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The demand for tax haven operations ☆

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Abstract

What types of firms establish tax haven operations, and what purposes do these operations serve? Analysis of affiliate-level data for American firms indicates that larger, more international firms, and those with extensive intrafirm trade and high R and D intensities, are the most likely to use tax havens. Tax haven operations facilitate tax avoidance both by permitting firms to allocate taxable income away from high-tax jurisdictions and by reducing the burden of home country taxation of foreign income. The evidence suggests that the primary use of affiliates in larger tax haven countries is to reallocate taxable income, whereas the primary use of affiliates in smaller tax haven countries is to facilitate deferral of U.S. taxation of foreign income. Firms with sizeable foreign operations benefit the most from using tax havens, an effect that can be evaluated by using foreign economic growth rates as instruments for firm-level growth of foreign investment outside of tax havens. One percent greater sales and investment growth in nearby non-haven countries is associated with a 1.5 to 2% greater likelihood of establishing a tax haven operation.

JEL Classifications: H87; F23; F21
Keywords: Tax avoidance; Multinational firms; Tax havens

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1. Introduction

Tax havens are low-tax jurisdictions that provide investors opportunities for tax avoidance. Examples of such tax havens include Ireland and Luxembourg in Europe, Hong Kong and Singapore in Asia, and various Caribbean Island nations in the Americas. Low-tax jurisdictions are also common within countries, taking the form of special economic zones in China, low-tax states and enterprise zones in the United States, and tax-favored subnational regions including eastern Germany, southern Italy, eastern Canada, and others. American multinational firms make extensive use of tax havens: in 1999, 59% of U.S. firms with significant foreign operations had affiliates in tax haven countries.

This paper analyzes the activities of a panel of American multinational firms from 1982 to 1999 to identify the types of firms using tax havens and the purposes that tax haven operations serve. The analysis begins by considering the characteristics of multinational parent companies with tax haven operations. Large multinationals, and those that are most active abroad, are the most likely to operate in tax havens, suggesting that there are economies of scale in using havens to avoid taxes. Additionally, multinational parents in industries in which firms typically face low foreign tax rates, those that are technology-intensive, and those in industries characterized by extensive intrafirm trade are more likely than others to operate in tax havens. While this evidence is consistent with the intuition that multinationals employ haven affiliates to reallocate taxable income from high-tax to low-tax jurisdictions through intrafirm trade and transfers of intangible property, the fact that multinationals in industries with low foreign tax rates are more likely to operate in tax havens indicates that haven affiliates do not merely serve to relocate profits away from high-tax locations. Instead, this piece of evidence suggests that American firms with low foreign tax rates benefit from using tax havens to defer, or otherwise avoid, U.S. taxation of their foreign incomes.

Some of this evidence is open to multiple interpretations. It is possible that aggressive tax-sensitive firms are the most likely to establish tax haven affiliates and also the most likely to concentrate their other foreign operations in low-tax jurisdictions, not due to any operational connection between these activities, but simply because these taxpayers, when given a choice, always select the lowest-tax locations. More generally, tax havens need not provide the same function for all multinational parents. In order to identify how a multinational's overall foreign tax rate influences its use of tax havens, the analysis distinguishes larger, more populous, tax haven countries from smaller tax haven countries, where little employment and capital are located. Taxpayers have greater opportunity to locate taxable profits in larger havens, given the sizes of local economies. The evidence indicates that these larger tax havens serve a distinctive function, facilitating the reallocation of income from high-tax to low-tax locations, as parents in industries with high average foreign tax rates make greater use of such larger havens, conditional on using havens at all, and ownership of an affiliate in a large tax haven country is associated with reduced tax payments elsewhere in the same region.

The size of a firm's foreign operations and its use of tax havens are jointly determined, complicating the analysis of the extent to which the scale of activity in non-haven countries affects the demand for tax haven operations. Fortunately, it is possible to use rates of economic growth in foreign countries to predict differences between the subsequent foreign investment levels of American firms whose initial investments were located in different countries. Evidence from this instrumental variables analysis indicates that