

Regulating multinationals' profit-shifting behavior: The case of China

by Meina Sai, MSc in Economics and Business Administration, NHH, Spring 2014

Many foreign multinationals have built establishment or related enterprises in mainland China since the open door policy in 1978. However, multi-residence makes tax collection from foreign multinationals difficult. The tax authority has therefore implement stricter legislation than before in order to prevent foreign multinationals from shifting profits out of China. This paper examines the effect of these regulations on foreign multinationals' profit shifting activities. Four main tax-avoidance strategies are discussed with the use of tax havens as the main focus. Using data from 2004 to 2012, I empirically confirm that tax havens are used to shift profits out of China. I also show that stricter regulations have reduced profit shifting among foreign multinationals with tax haven connections relative to a control group.

There are four main tax-avoidance strategies used by foreign multinationals in China, including manipulation of transfer prices for traded goods, high debt ratio, high royalty payments and license fees and use of tax havens. Chinese corporate income tax rates are lower than most of its trade partners and the government has provided favorable tax rate for manufacturing firms, but foreign multinationals still have incentives to shift profit to tax havens through trade price manipulations.

Tax losses due to foreign multinationals' tax avoidance is a big challenge to most countries. Therefore, many countries have tightened profit shifting regulations to limit multinationals' profit shifting behaviors. China has also been issuing laws and regulations to curb tax avoidance of firms in recent years. Especially in 2008, enterprise income tax law reforms were implemented. Measures such as thin-capitalization rules, controlled-foreign-company rules, general anti-avoidance rules also came in effect.

I start out analyzing the effect of the stricter rules using a model by Langenmayr (2013). I conclude that if the market entry costs in China are high, limitations on profit shifting is more likely to be welfare increasing, especially for firms in very competitive markets.

Next, I use Chinese data from 2004 to 2012, and empirically confirmed that foreign multinationals use tax havens to shift profits. My regression results also suggest that Chinese regulations are effective in reducing profit shifting activities by multinationals with tax haven connections.