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Mapping tax strategies in the FDI decision process

Jinning Hong¹, Keith W. Glaister² and Jane Frecknall-Hughes³

This study proposes a framework for mapping tax strategies in the developmental and sequential FDI decision process. The authors examined the relative importance of the stages of the FDI decision process with and without tax considerations for a sample of 192 UK MNEs. The stages of identifying investment opportunity, and the FDI legal and management structures are found to be important to the decision process when tax effects are considered. The findings suggest that availability of foreign partners is an important factor to the ownership and entry mode decisions. A favourable tax regime does not distort international organisational structure. Tax is considered both before and after the strategic decisions are made.

1. Introduction

Foreign direct investment (FDI) is a particular domain of strategic decision making. The process by which the FDI strategic decisions are made have an impact on the success of a firm's international operations. Despite the value of prior research into the FDI decision process (Larimo 1987, 1995; Mintzberg *et al.* 1976; Sykianakis and Bellas 2005), there has been no research that has empirically tested the FDI decision process with respect to tax incentives and the choice of entry mode and ownership form. The stages that are undertaken in the FDI decision process and the relative importance of the stages in relation to tax effects have been lacunae in the current literature. Although there have been considerable findings on the determinants of entry and ownership form decisions in the FDI (Bhaumik *et al.* 2010; Cui and Jiang 2012; Demirbag *et al.* 2008; Glaister and Buckley 1996), the foreign ownership and entry choice as a separate and individual factor and its correlation with the FDI decision process from a taxation aspect have not been examined in the mainstream literature. In light of the findings by Chang and Rosenzweig (2001) and Kogut (1983), the FDI decision is not discrete, but is part of a series of decisions that determine the overseas investments. It is necessary to propose a unified framework within which strategic decisions and interrelated tax strategies can be placed at each stage of the decision process. Thus, the interaction of corporate strategies and tax strategies can be examined from the perspective of a developmental and sequential decision-making process.

To address these under-examined research areas, 192 UK-based MNEs were selected to examine the relative importance of stages in the FDI decision process with respect to tax incentives, as well as to investigate how the underlying factors in the decision process vary with the choice of ownership and entry mode. The following specific research questions are subsequently addressed:

'Does the relative importance of the variables in the FDI decision process vary with the choice of the ownership and entry mode?'

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‘Does the relative importance of the tax factor in the FDI decision process vary with the ownership form and entry mode?’

The importance of this research is to address the gaps existing in the current literature by investigating the way in which tax factors are treated in the FDI decision making process. The tax issues are mapped and examined from a holistic perspective of the FDI decision process, the stages at which tax effects are identified, and the importance of the stages in the two situations of either considering or ignoring tax implications in the decision process are considered. These areas have not been addressed in the prior literature. Further, the strategic decisions in terms of ownership and entry modes and the determination of motives by which the FDI decisions are made in the investment decision process are neglected research areas.

The empirical results of the research indicate that the stages of identifying investment opportunity, and the FDI legal and management structures are found to be important to the decision process when tax effects are considered. The findings suggest that availability of foreign partners is an important factor to the ownership and entry mode decisions. A favourable tax regime does not distort international organisational structure. Tax is considered both before and after the strategic decisions are made.

The paper is organised as follows. Section 1 provides an introduction, and Section 2 reviews the previous literature on the role of tax in the stages of the FDI decision process, proposes the framework of mapping tax strategies in the FDI decision process, and sets out the research questions. Section 3 presents the research methods. Empirical results and discussion are in Section 4. Conclusions and implications are in Section 5.

2. Literature Review

Several researchers have examined the general model of the FDI decision process and the main factors affecting it (Larimo 1987, 1995; Mintzberg *et al.* 1976; Sykianakis and Bellas 2005), although little is known in respect of the corporate strategy interacting with the FDI decision process, and the role of tax in this process. According to Larimo (1987: 154), the FDI decision process can be summarised into three phases – identification, development and selection. The various tax strategies can be embedded into the different stages of the decision process in accordance with the model developed by Larimo (1987, 1995).

2.1 Embedding tax strategies in the FDI decision process

2.1.1 Tax strategy at the stage of recognition and diagnosis

At the initial decision process stage, it is important, where appropriate, to consider the availability of natural resources and take advantage of any low cost manufacturing base in the foreign market, as well as to overcome barriers to trade with respect to strategic orientation, as identified by Dunning (1993: 61). The importance of tax incentives in the stages of recognition and diagnosis of the FDI decision process is primarily related to strategic motives for, and location decision of, the FDI.

Tax in motives for and location of FDI

The extent to which tax incentives are a driving force in terms of the motives for FDI is relatively neglected in the existing literature. Tax incentives can serve as a motive, to attract FDI flows to particular locations by host governments offering an advantageous tax regime. The tax incentives are usually offered as exemptions or deferrals from property, inventory, sales or income tax, which includes exempting new companies from various national taxes, such as, corporation tax, for specified periods and exempting business sales from tax. The host country tax environment contributes to determining the comparative location advantages that can be offered to potential FDI investors relative to other destination countries. The findings of prior empirical studies indicate that MNEs tend to locate foreign investments in low tax countries rather than high tax countries, in order to reduce overall tax liabilities (Altshuler *et al.* 2001; Buettner and Ruf 2007; Devereux and Griffith 1998; Grubert and Mutti 1991; Hines and Rice 1994; Kemsley 1998; Slemrod 1990; Swenson 1994). Scholes *et al.* (2005: 287) declared, the variation in taxes across countries as fertile ground for creative tax planning because the MNEs are aware of the collective impact of various tax rates in different countries on their business decisions as a whole.

