Ethical Concerns in Multinational Corporations

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Ethical Issues in Multinational Corporations

Multinational corporations are legal entities that are very separate and distinct from its owners. They enjoy most of the rights that individuals enjoy. Multinational corporations, abbreviated as (MNC) operate in one more other country than their home country. They have assets and facilities in other countries. Moreover, a multinational company is determined by the number of customers as well as the profit margins. For example, a multinational corporations has a huge number of customers across the globe, which will in turn increase its profitability and competitiveness in the global market place. Generally, these companies have factories, institutions and/or offices in other countries. For global management of their assets, institutions, offices and facilities, the corporations have a centralized office that works as head office. The head office controls all other facilities from the corporation’s home country. In their operation, multinational corporations derive at least a quarter of their revenue from other countries other than its home country. A good number of these corporations are based in developed countries. According to Scott and Chen (2020), “A large majority of high revenue companies in the U.S. are multinational” (para.3).

There are two arguments that view multinational corporations differently. Advocates of multinational corporations argue that the corporations create job opportunities that are high paying in developing countries. They also argue that new products that would otherwise not be there in these developing countries are introduced. However, almost the same amount of weight against these corporations is exposed. Critics of these corporations argue and believe that these corporations have political influences to governments of countries they are in. They exploit these developing nations and cause job losses. For instance, a soap industry in Kenya (an East African Country), MNC investment has caused increased unemployment and regional inequality (Langdon, 2007).

Multinational corporations have been on the radar for faulting income taxes. It is worrying how these multinational corporations siphon from their profits in countries they are in, while in the process, they evade taxes. Palansky and Jansky (n.d.), have viewed that “around US$420 billion in corporate profits is shifted out of 79 countries every year. This equates to about US$125 billion in lost tax revenue for these countries” (para 1-2). It means that the corporations underpay for services they receive from these countries they are in. Alternatively, poor citizens of the countries these multinational corporations are, are forced to pay heavy taxes that result from lack of paying of taxes by these corporations. This is a clear indication of economic inequality considering that these corporations mainly thrive in developing countries. There are three ways in which these corporations use to shift profits so that they can evade paying taxed in high taxed countries. The three channels are; registration of intangible assets where these assets include copyright and/or trademarks, debt shifting and strategic transfer pricing.

To understand how this works, take for instance, two companies. Company X is situated in a jurisdiction whose tax is high while company Y is situated in a jurisdiction whose tax is low. The two companies belong to a corporation. Company Y is a holding company and claims ownership of company X. The two make profits and should hence pay tax according to the profits they earn and the terms of the country they are in. Shifting of profits from the high-taxed region to the low-taxed region is one of the methods. In our case, company X is in a region whose income tax is 30% while company Y is in a region whose income tax is 0%. This means that for every dollar shifted the company evades 30 cents of tax. Debt shifting comes in when company X gets into debt with company Y by borrowing it money, although it is money it does not need to borrow. Then the company pays the debt with interest. Company X is incurring a cost by paying company Y with interests and are hence tax-deductible. So, they reduce company X’s profits which is an effective move, and increase the profit reported in Company Y. The second channel, the multinational corporation transfers intangible assets.

These assets include, trademarks to company Y then company X pays royalties to company Y so that it can use those assets. Royalties are considered as costs to company X. This causes it to have its royalties lowered hence reducing taxable profits to company Y. The last channel is known as Strategic transfer pricing. This comes in when company X for example does business with company Y. For the companies to set their trade’s prices, they will use what’s currently been used in most countries. Known as, “arms length principle”. Meaning that, while setting prices, they should be set just as they would be if two non-associated did busines or traded. Usually, it is not easy in determining arm’s length price and hence, there’s space for corporations to set the price ensuring that it’s minimizing its overall tax liabilities.

**Internal Revenue Service.**

Internal Revenue service is an agency for the United States government that deals with collection of tax and administering the Internal Revenue Code passed by the congress (IRS, n.d.). The agency was started in 1982 by President Abraham Lincoln. The agency, is under the United States Department of Treasury. According to Segal (2019), IRS deals with “collection of individual income taxes and employment taxes. The IRS also handles corporate, gift, excise and [estate taxes](https://www.investopedia.com/terms/e/estatetax.asp), including [mutual funds and dividends](https://www.investopedia.com/ask/answers/which-option-better-mutual-fund-growth-option-dividend-reinvestment-option/).” The agency is colloquially named “tax man”. Its headquarters are in Washington, D.C IRS is involved in taxing Americans, individuals and their companies. It serves quite a number of people. In 2019, IRS processed more than $253million tax returns where it collected more than $3.5trillion and issued more than $452billion in tax refunds (IRS, n.d.). There are regulations that guide individual taxpayers and corporations. Parent entities of multinational enterprise are groups expected to have revenue of $850 million or more. The entities file form 8975, Country-by -Country Report. According to the IRS, the report. It is the role of the IRS to ensure that all companies across the United States of America pay taxes for the functioning of the country to continue.

