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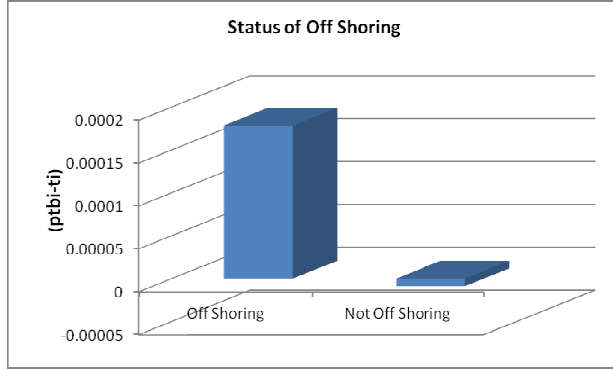
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The Correlation between Off-Shoring and Tax Avoidance

Elena Svetlov
Senior Honors Thesis
Spring 2012

College of Management
University of Massachusetts Boston
Thesis Advisor: Professor Stephan Manning
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Abstract

This research paper intends to examine the relationship between U.S Multinational Corporation off-shoring and tax avoidance. This paper will address the following research question: How does off shoring affect the difference between taxable and book income of U.S. multinational firms? The research is conducted via statistical analysis of data from the Off shoring Research Network (ORN) database. The findings of this research paper will potentially be valuable to tax economists, policy makers, and business managers as the findings will provide a better understanding of worldwide tax allocation. Also, the findings of this research may be useful for the potential establishment of regulations for the protection of the competitiveness of U.S multinational companies, while potentially maximizing government revenue.

I. Introduction

Over the past decade, the digital revolution and increased globalization has created opportunities for companies to take advantage of high-skilled, low-waged employees in various emerging markets across the world. Attracted by low costs, available talent, and quality work, businesses in high-wage nations, such as the United States, are increasingly off shoring a variety of services, business tasks and processes to low-wage nations. More recently, attention has shifted to the tax avoidance benefits of off shoring; companies are able to work around some of the US tax regulations by reinvesting profits in nations with low tax jurisdictions. There are different reasons why corporations might decide to off shore, some of these reasons are to reduce and control operating costs, gain access to world-class skills, gain access to new markets, and create new growth strategies; the focus of this paper is on the tax benefits generated by off shoring. Governmental regulation and incentives have a profound impact on corporate off shoring; “Differential tax rates drive off shoring, as many countries have provided specific tax advantages to attract off shoring” (Metters & Verma, 2007). In this paper, the focus is on attempting to understand the affect that corporate off shoring has on the difference in the book VS taxable revenue of U.S. corporations. The book and taxable revenues that are looked at for the purpose of this research paper are found in the ORN data base. More specifically, in the ORN data base, the book revenues are labeled as ptbi, and are the reported annual book revenues for a company, scaled for total assets in the beginning of the fiscal year (pre-tax), in other words,

(ptbi) stands for the measure of pre-tax book income scaled by total assets. The taxable revenues are labeled as t_i , and are the reported annual taxable revenues for a company, scaled for total assets in the beginning of the fiscal year, or in other words, (t_i) stands for the measure of taxable income scaled by total assets. The aim of this paper is to examine the difference between the two revenues ($ptbi-t_i$) in respect to the corporate status of off shoring activities, the relevance of off shoring as part of the corporate strategy, the size of the off shoring companies, and the utilization of a global resource center to coordinate off shoring activities. The latter are all part of the criteria examined to verify the existence of a correlation between off shoring activities and a change in the difference of ($ptbi-t_i$).

II. Literature Review

Often times the terms off shoring and outsourcing are used interchangeably, and therefore, are confused. They are technically different: “off shoring refers to the process of sourcing and coordinating tasks and business functions across national borders. Outsourcing, by contrast, denotes the delivery of products or services by an external provider – that is, one outside the boundaries of the firm. Off shoring may include both in-house and outsourced activities; outsourcing, in turn, may occur both domestically and abroad” (Manning, Massini & Lewin, 2008). Kimberly Clausing (2005) Rising globalization, as well as improvements in communication and information technologies has given rise to growing number of outsourcing and off shoring projects throughout the world. Small-medium firms can offshore their operations to compete with large companies across the globe, while reducing their expenses. Even though labor costs savings remains the top strategic driver of off shoring decisions, it is no longer the only reasoning. “Accessing pools of highly skilled talent around the world has emerged as a new key strategic driver. Related to this, off shoring is no longer limited to standardized information technology (IT) or business processes, but increasingly involves product development functions, such as engineering, research and development (R&D), and product design” (Manning, Massini & Lewin, 2008).

