Case #12b. Amazon, the "Undistributed Earnings Club," and Tax Avoidance

overview

Synopsis: Case #12b invites you to apply numerous course analytical tools to assess how Amazon and the companies in the "Undistributed Earnings Club" should handle the challenge to their tax avoidance practices.

Amazon.com is surrendering in another of its long-running European tax battles. Amazon announced that it would stop funneling its sales from across Europe through a Luxembourg-based entity to minimize its tax bill. Instead, Amazon will begin accounting for sales, and paying taxes, in individual European countries.

Amazon's critics are debating just how much impact the tax changes will have on the company's tax bill. But regardless, Amazon is a relatively small fish in the pond of international tax avoidance. The company's last annual report listed just $2.5 billion of "undistributed earnings of foreign subsidiaries that are indefinitely invested outside of the U.S." at the end of 2014. Those are cash reserves that can't be sent back to the U.S. for investment to build their domestic business or distribution to shareholders without first being subject to the 35% U.S. corporate tax rate.

More cash-rich tech giants, often referred to as the **"Undistributed Earnings Club"** have much more money locked out of the U.S. Microsoft, Apple and IBM have over $60 billion each in untaxed foreign profits, according to calculations by Bloomberg News. Starbucks and Google have also been heavily criticized in Europe for their tax avoiding ways. All of the companies have said their maneuvers are perfectly legal and enhance shareholder value by reducing taxes and thereby increasing net income.

It's not easy to estimate how much more taxes Amazon will pay just by changing its revenue allocations among different countries. Amazon could allocate substantial revenues to various countries, but still retain a substantial portion of the profit in a tax-haven.

Amazon's move likely means at least somewhat higher European tax bills but, as with the company's agreements to pay sales taxes in many U.S. states, it also brings relief from the regulatory pressure and PR damage of being labeled a tax dodger.

The move is part of Amazon's "corporate maturation process," says Ed Kleinbard, a USC law professor and former chief of staff of the Congressional Joint Committee on Taxation. "It is acknowledging that its tax model has to catch up with its actual business model."

But Kleinbard and other experts who have followed the issue for many years are less optimistic that Amazon's move will lead to any larger trend.

"If other companies join Amazon, it would be a major victory for tax authorities throughout the world," says Martin Sullivan, a former government tax expert. "But because this move is in large part about public relations, companies that do not sell (to) retail probably will be far less inclined to follow Amazon's lead."

Kleinbard doesn't see a trend, either. "Institutional maturity is in short supply in the new economy," he quips.

In the view of tax experts, it's long past time for other members of the **"undistributed earnings club"** to give up the tax avoidance strategy. In 2004, Congress and then-President George W. Bush declared a tax holiday for such trapped cash, imposing a tax rate of only 5.25%. But the move was widely criticized after companies failed to use the cash to expand hiring or investment in the United States. U.S. Congressional efforts to enact another holiday have gone nowhere.

The stash from tax-avoiding companies is now up to $2.1 trillion. The stashers have been able to avoid much of the potential damage from the limited access to their cash by issuing debt. But record low interest rates are on the way out and companies can only issue so much debt before investors realize the limitations on using trapped cash to back bonds.

There certainly would be an impact on the bottom line if companies stopped redirecting sales to tax havens around the globe. The moves bolstered earnings by about 8.5% last year, according to an estimate by Jack Ciesielski, editor of The Analyst's Accounting Observer, reported by the New York Times. But if it gave companies greater flexibility to pay dividends, buy back stock and invest in growth, the stock market might celebrate.

(There was minor editing of the vocabulary in the article to make it clearer to a non-US reader.)

Source: http://finance.yahoo.com/news/amazon-drops-popular-tax-avoidance-strategy-173922873.html;_

Before answering the questions below, please read the Support Articles A.1, A.2, A.3 and A.4.

