-firm communication channels may have much greater bandwidth than intra-firm channels or that inter-firm coordination requirements are more severe between firms than within firms” (Foss, 2000, p. 4). Firms are argued to adopt the ”network organization” (Miles and Snow, 1992 cited in Foss, 2000) and engage in ”corporate disaggregation” (Zenger and Hesterly, 1997 cited in Foss, 2000) to compete in the knowledge economy (ibid). In addition to these organizational changes the composition of inputs shifts towards knowledge inputs, ”an increase of the “knowledge-content” in outputs, a stepping up of innovative activity, an increasing differentiation of demand, increasing globalization, and increasingly inexpensive networked computing changes that are taken to indicate the emergence of the “knowledge economy” (Halal and Taylor 1998; Prusak 1998, cited in Foss, 2000, p. 2). The evolution of technology, especially the internet presents a new way of operation for MNCs. The ease of communication and the speed, in which the business could now be conducted from one side of the world to another, does not require the multinational to have its headquarters, business units, legal and managerial homes in the same place. For one, as argued by Desai (2008, p. 6) MNCs are no longer limited to national borders to define their identity: “national identities today are mutating and it has become difficult to ascribe firms to individual countries”. Before the MNCs have located their financial, legal and managerial homes in one country, usually considered their home country (ibid). From 1960s companies started locating their manufacturing facilities abroad, countries started implementing more liberal policies towards foreign direct investment (FDI) which in turn led to a peak in the world of FDI. Much of this economic internationalization is happening inside the multinational enterprise (Rixen, 2008). The identity of the firm is thus becoming more fluid as operations span across several countries making their operations more effective. The products of one branch no longer define the final product to be sold to another firm, but rather is only an integral part into the final product produced by another subsidiary of the same firm. Such disaggregation of firm activities allows for value to be created in one part of the world (be it for legal, financial or other reasons) allowing for maximum value creation, due to labour pricing differences, existence of certain resources or general business climate. The final value, or wealth enjoyed by the MNC is usually posted in another part of the world, due to the mobility and flexibility of MNCs capital.

This new multinational firm is federated rather than centralized (Helper et al, 2000). This new firm is based on different assumptions about cognitive abilities of constituent units and the importance of knowledge sharing and co-creation. The new firm is thus not oblivious to the routines it performs, as they are constantly questioned and improved - group discussions both intra and inter-firm are carried out to increase the efficiency levels. Engagement with suppliers through collaborative innovation is determined by pragmatic reasons of efficiency and optimization. This approach is especially suitable in the knowledge intense industries, where mass and undifferentiated production does not have that much value (ibid). Due to the continuous improvement process legal boundaries between firms and different units get blurred. Ownership-based and legal definitions of the boundaries of firms are becoming increasingly irrelevant for understanding the organization of economic activities (ibid). Diminishing legal boundaries make it harder for the state to organize their due-diligence processes as it becomes unclear what forms a separate business unit, how the control mechanisms are enforced and most importantly how value is created in such an entity.

The new decentered multinational firm is different from the 'old' multinational company. At the core of the standard firm view are firms that are centralized, hierarchical and vertically integrated. The core of these corporations is the desire to control top-down as well as along the value creation chain with their suppliers (Helper et al, 2000). Goals set by the headquarters are followed by hierarchical units. Clear division of labour allows to partition complex tasks into chunks that require separate solutions and are within the cognitive grasp of individual units (ibid). Ability to simplify transactions is viewed as a way to increase efficiency and decrease production time. The standard firm as a centralized unit is much easier to put under the framework of nationally oriented taxation. Units are engaged in specific tasks that are easier to track the transactions between separate units. Moreso, firms have a certain national identity, identified by the location of corporate headquarters. The value chain processes could indicate to the nation state where the economic activity is taking place and what the tangible outputs of this process are. However, the "archetypal multinational firm with a particular national identity and a corporate headquarters fixed in one country is becoming obsolete as firms continue to maximize the opportunities created by global markets" (Desai, 2008, p. 1).

The exponential growth of the MNCs represents a tectonic shift in the relationship between the firm and the state. The MNCs, which employ about 62 million workers globally and generate about $4.5 trillion in value added, (Collinson and Morgan, 2009) could actually be compared to countries by the amount of economic assets controlled and the influence they exert. Out of the 100 largest economies in the world, 51 are actually multinational corporations and only 49 countries – a vindication of the role and importance played by multinationals in the modern economy (Anderson and Cavanagh, 2000, cited in Collinson and Morgan, 2009). How is the state then to deal with a player, equal or larger than the state itself in size, operations and market outreach? Moreover, the national focus of jurisdictions is outgrown by the flexibility of MNCs to move across jurisdictions. Fundamentally, the sophistication of businesses paired with its ability to operate across multiple jurisdictions changes the power relationship between firms and jurisdictions. The national character of business taxation and the transnational character of the operations of the MNC determines to the decreased capacity of the state to control capital and money flows inside its borders.

5. INTERNATIONAL BUSINESS TAXATION – A MAP OF SCATTERED RULES

"The current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy"
OECD

This chapter will outline the core concepts of IB taxation and show how the current framework facilitates tax avoidance. Analysis of tax avoidance strategies by MNCs at the core of the knowledge economy will show that the current IB taxation architecture is ill equipped to effectively deal with businesses, whose production processes are based on intangibles. This chapter will provide a solid foundation for the case analysis of Google in Chapter 6. Analytically, this chapter will show how the disconnect between the value inputs and gains in the global value chain are facilitated through the existing IB taxation framework. This chapter will tackle the research sub-question pertaining to the facilitation of tax avoidance through the existing IB taxation set-up, especially when intangibles are introduced into the production process. By answering this question, I will show that the inability of the current IB taxation architecture to appropriately assess the transnational transactions including intangible inputs enables the global wealth chain mismatch from the global value creation.

As shown in the previous chapter, IB taxation is best seen as a network of national tax laws, intermingled together through bilateral treaties but lacking uniformity. Deeply embedded in this bilateral manner of international taxation are the *double taxation* and *double-non taxation* treaties between jurisdictions. The primary concern of nation states when the IB taxation rules where first drafted was to encourage multinational companies to operate internationally by preventing them being taxed for the same activity in several jurisdictions. *Double taxation* as an issue to international business arose at the end of the 19th century. This was because of the trade increase across borders and the emergence of the multinational corporation - due to the divergence in national tax laws, the international businesses suffered from double taxation (Rixen, 2008). The move to avoid double taxation was seen as fostering investment and international economic activities (ibid). With double taxation avoidance bilateral treaties strongly in place, another problem arose. As the businesses became increasingly global, it became much harder to track the transactions and attribute them to a particular jurisdiction.

The emergence of *double-non taxation* regulation was an attempt to prevent MNCs from not being taxed in any jurisdiction. With these dualistic goals in mind jurisdictions expected to keep their right to write their own rules as well as ensure that multinational businesses are neither taxed too much nor too little. Unfortunately, due to the very nature of national orientation the treaties on double taxation and double non-taxation are seen as facilitators of tax arbitrage and treaty shopping (Vann 1991, Lang 1997, Thuronyi 2001 cited in Rixen, 2008).

The double non-taxation treaties deal with an important issue, which is at the centre of the tax avoidance debate – as noted by the International Chamber of Commerce: "what constitutes the right of one country to tax the income of a taxpayer in preference to any other country" (Statement from the ICC's Committee on Double Taxation from 1923, cited in Picciotto, 1992, p. 15). The right to tax is determined on a "connection to a jurisdiction" basis (OECD BEPS, 2012). However, the *jurisdiction to tax* is not determined on a corporation basis, but rather on an entity by entity basis. In the world of taxation, the multinational corporation is not considered as a whole, instead every subsidiary is considered as a separate legal unit depending on the jurisdiction it is located. If the income is attributed to a certain subsidiary, the income it receives will be taxed particularly in that jurisdiction. The multinational corporation, as a network of different entities across the world is by no means restricted to trade between the different subsidiaries of the corporation. As a matter of fact, 60 per cent of world trade are intrafirm transactions (ChristianAid, 2008). Subsidiaries can buy or sell goods, rights or patents to one another as well as borrow from each other, thus altering the path of wealth in the global production process. These transactions could increase or diminish the taxable income of a particular subsidiary in a certain jurisdiction thus altering the wealth accruing in that spot.

The *separate entity* approach is at the heart of the IB taxation set-up. This approach is a principle on which the MNC is divided into independent parts for taxation purposes. This approach informs that the branches or subsidiaries of an MNC in different countries are to be taxed as if they were separate entities. For tax purposes their operations with each other are treated as if they were independent market participants – exchanging goods and services at *arm's length prices* (Eden 1998, cited in Rixen, 2008). This introduces a major concept of arm's length pricing (ALS) into IB taxation, which is supposed to ensure a fair and reasonable method of accounting for transactions inside the firm. The ALS principle was developed acknowledging that different arms of the same firm can participate as suppliers and buyers to each other during the value creation process. The ALS principle has the benefit of de-politicizing the issue of the distribution of the tax base by referring to the seemingly natural solution of market prices, instead of having to interfere with national definitions of tax bases (Picciotto, 1992). However, the disentanglement of the firm through the introduction of the un-associated entity represents another area for manipulation. The ALS principle defies the whole purpose of incorporation seeking to internalize the transaction costs: "according to the dominant theory of the multinational enterprise, the main reason for its existence is the fact that it can internalize transactions that cannot adequately be performed through market mechanisms" (Coase, 1937 cited in Rixen, 2008, p. 126). As long as the asset bought and sold is tangible, the principle seems to be working pretty well, as the regulators are more or less able to put a price tag on these assets. Yet the ALS principle falters with the introduction of intangibles (Picciotto, 1992). With an increasing complexity of international business and its products, novel products are based on the very notion of uniqueness. How is the jurisdiction then to assess the price of these unique products or inputs which form the competitive advantage of the firm? The assessment mechanism to determine the value and price of, for example, intellectual property rights or trademarks is not yet adequate to keep pace with the evolution of business and thus eliminate the deficiencies of the ALS principle in the knowledge based economy. A recent case of Starbucks in the UK showcases how the modern corporation carries out transactions inside the company: the UK subsidiary was paying licensing fees to another subsidiary of Starbuck which was the owner of the technology associated with the Starbucks brand and technology. The price charged for this transaction was so high that Starbucks UK was left with no taxable income for 14 years out of 15 it has been operational in the UK (House of Commons Committee of Public Accounts, 2012). The British parliamentarians raised their doubts as to why the UK subsidiary was still in the country, alluding to its unprofitability, while the ALS should have been in place to catch the inadequate price for licensing the coffee technology. This example amongst others attests to the inability of the ALS to appropriately assess intangible based transactions and grasp the wealth created at a certain point of production process.

