International Tax Policy

Tax Havens and related Tax Policy Issues

1. Introduction

This paper will discuss some of the recent intensified debate on international tax competition policy issues including tax havens, summarise the important work of the OECD in this area, discuss some of the ongoing debate on the issue, examine some of the limited international empirical data available and finally, in light of the above, discuss why sometimes Ireland is erroneously labelled a tax haven.

2. Background

For a whole variety of reasons the issue of 'tax havens' has been receiving worldwide attention of late.

In February 2008, a global tax scandal erupted after a former employee of a Liechtenstein trust company provided tax authorities around the world with data on about 1,400 persons with accounts at LGT Bank in Liechtenstein.

In May 2008, a second international tax scandal broke when the United States arrested a private banker formerly employed by UBS AG, one of the largest banks in the world, on charges of having conspired with a U.S. citizen and a business associate to defraud the IRS of $7.2 million in taxes owed on $200 million of assets hidden in offshore accounts in Switzerland and Liechtenstein.

In 2009 actions by the Organization for Economic Cooperation and Development (OECD) and the G-20 group of industrialised and developing nations targeted tax havens, by publishing a so called "black list" of territories who refused to exchange tax information.

3. Definition of Tax Havens

Part of the problem around the debate on tax havens is that there is no agreed definition of what the term 'tax haven' actually means. Typically, the term is applied to countries and territories that offer favourable tax regimes for foreign investors. The elements of these favourable regimes include low or zero corporate tax rates. Academic research on tax havens tends to focus on low income or corporate tax rates as the principal identifying feature. There are also a variety of other elements common to tax havens, such as low or zero withholding tax rates on foreign investors and bank secrecy laws.

Probably the best known definition of a tax haven is that used by the OECD. Four key indicators of tax havens are identified:

- No or only nominal taxes (and offering, or being perceived as offering, itself as a place for non-residents to escape tax in their country of residence);
- Lack of transparency (such as the absence of beneficial ownership information and bank secrecy);

- Unwillingness to exchange information with tax administrations of OECD member countries; and
- Absence of a requirement that activity be substantial (transactions may be "booked" there with no or little real economic activity).

Gravelle (2009) notes that the use of tax havens for tax avoidance and evasion can fall in two broad categories. The first is wealthy individuals seeking to avoid taxes such as those on dividends, interest or capital gains. The second is companies that seek to artificially inflate profits in low tax countries at the expense of those in higher tax countries. The magnitude of either is difficult to estimate but Gravelle surveys the literature and finds that the revenue cost to the US from the use of tax havens by companies is in the range of $10 billion to $60 billion per year. By contrast the cost of tax haven use by individuals is estimated to be in the range of $40 billion to $70 billion. The discussion of tax havens in Ireland tends to focus on companies but it should be borne in mind that this represents only part of a wider issue.

What distinguishes tax havens from the rest of the world? Even a casual observer is likely to be aware that tax havens tend to be small and that many are islands. Research by Dharmapala and Hines (2006) suggests that tax havens are on average substantially more affluent than non-havens. Another common characteristic found by Dharmapala and Hines is that tax havens differ substantially from non-havens in their legal origin. Havens are more likely to have British legal origins and to be dependent territories rather than sovereign states (based on the historical source of a country's system of commercial law, as classified by La Porta *et al*., 1999). In addition to being smaller in population size and more likely to be island countries, tax havens' geographical characteristics also lead them to be more intrinsically inclined towards economic openness.

4. OECD Project on Harmful Tax Practices

Concern about the use of tax havens to erode the tax bases of higher tax countries has prompted a major effort by the OECD to combat tax havens that has been ongoing for over ten years.

The OECD started the process with its 1998 report *Harmful Tax Competition: An Emerging Global Issue.* This report established the OECD definition of tax havens described in the previous section and this definition remains in force.

Following this report, a dialogue commenced between the OECD member states and the jurisdictions concerned. In 2002 a working group comprising representatives of participating partner jurisdictions and OECD member countries developed the OECD model Tax Information Exchange Agreement[1] (TIEA). Ireland was a member of this working group.