Questions: (15 points)

1. **(4 points—0.5 points each) Explain how the perspectives each of the Stakeholders in the Amazon case on Amazon's social contract differ from Amazon's as regards tax payments:**
    a. **US Treasury/Internal Revenue Service perspective:**
    b. **European Commission perspective:**
    c. **Tax haven EU countries (Ireland and Luxembourg) perspective:**
    d. **The 5 EU countries represented by their finance ministers perspective:**
    e. **UK Public Accounts Committee perspective:**
    f. **EU companies that do pay taxes either in their home countries or where their profits are earned perspective:**

   g. **Organization for Economic Cooperation and Development perspective:**
   h. **Transparency International perspective:**

2. **(3 points) What model will best describe the public policy decision-making of each of the key governmental actors in this case—the U.S. Treasury Department and the European Commission? Be sure to explain your choice.**
3. **(3 points) Diagram the most probable scenario for how this tax avoidance issue will play out for Amazon and the members of the "Undistributed Earnings Club", given the current actors involved**
   a. **In the short run,**
   b. **Then extend your scenario to the long-run outcome**

4. (5 points) Given your answers to the foregoing questions, what strategy do you recommend for Amazon and the other members of the "Undistributed Earnings Club"? In your answer, you may wish to discuss the distribution of power in the case, but you do not need to draw a power diagram.

There is no word limit.

Support Article A1.

Amazon Must Pay $300 Million in Back Taxes, EU Says

Ruling comes as regulator pushes to collect taxes from tech giants; it also says Ireland has failed to collect $13 billion owed by Apple

By Natalia Drozdiak and Sam Schechner Updated Oct. 5, 2017 Wall Street Journal

BRUSSELS—The **European Commission** on Wednesday upped the stakes in its bid to collect taxes from U.S. tech giants, pressing its cases against Amazon.com Inc. and Apple Inc.

The **European Commission**, the bloc's antitrust regulator, ordered **Luxembourg** to recoup €250 million ($294 million) from Amazon. The sum, identified as unpaid taxes over an eight-year period, amounts to one of the largest-ever tax recoveries under EU state-aid rules.

The EU said **Luxembourg** had granted the e-commerce giant illegal state aid in the form of a 2003 sweetheart tax deal, prolonged in 2011, that illegally lowered Amazon's tax payments to the Grand Duchy to the disadvantage of the company's rivals.

The regulator also referred Ireland to the bloc's highest court, the **European Court of Justice**, for failing to implement an order last year that Dublin retrieve roughly €13 billion from Apple in uncollected taxes. The regulator had said illegal tax benefits allowed Apple to avoid paying that money, which Dublin was supposed to recover by early January.

The decisions are part of a broader effort by the EU to wring more money out of technology giants in Europe through various means. In addition to the Apple decision, the EU is now considering potential legislative proposals to force large digital companies, such as Google Inc. and Facebook Inc., to pay more tax in Europe.

EU antitrust chief Margrethe Vestager said at a press conference on Wednesday that Amazon effectively was taxed at one-fourth the rate for other local companies subject to the same national tax rules. "Companies must pay their fair share of taxes," she said

"We believe that Amazon did not receive any special treatment from Luxembourg and that we paid tax in full accordance with both Luxembourg and international tax law," an Amazon spokesman said in response. The Seattle-based company said it would consider an appeal.

Luxembourg said it has taken note of the decision, but asserted that Amazon had been taxed in accordance with the tax rules applicable at the time.

Both Amazon and Luxembourg can appeal the decision.

Wednesday's decision concerns a structure Amazon set up in Europe between 2006 and mid-2014, part of a series of transactions known as Project Goldcrest.

Under the plan, the company funneled all of its e-commerce sales in the EU—totaling €61.59 billion between 2006 and 2013, according to Luxembourg corporate filings—through an operating company called Amazon EU Sarl. Meanwhile, that company reduced its taxable income by virtue of paying a significant royalty every year to an untaxed Luxembourg-registered parent called Amazon Europe Holding Technologies SCS.

According to company filings in Luxembourg, the untaxed parent between 2006 and 2013 took in €3.39 billion in income "related to royalties from affiliated undertakings," or "based on agreements with affiliated companies," and reported €1.71 billion in untaxed profit for those years.