2.1.2 Tax strategy at the stage of search, design and screening

Once an MNE determines why it will invest and where, the next stage is to consider the form of the FDI in terms of entry mode and ownership form. In addition to the choice of organisational structure, MNEs have to design and select the appropriate management structure, as well as the legal and financial forms of the foreign affiliates.

Tax in entry mode and ownership form of FDI

If an equity mode (note 1) of entry into a foreign market is chosen, the issue arises of whether to acquire an existing local firm or to establish a completely new entity through a 'greenfield' investment. Compared with building up a new entity from scratch, the acquisition of an existing firm located in another country with a different tax rate offers numerous possibilities for sophisticated tax strategy. This is because a substantial sum can usually be saved by paying careful attention to the structure of the deal, and the management of the tax burden of the combined enterprises. In many cases, however, the deal structure in respect of tax implications is often not given enough attention in the decision process. Equity-based entry modes of FDI are joint ventures (JVs), wholly owned subsidiary (WOS) and/or a branch/division of an established enterprise (note 2). Desai and Hines (1999: 380) argued that the tax system often provides firms with incentives to adopt certain forms. For instance, a subsidiary will be taxed on its corporate earnings and the royalties, interest payments flowing from the subsidiary to the UK. However, organising units as branches will result in the inclusion of all branch income in the world-wide income of the UK parent firm, because a branch is not an independent legal entity, but merely an extension of the parent. A JV involves the sharing of losses and profits, and can promote a partnership between the two organisations (Stevenson *et al.* 1994).

Tax in management, legal and financial structures of FDI

The incentive to use transfer pricing, an internal value placed on the transferred goods or services between related entities, to shift income/profit with the aim to save tax, can counteract the strategic delegation incentive. This delegation incentive involves deciding the management structures of either centralisation or decentralisation (note 3) for an MNE (Nielsen *et al.* 2005). For instance, income shifting within an organisation might require more centralised management structure as shifting income from one country to another may require considerable coordination

(Scholes *et al.* 2005) – and transfer pricing is something that tax authorities internationally look at very closely, so MNEs' processes are subject to considerable scrutiny (see below). If there is a small tax differential between the parent firm and foreign affiliate, earning high pre-tax profit in that country owing to a strategically set low transfer price will not be profit maximising for the MNE. In this case, more delegated authority can enable the subsidiary carefully to choose output and sales levels in order to achieve a lower transfer price as a pre-commitment device to maximise profit. Multinationals generally can choose the legal form of their foreign operations, and this choice can affect their tax obligations (Goolsbee 2004; Gordon and MacKie-Mason 1994). In a business partnership, partners pay tax on their individual shares of the profits. Whilst a limited company is liable to corporation tax on the profit, numerous studies suggest that tax incentives are one of the factors that affect financing choice (Hines and Hubbard 1990; Graham 1996; Grubert 1998; McKie-Mason 1990). Further, financing through debt or equity will have different tax implications because interest paid on debt is generally deductible in determining taxable income, while dividends on equity capital are not. The deductibility of interest was found to have an incentive effect toward debt financing hence, there is a tax benefit from leverage which may affect the manner in which foreign affiliates are financed.

2.1.3 Tax strategy at the stage of evaluation choice of FDI

The routine of evaluation of choice in the FDI decision process consists of three sub-decisions: (i) judgement; (ii) analysis; and (iii) bargaining to examine whether the investment project fits the corporate strategy. The main purpose of this routine is to evaluate the feasibility of the investment project in a foreign market. Strategies, such as, transfer pricing, income shifting and profit repatriation from foreign subsidiaries might be considerations in helping managers to reach decisions or draw conclusions.

Transfer pricing and income shifting in the FDI

Many studies have investigated the degree to which national tax rate differentials have led to transfer pricing manipulation where the transactions at issue are not entirely mediated by an open market price (Collins *et al.* 1997; Grubert *et al.* 1993; Gupta and Mills 2002; Harris 1993; Jacob 1996; Klassen *et al.* 1993). To minimise the manipulation of transfer prices, OECD Guidelines (OECD 2010) insist that all transactions must be carried out at an 'arm's length' price (note 4). However, it has been argued that the complexities of applying the arm's length principle in practice should not be under-estimated owing to the fact that market prices for intra-group transfers rarely exist (Oyelere and Emmanuel 1998; Rossing 2013). There can be genuine difficulties in enforcing and determining what arm's length terms would have been - especially where it is not possible to find wholly comparable transactions between unconnected parties (Hines and Hubbard 1990). Shifting income means that, as a result of FDI, income can be shifted from one tax jurisdiction to another without moving actual real assets. Prior studies indicate that MNEs have an incentive to increase their after-tax profits by shifting taxable income from entities operating in high tax countries to entities in low tax countries (Collins *et al.* 1997, 1998; Grubert *et al.* 1993; Gupta and Mills 2002; Harris *et al.* 1993; Hines and Rice 1994). The most popular methods of shifting income include the manipulation of the location of debt, rent on leases, royalties on licenses, and transfer pricing (Scholes and Wolfson 1992). (Transfer pricing, as mentioned above, is a specific type of income shifting, refer to note 5). If a foreign jurisdiction has lower tax rates than the home country, shifting income to the overseas subsidiary would be a tax saving action. However, tax authorities monitor this sort of activity closely, as indicated.

Timing of profit repatriation in FDI

The subsidiary of a UK MNE is not subject to UK corporation tax until earnings, such as, dividends, interest and royalties earned overseas are repatriated to the parent corporation, although this may be affected by the Controlled Foreign Company regulations. Altshuler *et al.* (1995: 253) argued, repatriation taxes on dividends may vary over time, and such variability may provide firms with an incentive to repatriate relatively more or less profit from the foreign subsidiary when the tax cost of repatriation varies. For instance, an MNE may increase dividend payments from the subsidiary during a period in which the parent is making losses at home with the objective of reducing future tax liabilities. By contrast, a MNE may delay paying dividends from overseas subsidiaries when the repatriation tax is temporarily higher than normal. The variation over time in the level of the repatriation tax provides parent corporations with the opportunity to time remittances (Altshuler *et al.* 1995).