Has to be filed for U.S. MNE group’s first reporting period in the year of taxing that begins on June 30, 2016. Two, must be filed with the income tax return of the parent entity where by the period of operating ends and cannot be filed as a stand-alone return. Thirdly, can be filed for reporting periods that start prior to the initial required reporting period. Form 8975 should be filed in the Modernized e-file (MeF) XML schema format. Entities of the parent not permitted to electronically file the returns must file Form 8975 together with their paper income tax. The IRS will automatically exchange Form 8975 information with tax authorities with which the United States enters into a bilateral Competent Authority

**Transfer Pricing**

Transfer pricing has been defined as an accounting or taxation practice. The practice involves pricing of transactions that are carried on internally within the businesses. The practice also can be carried on within subsidiaries operating under common ownership or control. For transfer pricing, it can be practiced within domestic and cross-border transactions. Transfer pricing prices are based on the market price of that service or good. It is the role of companies to ensure that there is effective transfer of prices to avoid issues that may affect its operation and profitability.

**Taxes and Transfer Pricing**

In our quest to comprehend, taxes and transfer pricing, let’s take for instance a printing firm. The firm has two divisions, Division A and division B. Division A creates designs while Division B prints and does branding. Division A creates and sells designs then sells the designs to other printing and branding companies as well as its parent company. Division B buys designs from Division A at the market price just as it charges other companies. In case Division A decides to charge Division B at lower price discarding the market price. As a result, sales and revenues from Division A are lowered because of the pricing that has been lowered for Division B’s sake. On the other hand, costs of goods sold (COGS) on Division B are lowered hence increasing the profits to the divisions. The equalization math is, revenues on Division A are lower by the same amount with the cost’s savings on Division B, hence no financial impact to the overall corporation.

However, in case Division A is in a country having higher tax than Division B, there is a mechanism in which the overall company could save on taxes. That can be achieved by lowering profits on Division A, while making Division B more profitable. Therefore, by Division A charging lower prices, then those savings can be passed onto Division B, ensuring that it boosts its profits, made possible by lower COGS. When it comes to taxing, Division A is taxed less by virtue of lowered profits. As for Division B, it will be taxed less since it is in a lower-taxed country that is by virtue of location. Division A’s decision lower costs for Division B hence not charge market pricing makes it possible for the overall company to evade taxes. Either by charging above or charging below the market price, most companies have used transfer pricing to be able to transfer costs and profits internally to other divisions reducing their tax burden.

**The IRS and transfer pricing**

The IRS dictates that for intercompany transactions, transfer pricing should be similar with if the intercompany had otherwise made transactions with a customer not from the company.

This makes the financial reporting of transfer pricing have strict guidelines. In addition, it is closely observed by the tax authorities. Regulators and auditors often require a lot of documentation. Sometimes, financial statements are restated and penalties applied if transfer value is observed and noted to have been done in appropriately or incorrectly. However, there is a lot of debate surrounding how divisions should account for transfer pricing and which of the divisions is to take the tax burden.

**Coca-Cola illegal price transfer**

In 2015, the IRS raised a concern, demanding for up to $3.3 billion from the Coca-Cola Company. The company had suppressed profits from 2007 to 2009 in the US then transferred them to countries considered to have lower tax rates. This demand is on transfer pricing adjustments resulting to more than $9 billion. This has affected the profitability and competitive capability of the company in the international market place.

According to records from the company, 57% of Coca-Colas $46 billion revenue for 2014 was from locations outside US. In addition, a bigger percentage of the company’s operating income is booked overseas. As a result, 23.4% was its effective tax rate, significantly below the 35% statutory rate.

Coke, has licenses in Brazil, Ireland, Swaziland, Mexico, Egypt, Chile and Costa Rica. These entities are tasked with producing concentrate that is sold to bottlers in countries. The IRS claims that, profits made by these companies in locations overseas are not real but inflated. So, if Coca-Cola had made transactions with unrelated parties, it would have made greater profits in the US. Through this claim, IRS is evaluating and identifying comparable “uncontrolled transactions”, that is, transactions that involve unrelated parties. The IRS demand is bestowed on an assessment that the company has undercharged its affiliates in the foreign nations for the intellectual property used in manufacturing and sale of the concentrates that make Coke in seven countries. Greater amounts should have been claimed by the company for allowing associate entities use Coke’s formulas and trademarks.

However, the company has disputed additional liabilities from tax. It maintains that the issues raised by IRS, that is the transfer-pricing issue dates way back to taxes of 1987. The two, that is Coca-Cola and IRS, in 1996 entered into agreement so as to settle the tax demands. This was a retroactive agreement to 1987, which came up with a method. The method was to allocate income between the US parent and the licensees. The company contends that it is clear that the agreement specifies that penalties would not be assessed provide the prescribed method was followed by the company as detailed in the agreement. Officials from Coke expressed surprise that the method used by IRS for assessing tax liability had changed.