The EU says Amazon had improperly inflated the royalty to eat up nearly all of the operating company's profit after expenses, such as paying for its merchandise. Ms. Vestager said the untaxed parent company was "an empty shell" with no employees.

The amount of the tax the EU says is due in Luxembourg could change depending on the outcome of litigation in the U.S., Ms. Vestager said.

The **U.S. Internal Revenue Service (IRS), part of the U.S. Treasury** had sought as much as $1.5 billion in additional taxes from Amazon over the same set of transactions, which could reduce its liability in Europe. But a **tax court** in March sided with Amazon, ruling that the IRS had made arbitrary determinations and abused its discretion in several instances. Ms. Vestager said Wednesday that the IRS was planning to appeal.

Some critics allege that the EU is picking on high-profile American companies, given that a swath of multinationals around the world use similar tax structures to reduce their tax bills. Tech executives say that practice undercuts the contention that these agreements are rare and therefore unfair to competitors.

The EU's antitrust regulator says it has scrutinized thousands of tax deals between governments and large multinationals and has opened formal investigations into a cluster of them. The highest-profile cases have centered on large U.S. tech giants, but they also include McDonald's Corp. and French energy company Engie SA .

In her announcement of the EU's decision to refer Ireland to court, Ms. Vestager said, "More than one year after the commission adopted this decision, Ireland has still not recovered the money, also not in part."

Both Ireland and Apple are appealing the EU's decision announced last year.

The implementation of the decision has been partly held up by negotiations between Ireland and Apple over the creation of an escrow account that would hold the company's dues while the appeal plays out.

"It is extremely regrettable that the commission has taken this action, especially in relation to a case with such a large scale recovery amount," **Ireland's Finance Ministry** said in a statement. "Ireland has made significant progress on this complex issue and is close to the establishment of an escrow fund."

Apple said it is continuing to cooperate with Ireland on the tax-recovery process.

In addition to the EU antitrust regulator's scrutiny of tax deals, France and Germany and other EU countries are pushing to change legislation. The countries want to better account for the revenue tech companies rake in from virtual operations, such as targeted advertising.

—Richard Rubin in Washington contributed to this article.

Support Article A2.

Amazon UK boycott urged after retailer pays just £4.2m in tax

Margaret Hodge says consumer action forced Starbucks to pay tax in UK and could persuade Amazon to follow suit

Friday 9 May 2014 10.10 EDT Last modified on Thursday 14 January 2016 04.57 EST

The Guardian

Shoppers have been urged to boycott Amazon's British business after it paid just £4.2m in tax last year, despite selling goods worth £4.3bn – more than the UK sales of Argos, Dixons or the non-food arm of Marks & Spencer.

Margaret Hodge, chair of the **UK Public Accounts Committee**, said shoppers should find alternatives to the Seattle-headquartered retailer, after consumer action persuaded coffee chain Starbucks to resume UK tax payments last year.

"It is an outrage and Amazon should pay their fair share of tax," said Hodge. "They are making money out of not paying taxes. I no longer use Amazon. We should shop elsewhere. What we demonstrated with Starbucks is the power of the consumer voice."

Amazon's most recent charge brings to just over £10m its contribution to the public purse through corporation tax in a decade. Over the last four years, Amazon has generated £23bn in British sales. It made a tax contribution of £3.2m the previous year.

Amazon is able to pay low tax because when shoppers in Europe buy from any of its local websites, the payment is taken by a subsidiary based in the low tax jurisdiction of Luxembourg. A British shopper's bank statement will show a payment to Amazon EU S.à.r.l. in Luxembourg rather than Amazon.co.uk.

Amazon's British arm employs thousands of staff in warehousing, software design, accounting, human resources and other functions. For tax purposes, its role is simply to provide services to the European master company in Luxembourg.

"People will look at this and feel it's incredibly unfair," said Tory MP and tax campaigner Charlie Elphicke. "That they work hard and pay their taxes while big American multinationals engage in industrial scale tax avoidance. This is why international tax reform is badly needed and why the chancellor has been right to make the international case. Tax abuse is wrong and must be stamped out."