2.1.4 Tax strategy at the stage of authorisation

The final routine in the decision process considers how investment decisions are implemented in organisations. If a conflict occurs between tax strategy and corporate strategy, managers would have to decide which one is likely to take priority in terms of FDI decision making.

Table 1 Embedding tax strategies in FDI decision process

Stages of FDI decision process	FDI strategic decisions	Tax strategy applicable
Recognition and Diagnosis	<ul style="list-style-type: none"> ▪ Strategic motives for FDI ▪ Location of FDI 	<ul style="list-style-type: none"> ➢ Tax rate differentials in different jurisdictions and/or per industry type ➢ Favourable tax incentives offered in different host countries
Search, Design and Screening	<ul style="list-style-type: none"> ▪ Entry mode choice ▪ Ownership form of FDI ▪ Management structure ▪ Legal form of FDI ▪ Choice of financing the foreign affiliates 	<ul style="list-style-type: none"> ➢ Tax incentives applicable to different legal structures, e.g., public or private limited companies, partnerships, etc. ➢ Tax benefits applicable to different organisational forms, e.g., JV, 'greenfield' site, M&A, subsidiary or branch ➢ Tax implications of organising management structures, e.g., centralised and decentralised structures in terms of tax effects ➢ Manner of financing foreign affiliates, e.g., mix of debt and equity applicable to tax liability
Evaluation choice (reviewing the strategic decisions and making adjustments, e.g., judgement, bargaining and analysis)	<ul style="list-style-type: none"> ▪ Transfer pricing strategy ▪ Maximising profits from investments ▪ Liaising between parent firm and foreign affiliates 	<ul style="list-style-type: none"> ➢ Arm's length price between related parties in cross-border transactions ➢ Shifting income from high tax country to low tax country (if possible) ➢ Timing of repatriation of dividends/profits from the foreign subsidiary
Authorisation	<ul style="list-style-type: none"> ▪ The stages at which tax issues are considered in the FDI decision process ▪ Priority between tax strategy and corporate strategy ▪ The relative importance of the stages of FDI decision process taking account of tax considerations 	<ul style="list-style-type: none"> ➢ Judging the integration of the tax strategy and corporate strategy ➢ Investigating the stages at which tax strategies are considered, e.g., before the corporate strategy or after ➢ Deciding, when there is conflict of corporate strategy and tax strategy, which one is given priority

Different stages in the FDI decision process would have different tax strategies applicable to the strategic decisions. The association of corporate strategies with tax strategies identified in the FDI decision process are summarised in Table 1.

2.2 Relative importance of the stages in the FDI decision process in respect of taxation effects

There is a number of theoretical and empirical studies examining the general capital investment decision process (Larimo 1995; Sykianakis and Bellas 2005; Venieris and Cohen 2004; Wei and Christodoulou 1997). However, the process by which the investment decisions are made is an area in need of further investigation, as several researchers have indicated (Larimo 1995; Mintzberg *et al.* 1976). There is little in the current literature to identify the relative importance of the different stages of the FDI decision process. The FDI decision process is still something of a 'black box' from a practical perspective, particularly with respect to tax issues. This is because there is very little evidence that indicates how tax issues are treated throughout the FDI decision process, and how the different stages of the decision process interact with tax issues in terms of the FDI strategic decisions. The interface between tax strategies and corporate strategies has never been studied from the perspective of a holistic and developmental decision making process. Glaister and Frecknall-Hughes (2008: 41) argued that the main process is that firms take commercial decisions and subsequently tax advice is sought, and the initial decision is reviewed for tax implications. Given the limited discussion of the nature of tax issues in the current literature, it is practical to derive research questions to investigate how tax issues interact with the stages of the FDI decision process, and examine whether the relative importance of the stages of the FDI decision process will vary with tax considerations. To contribute to the gaps identified in the current literature, the first research question raised is as follows.

- (i) *Does the relative importance of the stages of the FDI decision process vary according to whether tax issues are considered or ignored in the decision process?*

2.2 FDI decision process with respect to entry mode and ownership form choices

The taxation effects on the choice of foreign ownership form and market entry mode have attracted the attention of several scholars (Becker and Fuest 2011a, 2011b; Desai and Hines 2004). The current literature, however, generally treats tax issues as a single factor in a list of considerations underlying the choice of FDI organisational structure. Little research has considered the FDI decision process in respect of the ownership and entry mode choices. Certain stages of the FDI decision process might lead to different strategic decisions. For example, if tax strategy is considered before the business strategic decisions are made, the FDI financial structure or the choice of legal form may vary from the situation where the tax element is considered only after the commercial decisions are determined. However, the prior literature neglected the correlation between the variables of the FDI decision making process and the choice of ownership and entry mode. Owing to the role of tax in the FDI decision process varying with the ownership and entry mode being unidentified in the literature, the testable hypotheses to examine the relationship between the variables are subsequently unknown. It is important to develop research questions to examine the variation in importance of the determinants for FDI decision process with the choice of ownership and market entry mode, and also the role of tax in this process. This leads to the following questions, which are relatively unexplored in the literature.

