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Moving Money across Borders in the Perspective of International Taxation

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Abstract: Taxation plays a vital role in international operation of firms. It is the core of various financial decisions, such as international investment decisions, international working capital decisions, funds raising decisions concerning dividend and other payments. It is true that the tax issue is relevant to such decisions also in respect of domestic firms. But, the management of taxation is a highly complex issue for international corporations. There are two types of foreign investment, namely foreign direct investment and foreign portfolio investment. Pursuing the objectives of utilizing the firms' cash resources most efficiently and minimizing the firms' global tax liability requires the firm to be able to transfer funds from one location to another around the global. International businesses use a number of techniques to transfer liquid funds across borders. These include dividend remittances, royalty payments and fees, transfer prices and fronting loan. The investors are interested in real rates of return net of taxes. The international tax system should be neutral that is it should not affect economic efficiency. At the same time, it has to be equitable ensuring equal sacrifice by different tax payers. Besides, a firm should not be taxed twice for the same income. Some firms use tax havens to minimize their tax liability. The OECD has published a list of 35 tax havens. So, the OECD is very much concerned to remove the loopholes in the tax system and other obstacles in cross border trade and investment.

Key words: Capital flows, dividend drains, hedging, tax havens, tax harmonization, tax equity, tax index, unbundling

INTRODUCTION

Taxation plays a vital role in international operation of firms. It is the core of various financial decisions, such as international investment decisions, international working capital decisions, funds raising decisions concerning dividend and other payments. It is true that the tax issue is relevant to such decisions also in respect of domestic firms. But, the management of taxation is a highly complex issue for international corporations. The reasons are very obvious. Firstly, these firms have to operate in many tax jurisdictions where tax rates are different and also, the administration of tax system is not uniform. Secondly, the ultimate burden of tax in the context of international firms is determined by a more complicated interplay of varying definitions of tax base. Thirdly, the varying tax treatment in different countries can lead to distortions in international trade and investment. The firms located in a low-tax country may have an edge over other firms in international market. Similarly, investment can be diverted to those countries having lower tax rates. Fourthly, the international firms often straddle different tax jurisdictions, exploit the arbitrage opportunities and maintain an edge over the domestic firms, mentioned by Sharan (2009).

International business has been propelled by large cross-border flows of finance. While private financial flows are invariably, commercial in nature and related to official development assistance which also have implications of business. Broadly, there are two types of foreign investment; namely Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI). The financial account in a country's balance of payments covers a variety of financial flows mainly Foreign Direct Investment (FDI), portfolio flows (including investment in bonds and equities) and bank borrowing which have in common the acquisition of assets in one country by residents of another. Capital account liberalization in broad terms, refers to easing limitations or fees and taxes on capital flows across a country's borders. This can result in a higher degree of financial integration with the global economy through higher volumes of capital inflows and outflows which has referred in International Monetary Fund (IMF, 2012).

PRIVATE CAPITAL FLOWS

Private capital flows consist of net foreign direct investment and portfolio investment. Foreign direct investment is net inflows of investment to acquire a lasting management interest (10% or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term and short-term

Table 1: Private capital flows (US Dollars)

Countries name	2009	2010	2011
Australia	86,230,158,840	73,203,937,662	Not available
Brazil	86,315,854,300	99,929,860,898	103,000,055,133
Canada	71,003,524,769	84,552,143,790	71,851,620,627
China	114,254,431,168	209,788,277,465	190,087,834,876
France	253,441,658,989	114,880,995,972	298,576,033,769
Germany	-162,964,347,864	-237,268,026,278	42,016,478,401
India	40,606,179,024	49,869,991,944	Not available
Italy	29,549,763,035	27,867,125,412	-65,965,432,013
Japan	-279,294,082,788	-209,578,639,661	43,609,844,625
Mexico	-1,713,590,650	34,925,226,633	52,140,447,072
Netherlands	-29,659,121,216	-9,743,026,547	5,864,080,121
Russian Federation	-9,344,811,000	-10,894,961,810	-32,261,977,100
UK	68,393,200,798	21,084,021,497	-130,490,673,313
United States	-144,792,800,000	426,165,300,000	-32,979,300,000

World Bank, 2012

capital, as shown in the balance of payments. The FDI included, here is total net that is net FDI in the reporting economy from foreign sources less net FDI by the reporting economy to the rest of the world. Portfolio investment excludes liabilities constituting foreign authorities' reserves and covers transactions in equity securities and debt securities. The data of private capital flows of selected countries shown in Table 1, for 3 years only, i.e., 2009-2011 as per World Bank report, 2012.