Amazon’s UK company declared a turnover of £449m for 2013, up 40% on 2012. However, this money was not raised from sales but in payments for its warehousing, distribution and administrative work, such as negotiating purchasing deals with book publishers.

Amazon gives a fuller picture of its UK revenues in regulatory filings to US investors, and this data showed a growth in UK turnover of 13% during 2013, to $7.3bn (£4.3bn). The rise was lower than in previous years, but enough to overtake Marks & Spencer's entire UK revenue from non-food items.

The £4.2m in tax paid is just 0.1% of Amazon's UK revenues in 2013. But the Treasury sets corporation tax as a percentage of profits. Amazon.co.uk reported profits of £17m in 2013, and effectively paid 24% of that in corporation tax.

Hodge said: "If you are an Amazon user you get endless emails saying Amazon.co.uk. You then order your goods and you get them delivered by the Royal Mail in parcels stamped with the Queen's head, and they then pretend it's nothing to do with business in the UK. They are damaging British jobs. If you are a small bookshop in the high street you can never compete with their prices, because you pay taxes. Even for John Lewis their future is also threatened because they pay their taxes."

Amazon's British business, whose accounts were published at Companies House on Friday, increased its headcount by 41% during the year, to 5,912, although during a recent interview the company said it now employed 7,000 staff in the UK, with many more seasonal workers joining its warehouses at Christmas.

Amazon said: "Amazon pays all applicable taxes in every jurisdiction that it operates within. Amazon EU serves tens of millions of customers and sellers throughout Europe from multiple consumer websites in a number of languages dispatching products to all 28 countries in the EU. We have a single European headquarters in Luxembourg with hundreds of employees to manage this complex operation."

http://www.theguardian.com/business/2014/may/09/margaret-hodge-urges-boycott-amazon-uk-tax-starbucks

Support Article A.3.

EU Proposes Multinationals Publish Profits, Tax Bills Generated in Tax Havens

EU reworks proposals for increased reporting by multinationals following ‘Panama Papers’ leak

By Natalia Drozdiak April 12, 2016 Wall Street Journal

BRUSSELS—Large multinationals operating in the European Union will have to publish details of profits and tax bills generated in countries considered to be “tax havens,” the bloc’s executive arm said on Tuesday as it toughened up proposals for fighting tax avoidance following the “Panama Papers” leak.

The **European Commission** had already been working on plans to open up to the public reports by thousands of companies on profits reaped and taxes paid in individual EU countries—an unprecedented move for a major jurisdiction.

But the EU has reworked its proposals in recent days to require more exhaustive reporting of companies' operations in tax havens after newspapers around the world uncovered thousands of offshore accounts—allegedly held by officials, executives and celebrities—via documents leaked from the Panamanian law firm Mossack Fonseca & Co.

"By adopting this proposal, Europe is demonstrating its leadership in the fight against tax avoidance," said Valdis Dombrovskis, vice president of the European Commission in charge of euro and social dialogue.

Tuesday's proposals show how the commission is accelerating efforts to reveal large-scale corporate tax avoidance amid pressure from the public. A previous proposal that would require national tax authorities to share corporate reports on profits and taxes was approved by EU finance ministers only last month.

"The Panama Papers hasn't changed our agenda, but it has strengthened our determination to make sure that taxes are paid where profit is generated," Jonathan Hill, the EU's financial chief, said at a news conference.

Under Tuesday's plans, companies operating in the EU whose annual revenue exceeds €750 million ($856 million) would have to publish the reports, which would include details on business operations, such as the number of employees and nature of activities in different tax jurisdictions. That information would be made available on a company's website for at least five years.

The EU is still drawing up its list of non-EU countries that don't meet international standards for good governance in taxation. For all other non-EU countries whose tax rules are deemed in line with the standards, companies would only have to publish an aggregate figure of profits in all those countries.