[1] A Tax Information Exchange Agreement (TIEA), based on the OECD model, allows the tax authorities in both countries to request the other to provide information that is relevant to a tax investigation. Typical information requests would be in relation to bank accounts and ownership information for companies and trusts. The information is then exchanged directly between the tax authorities. Similar information exchange provisions are found in double taxation agreements, but the provisions in a TIEA are spelt out in much more detail. The agreement does not provide for automatic or spontaneous exchange of information. Information may only be provided on a request basis. Requests must be fairly specific and it will not allow for any trawling exercises.

Afterwards, a number of OECD member countries, including Ireland, commenced negotiations with other committed jurisdictions with a view to concluding bilateral TIEAs based on the OECD model. Progress was very slow. However, the position has dramatically changed recently.

In April 2009 G-20 countries issued a list identifying which jurisdictions were not in compliance with the OECD standard on the exchange of information. The G-20 communiqué of April 2009 set a threshold of 12 international agreements (either TIEAs or DTAs) being in place, that allow for information exchange, before a country will be regarded as having *substantially* implemented the OECD standard. OECD has made it clear however that 12 is just a starting point and jurisdictions will be required to sign agreements with all countries that ask them in the future.

The four OECD countries that had previously wanted to keep bank secrecy in relation to tax matters (i.e., Switzerland, Luxembourg, Austria and Belgium) also committed to the OECD standard in the wake of the G-20 communiqué. So too have important non-member financial centres such as Singapore and Hong Kong.

Agreement on the G-20 communiqué was based on outcomes reached at a joint EU/OECD meeting held in Paris on 21st October 2008. This drew upon previous EU work on the exchange of information and banking transparency based on the EU Savings Tax Directive, which came into operation on 1st July 2005, and provides for the automatic exchange of information on 'deposit style' savings products between EU States and between EU States and certain third countries, including some tax havens. The Savings Directive is currently being amended to extend its scope to 'savings-type products' such as insurance and trusts. The amended Directive will strengthen the automatic exchange of information between tax authorities and put further pressure on non-compliant jurisdictions that constitute tax havens. The amended Directive is currently used as a basis for anti-taxation fraud agreements being negotiated with jurisdictions such as Liechtenstein, Switzerland and the Channel Islands.

Work on the amended Savings Directive is being undertaken in tandem with Directives on Mutual Assistance and Administrative Co-operation which, together, will greatly improve the ability of tax authorities to work in concert to tackle fraud and tax evasion at an intra-EU level and between the EU and third countries, particularly those traditionally identified as tax havens.

The Paris EU/OECD meeting also drew upon Ireland's offshore funds initiative[2], praised by OCED Secretary-General Angel Gurría as a "very successful initiative to establish a comprehensive off-shore compliance strategy which included strong incentives for voluntary compliance for taxpayers".

A further joint EU/OECD meeting was held in Berlin on 23rd June 2009 as a follow on from the Paris meeting and the G-20 work. This has further linked the EU, OECD and G-20 work in this area to ensure that initiatives undertaken by the three organisations are done in tandem.

The OECD has reached agreement with members of the Global Forum (composed of OECD and Non OECD members) to set up a new organisation, similar to the Financial Action Task Force, to drive the work forward on exchange of information and

[2] This arose out of the investigation into bogus non-resident bank accounts and the evasion of DIRT payments (Ansbacher, etc which involved voluntary disclosure by taxpayers which resulted in €930m paid to Revenue.

transparency for tax purposes globally. The new forum entitled the Global Forum on Transparency and Exchange of Information for Tax Purposes will comprise more than 90 countries and will be responsible for implementing robust and transparent peer reviews of countries to ensure they meet the OECD standards on exchange of information.

5. Is Tax Competition Bad?

The standard negative view of tax havens, for example as formalised in Slemrod and Wilson (2006), is based on the belief that tax havens intensify international tax competition. This forces countries to compete on declining tax rates (encouraging a race to the bottom) and therefore lowering tax revenue in affected countries.