CROSS BORDERS CAPITAL FLOWS

Pursuing the objectives of utilizing the firms' cash resources most efficiently and minimizing the firms' global tax liability requires the firm to be able to transfer funds from one location to another around the globe. International businesses use a number of techniques to transfer liquid funds across borders. These include dividend remittances, royalty payments and fees, transfer prices and fronting loan. Some firms rely on >1 of the techniques to transfer funds across border a practice known as unbundling. By using a mix of techniques to transfer liquid funds from a foreign subsidiary to the parent company, unbundling allows an internal business to recover funds from its foreign subsidiaries without piquing host-country sensitivities with large dividend drains.

A firms' ability to select a particular policy in severely limited when a foreign subsidiary is past owned either by a local joint-venture partner or by local stockholders. Serving the legitimate demands of the local co-owners of a foreign subsidiary may limit the firm's ability to impose the kind of dividend policy, royalty payment schedule or transfer pricing policy that would be optimal for the parent company. For the international business with activities in many countries, the various tax regimes and the tax treaties have important implications for how the firm should structure its internal payments system among the foreign subsidiaries and the parent company. The firm can use transfer price and fronting any loans to minimize its global tax liability. In addition, the firm in which income is remitted from a foreign subsidiary to the parent company (royalty payments vs. dividend payments) can be structured to minimize the firm's global tax liability, referred by Hill and Jain (2007).

TAX PLANNING FOR INVESTMENT

The investors are interested in real rates of return net of taxes. It is, therefore necessary for investor to know the provisions relating to securities. The present tax system provides some benefits to tax paying investors, although many of them were deleted in the recent budgets for reasons of simplification of the tax system. Investors need to make tax planning which is not the same thing as tax avoidance. It means adopting a strategy for reducing the tax liabilities by proper planning. The basic objective is to have a net of tax return which is higher than the inflation rate and provides a proper risk premium.

International trade and investment would not be possible without the arrangements or mechanism for buying and selling foreign currencies because the rupee is not the international means of exchange. The foreign exchange market is a necessary concomitant to international transactions in an open economy. It is cleared at a conversion price, i.e., at the exchange rate which is an important part of financial analysis. The wealth accumulated in a given country is not always committed to the financial institutions there. The international aspects of saving and investment are reflected in the volume of capital flows between countries by Bhole and Mahakud (2009).

Taxation should not be regarded as an unmitigated evil. It provides benefit to some individuals that may outweigh the associated costs that others have to bear. Regardless of whether the benefits outweigh the costs, however taxes have a significant impact on investment decision and refuter-important aspects of taxation from investor's view point. Federal and state tax laws play a major role in the way securities are priced in the market place because investors are understandingly concerned with after-tax returns not before tax returns. Accordingly, the investor should determine the applicable tax rate before making any investment decision. This tax rate is not the same for all securities for a given investor.

In general, the most important taxes for investment decision-making personal and corporate income tax. The corporate form of organization is the largest in terms of the dollar value of assets owned, even though there are more firms organized as partnerships or as single proprietorships. Legally, a corporation is regarded as a separate entity whereas a proprietorship or partnership

Table 2: Total tax index of selected countries for the year 2012

Countries	CIT (%)	OCT (%)	SLC (%)	TETR (%)	TTI	Rank
Australia	22.8	4.1	49.6	76.5	125.1	10
Brazil	36.1	14.8	36.3	87.2	142.6	11
Canada	7.3	7.9	20.9	36.1	59.1	2
China	14.8	8.7	12.9	36.5	59.7	3
France	14.7	12.5	82.6	109.9	179.7	14
Germany	29.3	5.6	39.7	74.6	122.0	9
India	25.3	3.4	1.7	30.4	49.7	1
Italy	37.6	1.5	54.4	93.5	152.9	13
Japan	31.5	23.3	38.3	93.1	152.3	12
Mexico	27.3	1.8	9.8	38.9	63.6	4
Netherlands	18.6	13.0	27.3	47.2	77.2	7
Russia	17.6	11.1	15.2	43.9	71.7	5
UK	17.1	9.2	18.5	44.8	73.3	6
US	28.1	12.9	20.2	61.1	100.0	8

KMPG group, Forbes, CIT = Corporate Income Tax; OCT = Other Corporate Tax; SLR = Statutory Labor Cost; TETR = Total Effective Tax Rate; TTI = Total Tax Index

is considered an extension of its owner or owners. Income earned by proprietorship and partnerships is taxed primarily through personal income taxes levied on owners. Income earned by a corporation may be taxed twice once when it is earned through the corporate income tax and again when it is received as dividends by holders of the firms' common and preferred stock through the personal income tax (Alexander *et al*., 2009).