The EU has been cracking down on companies trying to dodge taxes following revelations in 2014 that many multinational companies struck sweetheart deals in countries such as Luxembourg that allowed them to pay little tax in the bloc. Corporate tax avoidance costs the bloc's member states between €50 billion and €70 billion a year in lost tax revenues, according to the EU.

"Our proposal to increase transparency will help make companies more accountable," said Mr. Hill.

Several large companies, including McDonald's Corp. and IKEA, have questioned plans to make the reports public, claiming that disclosing such commercially sensitive information would place them at a disadvantage compared with rivals operating elsewhere.

"We believe that these proposals, by making the EU a lone front-runner in terms of public disclosure, risk undermining our attractiveness as a location for investment, particularly from overseas," said Markus Beyrer, head of BusinessEurope, an advocacy group that represents companies including Alphabet Inc.'s Google and Comcast Corp's NBCUniversal.

But transparency campaigners said that the additional proposals still don't go far enough.

"The last minute addition of tax havens smacks of window dressing," said Elena Gaita, a corporate transparency policy officer at **Transparency International**, the global anticorruption group.

"This proposal cannot be called public country-by-country reporting, if it does not include most of the world," said Ms. Gaita.

Mr. Hill said the commission decided against requiring global country-by-country reporting because of concerns that companies in other jurisdictions could get their hands on important business data they could use to their competitive advantage. Some non-EU governments may also see information that could lead them to double-tax European businesses, he said.

The commission's proposal will still have to be agreed by EU governments before becoming law, a process that could take months.

Support Article A.4.

European Finance Ministers Urge Greater Information Sharing to Fight Tax Evasion

Letter to G-20 calls for more pooling of information on owners of offshore companies and trusts

By
Jason Douglas and
Richard Rubin
April 14, 2016 3:55 p.m. ET Wall Street Journal

European finance ministers on Thursday urged their counterparts in the **Group of 20 (G-20)** advanced economies to share more information about the owners of offshore companies and trusts, marking another step in a global effort to clamp down on tax dodging.

The initiative comes as authorities world-wide are struggling to contain the fallout from the leak of thousands of private documents from a Panamanian law firm that specialized in offshore tax deals for wealthy international clients.

In a letter to the **G-20** released by the U.K. Treasury, the **finance ministers of France, Germany, Italy, Spain and the U.K.** said they have agreed to share data on the owners of offshore entities and called on other jurisdictions to do the same.

The **five ministers** said that, under their new initiative, such information will be automatically exchanged among their countries' tax authorities, allowing them to identify and pursue tax evaders, money launderers and "aggressive" tax avoiders. The plan builds on existing information-sharing deals that allow tax authorities to track citizens' incomes and assets.

"To be fully effective such exchange should be on a global basis. We therefore hope you will support this initiative," the ministers wrote their colleagues. They recommended the G-20 ask the **Organization for Economic Cooperation and Development**, which has drawn up a package of measures aimed at closing international tax loopholes, to develop a single global standard to coordinate such exchanges.

The trove of confidential documents leaked from the Panamanian law firm Mossack Fonsesca and the information they contain has sparked public anger from Iceland to the U.K. to Russia and sown fresh doubts about the effectiveness of global efforts to rein in tax avoidance.

The fallout cost Iceland's prime minister his job and prompted questions in the U.K. about Prime Minister David Cameron's own tax affairs after it emerged that he once owned shares in an offshore fund set up by his late father. Mr. Cameron and other senior figures in government—including Treasury chief George Osborne, a signatory of the finance ministers' letter—took the unusual step of making details of their tax arrangements public in an effort to quell public demands for greater transparency.

The U.S. wasn't among the nations announcing Thursday's agreement, and U.S. nonprofit groups have criticized the country for allowing foreigners to use shell companies to hide assets in states such as Nevada, Delaware and Wyoming.

The **U.S. Treasury Department** is close to finishing rules that would require that banks and other financial institutions know the beneficial owners behind companies they serve. Treasury also plans to propose a rule to make foreign-owned limited liability companies to obtain a tax identification number.