The focus of corporate off shoring in this paper is the principle of reducing the amount of taxes that need to be paid in the U.S. The United States taxes corporations on their worldwide profits. Therefore, U.S multinational corporations are taxed on profits earned overseas, as well as profits earned in the United States. However, subject to limitations, corporations avoid a double tax by receiving a tax credit (FTC) for taxes paid to foreign governments. The tax credit is limited to the company's U.S tax liability (35%), therefore the U.S will collect revenue to the extent its tax rate surpasses the foreign tax rate. For instance, if the foreign tax rate is 5% and the foreign business of a U.S firm makes \$100 of profit, the United States will collect \$30 (with a 35% corporate tax rate). Another major tax shelter that U.S tax law provides corporations from U.S tax on their international income is deferral, a concept which is crucial for understanding international tax avoidance. "Most active business income of foreign corporations controlled by U.S parent companies is not subject to U.S tax until it is paid as a dividend, or 'repatriated' to the U.S parent" (Sullivan, 2004). Often times, U.S corporations defer taxes on foreign revenues made in low-tax jurisdiction for a long time. The U.S taxation of foreign revenues make exclusions in the case where the U.S parent company declares that the earnings in a foreign subsidiary will stay abroad and not be repatriated back to the United States. If those earnings were ever brought back, the firm would have to pay taxes on these earnings because they would have to be declared and recorded as an income tax expense. However, in a situation when the earnings stay overseas, the firm is not obligated to accrue the future U.S tax, which results in no income tax expenditure for U. S taxes on foreign revenue. Under the equity method of accounting, the financial statement filed by U.S. firms include the income or loss from "foreign subsidiaries that are 50% owned, and the representative share of income or losses of foreign entities owned between 20% and 50%" (Seto, 2008). In contrast, the firms U.S. tax return only includes dividend received from these entities. For a U.S. multinational corporation, the difference then between current year foreign accounting earnings and current year cash dividends

returned from foreign jurisdictions is a temporary difference between the generally accepted accounting principles (GAAP) and taxable income on which U.S. deferred taxes would be accrued. This would normally be included in the income tax expense on the financial statement reducing reported net income.

III. Data

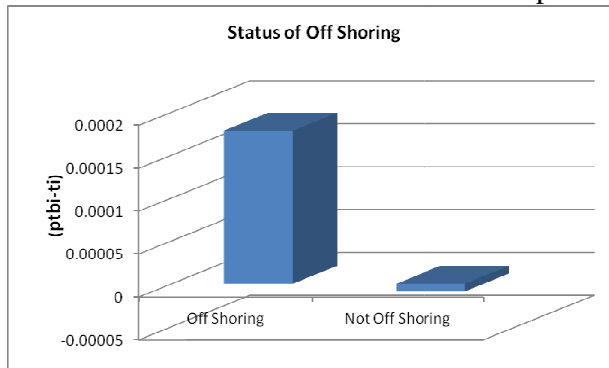
The data for this paper was originally collected by the international Off shoring Research Network (ORN). The ORN is a network of firms and scholars based in the U.S., Europe and Australia studying the dynamics and trends of global business services out sourcing. Since its foundation in 2004, the ORN research team has conducted two major annual surveys based on which data has been collected on global services out sourcing: the service provider survey and the corporate client survey. This study in particular uses data from the corporate client survey. The ORN corporate client survey has been collecting data from U.S. firms since 2004 on their global sourcing strategies, drivers, concerns, outcomes, future plans, and concrete implementations. This information also includes fine-grained information on tasks sourced – launch year, choice of location, choice of service delivery model (both captive and outsourced) and performance data, e.g. savings achieved. The data from the database used for this study is based on surveys conducted between 2006 and 2010, with data from 485 U.S. firms. 48% of these firms are currently off shoring, 17% are considering off shoring and 35% are not considering yet. Firms are based in different industries, primarily manufacturing, finance and insurance, software, and professional services. 37% are large firms; 36% are midsize and 27% are small. These firms reported 2,780 sourcing implementations, defined as the decision to locate a particular task or process in a location outside the home country, either through a captive unit or an external service provider. Tasks include all business services: IT infrastructure, administrative services (e.g. HR, legal, finance and accounting), call centers, software and product development, marketing and sales, and procurement. The survey of the ORN database

has been taken online: some respondents reach the survey website through external links or email invitations, whereas others randomly open the website and register for the survey. Once registered and approved by the ORN survey team, respondents are added to the database.