Tax systems are often categorized as *worldwide and territorial* ones. A worldwide taxation system generally subjects to tax its residents on their worldwide income, *i.e.* derived from sources within and outside of its territory and non-residents on the income derived from its territory. However, the income taxed abroad is entitled to receive a *foreign-tax-credit* on the amount or rate paid in taxes in the foreign country. This way, the MNC only pays the difference in rates once the income is repatriated to the worldwide tax applying country. A recent discovery by the IRS has unveiled the scheme called STARS, relating to the false generation of foreign tax credits (STARS IRS, 2008). The STARS deal (Structures Trust Advantaged Repackaged Securities) involved two counterparties: a bank in the US and Barclays bank in the UK. Under this deal a US bank would transfer assets to a trust, incorporated in Delaware. The bank then would sell the shares of the trust to Barclays, agreeing to buy them back later. The trustee of the newly established trust would be set up in Britain, thus making the income taxable in the UK. Through the trust, Barclays would provide financing to the bank at below market cost.
The US bank would then claim US foreign tax credits for the tax paid in the UK. Barclays would also claim a big UK tax break as it would reinvest the income and claim a tax deduction for this reinvestment (ibid). This scheme was taking advantage of US and UK tax rule differentials, which exist despite both countries applying worldwide income based taxation. The IRS argued that the deal did not serve any other purpose but to create foreign tax credits and thus minimize the tax bill of the entities involved (ibid). Another type of taxation system is a territorial system which subjects to tax both residents and non-residents only on the income derived from sources located in its territory. It is important to note that neither the worldwide nor the territorial system is employed in a pure form thus no two tax systems are exactly the same, making the IB taxation set-up varied and complex (OECD BEPS, 2012). This non-uniformity of taxation systems enables the MNCs to exploit the differences in taxation laws and regulations by picking the most beneficial features of various systems and combining them into a network facilitating tax avoidance.

We hereby come to the definition of the *residence* and *source* principles, which define whether the income is taxed in the country where the recipient of income resides (residence) or where the income has been generated (source). The definition is very important so as to not create a double tax burden on an international business (Rixen, 2008). The discussion between residence and source taxation has turned out to be not so straightforward and continuous amendments are taking place. As outlined by Rixen (2008, p. 58), the debate between residence and source is “couched in terms of normative claims about equality or fairness between individual taxpayers and between nations”. As this tax principle determines which jurisdiction is entitled to taxation income, it is appropriate to discuss arguments in favour of both principles. The arguments brought forward in favour of *residence* taxation are ability to pay and justice between individuals. The ability to pay principle argues that taxpayers should contribute to the provision of public goods in proportion of their incomes. The cornerstone of this argument is that the residence state is best able to assess the ability of a taxpayer to contribute, since it has the broadest information about its income and situation. The justice between individuals carries the notion that citizens with the same income should carry the same tax burden, irrespective of where their income was generated (ibid). On the other hand, source taxation is based on the principle that tax is a price to be paid for the benefits received. Therefore, as the public goods are vital to generate the income of the taxpayer, tax should be paid in the source country (Vogel, 1990; Musgrave, 1991 cited in Rixen, 2008). Another argument is the entitlement theory, which adds the factors such as access to natural resources and other markets which make the source country entitled to a “fair share” of the income generated within its borders (Rixen, 2008, p.59-60). Palan et al (2010, p. 84) sum up the outcomes of the debate between the residence vs. source taxation:

> *“both systems are problematic, but the difficulty of determining the share of an MNE’s profits assignable to a particular territory using the source principle … has resulted in use of the residence principle as the most common basis for corporate taxes. Based on this principle, firms and their subsidiaries are taxed at the place of their registration, with allowance being made for tax paid elsewhere”.*

This residence principle places a focus on the place of incorporation, which provides the MNCs with an ability to pick and choose jurisdictions to be incorporated based on most favourable tax regimes. In light of recent debates in the UK House of Commons Public Accounts Committee, companies called to testify against the committee were grilled because they did not appear to be paying enough tax in the UK, i.e. their place of residence (House of Commons Committee of Public Accounts, 2012). The policy makers argued, that the income generated in the UK (goods bought by the UK customers through an establishment enjoying the benefits of the UK economy), does not correspond to the tax paid in the UK. In the case of Starbucks, for example, the coffee is bought in the UK and the subsidiary is resident in the UK but the coffee making technology, which forms the competitive advantage of the company, is not owned by a UK company (ibid). As the subsidiary pays for the use of this technology, the profits generated in the UK are siphoned out from the UK to another subsidiary, leaving Starbucks UK with no taxable income. These subtleties associated with the dynamism of the MNC provide a difficulty of determining a connecting factor to a particular jurisdiction and, subsequently, the jurisdiction to tax.

Stemming from the principle of residence taxation, the foreign source income is only taxed by residence countries upon income repatriation (Rixen, 2008). A strategy often used by taxpayers to minimize tax payments is to make use of *deferral*. The notion of deferral was initially introduced into IB taxation to strengthen the legitimacy of territorial disentanglement in tax sovereignty and respect the legal form awarded to the entity in a foreign country (Graetz, 2003 cited in Rixen, 2008). However, the tax deferral allows to take advantage of the time value of money by being able to utilize the untaxed income today. One of the facilitators of the deferral strategy is to set up a *'corporate shell'* in a low tax country (Rixen, 2008). The corporations can thus hold full control in the entity and enjoy the preferential tax treatment of the host country through this '*controlled foreign corporation'* (ibid). To avoid the corporate shells taking the tax revenues of their legitimate owners, most OECD countries have introduced the *controlled foreign corporation (CFC)* rules. The idea behind these rules is that the resident shareholders that control or have a substantial interest (usually 50 per cent of shares) in a CFC in a tax haven should be treated as an extension of the main entity and "taxable currently on the proportionate share of income of the foreign corporation, whether or not the income is actually distributed to them" (ibid, p. 78). Therefore, if the income is never distributed to the residence country but earned by a CFC, the income is to be taxed by the residence country of the parent company. Having said this, the jurisdictions have several fine lines in their tax codes allowing MNCs to go past the CFC rules: in the US the so called *check-*

the-box election allows foreign subsidiaries, owned by the US companies to be considered invisible for US tax purposes. This slight refinement in the tax code allows MNCs to make full use of corporate shell establishments in foreign jurisdictions thus minimizing their tax bill and sever the connecting factor to a certain jurisdiction.

The rules against deferral were also designed to discourage the accumulation of *passive* income in a CFC in order to defer tax. *Passive and active income* is another distinction referring to whether the income should be taxed at the residence or the source country. The corporate tax base (active business income) is assigned to the country of source and the personal income and investment tax base (passive income) to the country of residence (Avi-Yonah, 2006 cited in Rixen, 2008). This links closely with the benefits theory described earlier since it is likely that a business actively generating profits in a specific country is making use of the resources available there, therefore it should pay tax exactly there. The distinction between active and passive income is important when it comes to CFCs of companies in different jurisdictions. Manipulations can be applied by MNCs to term the income earned in their CFC as active, as it then would be taxed at more favourable rates in the CFC jurisdiction. For example, the lobbying efforts by the financial services industry achieved that most banking, insurance and finance income is termed non-passive, which allows this income to avoid being taxed at the high-tax jurisdiction of the parent company and enjoy the more favourable rates at the CFC country of establishment (Picciotto, 2012). Ability to keep or transfer the money to a different jurisdiction than that of value creation frames the movement of wealth of this chain. Once again the set-up of IB taxation facilitates the mismatch between the movement of wealth and value in the same production chain.

While talking about active and passive income it is important to bring in the concept of *withholding* taxes. Most countries impose a withholding tax on the investment income – that is, interest, dividend or royalty payments – when they are repatriated to the foreign investor (Rixen, 2008). This tax is intended to prevent all income being repatriated from the source countries and assure that the source countries get their share of tax income generated from economic activity taking place within their borders. Withholding taxes are agreed upon bilaterally between countries, since whatever the source country withholds, has to be provided tax relief at the residence country. Therefore, caps are set on the maximum rate each country can levy as withholding tax (Picciotto, 1992). Bilateral agreements also allow for reciprocity between agreeing parties establishing the sense of fairness. The Netherlands, for example, levies no withholding tax on royalty or interest payments repatriated to other parts of the corporation (Deloitte The Netherlands, 2013). In the case of IKEA, the non-existence of withholding tax in the Netherlands provides an opportunity to siphon funds in the form of royalty and interest payments to another subsidiary in Luxembourg (which is further owned by a company in the Netherlands Antilles) without paying a penny of withholding tax in the Netherlands (Dijk et al, 2006). This attractive tax code allows IKEA to optimize their tax bill by moving funds motivated by regulation differentials in different countries. The differing tax laws across jurisdictions allow MNCs to create a network of subsidiaries making use of useful tax exemptions or provisions in multiple jurisdictions. Fundamentally, the movement of these funds serve no purpose to add value to the production process, rather they act as a separate wealth chain, motivated by regulatory differentials.

Corporations are often considered to be resident in the country where they are incorporated or where their management is located – different countries apply different characteristics to determine residency. This brings us to another important concept in IB taxation – *permanent establishment* (PE). Through the notion of permanent establishment dependent foreign branches create liabilities to be taxed: “if some activity passes the threshold of being considered a PE, the profit derived from it is subject to business taxation in the country of source – according to the rules of that country” (Rixen, 2008, p. 65). OECD defines a PE as a “fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD 2010, p.24). However, the concept of PE is not as straightforward in practice and provides for yet another area of ambiguity. For example according to the Irish incorporation law, a company’s legal home is determined by where its management board meets. For a multinational company, this is an excellent opportunity to locate a management board in a low-tax jurisdiction, while still having activity in other jurisdictions yet not being taxed there. Generally, a “place of management”, a branch, an office, a factory or a “place of extraction of natural resources” are PEs (ibid). Unfortunately, the list of definitions is not exhaustive or up to date with the mobile businesses of today. As an example, Amazon UK owns a warehouse in the UK from which it ships to UK customers, who order goods through the amazon.co.uk website. A warehouse, as well as a store would come under the definition of permanent establishment, and thus make the income stemming from Amazon's activity in the UK taxable in the UK. However, the "warehouse" is not exactly a warehouse according to Amazon. It is termed a "fulfilment centre", a term not included in the permanent establishment definition, thus allowing Amazon UK to de-link its profits derived in the UK from this country. Moreover, the domain indicating the British location of the online store (amazon.co.uk) is not touched upon under the existing regulation, thus online businesses cannot be treated in the same manner as the physical ones. These deficiencies allow Amazon to link the profits, deriving from the UK, to a subsidiary in Luxembourg, making use of favourable taxation laws in Luxembourg House of Commons Committee of Public Accounts, 2012). Even though the goods are stored and shipped from the UK, sold through a domain indicating British residence, the invoices are issued by a company in Luxembourg, thus directing all taxable income to the establishment in Luxembourg. The inadequate regulations pertaining to online businesses allow to strip away the potential tax income from activity generated in the UK to another jurisdiction. This goes on to prove that the MNCs with mobile capital and online based businesses are inadequately covered by the existing IB taxation rules, which in turn facilitates tax avoidance.