The few results of study (KPMG, 2012), made by the KMPG Ltd. has been referred here that how the variations shows in tax policy and cost among the selected industries and countries. Table 2 shows the Total Tax Index (TTI) ranking of selected countries in 2012.

The three important taxes considered for the study are corporate income tax, other corporate taxes and labor costs (tax rates used are those in effect as at Jan. 1, 2012). Tax calculation over the 10 years analysis horizon incorporate future tax changes announced before Jan. 1, 2012. The overall results for all locations are based on average results of few international operations.

The data is based on select corporate of the few counties. The different sectors of corporate are like business operation, manufacturing unit, R&D, digital and service operation. The USs' score as 100.0 is the bench mark against the other countries. Among the countries, India has the lowest TTI as compared with other select countries. It is followed by China and Canada and variation among these two countries is 6%. Australia, Brazil, Germany, Italy and Japan have crossed the score of US, i.e., the total tax index is more than US economy. At the other end of the spectrum, France TTI of 179.7 signifies that the total tax costs in France are 79.7% higher than the US standard.

Tax policy varies widely by countries: The study reveals that there is no standard approach in setting tax policy among the countries. Although, the types taxes used to raise government revenues are more or less the same, there is a variation in how these taxes are weighted and applied. Some countries have a tax policy focused on delivering a low corporate income tax rate in order to compete for more businesses. These countries may need to rely more heavily on other taxes, such as sales or payroll taxes to derive their tax revenues. Similarly, some countries use their tax policies to attract certain types of businesses with targeted incentives for activities, such as manufacturing and Research and Development (R&D). A country's tax policy choices can significantly affect the tax cost of doing business in that country.

Tax costs vary widely by industries: The results among the different business sectors vary widely. For companies in service industries, labor costs generally represent a more significant cost factor than for other companies and so, the impact of statutory labor costs on these companies are more of an issue. Companies in the manufacturing industry are more capital intensive and less affected by the statutory labor costs. So, the imposition of capital taxes, property taxes and the availability of tax incentives for manufacturing activities are more important consideration in location decisions. Research and Development (R&D) operations see the most extreme variation in tax costs among countries, due to intensive competition among many countries to attract R&D businesses by offering generous tax incentives.

BASES OF INTERNATIONAL TAXATION

The international tax system should be neutral that is it should not affect economic efficiency. At the same time, it has to be equitable ensuring equal sacrifice by different tax payers. Besides, a firm should not be taxed twice for the same income.

Tax neutrality: Neutrality of international taxation is based on the concept of economic efficiency. It should not come in the way of optimal allocation of capital among different countries. If tax is neutral, it does not affect either the location of the investment or the nationality of the investor. Capital will move from a country with lower return to a country higher return. Consequently, resources may be allocated efficiently and the gross world output in turn will be higher. Tax neutrality may be capital-export neutrality and capital-import neutrality.

Capital-export neutrality which means the rates of taxes should be the same between domestic investment and foreign investment. It implies that investors are indifferent between domestic and foreign investment. It is possible when pre-tax and post-tax returns on capital are the same between capital exporting country and the capital importing country. But, uniformity of this kind is difficult to be achieved in practice. This is so because accounting norms vary in different countries and tax policy of different governments is also heterogeneous. Whereas capital import neutrality focus that the taxes should not discriminate between firms operating in a particular capital-import country. It occurs when the same tax rate is applied to the income of all firms competing in the same capital-importing country so that no firm domestic or foreign enjoys any competitive advantage. But since tax bases are different, it is not easy to achieve capital-import neutrality.

Tax equity: The principle of tax equity rests on the belief that all similarly situated tax payers should participate in the cost of operating the government according to the same rules. The concept of equity can be interpreted in two ways. One is that the contribution of each tax payer should be in conformity with the amount of public services he or she receives. The other is that each tax payer should pay taxes according to his or her ability to pay. The ability to pay is a person with greater ability has to pay a greater amount to tax.

Tax management strategy: The minimization of the overall tax burden so, as to maximize the overall profit is the strategy of international firms. International tax management strategy aims at maximizing profit and the activities are directed to this end are: Firstly, trade-off between retention and repatriation of profits, by subsidiaries; secondly, cost allocation among subsidiaries facing varying tax rates and third, decision to operate through either branches or subsidiaries. Whatever the strategy, a firm needs considering the tax provisions in the home country, as well as in the host country like income tax, withholding tax and value added tax.