- (ii) *Does the relative importance of the variables in the FDI decision process vary with the choice of the ownership form?*

- (iii) *Does the relative importance of the variables in the FDI decision process vary with the market entry mode?*
- (iv) *Does the relative importance of the tax factor in the FDI decision process vary with the ownership and entry mode?*

3. The Methodology and Model

Data for this study were obtained from a questionnaire survey completed by senior finance or tax specialists in 192 UK-based MNEs. In order to confirm understanding of the main research issues on the part of potential respondents and to make sure that the content and format of the questionnaires were clear and unambiguous, a pilot test was undertaken with a total of 30 companies. Feedback from the pilot respondents indicated that the questionnaire was adequately designed, comprehensive and would obtain detailed data on the role of tax in the FDI decision process. Feedback from the pilot also indicated that the best persons to complete the questionnaire were the Chief Financial Officers (CFOs) or Group Directors of Taxation rather than tax managers. This was because tax managers found it difficult to answer several of the questions as they had not been involved in the FDI decision process, hence they could only make a limited contribution to this survey.

The questions incorporated in the instrument were broadly of two types: (i) categorical questions of a factual nature, for example, year of investment and annual sales, etc.; (ii) questions designed to measure the attitude and perceptions of the respondents. In line with prior research, these questions were of an ordinal nature. Ordinal classification of attitude and perception was considered a more realistic task for respondents than the use of interval or ratio measures. Questions were restricted to a five-point Likert scale since it was felt that more numerous response categories would make it too onerous for respondents to discriminate, leading to 'noise' rather than more precise data (Glaister and Buckley 1998). The questionnaire presented a list of eight stages in the FDI decision making process and eight determinants affecting the FDI decision process. The list of stages and determinants in the order they appeared on the questionnaire are shown in Table A1 and Table A2 in the Appendix. Respondents were asked: 'How important were the following factors in affecting the FDI decision making process?', 'How important were the following stages in the FDI strategic decision process?' and 'How important were tax considerations at each stage of the FDI decision process?' Responses were assessed using a five-point Likert scale (where 1 = 'of no importance' and 5 = 'of great importance').

The Financial Analysis Made Easy (FAME) database for UK companies was used as a sampling frame. FAME is a comprehensive database of listed companies in the UK, which contains ten years of detailed information and includes summary data for subsidiaries, as well as information for liquidated companies. Also, the Hemscott Company Guru database was used to provide detailed information on directors, organisational management and the activity status of firms. The initial selection criterion was a minimum annual turnover of £200,000 (which aimed to filter out very small businesses) and companies for which the FAME database contained e-mail addresses, since the questionnaires were to be sent by e-mails with a direct link to an online questionnaire. A total of 3,500 companies was contacted initially with a request to participate in the survey. Non-participation of 780 firms resulted. A total of 2,720 online questionnaires was then distributed to the potential respondents. To increase the number of responses, two UK professional organisations, the Chartered Institute of Taxation (CIOT) and the Institute of Chartered Accountants of Scotland (ICAS) agreed to support this research by assisting with the distribution of the questionnaires to their industry and company members identified as being included in the FAME database.

To ensure the likelihood of good quality responses, e-mails were sent out with covering letters to the CFOs and Group Directors of Taxation in UK MNEs. The covering letter identified the researchers, explained the research objective, assured confidentiality (i.e. that all responses would be treated confidentially and that neither the respondents nor their organisations would be identified during the analysis and report stage of the study), and created a direct link to the online questionnaire. To improve further the response rate, there were two rounds of reminder e-mails and follow-up telephone calls to non-respondents. Of the total of 2,720 questionnaires distributed, 192 usable replies were obtained, a response rate of 7.1 per cent. Given the well-documented difficulties of obtaining questionnaire responses from executives (Harzing 1997) and the decreasing rate of response from executives (Cycyota and Harrison 2006), the study's response rate can be considered satisfactory. This response rate is similar to that reported in other academic studies of executives. Moreover, some studies have reported lower response rates than that reported in this study. For example, studies by Antoncic and Antoncic (2011), Koch and McGrath (1996) and Lepak *et al.* (2003) were successful in obtaining only 6.5 per cent response rates.

Characteristics of the sample

The respondents numbered 192 multinational companies undertaking FDI. The characteristics of the sample are summarised in Table 2.

Table 2 Characteristics of the sample

	Total	%
FDI equity ownership form		
Joint venture (JV)	39	20.3
Wholly owned subsidiary (WOS)	132	68.8
Branch/division	<u>21</u>	<u>10.9</u>
	<u>192</u>	<u>100</u>
Market entry mode of FDI		
'Greenfield' investment	66	34.4
Merger or acquisition (M&A)	<u>126</u>	<u>65.6</u>
	<u>192</u>	<u>100</u>
Size of parent firm (no. of employees)		
3 – 1,000	97	51.6
1,001 – 10,000	<u>91</u>	<u>48.4</u>
	<u>188^a</u>	<u>100</u>

Notes:

^aMissing values = 4

The distribution of the sample of FDI by equity ownership forms can be categorised into three sub-groups, namely JV, WOS and branch/division. The market entry mode of FDI can be partitioned into 'greenfield' investment and merger and acquisition. The size of the parent firm is classified by reference to the number of employees. The data, however, shows that outliers positively skewed the distribution. According to Field (2013: 166), outliers can affect the measure of the mean. The median was therefore considered as the best representation of the size of parent firm in the study. Hence, four outliers were removed from the sample in order to reduce the effects of the outliers skewing the statistical results. The range of the minimum and maximum of the size of parent firm extends from 3 to 10,000 employees. The median value was thus adjusted to 1,000 employees, hence a firm with a number of employees from 3 to 1,000 is

categorised as a small sized firm whereas one with 1,001 to 10,000 employees is classified as a large sized firm.