We now come to the tax avoidance strategies, employed by the MNCs that make use of the idiosyncrasies between the tax systems in different jurisdictions. The most popular strategy is called *transfer pricing,* or transfer mis-pricing (Rixen, 2008). Raymond and Baker (2005, cited in Palan et al, 2010) calculate that around 70% of all capital flight occurs through schemes of transfer mis-pricing between different arms of the company. Another survey by Ernst & Young (ibid) of 850 multinationals in 24 countries shows that 77% of the respondent companies placed transfer pricing at the heart of their tax optimization strategy. Transfer prices hereby refer to the prices set between different branches of the company charged for intra-group, cross-border sales of goods and services and rely heavily on the ALS principle (Palan et al, 2010). The goal of this strategy is to ensure that incomes and profits are assigned to low tax countries and costs, reversely, to high tax countries thus minimizing the taxable income there (Rixen, 2008). The schemes for transfer pricing become even more attractive for the MNCs when the notion of intangibles is introduced - the MNCs place the subsidiaries, in control of intellectual property rights, patents, trademarks, know-how and other intangibles in low tax jurisdictions and then shift profits from high tax jurisdictions in the form of intra-firm transactions. The non-physical nature of goods or the inputs that go into the production of these goods makes it difficult for the regulators to challenge the super high, or super low prices placed on transactions including intangibles. A case study of Google will show how the knowledge economy based firms navigate the rules of taxation of different countries and use it to their advantage on a massive scale.

Another way of profit shifting is called *thin capitalization*. A company employing thin capitalization practices finances itself by debt rather than equity. This is done because the interest one has to pay on debt servicing gets a preferential tax treatment over the dividends that are paid out to equity holders (Rixen, 2008). Therefore a corporation would aim to receive loans in high-tax jurisdictions and deduct the interest as costs, thus minimizing the tax base. This is advantageous for the corporation, because dividends paid out are not deductible as costs, whereas interest payments are (ibid). In many countries thin capitalization rules have been introduced to prevent this practice. The rules quantify what is considered to be excessive debt by looking at the debt to equity ratio (ibid). However, many corporations make use of this mechanism as once again the entity is not considered a whole for tax purposes – a subsidiary in a high tax jurisdiction would give out loans to another subsidiary in a low tax jurisdiction, thus siphoning out the taxable income in a form of intra-group loan. This practice allows MNCs to take advantage of different rules of taxation as well as pair it with an advantage of a multinational business to divert money from one subsidiary to another without much complication.

To conclude, the reliance on intangible inputs in the production process and lack of physical substance present challenges to the current set-up of the IB taxation. Terminology and mechanisms do not exist that would be able to address the patents, licensing fees and royalty payments associated with trade inside the firm. Moreso, the IB taxation system, as a network of national taxation systems is not able to assess the transactions taking place across borders. Through the analysis of core concepts in IB taxation architecture I have shown that the system is ill equipped to effectively tax the modern MNCs. McLure (2001, cited in Rixen, 2008) summarizes neatly that the principles of business taxation were formulated for a world that no longer exists, instead the principles designed to effectively apportion tax income facilitate the disappearance of the tax base. Fundamentally, the inability to appropriately assess the business environment lead to global wealth chains taking a different path from value creation.

6. THE GLOBAL WEALTH CHAIN OF gOOgle

In this chapter I will analyze the operations of Google Inc., an American multinational corporation. By looking into the locations of their subsidiaries and the roles of these subsidiaries in the value creation process I will show that the value creation and wealth distribution in the value chain are not aligned. Moreover, through the case study I will demonstrate that the major impetus for Google to move funds to various jurisdictions exists because of differentials between tax codes and regulations of various countries. Google being a multinational company is able to shift money within the corporation between different subsidiaries across borders. The taxation systems of the jurisdiction are mostly nationally focused engaging with other jurisdictions through bilateral agreements. This system allows Google to navigate the scattered system of taxation rules and divert the flows of money to the jurisdictions offering most advantageous conditions.

A rapidly integrating world suggests that there is a mismatch between yesterday's tax policy and today's reality and that this is particularly pronounced with respect to international taxation (Desai and Hines, 2004). An important aspect of this case analysis is juxtaposing the MNC embedded in the knowledge economy with the taxation system created for the industrial economy. The nationally based system is geared towards a corporation with tangible inputs and outputs, whose transactions are arguably easier to follow. There is a stark difference between the knowledge economy and the tangible inputs based economy where the products can be measured and evaluated by the tax authorities as holding specific value. In the knowledge economy it becomes easier for companies to trade products across borders as the products themselves might not take an actual physical form. The lack of physical substance as well as the uniqueness of the product makes it hard to come up with an arm's length price in the market, as the market simply does not exist for the same exact product. Therefore the price charged to consumers, and more importantly to other subsidiaries becomes arbitrary and hard to verify. As the IB taxation architecture is largely built to tax the businesses trading some physical goods, that are easy to compare and quantify, the very same architecture becomes incapable of dealing with the products based on intellectual property or those lacking physical substance.

6.1 Google – a firm embedded in the knowledge economy

Google, Inc., the developer of the award-winning Google search engine, has its roots in 1995 by Stanford University students Larry Page and Sergey Brin. Their meeting at a spring gathering of new PhD computer science candidates launched a friendship and later a collaboration to find a unique approach to solving one of computing's biggest challenges: retrieving relevant information from a massive set of data (International Directory of Company Histories, 2003). Today the product range of Google is more varied - web search, news, translation service online, search engine, cloud computing, networking, etc. Google is at the core of the knowledge economy, with its products based on innovation in technology, lacking physical substance as well as tangible inputs into the production process. Google's products are revolutionary and, arguably, remain the only one of their kind, thus the rights to these products are protected under intellectual property right (IP or IPR) laws. Even the subsidiaries, involved in the value creation process, pay fees to use or sell Google's products.

Google went public in 2004, with an opening share price of USD 85. These days Google's shares trade around USD 900 at NASDAQ with the market capitalization of USD 290.51 billion, making it one of the largest companies by this measure at the time of writing (Yahoo Finance, 2013). Year 2004 marked another milestone for Google as it opened its office in Ireland - a move officially welcomed by the Deputy Prime Minister or Ireland showing how much value Ireland is placing on this partnership (Google Company Info, 2013). Dublin became the first location for Google's regional operations outside the U.S. and was "chosen to serve Google customers across multiple time zones and languages spanning Europe, the Middle East and Africa" (Google Company Info, 2013). From the discussion below, we will see that Google's choice of location in Ireland was also impacted by other reasons, such as an attractive legislative system and tax laws particularly. This move is a watershed moment as it shows how Google chose to manage its tax affairs with Dublin becoming an incremental part in the network of tax schemes in Google's operations. So what is this tax arrangement scheme exactly, that allows Google to minimize their effective tax rate to staggering 2.4 per cent while operating in mostly high-tax jurisdictions (Bloomberg, 2010)?

6.2 The tax network of Google

I have previously argued that by looking at the global value chain production processes we can hardly trace the movement of wealth along the chain. The reason for that is that the global value chains only trace the movement of the product or service and inputs into the production processes as well as the relationships of those input producers along the chain (i.e. governance). However, once we look at the distribution of gains along the same value chain, we can observe certain asymmetries. In order to explain the asymmetries I have suggested looking into the legislative systems (and taxation systems most importantly) at the different points of "production" along the value chain. The choices that the companies make to locate their subsidiaries in certain countries have to do with ease of production as well as "ease of legislation". These choices of location have everything to do with how the wealth is later distributed along the value chain. In this part of the thesis I will analyze the production and gain distribution processes along the value chain of Google, a firm embedded in the modern knowledge economy. Using Google's example will allow me to pinpoint how the architecture of IB taxation does not reflect the business set-up of today, especially the way a decentered multinational corporation operates. This analysis will help collect evidence that even though Google is mostly operating in high-tax jurisdictions, its subsidiaries are set up in such a manner, that the tax bill would be diminished to the minimum. Therefore, the discrepancy between the set-up of production (development of products takes place in the US) and the distribution of gains (most money ends up in Bermuda) could be explained by paying special attention to the taxation rules and benefits offered by different states of Google's incorporation. Murphy (2013, Figure 1) describes two major strategies for profit shifting used by companies: shift of sales from high-tax to low-tax jurisdictions, and the shift of the expenses in the opposite direction.

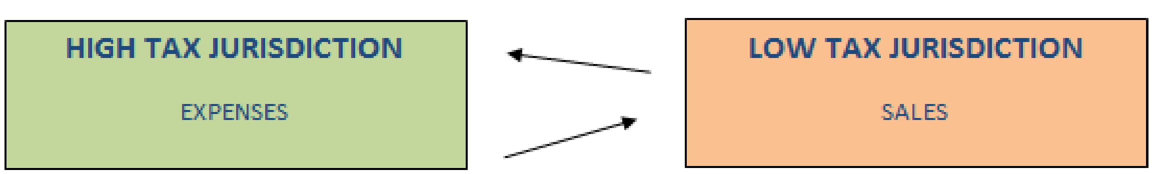

Figure 1. Profit shifting strategies in a MNC

Weyzig and Van Dijk (2009, p. 1261) summarizes the tax avoidance techniques in a more detailed manner: “the main strategies to shift profits within multinationals are the manipulation of prices of goods that are traded internally, called transfer mis-pricing, and the manipulation of internal financial flows such as interest, royalties and dividend payments”. Both of these strategies will be discussed below as they are employed by Google. I will hereby analyse Google’s operations in the countries of incorporation, discussing each country and their contribution to the wealth and value chain separately, focusing on the role in the tax planning operations. I will look into laws, governing corporate taxation in different countries as well as the financial statements of Google’s subsidiaries in various jurisdictions. An effort is made to analyze the latest statements where available in addition to the most recent media articles, as few academic articles exist on this case as of today.

6.2.1 Home base: The United States

As eagerly stated by Matt Brittin, Google’s Vice President for Sales and Operations in Northern and Central Europe during a hearing in the Public Accounts Committee (2012) in the UK, Google considers itself a truly American company. The head office is located in Mountain View, California where Google’s products are created and developed (Google, 2013). The products (algorithms, applications, operating systems) developed in the US are then distributed through Google’s offices around the world: the company has around 70 offices in more than 40 countries (Google, 2013). Company’s American roots and credits to product development where at the core of Mr. Brittin’s testimony in front of the Public Accounts Committee of the UK, as he was explaining the meagre amount of tax paid by Google in the UK. *Figure 2* represents the first layer in Google’s production and wealth distribution network – it’s Home base in the United States.