Therefore, Coca-Cola has petitioned against the IRS claim to the US Tax Court. The company claims that it has taken into account the risks and entrepreneurial responsibilities in its method calculating income taxes assumed by the licensees. During the 1987 to 2009 period, an investment of $45 billion in marketing and operating expenses and incentive programs have been made by these foreign entities.

**Facebook Price Transfer row**

Another company that has been targeted by the IRS is Facebook Inc. Facebook has been challenged by IRS on its arrangements in transfer pricing in Ireland back to 2010. Facebook has been accused of “downplaying” its intangible assets value in order to pay the US less tax. Facebook valued its assets at $6.5 billion in 2010 before going public. However, the IRS claims that the true value is $21billion. In case IRS wins the case in court, Facebook will pay $9 billion topped by interests and penalties. Therefore, there is the need for a company to be faithful with its operations rather than waiting for IRS to make huge fines that will affect its operations and competitiveness in the global market place.

The company stands by the valuation of 2010 when it did not have revenue from mobile advertising. IRS argues that projections from Facebook were argued to be much “lower” than how they would be in realistic. In 2010, the company went through a year of uncontrolled growth where its experimental advertising model became a success.

Facebook will argue that in its valuation, international expansion risks were taken into account. This was time before Facebook was the world’s second biggest ad seller. Secondly, it will argue that in its expansion, the Irish subsidiary was a key factor. Witnesses who have seen the company’s grow in 10 years have been called to testify. They include, David Fischer, the chief revenue officer, Mike Schroepfer, chief technology officer with Naomi Gleit and Javier Olivan.

Since 2010, a lot has changed with Facebook taking on the social media platform globally. Facebook employed over 2,000 people when it restructured. This happened in Dublin, giving signs that it was not going to shift its workforce in Dublin. Currently, Facebook Ireland has employed over 5,000 employees in the country. Its effective tax rate has thus changed and risen from 13% in 2018 to 25% in December 2019. This is after an increase in its effective tax rate from 18% in 2016 to 23% in 2017.

Facebook Ireland, under the old structure would have its royalties paid to the parent company which is US based, for its trademark access, platform technology and users. The Irish company paid Facebook US over $14 billion in royalties and payments on cost sharing from 2010 to 2016. Yet, $13.6 billion in European revenue was shifted through Ireland in 2016. Tax of up to €29.5 million was paid. This practice was common when a structure known as the double Irish was still in use. This loophole allowed movement of intangible assets by companies to low-tax jurisdictions like Ireland and then have the income channeled through countries like Cayman Islands, Bermuda, and the British Virgin Islands.

Facebook has over $55 billion in cash reserves. The tax bill. Not including penalties and interests would cost Facebook almost 20% of those reserves. This comes in just as the company is taking investments that are capital-heavy, in undersea cable networks and new data centers. However, this case is more than a company’s plan. This case means that questions will be imposed to platforms about past structures. Alternatively, it could mean that the past remains behind if the company is able to persuade the US Tax Court to be on its side.

**Guidance to avoid issues with IRS**

Although subsidiaries are partially or fully controlled by their parent companies, the law expects them to maintain their own set of financial books, pay income tax and file their own tax returns on revenues they generate. (Harris, n.d.)

Tax liability; at registration, subsidiary incorporators submit the articles of incorporation, bylaws and name of the subsidiary then they obtain a number known as federal tax identification number very distinct from that of the parent company. They are hence companies on their own. Therefore, they are expected to pay income tax. Tax Relief; Internal Revenue Code allows subsidiaries file consolidated group financial reports at very limited circumstances. Parent companies cause a tax relief for the subsidiary by submitting a consolidated tax return when it presents itself as a single taxpayer together with its subsidiary. State taxes; the state imposes corporate taxes that include use tax, sales and use of intangible assets taxes like patents and trademarks. Subsidiaries may aid reduce these taxes since parent companies may set them up in corporations that are in countries that have lower taxes or the taxes are not in existence. For instance, a subsidiary corporation may want to exploit a new trademark. Delaware would be the best choice to exploit a trademark since there are no trademark taxes there. Foreign subsidiaries; Profits made by a foreign subsidiary corporation are ordinary. They are not taxed in the United States because IRS rule is that foreign subsidiaries are not taken as US corporations.

In conclusion, IRS is a very important agency. The IRS regulates filing of tax returns and keeps corporations and big institutions on toes. There are ways in which corporation can manipulate so that they pay less taxes. However, IRS has been able to reach to those companies that have been evading paying of taxes. Therefore, there is the need of companies to operate in relation to the rules and regulations governing IRS to prevent the existence of fines that will affect the operation of a company.

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