Statistical analysis

The research questions were examined by comparing the relative importance of stages in the FDI decision process with and without tax considerations, and also by evaluating the underlying factors in the FDI decision process varying with the choice of entry mode and ownership form with respect to tax implications. Given the reasonable sample size and assumption that the sample is from a normal distribution, it was appropriate to use parametric tests and logistic regressions. The relative importance of taxation in decision making process by reference to the characteristics of the sample was therefore tested by implementing two-tailed *t*-tests, multinomial and binomial logistic regressions, as appropriate.

4. The findings

4.1 Relative importance of stages of FDI decision process with and without tax considerations

In light of the FDI decision process developed by Larimo (1987, 1995), eight stages were identified for this research. To examine the specific stages varying with the tax implications, a paired-sample *t*-test was applied. The empirical results indicate that in six out of eight stages there are statistically significant differences in the scores for the stages of the FDI decision process, as shown in Table 3.

Table 3 Comparison of stages in FDI decision process with and without tax considerations

Stages in FDI decision process with and without tax considerations	Rank		Mean	SD	<i>t</i> -value
	Without tax	With tax			
Recognition of investment opportunity (without tax)	1		4.35	1.00	
Recognition of investment opportunity (with tax)		6	2.21	1.24	18.10***
Investigation of investment opportunity (without tax)	2		4.34	1.04	
Investigation of investment opportunity (with tax)		5	2.47	1.31	15.83***
Investigation of target market (without tax)	3		3.89	1.02	
Investigation of target market (with tax)		7	2.20	1.24	14.97***
Identifying the organisational form (without tax)	8		3.16	1.05	
Identifying the organisational form (with tax)		3	3.11	1.23	0.49
Identifying the ways of financing the FDI (without tax)	6		3.29	1.21	
Identifying the ways of financing the FDI (with tax)		2	3.22	1.24	0.71
Identifying the legal structure (without tax)	7		3.24	1.01	
Identifying the legal structure (with tax)		1	3.52	1.38	-2.81***
Identifying the management structure (without tax)	4		3.39	1.03	
Identifying the management structure (with tax)		8	2.03	1.15	14.73***
Reviewing the choice of decision (without tax)	5		3.30	1.11	
Reviewing the choice of decision (with tax)		4	2.59	1.10	7.13***

N = 192

Notes:

The mean for the individual stage is the average on a scale of 1 (= 'of no importance') to 5 (= 'of most importance').

****p* < 0.01 (two-tailed).

In addressing the first research question, the findings suggest that tax issues do have an impact on the relative importance of the stages of FDI decision process. Specifically, the results suggest that when tax issues are brought into the decision process, the stages of identifying the legal form, and selecting the financial and organisational structures are ranked as the most important stages. By contrast, when tax effects were not considered in the FDI decision process, the stages, such as, recognition and investigation of investment opportunity, and target market investigation, scored the highest means. Such results might be mainly because decision makers attempt to balance tax and non-tax strategic decisions, hence subsequently, the relative importance of the general stages of FDI decision process could be affected. There are statistically significant differences in means at the initial stages of FDI decision process, that is, *recognition of investment opportunity* ($p < 0.01$), *investigation of investment opportunity* ($p < 0.01$) and *investigation of target market* ($p < 0.01$). The results suggest that tax issues are important for the early stages of FDI decision process, particularly when recognising and investigating the FDI opportunity, with the mean score being significantly higher than the rest of the stages. Similarly, tax considerations are found statistically important to the stage of *reviewing the choice of decision* ($p < 0.01$). Such results provide evidence to argue that tax issues are considered both before and after the strategic decisions are made in the decision process.

Further, the stages of *identifying the legal structure* ($p < 0.01$) and *identifying the management structure* ($p < 0.01$) show a significant difference in the mean scores. This implies that tax issues are important to the choice of FDI legal and management structures, as the choice of the legal form of entity in the host country results in different tax liabilities for the UK parent firm. For instance, the UK firm has a choice to establish the foreign affiliate as a partnership or a company. The overseas company is generally subject to the tax liability when its profits are repatriated from the overseas to the UK parent firm. By contrast, the partnership itself does not pay tax on its profit, but instead each partner is liable for tax on its share of the profits. The stage of *identifying the management structure* ($p < 0.01$) has a mean that is significantly different, which suggests that tax minimising is important in terms of rendering centralised and decentralised management structure. The findings align with the results of Nielsen *et al.* (2005). The management structure determines the level of authority delegated to the foreign affiliates by utilising income shifting and transfer pricing strategies in order to eliminate tax liabilities. It is important to note that this stage was ranked lowest in terms of the mean measures, which indicate that this stage is less important to managers when tax effects are taken into account. Importantly, the stages of *identifying the ways of financing the FDI* and *identifying the organisational structure* do not show significant differences in means, although both of them were rated as top-rank stages with tax considerations. It means that the tax factor is important to the financial and organisational structure decisions. Such results are contrary to the findings of Desai and Hines (1999), Grubert (1998), and Graham (1996), which found that the choice of organisational form and financial structure is less responsive to the tax factor.

The results of identifying the relative importance of stage in the FDI decision process in relation to tax effects provide a contribution to prior literature, suggesting that when the tax factor is not considered, the various stages, such as, recognition and investigation of investment opportunity are important. Whilst the stages of selecting the legal form and reviewing the FDI decisions become important in the decision process when tax issues are considered, comparatively, the stages of recognising and investigating the FDI opportunity were rated less important. Further, the stages of identifying the organisational form and financing structure of FDI are not statistically significant, although the two stages scored a high rank in mean measure when tax is taken into consideration. The evidence leads to the argument that UK MNEs do take the role of tax into

consideration when considering a new investment project. The tax effects are considered both before and after the strategic decisions are made, particularly for the choice of FDI legal forms.