Google Inc. (USA)

Headquarters, responsible for development of products, also holds rights to intellectual property.

Figure 2. Google Inc. USA

The first step in Google's taxation grid is the way it licenses its search and advertising technology. Google's products and technologies on which these products are based, are developed in the US, the company's home base is United States. According to the IB taxation rationale, the profits deriving from this activity would then be subject to around 35 per cent of corporation tax, a statutory tax rate in the US (KPMG, 2013). As a high tech company, much of Google's product value rests in the innovation and novel developments to which the intellectual property rights (IP) are attributed. The IP rights' holder then becomes the benefactor of the profits, derived from selling the products, based on these rights. The first step taken by Google in its tax optimization grid is to license the rights to IP to a subsidiary in Ireland. The reasons for this choice will be discussed below, it is important to note that this arrangement allows Google to attribute their overseas profits to a subsidiary in Ireland as it is a legal IP rights holder from which these sales stem. This transfer of IP rights is allowed by several components in the tax code of the US. Under the US tax code, corporations are subject to federal tax on their worldwide income, i.e. the income earned abroad would be taxable as well (Darby and Lemaster, 2007). Another fundamental principle in the US tax code is that accession to wealth is not taxable until recognized by the taxpayer, i.e. until the income is repatriated to the United States (ibid). Therefore, by transferring income generating assets to a foreign entity neither the US corporation, nor the US taxpayer are taxable in the US on this part of corporation's income (ibid). A set of rules exists, referred to as "anti-deferral" rules to prevent the US corporations avoiding tax by simply transferring income generating assets abroad. Code 482 and sub-part F, considered to be one of the most complex areas of the US taxation code, are the principles on which the transfer pricing rules are to be based: 1) a US entity must transfer property or provide services to a related party at a price equal to the fair market value of such service; 2) US corporations have to recognize income received by their subsidiaries that are classified as controlled foreign corporations (CFCs). In simplistic terms, a CFC is an entity to which more than 50 per cent of the voting power is held by the US company (ibid). The income, considered eligible under these rules includes active income from sales of property or provision of services involving a related party, as well as most types of passive income. It appears then, that Google Inc. should be taxed on the income, generated by the subsidiary in Ireland, yet several exceptions exist to foreign based company sales income. The first one is if the CFC "manufactures" the products it sells or participates in the creation process, or alters a significant part of the product it is considered exempt from the duty to pay tax in the US. As the manufacturing regulations were adopted in 1964, the IP rights were not touched upon and their application in the development of intangible products could be interpreted differently. Another exemption is the area of US federal tax law pertaining to the entity classification regime. Under this regime, a foreign entity has the ability to elect whether to be treated as a corporation, partnership or a disregarded entity for US federal tax purposes by filling a form with the IRS (Internal Revenue Service – US taxation authority). A disregarded entity owned solely by one shareholder which is US corporation is then treated as a branch of a US company for federal tax purposes. This election, referred to as "check-the-box" typically has no effect on the company's legal status for foreign tax purposes but in the US, income deriving from this CFC would not be subject to the tax in the US. This is particularly the election Google makes, as it transfers the IP rights, and the profits to be derived from these rights to an Irish subsidiary. By this election the connecting factor to the US is removed and the gains in the form of tax revenue from the value created in the US are transferred to another jurisdiction.

As a testament to the legitimacy of this arrangement, the IRS has approved the transfer of IP rights to a foreign subsidiary as well as the advance pricing arrangement between two arms of the company (Bloomberg, 2011). Another important aspect between the US and Irish subsidiaries is the amount of the licensing fee for IP rights. The Irish sub pays a licensing fee for the use of IP rights, which is negotiated between the American and the Irish arms of the company. According to arm's length pricing principles, the price set for the usage of these IP rights should be the same if Google Inc. was licensing the use of IP rights to an unrelated entity. However, Google Inc. has an incentive to set this price as low as possible so as to avoid a high stream of income coming into the US where it would be subject to 35 per cent of tax. The annual report, filed by Google Inc. is filed as a consolidated financial statement, including all the wholly-owned subsidiaries and thus does not show intercompany cash flows, an exemption allowed in the US tax code. For this reason, the amount paid by the Irish subsidiary to its American parent for the use of IP rights could not be determined from the financial statements.

From Google's Annual Report for 2011 (Google Inc., 2012) it can be observed that 46 per cent of Google's worldwide income of USD 37.9 billion is generated by the customers based in the US (Table). As the hub for innovation, Google Inc. Incurs heavy costs associated with product development – USD 13.2 billion go to staff compensation, USD 5.2 billion to R&D expenses, USD 7.2 billion is spent on marketing and administrative expenses (ibid, p. 52). After all these expenses, before income tax Google Inc. reports a net income of USD 9.7 billion. On this amount it pays tax in the amount of USD 2.6 billion, inclusive of both domestic and foreign sourced income repatriated to the US (ibid). This rate represents around 27 per cent, still shy of the statutory rate of 35 per cent in the US. The difference is due to Google's re-incorporation to Delaware in 2003 from the state of California. According to the Tax Justice Network (TJN, 2005) Delaware exhibits several characteristics attracting mobile capital: it does not require the payment of a minimum corporate tax and only charges a rate of 8.7 per cent on the income apportioned to Delaware. Delaware also does not tax certain intangible items —trademarks, royalties, leases and copyrights, a particular lure for Google as it receives the royalty payments stemming from its IP rights (State of Delaware, 2013). While Delaware is a choice allowing to minimize the tax bill in the US, Google has declared that US income taxes and foreign withholding taxes on undistributed earnings of foreign subsidiaries are not provided, as the company intends to permanently reinvest these earnings outside of the US. The amount undeclared for US tax purposes is around USD 24.8 billion (Google Inc., 2012, p.80). The figures below illustrate that the US, being a home base for Google's innovation and R&D do not represent the Home base for the gains in the form of income tax, as the largest chunk of earnings are attributed overseas (*Figure 3*).

	Year Ended December 31,		
	2009	2010	2011
Revenues:			
United States	$ 11,194	$14,056	$ 17,560
United Kingdom	2,986	3,329	4,057
Rest of the world	9,471	11,936	16,288
Total revenues	$23,651	$29,321	$37,905

Table. Revenue distribution from Google's operations (Google Inc., 2012, p. 82)

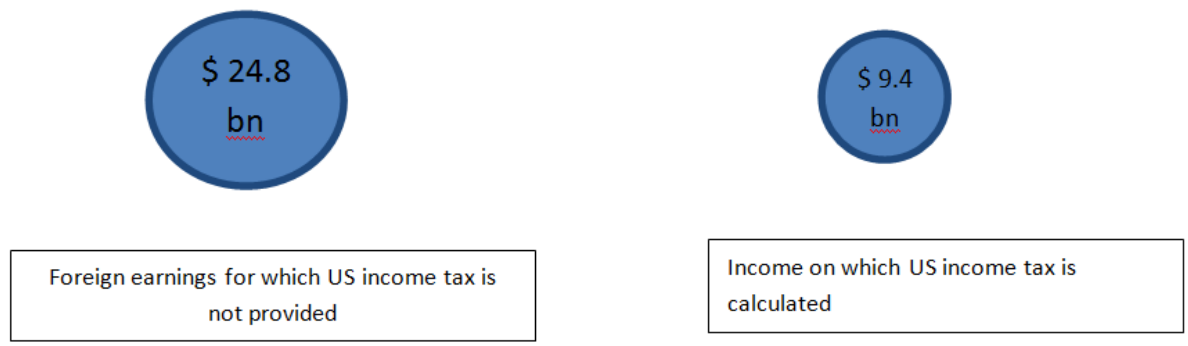

Figure 3. Distribution of taxable earnings, Google Inc. 2012

6.2.2 The Almighty Ireland

As a second step – Ireland comes into the grid. Google's choice of Dublin as a hub for its overseas sales is an outcome of the well-developed MNC attraction strategy developed by Ireland. Even though Ireland is not considered to be a tax haven state by the OECD, other authors have found certain attributes in its taxation policies that would allow Ireland to be categorized as such (Hines and Rice, 1994; TJN, 2005, cited in Palan et al, 2010). With a headline rate of 12.5 per cent on trading income widely advertised, the effective tax rate of subsidiaries of US companies has been calculated at an even lower rate of 8 per cent in 2004 (Sullivan, 2004 cited in Palan et al, 2010). Comparing the statutory tax rate of 12.5 with 23 per cent offered in the UK (KPMG, 2013) or 35 per cent in the US (ibid) immediately conveys the attractions of Dublin. The development of taxation in Ireland gives an example of how a country uses its sovereignty to write taxation rules to attract multinational businesses. According to the Department of Finance in Ireland (2013) since the 1950s a major shift in industrial and tax policy from protectionism to a more "open and outward oriented approach" appeared in Ireland. This approach was focused on attracting and retaining foreign direct investment through a competitive corporate taxation strategy (ibid). Ireland's strategy to attract FDI, growth and create jobs was put in place with a goal to raise revenues for public services. During 1996-2003 Ireland has introduced a broad-based general rate of corporation tax of 12.5 per cent on trading income (ibid). The Minister of Finance of Ireland has reiterated Ireland's commitment to stick to this rate going forward basing his arguments on OECD's research on the hierarchy of taxes (ibid). The research concludes that corporate taxes are the most harmful to growth - in 2010 the share of corporate taxation as percentage of GDP in Ireland was 2.6 per cent, compared with 2.4 per cent in EU 27 countries (ibid). While not a significant difference, Ireland sees this as a testament to the success of its policy. An even more important attribute to Ireland's attraction as a base for MNCs is its' broad base of double-taxation avoidance agreements. Currently 74 double-tax avoidance treaties are in place with different jurisdictions allowing MNCs to enjoy the benefits while trading with other countries (DTA Ireland, 2013).

Owing to the well developed MNC attraction strategy Ireland is now home in Europe for over 1,000 MNCs, Google being one of them. Google has established its subsidiary in Dublin, Ireland in 2004 as a hub to sell advertising across Europe, the Middle East and Africa (EMEA). Today it employs around 2,000 people and is credited with almost 90 percent of Google's overseas sales (Bloomberg, 2010). Going deeper into the Irish business of Google we can observe that Google has two subsidiaries in Ireland. The first one, Google Ireland Limited is itself a subsidiary of another Irish establishment: Google Ireland Holdings (Duedil Google Ireland Limited, 2013). Its ownership was transferred from a previous owner in 2011 – Double Click Internet Ireland Limited, which was diluted as part of a broader attempt to minimize the amount of subsidiaries in Google's network (ibid). There are thus two Irish companies in play: Google Ireland Limited (responsible for sales across the EMEA region) and Google Ireland Holdings (an owner of the former Irish company). This is where the term "Double Irish Sandwich" comes into play as the monetary interactions between the two firms follow an interesting pattern.

