

“Tax Havens and Cross-border Licensing” by J.P. Choi, J. Ishikawa, H. Okoshi

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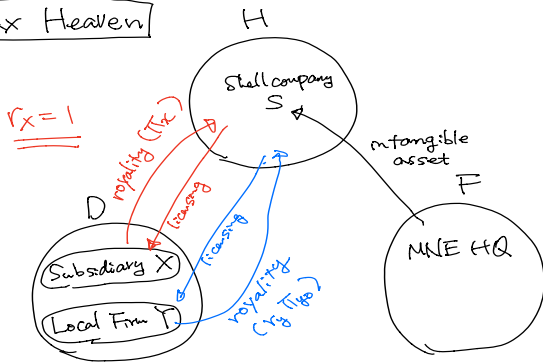
Issue:

Manipulation of licensing fees of intangible assets by MNEs

⇒ Profit-shifting to low tax countries (e.g., Ireland).

⇒ Tax is avoided!

Tax Heaven



$$\begin{aligned} \pi_x^{TH} &= \pi_{x0} + \underbrace{\Delta}_{\text{(No tax paid)}} \\ &= \pi_{y0} - \pi_{yc} \end{aligned}$$

$$\pi_y^{TH} = (1-t) \pi_{yc} \quad \leftarrow \text{extracts all surplus}$$

Issue:

- The OECD countries tackle this tax avoidance by the Arm's Length Principle (ALP).
- Idea of the ALP: licensing fee determined by market forces.
- How does an introduction of the ALP affect MNE's licensing decision and country's welfare?

Implementation of the ALP is not easy

Difficult to determine licensing fees (r_x) for intangible assets

① **Comparable uncontrolled price (CUP):**

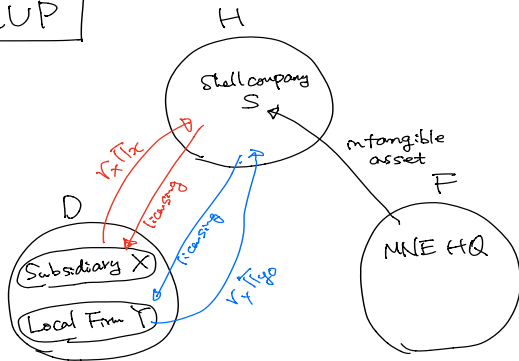
a licensing fee to local firms (r_y) $\Rightarrow r_x = r_y$.

② **Transactional Net Marginal (TNM) method:**

a reference firm's profit margin (η) $\Rightarrow r_x = \eta$.

③ MNEs choose between CUP and TNM under the ALP.

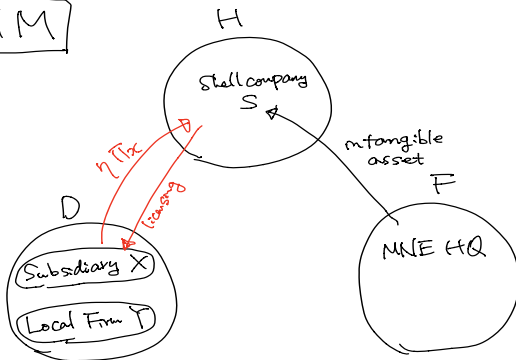
CUP



$$\Rightarrow r^{CUP} = r_x = r_y$$

$$\Rightarrow \Pi_{xc}^{CUP} = (1-t)(1-r^{CUP})\Pi_{xc} + r^{CUP}(\Pi_{x0} + \Pi_{y0})$$

TNM



$\Rightarrow r_x = \eta$ (exogenous reference profit)

$$\Rightarrow \pi_x^{TNM} = (1-t)(1-\eta)\pi_{x0} + \eta\pi_{x0}$$

Main Results

- 1 Under ALP, MNE faces a trade-off between licensing revenue from local firms and the profit shifting.

⇒ ALP may lead to non-licensing if η , t or π_{x0} is sufficiently large or Δ is sufficiently small.
- 2 ALP may decrease domestic welfare if the MNE stops licensing to local firms (i.e., TNM is chosen by MNE).
- 3 When η is high, ALP may decrease domestic welfare for high-tax countries.

Comments

- A reference profit margin η is important but exogenously given in theory. How is the value of η determined in reality?
- How are the values of η differ across country/product/firm's characteristics?
- Are there any observable variables in data sets which may potentially explain the value of η ?
- Can we think of η as a policy variable, which the policy maker can manipulate?

Comments

- Any cross-country panel data set on MNE's licensing decisions to local firms?
- Any evidence for MNEs licensing to local firms?
- Test whether an introduction of ALP has decreased MNE's licensing to local firms especially for high-tax countries (using diff-in-diff).
- If we can relate η to observable variables, then we may test the differential impact of ALP on MNE's licensings across different observables that determine η .