4.2 FDI decision process in respect of ownership and entry mode choice

The correlation matrix of nine determinants of the FDI decision process revealed a number of low to moderate inter-correlations between determinants. Owing to potential conceptual and statistical overlap, an attempt was made to identify a parsimonious set of variables to determine the underlying primary dimensions governing the full set of FDI decision making motives. Exploratory factor analysis (EFA) using varimax rotation was adopted to extract the underlying constructs, as shown in Table 4. Three underlying factors were summarised as: *corporate strategic considerations*, *evaluation of management, tax and competition*, and *availability of foreign partner*. The three factors make good conceptual sense and explained a total of 58.4 per cent of the observed variance. An internal reliability test showed that the Cronbach alphas for the first two factors are 0.61 and 0.59 respectively. A negative low value for Cronbach alpha of -0.05 was obtained for the third factor. This is mainly due to the largely mutually exclusive relationship between the two variables of ‘available acquisition candidate’ and ‘available joint venture partner’. This implies that if UK companies choose an available acquisition candidate, then joint venture partners are unlikely to be selected, and vice versa.

Table 4 Factors of FDI decision making process

Factors	Factor loads	Eigen-value	% Variance explained	Cumulative %	Cronbach alpha
<i>Factor 1: Corporate strategic considerations</i>		2.30	28.8	28.8	0.61
Size of the investment	0.745				
Potential target country	0.698				
Prior international operation experience	0.695				
Strategic plan of the firm	0.436				
<i>Factor 2: Evaluation of management, tax and competition</i>		1.41	17.4	49.2	0.59
Effective management	0.835				
Competition situation	0.767				
Taxation effects	0.484				
<i>Factor 3: Availability of foreign partners</i>		1.14	14.2	58.4	-0.05
Available acquisition candidate	0.763				
Available joint venture partner	-0.551				

Notes:

Principal components factor analysis with varimax rotation.

K-M-O Measure of Sampling Adequacy = 0.620.

Bartlett Test of Sphericity = 183.204; $p < 0.000$

To investigate further the underlying nature and pattern of the FDI decision process in relation to the choice of ownership and entry mode, the analysis was developed by undertaking multinomial and binomial logistic regressions. The three underlying factors of the FDI decision process were assumed to be a set of independent factors, while the ownership form and market entry mode were considered as dependent variables, and the size of parent firm was regarded as a control variable in the statistical test. The overseas ownership forms consist of JV, WOS and branch/division in this study. As the dependent variable can be categorised into more than two non-ordinal categories, a multinomial logistic regression was employed in the statistical test. Before the analysis, the assumptions of the model were checked, including the collinearity within

the data, as shown in Table 5. The Durbin-Watson test was used to check whether the residuals in the model were independent.

Table 5 reports the descriptive statistics and correlation matrix of the variables in the FDI decision making process. The pair-wise correlations do not seem to present serious collinearity (note 6) problems for the multivariate statistical analysis, as none of the variables has a correlation coefficient above 0.60 (Hair *et al.* 2006: 227).

Table 5 Correlation matrix

Variables	Mean	SD	1	2	3	4	5	6
1. FDI ownership form	2.48	0.81	1.00					
2. Foreign market entry mode	0.66	0.48	0.14	1.00				
3. Size of parent firm ^a	1.48	0.50	-0.20**	0.15*	1.00			
4. Corporate strategic considerations	4.04	0.67	-0.04	0.07	0.07	1.00		
5. Evaluation of management, tax and competition	3.46	0.91	-0.04	0.02	0.02	0.27**	1.00	
6. Availability of foreign partners	2.81	1.03	-0.36**	0.33**	0.17*	0.34**	0.23**	1.00

Notes:

N = 192; SD = standard deviation.

^a Number of employees

* $p < 0.05$; ** $p < 0.01$ (two-tailed).

4.2.1 Determinant factors in FDI decision process and ownership form

Table 6 shows the results of multinomial logistic regression of the determinant factors in the FDI decision process associated with the ownership form. The chi-squared values are significant for all three models ($p < 0.01$), exhibiting a high level of overall explanatory power. Pseudo *R*-square and log likelihood measures suggest that all the models have adequate explanatory power. Further, the models have a good fit with a classification rate of 73 per cent of the observations. Rates that are higher than that would be expected by chance. The primary interpretation is based on the estimated odds ratios (exponentiated β), which relate independent variables of the three determinant factors of the FDI decision process for the ownership form categories to their impact on a reference category (Feeney and Bozeman 2010: 1665). In reference to the second research question, the empirical results suggest that there is relatively weak support for the view that the relative importance of the variables of the FDI decision process will vary with the choice of the foreign ownership form, because only one factor of *availability of foreign partners* ($p < 0.01$) shows statistically significant coefficients.

The findings indicate that although all the three determinant factors of the FDI decision process affect the general strategic decision making in the FDI, the choice of the ownership form is not highly associated with the underlying factors, except for *availability of foreign partners*. The factor of *availability of foreign partners* ($p < 0.01$) was the only factor found to be statistically important to the ownership form decisions. When UK firms select the ownership forms between JV and WOS, the factor of *availability of foreign partners* obtains a positive coefficient in model 1 and a negative coefficient in model 2, which suggests that the particular factor is more important to the ownership form of the JV than the WOS. Similarly, when the choice is made

between branch and JV, the factor of *availability of foreign partners* obtains statistically significant coefficients. The negative coefficient in model 2 and positive coefficient in model 3 indicates that this factor is predicted as a more important determinant to the ownership form of JV than the branch/division. Such results might be mainly due to the fact that a JV is a form of partnership. Thus, the UK firms are more likely to choose the ownership form of JV when the choice of the ownership form is made between JV and any other forms because of partner availability, whereby foreign firms exist for the UK firms to select and co-operate with. The finding implies that if foreign partners are available, UK companies tend to choose an easy option in terms of ownership form as it makes investment relatively easier by going for partnership rather than building up an enterprise from scratch. It is important to note that when the ownership form decisions are made between branch and WOS, the factor of *availability of foreign partners* is no longer significant because neither form can per se operate as a partnership. None of the previous research has emphasised the importance of *availability of foreign partners* in association with the factors of FDI decision process varying with the choice of the market entry mode.