In 2011, Google Ireland Limited had a turnover of EUR 12.5 billion and earned a gross profit of EUR 9 billion. As the company's sales increased it incurred increasing administrative and staffing costs - all that could be normally associated with business expansion. In the annual report (Duedil Google Ireland Limited, 2012, p. 4) the company breaks down what the administrative costs of the company are: staff, sales and marketing costs as well as royalty fees for the use of IP rights. The company with EUR 12.5 billion turnover ended up paying EUR 22.2 million in taxes in Ireland which left Google with EUR 2 million in profit in Ireland from their EMEA operations (ibid). This return either signifies a very poor management on behalf of the shareholders or serves as an indication that the biggest chunk of the money was transferred out of the company. The company does not explain in its notes to financial statements how much was attributed to each category included in the administrative expenses of EUR 9 billion, as it opts to not disclose its cash flow statement, closing the door to any more scrutiny (ibid). This non-disclosure is allowed by the Financial Reporting Standards (FRS, 1996) if an entity is a subsidiary of another entity and the parent holds more than 90% of shares, which is exactly the case between Google Ireland Holding and Google Ireland Limited. The one key fact and takeaway is that even with the attractive 12.5 per cent corporation tax rate, Ireland is not getting the whole pie of Google's taxes and the money flows need to be investigated further down the value chain. *Figure 4* below is a snapshot of the financials of Google Ireland Limited, showing that due to very high administrative expenses, that include the royalty payment for the use of IP rights, Google's tax bill in Ireland is minimized to EUR 22.2 million.

Figure 4. Google Ireland Limited Financial snapshot, 2011

This is where another Irish company, Google Ireland Holdings comes into play. As mentioned above, Google Ireland Holdings is the parent company of Google Ireland Limited. This is the same "Irish" company that subleases IP rights from Google Inc. in the US. However, Google Ireland Holdings is not really an Irish company, as its management board meets in Bermuda, which, according to the Irish law, qualifies it as a Bermudan company. Another important development is that while Google Ireland Limited is responsible for carrying out the sales and billing the clients, it is Google Ireland Holdings that holds the intellectual property rights to Google's products. A following relationship between the two Irish companies is formed – one is paying the other for the right to sell products across the region. This lease is billed in a form of a royalty fee. The amount of this royalty is hard to determine once again because of the legal intricacies - Google Ireland Holdings is a private company incorporated in Bermuda, its financials are not disclosed publicly. It is thus impossible to find out what constitutes the bulk of EUR 9 billion expenses incurred by Google Ireland Limited, but one would guess that royalty fees for the use of IP rights could make a big chunk of it. The rationale would follow the same pattern discussed at the beginning of this chapter – expenses are incurred in the high tax jurisdiction (Ireland), while the revenue is booked in the low tax jurisdiction (Bermuda). *Figure 5* below shows the roles of the two "Irish" subsidiaries in Google's production and wealth distribution chain.

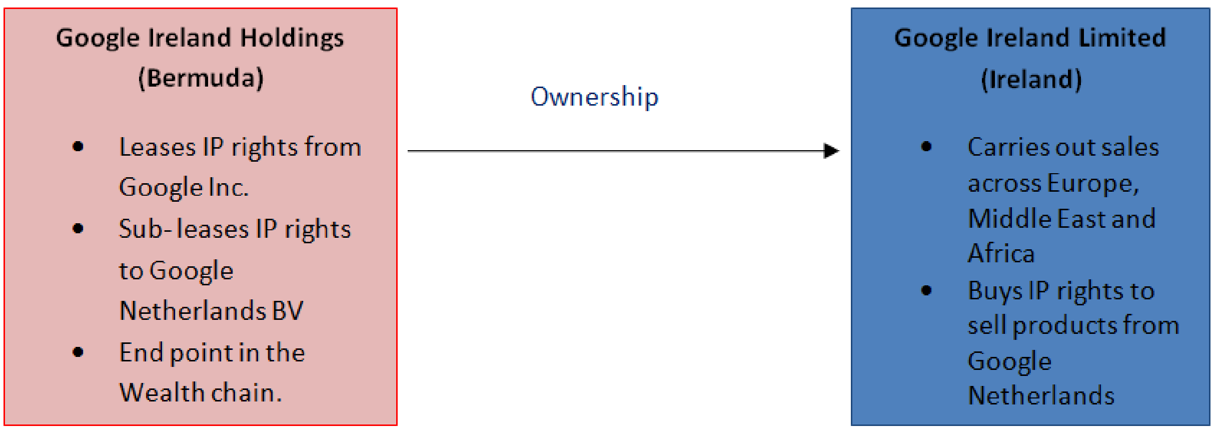

Figure 5. Relationship and roles of the Irish subsidiaries

Until recently, one clause in the Irish tax law precluded Google Ireland Limited paying the royalty fees to Google Ireland Holdings directly. As a precaution for large amounts of money being siphoned out of the country in the form of royalty payments, Ireland used to impose a 20 per cent withholding tax on royalties paid to non-Irish companies. This rate did not apply if the country, to which the royalty payments were being transferred, had a tax treaty under the EU regime (Deloitte Ireland Highlights, 2013). Thus another important link was added in Google's tax grid – a subsidiary in the Netherlands. Google Ireland Limited would generate income from sales and would pay for the use of IP rights to a subsidiary in the Netherlands, avoiding to pay the Bermudan-Irish Google Ireland Holdings directly. There is no withholding tax to be paid by the Irish company on the royalty payments to the Dutch company because of the tax treaty between the two countries (Irish Tax and Customs, 2013). To conclude, Ireland, with its attractive statutory tax rate and a wide array of tax treaties indeed attracts MNCs to establish residency on its soil. However, as observed through Google's example, the sweeteners Ireland offers are not enough for all the tax share to be paid in Ireland. Continuous, more beneficial routes are sought through other jurisdictions further muddling the line between how and where the value is created in the global value chain and how the money flows within the same chain. It is obvious though that the regulations in the area of taxation are the main motivation for countries to move their wealth across jurisdictions.

6.2.3 The contribution of the Netherlands

Netherlands play an important role in the wealth chain of Google. As explained above, before changes in Irish law, withholding taxes prevented Google Ireland Limited paying Google Ireland Holdings directly for the use of IP rights during the sales process. Therefore, the money had to make another stop through the Netherlands. The role of the Netherlands as an important partner for MNCs began in the late 1970's, when it started so-called advance-pricing agreements to attract multinational companies (Financial Post, 2013). Since then the Netherlands has been known as an international tax planning centre for MNCs (Weyzig and Van Dijk, 2009). Through the conduit structures, allowed by the Dutch law, FDI funds as well as interest, royalties and dividend payments are funnelled from one country to another via entities in the Netherlands (ibid). The main elements of the Dutch tax regime are a large network of double-tax avoidance treaties, zero withholding taxes on outgoing interest and royalty payments, exemption of foreign dividend income and capital gains tax (ibid and Deloitte The Netherlands, 2013). Some even argue that under the agreements with the Dutch Government MNCs agree to leave a tiny amount of income in the Netherlands to be taxed in exchange for being permitted to route profits through the country. This remainder left for the authorities in the Netherlands is known to be as "the Dutch Turn" (ibid). A combination of these exemptions on income, as well as an extensive network (more than 90) of double tax avoidance treaties make the Netherlands home to 23,000 mailbox companies (Dijk et al, 2006 and Financial Times, 2013). These letterbox companies are managed by 176 licensed trust firms and attract huge flows of money – EUR 8 trillion in 2011, which is 13 times the GDP of the Netherlands (Financial Times, 2013). This favourable taxation architecture explains why

Google has picked the Netherlands as home to their mailbox subsidiary - it adds an important component allowing to avoid paying withholding tax in both Ireland and the Netherlands en route to the final destination. Besides the diversion of wealth inside the global value chain, another mismatch occurs – while the Netherlands is the biggest global location of gross profits reported by the US companies' foreign subsidiaries, it does not appear on top 10 list of their reported employment (ibid). This goes on to illustrate that the tax laws, created and offered by the Dutch to MNCs play a role in attracting huge inflows of money, but not substantial economic activity, exemplifying how the value and wealth creation go separate ways in the global value chain process.

The subsidiary in the Netherlands - Google Netherlands Holdings BV - has no employees and exists mostly for the purpose of dealing with the two entities in Ireland as a shell company. It is also a private company, not having to file any financial reports publicly, which makes it harder to collect data about the cash flows of the company. Google in the Netherlands is involved with both of the Irish names – it leases the IP rights from Google Ireland Holdings and subsequently sub-leases the use of these rights in the sales process to Google Ireland Limited (Irish Times, 2012). This middleman's role is what earns the Netherlands its Dutch Sandwich name. The money is collected from Google Ireland Limited for the use of IP rights in the sales process, without having to pay the withholding tax in Ireland, which would otherwise be due if it was transferred to Bermuda directly from Ireland. *Figure 6* below shows the relationships between the "Dutch Sandwich" and the "Double Irish" companies.