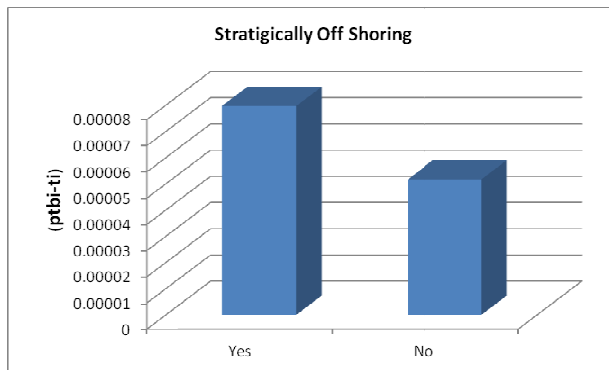
IV. Preliminary Insights

An initial review of the (ptbi) and (ti) data available in the ORN data base as turned up some interesting insights. It appears as if there is a visible correlation in the difference in book income and tax income for U.S. companies with respect to off shoring activities. Based on these insights, 4 initial hypotheses were formed:

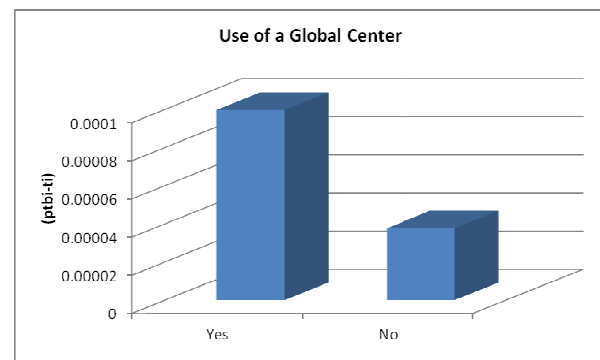
Hypothesis 1: Companies that are currently off shoring have a greater difference between the book and taxable income in the U.S. compared to companies that are not off shoring.



Hypothesis 2: Companies that have a corporate strategy guiding off shoring decisions have a greater difference between book and taxable income in the U.S. than companies that do not have a corporate off shoring strategy.

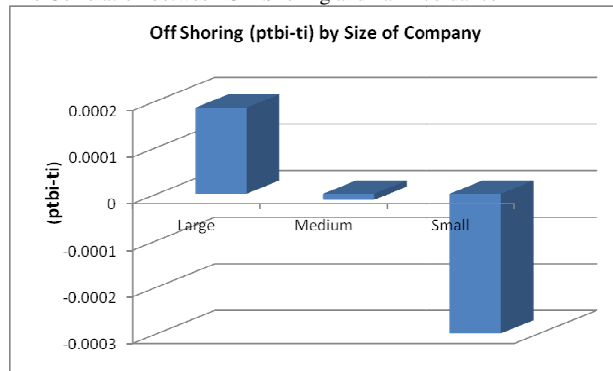


Hypothesis 3: Companies that have a global resource center supporting off shoring projects have a greater difference between book and taxable income in the U.S. than companies that do not have a global resource center.



Hypothesis 4: Size of companies does not significantly affect the difference between book and taxable income in the U.S.

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V. Methods

In order to test the validity of the initial hypotheses, Excel was used to conduct a series of T, F, and ANOVA tests. The first step was to export and filter out the company data from the ORN database. The aim was to export all U.S. company data between 2006 and 2010. Then, there was a need to eliminate all company data if a specific company was missing pre-tax book income scaled by total assets (ptbi) and taxable income scaled by total assets (ti) values, or missing any annual data between 2006 and 2010. Once a complete list of companies with ptbi and ti data between 2006 and 2010 was achieved, the company list was filtered according to the criteria specified in the initial hypotheses. Based on these criteria, and working around the issue that there was a significant amount of missing data in the data base, the resulting company list was reduced from the initial list of 485 firms, to 122 firms. The ptbi-ti difference was calculated via an Excel formula for each year (2006-2010) of each of the 122 companies on the list. At this point it became evident that there were a number of abnormal firms with suspicious ptbi-ti values which lead to the exclusion of all companies in the Transport, Professional Service, Media, and Construction industries, resulting in a final list of 106 companies. T-Tests were then performed on the samples of hypotheses 1-3 to verify the significance in the difference of the means, or in other words, to confirm that the difference in the means was real, and not caused by chance. F-Tests were then performed on the same samples for hypotheses 1-3 to confirm that the variances

in the samples were real and not caused by chance. For hypothesis 4, an ANOVA test was performed to test if there was a significant difference in the means of the 3 samples.