A significant part of the tax revenue in a country is represented by tax on personal income, as well as corporate income tax. The tax is levied on income arising out of a firm's operation whether the operation is a manufacturing one or it is concerning the provision of services. However, the rate of the tax varies widely among different countries or different tax jurisdictions with the result that the concept of neutrality or equity is hard to be adhered. Withholding tax is a tax levied on passive income earned by an individual or a corporate body. The word passive is used because the income arises or is generated in some other country. Suppose a corporate body in India gets dividend from its subsidiary operating in some other country and pays tax on the dividend income to the Indian government. The dividend income is a passive income (many forms, such as income from royalty, technical service fees and income from interest) as it is generated abroad. The tax on such income is known as withholding tax because the corporate body receiving the dividend withholds the tax borne by the tax payer (shareholder) and passes on the tax amount to the tax authorities.

A Value Added Tax (VAT) is a tax levied on the value added at different stages of production of a commodity or services. VAT is an indirect tax and is often preferred to direct income tax in so far as it discourages unnecessary consumption, fosters national savings and is easier to be collected. However, this tax too faces the same problem that is the rates are different in different tax jurisdiction (Sharan, 2009).

Tax harmonization: Tax harmonization, like tax simplification is one of those goals that everyone favors and no one is willing to give up very much to achieve. Its support is very broad and very thin. As the economies of most countries are becoming more and more global, however the potential benefits from tax harmonization increase markedly. If there is no substantial harmonization of tax rates, countries will face increasing market pressures to avoid origin-based taxes, such as the income tax. The alternative, destination based taxes may also be used like, Canada has encountered competitive problems, as a result of its recently enacted General Sales Tax (GST) due to the opportunities available to many Canadian residents to shop in the United States. Also within an economic community, such as the EC or NAFTA, the need for harmonization has increased (McIntyre, 1993).

Double taxations: Many nations follow the world wide principle that they have the right to tax income earned outside their boundaries by entities based in their country. Thus, US government can tax the earning of the German subsidiary of an enterprises incorporated in the United States. Double taxation occurs when the income of a foreign subsidiary is taxed both by the host country government and by the parent company's home government. However, double taxation is mitigated to some extent by tax credit, treaties and the deferral principle. A tax credit allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government. A tax treaty between two countries is agreements specifying what items of income will be taxed by the authorities of the country where the income is earned. A deferral principle specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.

Tax havens: Some firms use tax havens to minimize their tax liability. A tax haven is a country with an exceptionally low or even no income tax. International businesses avoid or defer income taxes by establishing a wholly owned, non-operating subsidiary in the tax haven. The tax haven subsidiary owns the common stock of the operating foreign subsidiaries. This allows all transfers of funds from foreign operating subsidiaries to the parent company to be funneled through the tax haven subsidiary.

There are some non-tax factors given by Gordon (1981) that make a country tax haven as:

- Strict rules on secrecy and confidentiality in respect of business transactions
- Relative importance of banking and other financial activities
- Lack of currency controls
- Governmental measures promoting tax havens status

According to Alworth (1988), categories the tax havens into four types:

- Those having no income or capital gains tax
- Those having a very low rate of tax
- Those exempting from tax all income from foreign sources
- Those allowing special tax privileges in specific cases

In the first group are Bahamas, Bermuda, the Cayman Islands, Nauru, New Hebrides and Turks and the Caicos Islands. In these countries, the government does not impose any specific rate of taxes but has fixed a small amount of tax. The manufacturing companies get a long-term guarantee against taxes.

In the second group of countries are British Virgin Islands, the Netherlands Antilles, Montserrat, Gersey, Guernsey and Isle of Man where tax rates are very low and special tax privileges are provided to shipping, aviation and to holding companies.

Costa Rica, Hong Kong, Liberia and Panama represent the third group. In these countries, the government taxes only locally generated income and not any income flowing from foreign sources.

In the Fourth group are Luxembourg, the Netherlands, Switzerland, Liechtenstein, Gibraltar, Barbados and Grenada. In the first four of these countries, special tax privileges are provided to qualified holding companies while in the latter three countries, low rates of taxes are applicable to special status companies or to international business companies.

The OECD (Organization for Economic Co-operation and Development) has also published a list of 35 tax havens (Appendix). It is noted that small counties with poor economic background use tax haven status to attract international banking and other commercial activities. Tight secrecy laws support such activities. Moreover, the growth of internet services has given impetus to these activities. MNCs maintain their centralized cash pool in these countries in order to evade taxes (Sharan, 2009).