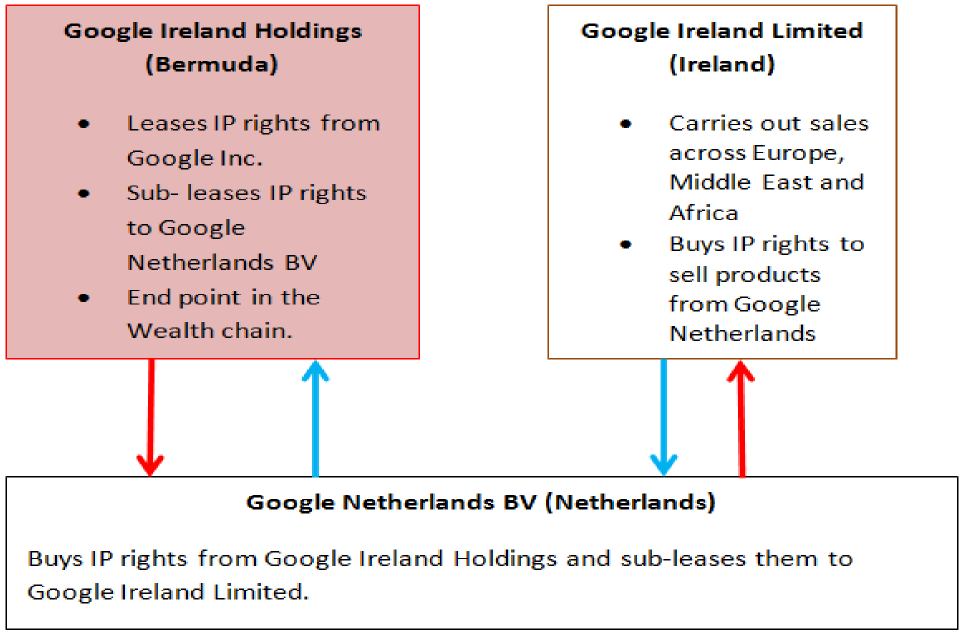

Figure 6. Dutch Sandwich and Double Irish

Another important aspect in the IP rights lease between the three entities is the amount that is paid for the lease of IP rights at all ends. As all companies are part of the same company the price is set inside the firm. Once again arm's length pricing has to be used in setting this price, i.e. a comparable product price found in the market that would be charged to an unrelated company. However, as Google's competitive advantage is the uniqueness of its products, no comparable market exists for these IP rights. Furthermore, the current IB taxation regime is ill equipped to determine the values of intangible inputs or outputs into the production process (OECD BEPS, 2012). It means that the price charged by Google Ireland Holdings (IP rights holder) is charged at their own discretion with several drivers in mind. Some of these drivers take into account the fact that once in Bermuda, the profits will be subject to a very different taxation regime than if they were to stay in Ireland. The Netherlands has no withholding tax on royalties, no matter where they are paid out to, so the Bermudan residence of the Irish company does not result in additional tax being caught in the Netherlands, thus allowing for significant savings for the corporation. According to Bloomberg (2010) Google Netherlands Holdings BV "pays out about 99.8 per cent of what it collects to the Bermuda entity". The price to be paid by Google Ireland Limited to the subsidiary in the Netherlands is also set inside the firm, but following the same logic this price would be as high as possible so as to shift the money from Ireland to the Netherlands en route to Bermuda. *Figure 7* is an illustration of how the IP rights are sub-leased between different subsidiaries. Blue coloured subs indicate a relatively high tax jurisdiction, in comparison to Bermuda, indicated in green. The prices for the use of IP rights are motivated by the location of the receiving subsidiary. This figure is meant as an illustration from the indications the author has been able to gather from existing information. This thinking is in line with the profit shifting behaviour described in academic literature (Murphy, 2013). Meanwhile, from the US tax point of view, Google Netherlands does not exist at all, thanks to the same check-the-box selections as described above for Google Ireland Holdings. This rerouting of funds through the Netherlands conforms to the definition of income shifting, as the transfer of IP rights to a Dutch subsidiary does not serve any productive purpose and no real value is created there. Once again, the value creation processes and the wealth distribution processes do not match and discrepancies between the value inputs and gains occur.

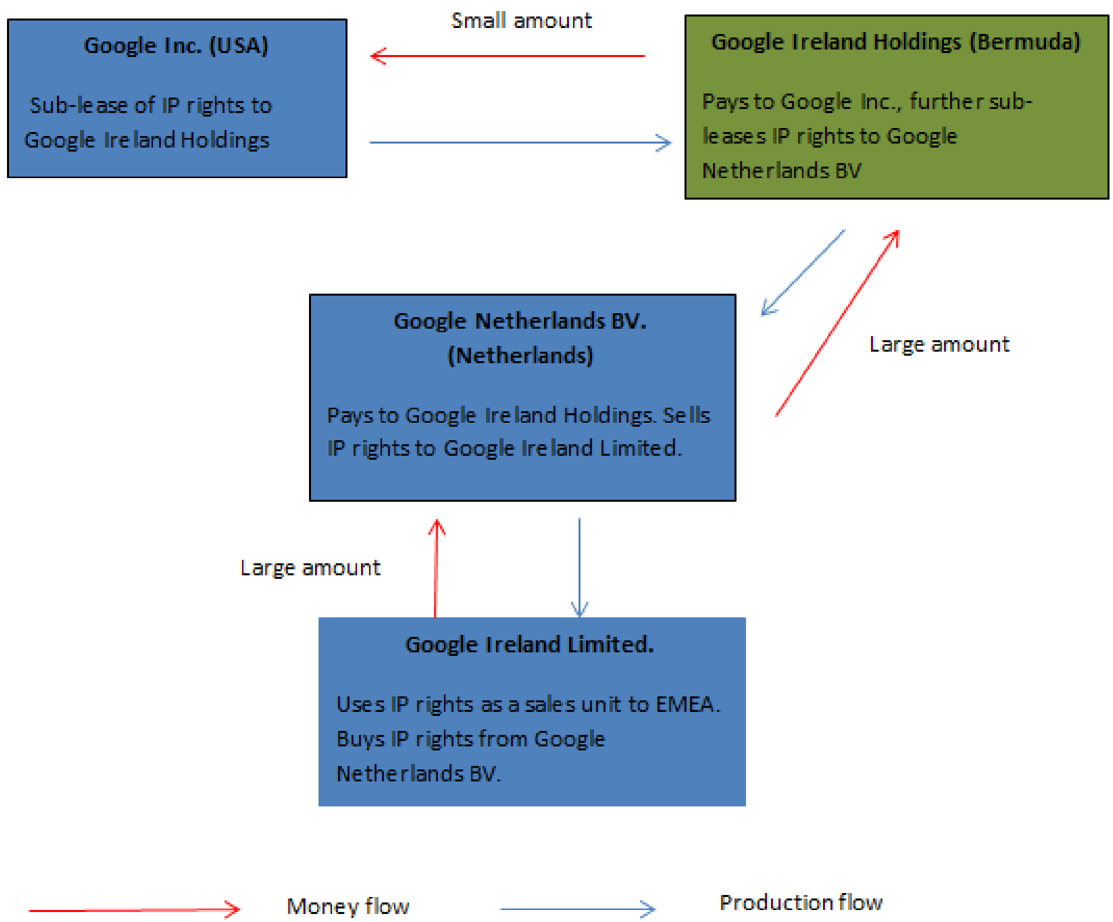

Figure 7. Money and IP rights flows between Google's subsidiaries

6.2.4 The Bermudan Triangle of Tax

The last stop in Google's wealth chain from the US, to Ireland and through the Netherlands is Bermuda. The Islands of Bermuda are a British Overseas Territory and a former British colony. While the Head of State of Bermuda is the British Monarch it otherwise has a local Government, which means Bermuda has the power to create their own law as well as economic and fiscal policy (CIA Bermuda, 2013). With the size of 54 square kilometres and a population of 70,000 inhabitants, Bermuda struggled to even be reached by air transport as the first plane landed in Bermuda only in the beginning of the 20th century (ibid). With all these factors not exactly working in their favour, Bermuda had to look for alternative ways to build their economy. While tourism was one path to income for a beautiful tropical island, becoming and offshore centre was another way to flourish, and it was the path of choice by Bermuda. Today, despite four years of recession and a public debt of USD 1.4 billion, Bermuda enjoys the fourth highest per capita income in the world, about 70% higher than that of the US (ibid). So what is Bermuda's history with tax? Bermuda has long had a tax system based on indirect taxation, such as customs duties on imports, thus being able to offer zero direct taxation to corporations and individuals (Guardian, 2013b). Island's infrastructure (it now boasts excellent communications and travel connections), educated workforce, attractive legal framework and low tax structure has proven to be a successful strategy for a remote tropical island and it is a location of choice for many MNCs today (ibid). Bermuda's specialism is insurance, reinsurance and it is home to one of the largest captive insurance industries in the world (US Commercial Service, 2010). The principal legislation governing corporate matters is the Companies Act of 1981, which presents an opportunity for non-Bermudan residents to establish an Exempt Company (Bermuda Company Act, 1981). Upon incorporation, the company has all the powers of a natural person. The registered office must be maintained in Bermuda, as off-the shelf companies are not permitted. The Exempt Company shall not carry out any trading activity in Bermuda, as that is reserved to Bermudan businesses. The required authorised share capital for the Exempt Company is USD 12,000, moreover the Exempt Company is not to pay any income or corporation tax, instead only a licensing fee to the Government. The top limit of this licensing fee is USD 27,825 for a really large company with authorized capital of more than USD 500 million. Top this impressively simple list of attractions with an official language of English and you get an irresistible location for mobile capital. This focus on mobile capital is reflected by the top 3 contributors to the GDP in Bermuda: international companies account for 25.27 per cent, the real estate/rental sector at 13.75 per cent, followed by the financial intermediation sector at 11.61 per cent (US Commercial Service, 2010). Bermuda is to be found on all of the tax haven lists – Tax Justice Network's, OECD's as well as the IMF's (Tax Justice Network, 2013). As a response to a recent attention throughout the UK's G8 Presidency, Bermuda has never denied its status as an offshore jurisdiction. However the island claims it is compliant with information exchange agreements with other countries, as well as prides itself with enforcing know-your-customer practices (Guardian, 2013). The local banks offer full international banking, investment and fiduciary services complementing the established governance system. This conforms with the argument that good governance goes a long way in the tax haven world (Dharmapala and Hines, 2009).

Unsurprisingly, Bermuda is also the destination of choice for Google and was chosen as a location to hold the IP rights of Google's products House of Commons Committee of Public Accounts, 2012) Google's Brittin argued that "what creates economic value for Google is the technology and the computer science" thus arguing a case for the role Bermudan incorporation plays in the economic activity picture (ibid, p. 60). By having Bermuda as an IP rights holder to Google's products, Bermuda is brought into the wealth chain of Google. However, there is no value created in Bermuda besides assigning IP rights to an establishment located on the island. According to the business taxation rules of Ireland, as discussed above, Google Ireland Holdings is actually a Bermudan company. A nuance in Irish law allows the legal home of the company to be decided upon where the management board meets – and in the case of Google Ireland Holdings that board meets in Bermuda. Thus once the money for the use of IP rights during the sales process is transferred to the Netherlands (to avoid the Irish withholding tax), the entity in the Netherlands transfers the amounts due to Google Ireland Holdings in Bermuda. The Netherlands do not impose a withholding tax on royalties to companies incorporated in Bermuda, and thus no additional tax is charged in the Netherlands when the funds leave the country. The difficulty of getting to know how much money is being siphoned to Bermuda is facilitated by rather lax legal requirements for financial accounts in Bermuda. As a matter of fact, Bermuda does not impose any requirement to file financial accounts with the tax office, making it hard to determine the cash flows between the Dutch and the Irish/Bermudan subsidiary. However, as we observed earlier EUR 9 billion was expensed in Google Ireland Limited, of which the royalty payments were also a part. The arms-length price set for the transactions between the subsidiaries make it hard for the regulators to determine the true price of these unique products. Therefore, a large chunk of the EUR 9 billion is presumably siphoned in the form of royalties to the Netherlands and then Bermuda. According to the data by Financial Times (2012) Google has nearly doubled the revenues shifted to Bermuda over the past three years to USD 9.8 billion, attesting the former presumption. The check-the-box selections made on behalf of foreign subsidiaries make these companies not liable for any tax in the US. As a matter of fact, in the annual statement Google Inc. named the precise amount for which the US income tax is not calculated – USD 24.8 billion (Google Inc., 2012). Legislative infrastructure and the tax regime of Bermuda explain why it is chosen as the final IP rights holder. It also helps answer the question how the wealth and value creation part ways in the global value chain. The assignments of IP rights to a sequel of subsidiaries exemplify how a knowledge based firm locates the income generating activities in low tax jurisdictions, while accounting the largest chunk of their expenses in high tax jurisdictions.