Table 6 Multinomial logistic regression of the factors of FDI decision process on overseas ownership form

	Model 1 ^a		Model 2 ^b		Model 3 ^c	
	JV vs WOS	Branch vs WOS	Branch vs JV	WOS vs JV	JV vs Branch	WOS vs Branch
<i>Explanatory variables</i>	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient
Intercept	-3.14	-1.06	2.09	3.14	-2.09	1.06
Factor 1: <i>Corporate strategic considerations</i>	-0.38	-0.21	0.17	0.38	-0.17	0.21
Factor 2: <i>Evaluation of management, tax and competition</i>	-0.09	-0.18	-0.13	0.08	0.13	0.19
Factor 3: <i>Availability of foreign partners</i>	1.35***	0.10	-1.25***	-1.35***	1.25***	-0.10
<i>Control variable:</i>						
Size of parent firm	-1.18*	0.57	1.75***	1.18*	-1.75***	-0.57
Model chi-square X ² (8)	40.96***		40.96***		40.96***	
Log likelihood	220.96		220.96		220.96	
Correct classification	0.73		0.73		0.73	
Pseudo R-square:						
Cox & Snell	0.21		0.21		0.21	
Nagelkerke	0.26		0.26		0.26	
McFadden	0.14		0.14		0.14	
N	181		181		181	

Note:

^a Ownership form of wholly owned subsidiary (WOS) as a reference category

^b Ownership form of joint venture (JV) as a reference category

^c Ownership form of branch as a reference category

* $p < 0.1$; *** $P < 0.01$ (two-tailed test of significance)

4.2.2 Determinant factors in FDI decision process and entry mode

In order to examine the relationship between the variables of the FDI decision process and the choice of market entry mode, a binomial logistic regression was undertaken to identify the main predictors. The dependent variable is a binary and dichotomous variable which can be coded as Yes/No or 0/1. A binomial logistic regression was therefore used to implement the data analysis (Pallant 2016: 178), as shown in Table 7.

Table 7 shows weak support for the view that the relative importance of the underlying factors of the FDI decision process will vary with the choice of entry mode, which addresses the third research question. Only one of the three factors, that is, *availability of foreign partners*, shows a statistically significant coefficient ($p < 0.01$). In order to examine whether the variables of the FDI decision process will vary with the choice of foreign entry mode, 'greenfield' investment was used as the base mode and assigned a value of zero. The model has a highly significant explanatory power with a model chi-square of 27.04 ($p < 0.01$) and correctly classifies 79 per cent of the observations. In line with the examination, the coefficient of *availability of foreign partners* is positive, indicating that, regarding the availability of partners in the host market, the entry mode of 'greenfield' investment is relatively more important than cross-border merger and acquisition.

Table 7 Binomial logistic regressions of the factors of the FDI decision process on foreign entry mode

Variables	Greenfield vs Merger or Acquisition (M&A = 1)	
	Coefficient	Wald statistics
Intercept	-1.25	0.29
Factor 1: Corporate strategic considerations	-0.13	0.88
Factor 2: Evaluation of management, tax and competition	-0.10	0.91
Factor 3: Availability of foreign partners	0.81	2.25***
<i>Control variable:</i>		
Size of parent firm	0.42	1.53
Model chi-square $X^2(8)$	27.04***	
Sensitivity	0.94	
Specificity	0.48	
Correct ratio	0.79	
Pseudo <i>R</i> -square: Cox & Snell	0.13	
Nagelkerke	0.18	
N	181	

Note:

*** $p < 0.01$ (two-tailed).

Not surprisingly, the findings suggest that firms might prefer to choose a comparatively easier option instead of a difficult one in terms of the choice of market entry mode. A firm can establish a subsidiary from scratch, that is a so-called greenfield investment, or by merging with or acquiring an existing enterprise in the target market, that is an M&A. With respect to the availability of acquisition candidates in the host market, it was expected that the M&A would be preferred to greenfield investment. However, the results were surprising, which suggest that UK firms are more likely to select a greenfield investment than an M&A. This might be because an M&A is relatively more challenging than a 'greenfield' investment owing to the effects of external factors and risks associated with acquisition (Wang 2009). Intuitively, the results indicate that there may not be a suitable target in the foreign country, therefore the 'greenfield' investment is the option. This might be due to the difficulties in integrating a parent company with its acquisition targets in respect of the business portfolio or cultural distance. Hence, it benefits the firm to take matters into its own hands and create a new site of operations in the foreign country rather than purchase of an existing company.

In response to the fourth research question, the empirical results in Table 6 and 7 show no evidence of the motive of *taxation effects* correlating with the choice of ownership and entry mode in the FDI decision process. The results align with the findings shown in Table 3, that when tax issues are considered, the organisational form is not statistically important to the FDI decision process, although the stage of *identifying the organisational form* is ranked as an important motive in the decision process. The finding of this study provides further evidence that tax implications do not necessarily distort the FDI entry mode and ownership form decisions. This is in line with earlier studies on the correlation between international differences in tax rates and mergers and acquisitions (Becker and Fuest 2011b). However, our results run counter to the study by Huizinga and Voget (2009: 1244), who suggested that tax may create significant economic costs by distorting international relationships of ownership and control. The empirical results show the significant importance of the strategic decisions in the choice of organisational form, and tax consideration is an influential factor to the decision making. It may be argued that investor firms make strategic decisions in the choice of ownership and entry modes first, then incorporate tax strategies into their commercial decisions afterwards. This argument was reinforced by Glaister and Frecknall-Hughes (2008: 43), who argued that strategic decisions are given priority and that tax decisions follow in the wake of strategic decisions. It is important to note that there are statistically significant differences in means in the stages of *reviewing the choice of strategic decision* and *recognition and investigation of FDI opportunity*, as shown in Table 3. The evidence leads to the suggestion that tax effects can play an influential role both before and after the FDI decision is made, however, it cannot distort the decisions that are drawn from economic and investment aspects.