VI. Results

For the first hypothesis, the 5 year ptbi-ti values for the 122 companies were sorted by the status of off shoring as represented in the ORN database. This parameter was labeled (Off) in the database and contained three possibilities for the corporate status of off shoring: currently off shoring, considering off shoring, not off shoring. For the purpose of this study, considering off shoring and not off shoring were grouped together under the not off shoring sample for the descriptive statistical analysis.

Hypothesis 1: Companies that are currently off shoring have a greater difference between the book and taxable income in the U.S. compared to companies that are not off shoring.

t-Test: Two-Sample Assuming Unequal

Variances

(ptbi-ti)

	<i>Off Shoring</i>	<i>Not Off Shoring</i>
Mean	0.000896245	0.027428062
Variance	0.068978976	0.003600832
Observations	430	100
Hypothesized Mean Difference	0	
df	528	
t Stat	2.020977161	
P(T<=t) one-tail	0.021893141	
t Critical one-tail	1.647744655	
P(T<=t) two-tail	0.043786283	
t Critical two-tail	1.964466979	

From the results above, there is a significant difference between the means of the companies that are currently off shoring and companies that are currently not off shoring. The P value for both the one tail and two tail T-Test are smaller than of .05 indicating that this difference is not by chance, as a result, the first hypothesis is accepted. However, it is important to note that the difference in means is exactly the opposite of what the first hypothesis is assuming. There is a

difference between (ptbi-ti) for companies that are off shoring and companies that are not off shoring, but companies that are off shoring exhibit a smaller ptbi-ti difference.

A secondary hypothesis (H1b) was formulated prior to testing H1 in order to determine whether equal variances could be assumed in H1.

H1b: The variances in the difference between the book and taxable income are equal for off shoring and non off shoring companies

F-Test Two-Sample for Variances

(ptbi-ti)

	<i>Off Shoring</i>	<i>Not Off Shoring</i>
Mean	0.000896245	0.027428062
Variance	0.068978976	0.003600832
Observations	430	100
df	429	99
F	19.15639987	
P(F<=f) one-tail	4.95208E-43	
F Critical one-tail	1.313409119	

As can be seen from the test results above, the P value for the F-Test are much smaller than of .05 indicating that the difference in variance is real, and significant. As a result, H1b is rejected; the variances are not the same for companies that are off shoring and not off shoring, lending additional support for the results of the T-Test of the first hypothesis. Also, the result of this test is interesting in its own right, as it indicates another type of difference between the two companies, more specifically, that perhaps the data of (ptbi-ti) is not normally distributed.

For the second hypothesis, the 5 year ptbi-ti values for the 122 companies were sorted by the existence of a strategic agenda for off shoring activities, as represented in the ORN database. This parameter was labeled (Stra_Comp) in the database and contained two possibilities for the existence of a strategic agenda for corporate off shoring: Yes, or No. For the purpose of this study, there was a further need to filter out companies with missing data under the Stra_Comp

parameter. As a result, the sample of companies in the ORN database was reduced from 122 to

63 for the analysis of the second hypothesis.

Hypothesis 2: Companies that have a corporate strategy guiding off shoring decisions have a greater difference between book and taxable income in the U.S. than companies that do not have a corporate off shoring strategy.

t-Test: Two-Sample Assuming Unequal Variances

	(ptbi-ti)	
	Yes	No
Mean	0.007965841	0.005167449
Variance	0.004471239	0.010767998
Observations	190	125
Hypothesized Mean Difference	0	
df	192	
t Stat	0.267209037	
P(T<=t) one-tail	0.394797509	
t Critical one-tail	1.65282859	
P(T<=t) two-tail	0.789595017	
t Critical two-tail	1.972396447	

Looking at the table above, it is seen that there is a difference between the means of the companies that currently utilize a strategic agenda for off shoring and companies that do not, as assumed by the second hypothesis. Companies that utilize a strategic agenda have a greater mean of ptbi-ti difference than companies that do not have a strategic agenda. However, the P value for both the one tail and two tail T-Test are much larger than of .05 indicating that this difference is not ruled out as caused by chance. As a result, the second hypothesis is not rejected.

Again, a secondary test was conducted first in order to determine whether equal variances could be assumed for the t-test in H2.