Tax revenues in OECD: Increasing tax ratios in 2010 and 2011 are due to a combination of factors like a progressive tax regime, economic recovery which led to tax revenues rising faster than GDP and at the same time many countries raised tax rates and broadened bases (Appendix, Table 3). Some countries shows declining ratios due to the severity of the recession during 2008 and 2009 and responded by cutting tax rates. Table 3 shows the tax to GDP ratio ranking for the year 2011 of selected countries under the OECD.

Denmark has the highest tax to GDP ratio among OECD countries 48.1% in 2011, followed by Sweden 44.5%, Hungary 35.7%, Spain 31.6%. They are followed by Turkey at 25.0%, the United States which has the 4th lowest ratio in the OECD region at 25.1% and Korea at 25.9%, Mexico 19.7% in 2011 and Chile 21.4% have the lowest tax to GDP ratios among OECD countries. Other European countries with significant rises were the Czech Republic (1.1), Germany (1.0), Finland (0.9), Iceland (0.7) and the UK (0.7).

Table 3: Tax to GDP ratio ranking of selected countries

Countries	Tax to GDP ratio (%) (2011)	Rank
Hungary	35.7	3
US	25.1	6
Spain	31.6	4
Denmark	48.1	1
Sweden	44.5	2
Mexico	19.7	9
Chile	21.4	8
Turkey	25.0	7
Korea	25.9	5

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Aggressive Tax Planning (ATP) based on after tax hedging: ATP is a straight forward risk management technique. The scheme is originated in the banking sector and in few medium-sized enterprises which generate threat to tax revenue for governments. The ATP based on after-tax hedging scheme is concerned with:

- Ensure that their tax administrations have access to sufficient resources
- Mitigate the disparate tax treatment of hedged items and instruments
- Verify whether their existing general or specific anti-avoidance rules are suitable to counter ATP schemes and if not to consider amending those rules or introducing new rules
- Adopt a balanced approach in their response to after-tax hedging, recognizing that not all arrangements are aggressive
- Continue to exchange information spontaneously and share relevant intelligence on ATP schemes based on after-tax hedging and response strategies used and monitor their effectiveness

Though, the benefit of ATP based on after-tax hedging is recommended, on the other end, the report of OECD directory dictates that ATP would generate the tax policy issues in terms of tax revenues, competition, economic efficiency, fairness transparency and also leads to double non-taxation. So, the OECD is very much concerned to remove the loopholes in the tax system and other obstacles in cross border trade and investment OECD pub., 2012.

Foreign exchange policy, fiscal policy: Government's strategy in respect of public expenditure and revenue can have significant impact on the business. The pattern of public expenditure may effect the development of various regions, sectors and/or industries differently. Such is the case with the taxation policy. Governments often use tax incentives or disincentives to encourage or discourage certain activities.

For example, when an industry suffers from recession, a reduction of taxes like excise duty or sales tax may help improve the demand. A reduction of rates of direct taxes like personal income tax and corporate tax would help to increase because of the resultant increase in the disposable income, the spending in the economy leading to an increase in demand. Government, central as well as provincial of many countries offer different fiscal incentives to woo industries (Cherunilam, 2010).

CONCLUSION

Every country should make attempt to increase tax revenue and for long term growth prospects, strengthen economic activity and create jobs. This is possible when there is changes in foreign exchange policy and fiscal policy like liberalizing capital flows which would result in a higher degree of financial integration with the global economy through higher volumes of capital inflows and outflows. Second in order to promote international tax comity, the countries should provide its citizens and residents unilateral relief from double taxation for tax paid of their genuine income. Third, a country should work towards the harmonization of worldwide tax rates in order to reduce economic pressures and should destabilize the viability of tax havens through all appropriate means. Finally, countries should support towards the internationally sanctioned formulary in order to simplify the taxation on multinational corporations and fair distribution of tax revenues.

APPENDIX

OCED list of 35 tax havens countries

S. No.	Countries	S. No.	Countries
1	Andorra	18	Liechtenstein
2	Anguilla	19	Maldives
3	Antigua and Barduda	20	Marshall Islands
4	Aruba	21	Monaco
5	Bahamas	22	Montserrat
6	Bahrain	23	Nauru
7	Barbados	24	Netherlands Antilles
8	Belize	25	Nieui
9	British Virgin	26	Panama
10	Cook Islands	27	Samoa
11	Dominica	28	Seychelles
12	Gibraltar	29	St. Lucia
13	Grenada	30	St. Christopher and Nevis
14	Guernsey	31	St.Vincent and The Grenadines
15	Isle of Man	32	Tonga
16	Jersey	33	Turks and Caicos
17	Liberia	34	US Virgin Islands
		35	Vanuatu

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