6.2.5 How about the UK?

The UK has recently been in some deep discussions through its Public Accounts Committee trying to find out why being home to 11 per cent of Google's revenues it does not enjoy the benefits of Google's taxes (House of Commons Committee of Public Accounts, 2012 and *Table* on p. 63). Google is able to minimize their tax bill in the UK by taking advantage of some simple elections allowed by the existing IB taxation set-up. On the UK corporate tax policy front, it could be observed that the corporate taxation rate has been gradually declining from 30 to 23 per cent during the 2008-2013 period (UK Corporate Tax, 2013). It still is a long way to go to compete with the 12.5 per cent of Ireland or the nil taxation that Bermuda can offer (KPMG, 2013). In the UK, corporate taxes are imposed on corporations and their profits from taxable trading income as well as capital gains. All corporations with a permanent establishment in the UK are taxable, regardless of where their income is coming from. Tax is to be levied on non-UK corporations that trade through a permanent establishment as well (ibid). From these descriptions it would appear that Google should be liable to corporate tax in the UK for the full 11 per cent of income that it generates from the UK customers.

Google Ireland Limited is the only subsidiary responsible for sales in Europe, Middle East and Africa. The role of the subsidiary in the UK (Google UK Limited) is provision of marketing services to the Irish subsidiary as well as R&D services to Google Inc. (Companies House Google UK Limited, 2011). The services by the UK subsidiary include "promoting Google products, providing education training to clients on these products and making sure they worked for UK consumers" (House of Commons Committee of Public Accounts, 2013). Sales to customers are not to be executed by the subsidiary in the UK and all sales to the UK customers are booked from Ireland. The Irish company should be subject to UK tax on its profits earned from UK activities only if it were trading in the UK through a 'permanent establishment' (UK Public Accounts Committee, 2012). However, provision of marketing services does not count as being sufficient to be treated as a permanent establishment, due to the fact that the UK subsidiary does not have the authority to draft contracts on behalf of the Irish company. This interpretation of the taxation rules makes Google UK Limited only taxable in the UK for the marketing services that it provides. As a result of this structure between the UK and Irish subs, the UK subsidiary has only earned revenues of GBP 396 million in 2011 and after GBP 417 million in administrative expenses it ended up at a loss of GBP 24 million (Duedil Google UK Limited, 2013, p. 8). On the standalone basis, Google UK Limited should not have paid any tax at all, however as it is part of a larger group through cost share agreements and interest payouts Google paid GBP 3.4 million in taxes in the UK in 2011.

The politicians in the UK claim that there are arguments that Google UK Limited is indeed creating economic value in the UK. Through the UK subsidiary it employs 1,309 people (ibid) which is only less by 700 than Google Ireland Limited. Mr. Brittin, Google's Head of Operations in Northern Europe, has recently admitted that the 500 engineers in the UK office are contributing to product development, something that would count towards establishing taxable presence in the country (House of Commons Committee of Public Accounts, 2013). Moreover, it has been found that the job descriptions of employees in the UK office as well as the pay based on commissioned sales indicate that sales are indeed taking place in the UK, something the legislators will have to yet prove as the declared purpose of the UK subsidiary is not to carry out sales (House of Commons Committee of Public Accounts, 2013). If the economic value stemming from the UK sales was to be booked in the UK, in 2011 the UK would have generated revenue of GBP 3.3 billion. Taxing this figure at a rate of 23 per cent would have provided the UK with a more pleasing income of GBP 0.8 billion in tax income. The situation in the UK is reverse from that in Bermuda in a sense that the connecting factor to the UK is being muddled, yet arguably the value is created in the UK.

6.2.6 Conclusion

Through the analysis of Google and the way it has structured its operations I have aimed to show that the legislative infrastructure, and tax regulations in particular, is a strong factor when companies decide where to locate their subsidiaries. The appeal to move profitable activities to low tax jurisdictions, while accumulating expenses in the high tax jurisdictions is the general framework that Google follows to minimize its tax bill globally. Through the use of mobile capital and intangible inputs into the production process the company is able to have multiple subsidiaries in various jurisdictions. In many cases, the regulations are yet lacking definitions as well as appropriate tools to determine the correct arms-length prices, thus allowing the corporations to set the prices between themselves arbitrarily. Moreover, the nationally oriented taxation laws of jurisdictions are unable to appropriately asses the MNC which is able to mix and match the rules of different countries. In the case of Google, it is a combination of laws in different jurisdictions that allow their tax network puzzle come into play and work in their benefit. As it was observed, jurisdictions take proactive action to attract the mobile capital with expectations of higher income. Some of these expectations fail due to continuous siphoning out of funds to more favourable locations. Fundamentally, it has been observed that the production process and the distribution of gains do not correspond in the case of Google. The wealth chain follows a separate route motivated by tax differentials, regulations and other sweeteners offered by jurisdictions thus altering the gains from participation in the global production process.

The structure described above represents an insight into Google's tax planning operations that existed until very recently. This structure is primarily meant to exemplify the role of taxation rules in various jurisdictions in the global wealth chain of MNCs (*Figure 8*). Analysis of the most recent Google's Annual Report of 2012 shows that Google has eliminated all but two of its foreign subsidiaries in 2012 (Google Inc., 2013 and 2012). Among the eliminated ones is also a subsidiary in the Netherlands. This change most probably has to do with changes in the Irish taxation law and the treatment of withholding tax (Deloitte Ireland Highlights, 2013). This change would simplify Google's tax structure and would mean that going through the Netherlands is unnecessary as long as the funds are transferred from Ireland to a non-Irish company. This change in law by the country shows how fluid and open for change the taxation rules are on a single country level, as well as a fast response time by the MNCs to adapt to the new rules of the game. A potential new structure is represented in *Figure 9*.