H2b: The variances in the difference between the book and taxable income are equal for corporate strategy guiding off shoring and lack of corporate strategy for off shoring.

F-Test Two-Sample for Variances

	(ptbi-ti)	
	No	Yes
Mean	0.005167449	0.007965841
Variance	0.010767998	0.004471239
Observations	125	190

df	124	189
F	2.408280755	
P(F<=f) one-tail	2.38331E-08	
F Critical one-tail	1.303870596	

The table above shows that the P value for the F-Test are much smaller than of .05 indicating that this difference in variance is real, and significant. As a result, H2b is rejected; the variances are not the same for companies that utilize a strategic off shoring agenda and companies that do not. With more data, it might be possible to find a significant difference. Also, the result of this test is interesting as it indicates another type of difference between the two companies, more specifically, that perhaps this data of (ptbi-ti) is not normally distributed

For the third hypothesis, the 5 year ptbi-ti values for the 122 companies were sorted by the existence of a global resource center to coordinate the activities of off shoring as represented in the ORN database. This parameter was labeled (Stra_Grc) in the database and contained two possibilities for the existence of a strategic global resource center to coordinate off shoring: Yes, or No. For the purpose of this study, there was a further need to filter out companies with missing data under the Stra_grc lable. As a result, the sample of companies in the ORN database was reduced from 122 to 50 for the analysis of the third hypothesis. When translated to the observations made, there were 5 data points for each company, 145 that unitize a canter, and 105 that do not:

Hypothesis 3: Companies that have a global resource center supporting off shoring projects have a greater difference between book and taxable income in the U.S. than companies that do not have a global resource center.

t-Test: Two-Sample Assuming
Unequal Variances

(ptbi-ti)

	Yes	No
Mean	0.009969351	0.00377211
Variance	0.002371991	0.015577088
Observations	145	105
Hypothesized Mean Difference	0	
df	127	
t Stat	0.482876454	
P(T<=t) one-tail	0.3150074	
t Critical one-tail	1.656940344	
P(T<=t) two-tail	0.630014801	
t Critical two-tail	1.978819508	

As can be seen from the table above, there is a difference between the means of companies that currently utilize a global resource center to coordinate the activities of off shoring and companies that do not. As assumed by the third hypothesis, companies that utilize a global resource center to coordinate the activities of off shoring have a greater difference in the mean of the difference of ptbi-ti than companies that do not have a global resource center. However, the P value for both the one tail and two tail T-Test are much larger than of .05 indicating that this difference is not ruled out as caused by chance. As a result, the third hypothesis is not rejected.

H3b, like H1b and H2b is checked to determine whether the assumption of equal variances is appropriate for H3.

H3b: The variances in the difference between the book and taxable income are equal for companies utilizing a global resource center to support off shoring projects.

F-Test Two-Sample for Variances

(ptbi-ti)

	Yes	No
Mean	0.009969351	0.00377211
Variance	0.002371991	0.015577088
Observations	145	105
df	144	104
F	6.567094919	

P(F<=f) one-tail

1.90844E-24

F Critical one-tail

1.344916005

The results of the F-Test in the table above show that the P value is much smaller than of .05 indicating that this difference in variance is real, and significant. As a result, H3b is rejected; the variances are not the same for companies that utilize a global resource center to coordinate the activities of off shoring and companies that do not. There is a need to further explore the reasons for why the difference in the mean of the difference of ptbi-ti in the third hypothesis was found to be insignificant. Also, the result of this test is interesting in its own right, as it indicates another type of difference between the two companies, more specifically, that perhaps this data of (ptbi-ti) is not normally distributed

For the fourth hypothesis, the 5 year ptbi-ti values for the 122 companies were sorted by the size of the respected companies as represented in the ORN database. This parameter was labeled (size) in the database and contained three possibilities for the classification of the companies (by number of reported employees): Large, Midsize, and Small. For the purpose of this study, there was a further need to filter out companies with missing data under the size label. As a result, the sample of companies in the ORN database was reduced from 122 to 106 for the analysis of the fourth hypothesis.

Hypothesis 4: Size of companies does not significantly affect the difference between book and taxable income in the U.S.