The Tax Justice Network, an NGO which seeks to promote transparency in international tax and finance matters, argues that tax havens have a broader social impact.[3] According to the Tax Justice Network, tax havens undermine the interests of poor countries in four major ways:

- Secret bank accounts and offshore trusts in tax havens provide wealthy elites and companies with the means to escape their tax obligations, thus depriving poorer nations of the tax revenue they need;
- Multinationals' ability to substantially lower their tax burden by routing capital flows through mailbox companies in tax havens provides an unfair competitive advantage vis-à-vis their competitors in developing countries;
- Banking secrecy and offshore trusts offered by financial institutions in tax havens make it possible to launder the proceeds of corruption, illicit arms deals, embezzlement, and global drug trade; and
- Tax havens have contributed to the rising incidence of financial crisis.

The empirical evidence to support a negative view of tax competition (as distinct from tax havens) is mixed. For example, member states in the European Union have made considerable reductions in their statutory corporation tax rates in recent decades. However, revenues from corporation tax have remained relatively stable in the EU over that period and actually increased in some years (Nicodeme, 2006).[4]

Similar results hold in the US. Dharmapala (2008) shows that the share of US tax revenue from corporate taxes actually increased between 1994 and 2006 despite an increase in the share of US outward FDI in tax havens over the same period. The US statutory corporate tax rate was unchanged over the period.

On a broader note, Baldwin and Krugman (2004) show differences in corporate tax rates may be beneficial, as opposed to encouraging a harmful race to the bottom, when they are used to address differences in the economic and geographic characteristics of countries. For example, a peripheral country, such as Ireland, needs to set a lower tax rate to attract investment than a centrally located core European country such as Germany.

6. Why Ireland is sometimes unfairly labelled a Tax Haven?

Ireland is not a tax haven and the international community does not regard Ireland as a tax haven. Ireland is on the OECD/G-20 white list of countries published in April, 2009. We are not regarded as a tax haven by the United States or any of the other major

[3] See http://www.taxjustice.net/.

[4] de Mooij and Nicodeme (2007) discuss reasons for this, including base broadening and rates of incorporation.

industrialised countries of the world.[5] This is evidenced by the large and growing network of tax treaties that Ireland has in place with other countries.[6]

By any measure, Ireland is an extremely open economy. As noted by Barry (2006), Ireland is the most FDI-intensive economy in Europe. As an example, Barry shows employment in foreign owned firms. Foreign firms account for almost 50 percent of Irish manufacturing employment (compared to an average of 23 percent for the Western EU member states) and Ireland also records the highest share of services sector employment in foreign-owned firms in OECD countries for which data are available. Per head of population, the Irish inward FDI stock is a multiple of the EU average.

Ireland's success in attracting foreign investment is due to several factors, one of which is a favourable tax regime that makes Ireland an attractive location for multinational companies. However, there are a range of other advantages that all contribute to encouraging multinational investment to locate in Ireland. These include access to the European market, the common legal framework that EU membership establishes, membership of the Euro, an English speaking population, an institutional structure that adapts rapidly and a good infrastructure. A good education system is a key component of this infrastructure, as Barry (2006) notes, Ireland surpasses the OECD average in terms of the proportion of the cohort aged 25 to 34 with tertiary education, and has one of the highest proportions in the world of science and engineering graduates among this age group. Ireland's long-standing FDI orientation has also allowed agglomeration effects to accumulate. Having established a reputation as a reliable location for FDI in high-tech sectors, Ireland was well placed to profit from the global high-tech boom of the 1990s (Barry, 2006).

Ireland maintains a low general corporation tax rate by ensuring a wide tax base. The Irish 12.5% corporate rate is a general rate on trading activity and as such is not focused on any particular segment of Irish industry. There is no distinction between small and large enterprises or between enterprises that service the local economy or those that have a multinational focus.

However, from time to time Ireland, just like many other countries[7], has been criticised for having characteristics similar to tax havens

There are two main reasons for this:

- Firstly because of the perceived interaction of Ireland's 12 ½ % corporation tax rate and the potential to abuse international transfer pricing regulations; and
- Secondly because of a rather obscure and flawed but nonetheless influential academic paper by Hines and Rice dating back to 1994.

[5] Doggart (2002) discusses in detail the haven lists used by several countries.

[6] As of September, 2009 Ireland has 46 Double Taxation Treaties ratified with a further 13 signed awaiting ratification. Ireland also has signed 8 TIEAs.