"The misuse of legal entities to obscure beneficial ownership is a significant weakness in an otherwise strong and resilient U.S. financial system, and it can only be resolved with meaningful congressional action," Josh Drobnyk, a Treasury spokesman, wrote in a blog post on Wednesday.

The Obama administration has asked Congress to enact a law that would require banks and other financial institutions to provide the government with account balances and other information on

assets held by foreigners as part of a global information-exchange system where the U.S. is lagging.

Support Article A.5.

After a bite of Apple, Margrethe Vestager targets another tech giant

The Economist Oct 7th 2017

MARGRETHE VESTAGER'S assault on technology firms she deems to have improperly massaged down their tax bills continued this week with a tilt at Amazon. The internet retailer faces a bill of €250m ($293m) for back taxes over what the European Union's competition commissioner considers to have been an illegal sweetheart deal with Luxembourg.

The order requiring the Grand Duchy to recover the money follows a well-publicised three-year investigation. It is the latest in a series of tax-avoidance cases brought by the European Commission against multinationals, most of them American. Last year, Ireland was ordered to recover €13bn from Apple—smashing all past records for EU corporate-tax cases.

As with Apple, the commission concluded that Amazon received illegal state aid—in the retailer's case between 2006 and 2014—through a tax-cutting arrangement unavailable to its rivals. It came in the form of a ruling from Luxembourg's tax authority, known as a "comfort letter". Amazon accordingly moved intellectual property of various types into a Luxembourg partnership that served as an intermediary between Amazon's European operations—whose headquarters were a separate Luxembourg entity—and its American parent. As a partnership, the go-between was not subject to tax under Luxembourg law (the statutory corporate rate is 29.22%). The European operating firm was.

The operating company was required to pay to the partnership substantial royalties for, among other things, the right to use the Amazon name, thereby shifting lots of profit to the untaxed entity. The commission argues that the level of royalty payments was inflated and did not reflect economic reality. It says the arrangement allowed Amazon to avoid tax on three-quarters of all profits on its sales in the EU (which the company does not disclose).

Both Luxembourg and Amazon deny wrongdoing. Luxembourg's authorities have said before that Amazon chose to put its main European operations in the tiny landlocked country for a variety of reasons, tax not being the main one. They have also pointed out that its operations in Luxembourg are hardly empty shell companies: the company employs over 1,500 people there (though the IP-holding partnership, which no longer exists, had no employees or offices). Amazon says it did not receive special treatment and is considering an appeal.

This week's order could stoke transatlantic tensions. After the Apple ruling last year, American politicians queued up to echo the sentiments of Tim Cook, the firm's boss, who derided Ms Vestager's action as "total political crap". Many of them saw Brussels' tax probes as being driven by tech-envy, not sound economics. Washington hinted at retaliation, though nothing specific has been suggested.

The commission's critics have a point. The details of the case are complex, and tax experts will disagree about the legality of the arrangements under the spotlight, just as they did with Apple. Few would deny that the frayed patchwork of international corporate-tax rules need reforming; one proposal, espoused by President Emmanuel Macron of France and supported by several other EU countries, would see multinationals taxed on revenues in particular territories instead of on profits. But punishing a firm for a 14-year-old ruling from a national government, happily accepted by both sides at the time, looks harsh. The uncertainty it stokes may also dampen foreign investors' interest in Europe. Ms Vestager's ruling will add to the discomfort felt by Jean-Claude Juncker, the commission's president, who was prime minister of Luxembourg when the tax arrangement in question was hammered out. American firms should brace for further scrutiny of past tax deals. The commission is also looking into McDonald's and Fiat Chrysler's arrangements in Luxembourg, and those of Starbucks in the Netherlands. The only other non-American firm known to be in its sights on tax is Engie, a French utility. The Apple case is likely to produce plenty more drama, too. The company and Ireland are both appealing. The commission, meanwhile, is taking Ireland to the European Court of Justice over its failure to collect the €13bn which it has been told it is owed but clearly does not want.

This article appeared in the Business section of the print edition of the Economist under the headline "Raining on Amazon"