Anova: Single

Factor (ptbi-ti)

SUMMARY

<i>Groups</i>	<i>Count</i>	<i>Sum</i>	<i>Average</i>	<i>Variance</i>
Large	190	3.518794027	0.018519969	0.002823958
Midsize	315	0.411839367	0.001307427	0.091958127
Small	25	0.749533669	0.029981347	0.021970009

ANOVA

<i>Source of Variation</i>	<i>SS</i>	<i>df</i>	<i>MS</i>	<i>F</i>	<i>P-value</i>	<i>F crit</i>
Between Groups	0.077692709	2	0.038846355	0.683863062	0.505110947	3.012826237
Within Groups	29.93586004	527	0.056804289			
Total	30.01355275	529				

Looking at the table above, it is clear that there is a difference between the averages and variances of the companies based on the respective size classification going against what was assumed by the fourth hypothesis. However the difference in the means and variances of the difference in ptbi-ti is rendered as insignificant as P value for the ANOVA F-Test is much larger than of .05 indicating that this difference is not significant. As a result, the forth hypothesis is accepted as the respective size of the companies doesn't have a significant effect on the ptbi-ti difference

VII. Limitations to This Study

There are several limitations that should be brought up regarding this study. The first is the ambiguity to the quality of the data provided by the ORN data base. The ORN data base is a confidential source of information that compiles confidential book data that provided by the respective companies. There is no resource available to cross examine the accuracy of the reported ptbi and ti values used for this study. Second, the ORN data base is missing a great deal of information, there are many companies in the database that are missing one or more of the parameters used for the statistical analysis in this paper. As a result, the number of sample companies for the purpose of this study has been greatly reduced compared to the actual number of companies represented in the ORN database. This may be the cause for statistical analysis that does not accurately represent the off shoring trends this paper was looking to analyze. The third limitation is the financial crisis of 2008. This crisis falls right in the middle of the data spread that this paper was looking at for the propos if the analysis (2006-2010). This may be a

significant cause for the discrepancy between the hypothesized differences in the means of the ptbi-ti difference for companies that are off shoring. It was predicted that the mean is to be greater for companies that are off shoring, however, the data shows that the exact opposite is occurring. It is assumed that many of the companies in the ORN database repatriated profits from oversea sources to compensate for the losses generated by this crisis. This may explain the reversal of the ptbi-ti difference observed in this study.

VIII. Conclusion

After reviewing the results of this research paper, it has become evident that by utilizing off shoring practices in general, as part of a strategic plan, or having global resource centers to coordinate off shoring practices, enables U.S multinational companies to substantially reduce taxable income in comparison with the declared book income. This evidence was observed by the difference in the means of the ptbi-ti difference. It is also implied by the results of this research paper that when a financial crisis occurs, companies tend to repatriate more profits, in attempts to compensate for losses in the affected bad economy markets. This action leads to an increase in the declared taxable incomes as profits that were previously intended to be reinvested are instead repatriated for book profits. This information may potentially be valuable to tax economists, policy makers, and business managers in order to have a better understanding of corporate financial trends. The knowledge of these trends may also be found useful to U.S. tax policy makers and corporate strategic consultants as they review existing and/or prepare new contingency plans for dealing with bad economies. The first hypothesis turning out to be significant supports that there is a real trend between off shoring activities and an actual difference in the ptbi-ti values of companies. Although the difference shown by the tests of the first hypothesis was exactly the opposite of what was expected, it is still possible that with more data, a positive correlation could be found. The test results that show that the rest of the hypotheses were insignificant could also be retested and possibly be shown as significant with more data. The differences in the means (i.e. the variances) of the samples suggest that the

hypothesized trends are there, the data just aren't conclusive enough to prove it as statistically significant. The trends that were studied and tested in this paper coincide with the information that is already known about corporate off shoring practices. The reason companies partake in such practices is to pay less taxes and retain more profits, this is shown in the ptbi-ti hypothesis 2-4 tests in this paper (even though they were found to be insignificant). Companies that offshore have a smaller difference in their beginning of the year book income (ptbi) subtracted by the taxable income at the end of the year (ti).

IX. Further Research

In order to further examine the affect that off shoring practices have on the book and taxable revenues of U.S. companies, there is a need to find another source of book and taxable information to supplement the ptbi and ti data provided by the ORN data base. Since this data is confidential, it is likely that there will be no other source for this data other then the ORN data base. To account for this, it is proposed to contact U.S. companies directly by conducting a survey, specifically, to supplement the existing research found in this paper. The intent of conducting this survey would be to gather more book and taxable information, with known validity, directly from the corporations. Doing this would be another way to form a more accurate picture of the actual affects of off shoring activities on the book and taxable revenues of U.S. multinational corporations.

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