5. Summary and Conclusions

There is a substantial amount of empirical evidence to show that international taxation differences influence the strategic decisions of MNEs. The strategic decisions in terms of ownership and entry modes in relation to the decision process and the determination of motives by which the FDI decisions are made, however, are neglected research areas. Little is known about the way tax issues are treated in the FDI decision process, and also the specific stages at which tax implications are brought into the FDI decision process. In an attempt to bridge the gap in the literature, this paper has examined several relevant research questions.

This paper is a first attempt to uncover the nature of the FDI decision process from a taxation perspective. The study contributes to the literature in several respects. Based on a set of primary data, the study presents the first empirical results of the FDI decision process and the factors involved in the investment process varying with the choice of international ownership and entry modes, together with the importance of tax in the stages of this process. Tests of the variables of the FDI decision process provided evidence that the relative importance of the variables hardly varies with the FDI strategic decisions in terms of ownership and entry mode. The factor of availability of overseas partners is significant to the organisational form of FDI. If a JV partner is available in the foreign market, firms are more likely to select the JV formation as an ownership form as compared with the forms of WOS and branch. From the perspective of available foreign partners, 'greenfield' investment is preferred over M&A in terms of market entry mode owing to a lack of availability of foreign partners. Moreover, tests of the relative importance of the stages of the FDI decision process with or without tax considerations provides evidence to suggest that the relative importance of the stages of the decision process will vary with the situation where tax implications are considered. Importantly, it is found that tax issues are usually considered both before and after the corporate strategy had been made in the FDI decision process. No support was found for the view that tax effects can distort the ownership and entry mode decisions.

This research sheds light on the practice in the UK MNEs regarding the role that tax and key factors play in the FDI decision making process, correlating with the choice of ownership and entry mode. This research is unique in identifying the factors considered in the FDI decision process undertaken by the UK multinationals, and discovering the effect on strategic decisions exercised by the UK managers. The main limitation of the research is the restricted number of variables designed and developed in the original survey. Such limitations may weaken the generalisability of the findings. Another limitation is our inability to identify the reasons underlying the choice of the organisational structure and the importance of tax implications being placed in the FDI decision process. It would be beneficial to investigate the rationale behind the strategic decisions by conducting qualitative interviews. Further research could develop understanding of the integration between tax strategy and corporate strategy in the FDI strategic decision process. As the tax factor could be considered by the MNE before, after or both before and after the strategic decision relating to FDI, future research could examine the stages at which tax is taken into account.

End Notes

1. An equity-based entry mode is a form in which the local enterprise is either partly or wholly owned by the parent firm whereas a non-equity entry mode includes exporting through agents and licensing (Harzing 2002: 211).
2. A JV is a form of partnership whereby parent companies which may originate from different countries and backgrounds, share resources and supply each other's needs to maximise the benefits and capacities to achieve a 'win-win' relationship. A WOS is a separate legal entity of the parent firm whereas a branch/division of the established enterprise is part of the MNE, but not a separate legal entity.
3. Managers in centralised organisations remain the major responsibilities and powers, while decentralised organisations tend to spread responsibility for specific decisions across various outlets and lower level managers, including branches or units located away from headquarters (Siggelkow and Levinthal 2003: 651).
4. For each part of the multinational entity (whether it is a branch or a subsidiary), a price is substituted for taxation purposes that would have been used in the transaction had it been with an unrelated third party rather than a related party within the same multinational entity.
5. Both transfer pricing and income shifting are ways of moving or repatriating profit (the latter occurring if profit returns to the 'home' country of the FDI). Paying dividends is, of course, a more direct means of achieving a similar result where FDI is set up as a company. Dividends are paid out of post-tax profit and on a per share basis to shareholders, so the nature and location of shareholders can determine the ultimate location of profits paid out in this way – although the shares in an FDI company are likely to be held by a parent company not individuals, so there may not be much difference ultimately between this and other methods. Tax treatments of dividends received may differ between countries.
6. The effect of collinearity is to inflate the variance of the least squares estimator and possibly any predictions made, and also to restrict the generality and applicability of the estimated model (Wetherill 1986: 82).

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Appendix

A1 Determinants affecting FDI decision making process: item listed by order of appearance on the questionnaire

-
- | | |
|-----|--|
| (1) | Strategic plan of the firm |
| (2) | Prior international operation experience |
| (3) | Size of the investment |
| (4) | Potential target country |
| (5) | Available acquisition candidate |
| (6) | Available joint venture partner |
| (7) | Competition situation |
| (8) | Effective management |
| (9) | Others |
-

A2 Stages in FDI decision process: items listed by order of appearance on the questionnaire

-
- | | |
|-----|--|
| (1) | Recognition of investment opportunity |
| (2) | Investigation of investment opportunity |
| (3) | Investigation of target market |
| (4) | Identifying the appropriate organisational form |
| (5) | Identifying the ways of financing the FDI |
| (6) | Identifying the appropriate legal structure |
| (7) | Identifying the appropriate management structure |
| (8) | Reviewing the choice of decision |
-