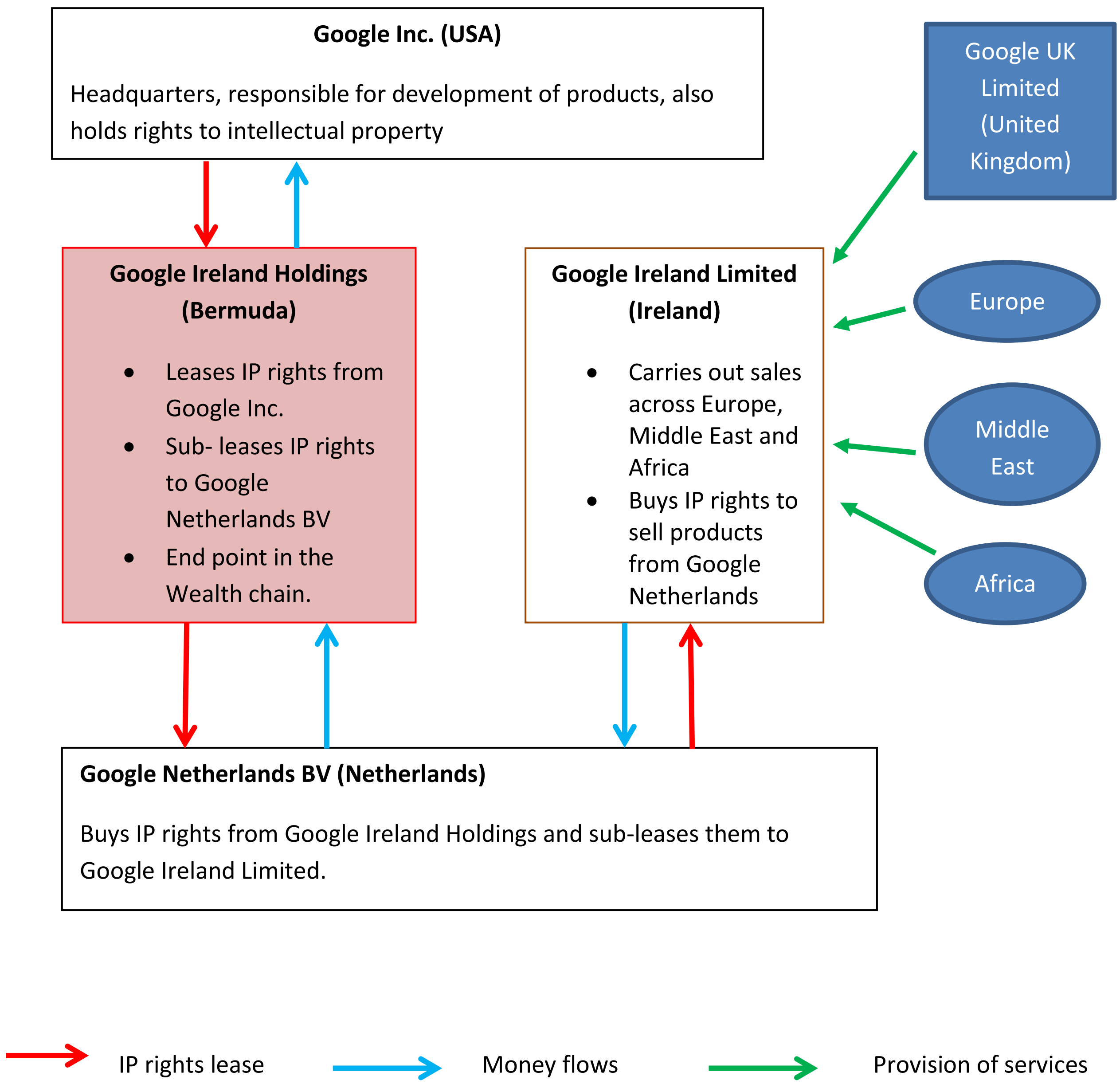

Figure 8. Google's tax structure as of 2011

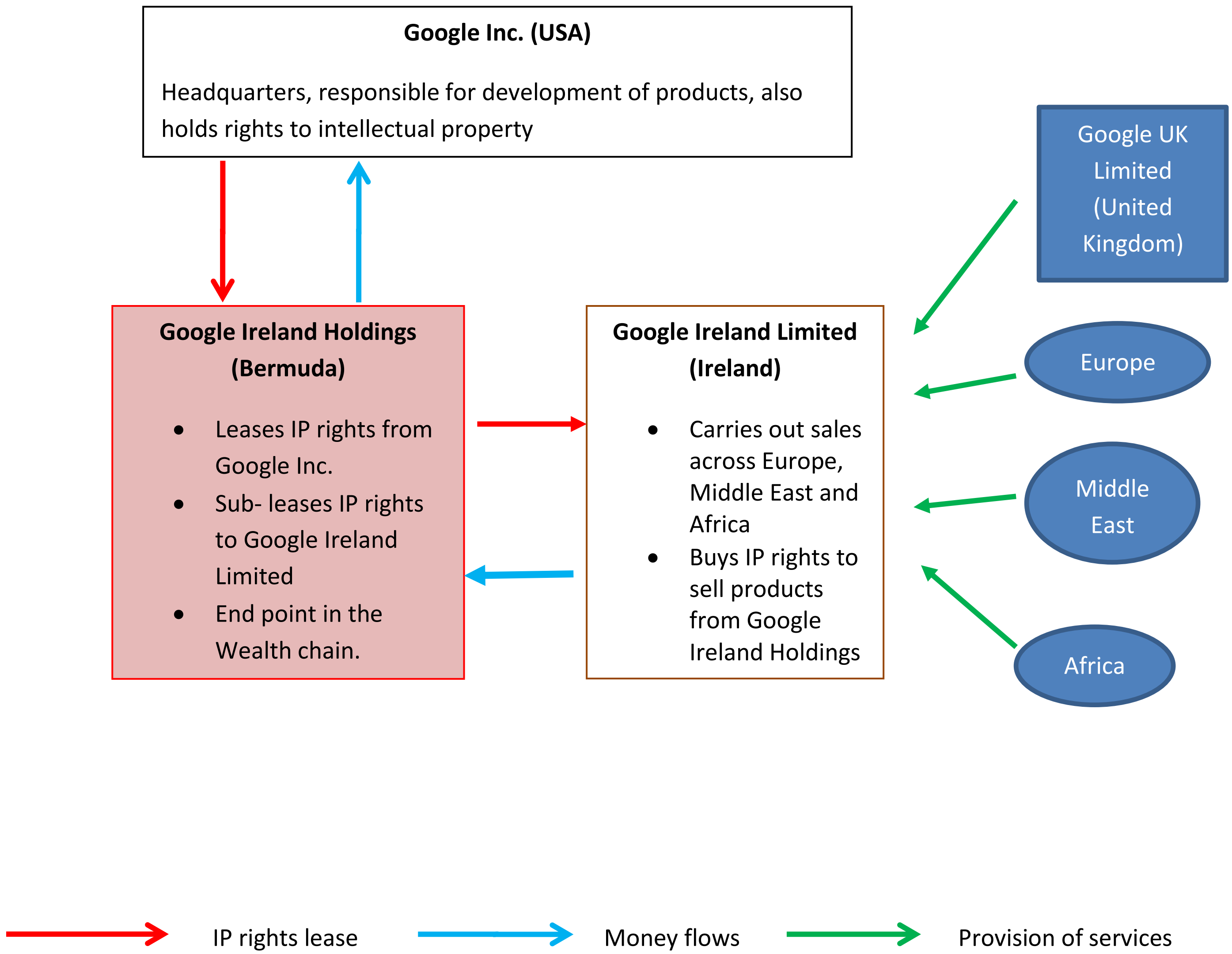

Figure 9. Google's tax structure as of 2012-13

7. CONCLUSION AND DISCUSSION

In light of the focus of the international community throughout 2013 on the issues posed by tax avoidance the goal of this paper was to analyze this phenomenon a bit further. Firstly, the evolution of the corporate form and the decreased capacity of the state influence the inability of the state to control the capital flows between and inside the firm. Moreover, the current international business taxation architecture is ill-equipped to address the challenges posed by the multinational corporation of the knowledge economy. Lastly, it was argued that the combination of these factors impacts the distribution of wealth in the global value chains.

In chapter 3 I positioned the paper theoretically in the global value chain and offshore literature. The global value chain literature largely sees the different economies tied together in a process of global production. GVC school of thought encompasses the disaggregation and spatial spread of production activities, which are reintegrated by multinationals into a coherent production process (Lee, 2010). This holistic view is a breakaway from the previous way of analysis, which focused on export and trade between firms as a disintegrated and a rather independent process. While the global value chain tradition has its roots in the global commodity chain research, a term value, rather commodity is seen as more suitable for the purpose of this thesis. Value, rather commodity is an industry neutral term fit to analyze the firm of the knowledge economy. Global value chain production is far from uniform, and often protected by patents or intellectual property rights to preserve their uniqueness. Moreover, financialization of the production process means that even firms whose primary business is not in finance are increasingly using finance rather than production as both a source and a use of their funds (Milberg, 2008). The financialization of firms' activities and increasing globalization of production leads to increasingly shifting distribution of activities as well as gains in the value chain. The literature on financialization of production activities touches upon the asymmetrical distribution of profits in the value chain. However, it fails to address the profit shifting and transfer pricing schemes employed by MNCs involving the tax haven countries.

GVC tradition acknowledges that the geographical spread of economic activity does not correlate well with the spreading of gains from participating in this global production process

(Kaplinsky, 2000). However the attempts it makes to explain this dissonance are focused on the firm level upgrading in the production chain, ability to innovate and create barriers to entry. These arguments do not take into account the macro level conditions, such as the taxation regulations and accounting policies of various jurisdictions that determine the location of subsidiaries in a specific jurisdiction. For this reason, I bring in the literature on offshore jurisdictions which focuses on the development of tax haven states and their role in the global value creation process. Fundamentally, the legislative environment, taxation rules and accounting regulations of offshore states attract the mobile multinational firm to establish profit generating activities on their soil. Focus on the regulations on state level allows to explain how the wealth is moved along the value chain and why the locations of wealth and value creation are not the same.

In Chapter 4 I analyzed the two sides to the tax avoidance phenomenon – the State and the Multinational Firm. The profit shifting MNCs have received much attention in the past years due to their tax avoidance strategies. Liberalization of trade and the emergence of new production patterns, such as intangible based products, adds to the mobility of capital of the international business. MNCs can now be incorporated, managed and financed from different locations and are no longer limited to national borders to define their identity (Desai, 2008). Moreover, in the past decades the level of sophistication in the structuring of cross-border transactions has increased as the companies rely on intangible inputs into their production processes (OECD, 2012b). On the other side, the states compete to be homes to multinationals by drafting attractive taxation laws, accounting policies and various other sweeteners. At the same time these laws are implemented nationally, and interaction with other states happens only through bilateral treaties. The states, while willing to attract mobile capital to their shores, end up losing control over this capital. The nationally oriented taxation regulations and accounting policies stem from the desire of jurisdictions to preserve their national sovereignty. These rules lack uniformity and are idiosyncratic in nature which the mobile multinational corporation is able to take advantage of by positioning its revenue generating activities in locations offering most convenient regulations. These innate differences influence the dynamics and power relationship between states and firms as the mobile capital transcends the nationally oriented regulations of the state. Existence of multiple jurisdictions with attractive regulations for a particular production process is an impetus for the MNC to be moving the wealth accruing from production to the most favourable spot. Therefore, the value created in the certain jurisdiction and the wealth, accruing to the same jurisdiction do not necessarily correspond. The wealth travels to those jurisdictions offering the most attractive bundle of services in the form of accounting policies and tax laws.

In Chapter 5 I addressed the problem with international business taxation. By discussing the core concepts of IB taxation it was shown that the current set up is ill-equipped to address the challenges posed by the mobile multinational businesses embedded in the knowledge economy. The *separate entity approach* and *arm's length pricing* principle are at the heart of international business taxation architecture, which consider the subsidiaries of the corporation as distinctive pieces to be regarded separately for the purpose of taxation. These principles allow MNCs to position their revenue generating subsidiaries in favourable jurisdictions which allows them to minimize the overall tax bill. The mechanism to determine the prices of intangible inputs or products, traded within a multinational firm, is yet to keep pace with the evolution of the knowledge economy (OECD BEPS, 2012). The misalignment between the rules governing international businesses globally and the mobility of the multinational corporation facilitates tax avoidance and the disappearance of the tax base (McLure, 2001, cited in Rixen, 2008). Most importantly, the architecture of international business taxation facilitates movement of wealth to jurisdictions with favourable conditions, rather than where the value is being created.

In Chapter 6 I took up the case study of Google and their tax planning operations. As an American firm, Google is based out of the US, having relocated their quarters to the State of Delaware. At this first stop already tax savings are generated due to favourable conditions to corporations offered by this state. The hub for Europe, Middle East and Africa is Ireland, where the sales for the region are carried out from. However, the biggest chunk of wealth is siphoned out of Ireland, regardless of the already very attractive regime to MNCs that it offers. The money flows to Bermuda, via the Netherlands, making use of a vast array of double-tax avoidance treaties that the Dutch have with other jurisdictions as well as the non-existence of withholding tax. Through these schemes Google is able to minimize their effective tax rate to

2.4 per cent. Evidently, the value and wealth chains do not correspond as the majority of income lands in an offshore account in Bermuda, where no production is carried out or value created. Through the case analysis I demonstrated that in order to track the wealth in the global value chain one needs to look into the accounting policies and taxation rules of different jurisdictions. These rules are a fundamental factor when MNCs decide the location of certain activities and thus where they land their profits. Furthermore, the case analysis served as an illustration of the decentered multinational firm deploying mobile capital in value and wealth generation. The intangibles based business, embedded in the knowledge economy transcends state borders with nationally focused taxation laws.

This paper is grounded in the hermeneutical tradition which allowed to both explain the phenomenon of tax avoidance, as well as aim to understand the roles played by different actors. The decentered multinational firm and the decreased capacity of the state to control capital play a significant role in shaping the phenomenon. As the states actively seek to attract mobile capital they move beyond the role of the regulator. This understanding of the state as a supplier of laws is allowed by the ontological stance of subjectivism in which hermeneutics is embedded. The importance of history and how the states chose to be involved in tax competition adds to the understanding of tax avoidance and how the tax haven states emerge.

During the time of writing this paper inevitable renewal of the current IB taxation set-up was on my mind. Going forward, to keep the momentum of the attention from the G8 presidency it would be interesting to explore the proposals for unitary taxation. Its proponents argue that this method of taxation would address several problems embedded in the current set up of IB taxation: 1) it would not allow the MNC to be treated as a collection of separate entities and 2) it would address the problem with arm's length pricing between different subs of the same firm (Picciotto, 2012). Unitary taxation would treat the MNC as a unified business entity, requiring it to submit a single set of worldwide consolidated accounts in each country with a business presence (ibid). A weighted formula reflecting genuine economic presence in each country would apportion the overall profits to different countries. This method would be in line with the transaction costs theory, which admits the motivation of a corporation to internalize transactions that can be carried out cheaper than externally. While not without flaws (agreeing on a formula seems like a utopia) this system would be a step forward particularly for the developing nations. Furthermore, the evolution of the role of the OECD in the tax world will be interesting to observe. This year OECD was mandated by the world leaders to implement automatic information exchange agreements as well as a common template for country-by-country reporting (G8 Communique, 2013). The focus and continuous engagement not only by the politicians but by the general public might result in changes in the existing set-up of IB taxation. The goal of the policy makers will hopefully be on making the taxation systems more in line with the development of the economy and the evolution of the businesses.

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