[7] A 2009 report on tax havens by the US Congressional Research Service (Gravelle, 2009) includes a long list of countries with tax haven characteristics including: US (Delaware, Nevada, Wyoming) UK, Denmark, Iceland, Israel, Portugal's Madeira Island, Hungary, Brunei, Uruguay, Labuan (Malaysia).

These issues are elaborated upon in the following paragraphs

Transfer Pricing
Double taxation results in an impediment to cross border transactions and the movement of capital. To overcome this, each taxing jurisdiction should tax an "appropriate" share of the profits of the multinational group. Determining such appropriate shares requires establishing prices on the transactions between the associated enterprises (McDonald, 2008).

Many countries have agreed to a standard for determining transfer prices for tax purposes: the arm's-length principle. The arm's length principle and its relevance to the taxing rights of jurisdictions is established in the OECD Model Tax Convention:

> *[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

Essentially, the arm's length principle requires that multinationals price their inter-company transactions at the same price (the arm's length price) that would arise between two independent companies carrying out the same transactions. The recommended methodology of the OECD, which Ireland adheres very closely to in dealing with transfer pricing cases, is to find comparable independent transactions from which to set transfer prices. This is quite difficult in practice even with fairly standard goods and services transactions. It becomes extremely complex when attempting to find comparables for transactions involving intellectual property. This is an important aspect from the Irish perspective, as many of the multinational companies operating in Ireland are in high-tech areas of electronics, medical devices and pharmaceutical products. These areas typically involve considerable intellectual property.

Ireland does not have specific transfer pricing legislation but Sections 81 and 1036 of the Taxes Consolidation Act 1997 have relevance to transfer pricing and require the application of the arm's length principle. These Sections reinforce the principle of Transfer Pricing in Ireland in accordance with the arm's length standard.

Difficulties with Transfer Pricing
Globally, multinational corporations have long been accused of utilising the difficulties inherent in applying the arms length standard in order to facilitate so-called 'income or profit shifting' from high tax countries to low tax countries so as to minimise their tax bills (McDonald, 2008).

Given the difficulties in determining arm's length comparables and setting transfer prices, it is difficult to estimate the scale of the abuse of transfer pricing (through the setting of prices that are not arm's length). A number of academic papers have examined the available empirical evidence to see if it provides evidence of profit shifting.

Typically, the approach uses aggregated macro level data on profitability or productivity of multinational companies and their subsidiaries across locations. When compared to tax rates by location, most studies do find higher levels of profit reported in locations with low tax rates. The assumption then made is that abusive transfer pricing and profit shifting are driving the results.

Given that Ireland has a relatively low statutory corporate tax rate and has been a significant recipient of US outward investment for several decades, it is not surprising that Ireland features regularly in such analysis and as a consequence is drawn into the tax competition debate. However, there are several important shortcomings of the research on this topic that should be considered.

The first is the nature of the data used. It is nearly all macro level data, aggregated up from the company level and is likely to be misleading as it does not allow for genuine differences at company level to be distinguished. McDonald (2008) notes that apparent income shifting in the aggregate data may in fact be fully supportable when specific transactions are analysed.[8]

Second, the most common sources of data used are those from the BEA or the IRS data on controlled foreign corporations.[9] These sources are notoriously volatile from year to year and in general one year's data should not be looked at in isolation.[10] The US Treasury has itself noted the volatility and unreliability of such raw data.

Finally, the underlying assumption that varying levels of profitability across locations are explained by profit shifting is also flawed. Profitability across multinational companies is likely to differ depending on the activity (the industry) of the company. Multinational companies spread their operations across multiple locations. Different stages of the manufacturing process are likely to have different profitability levels. The activities of such companies are highly heterogeneous. Some stages are likely to be highly skilled and capital intensive (such as research and development). Others will be more low skilled, assembly or production type functions. Multinationals will choose location based on these (e.g., low skilled labour intensive stages in countries with low labour costs). Similarly, some stages will be more profitable and companies are likely to seek to locate them in low tax countries. There is often a link between high skills and high productivity, those stages that require the most skilled labour are often the most profitable and companies will seek to locate them in stable countries, with better skilled workforces.

The result, as McDonald notes, is that multinationals may undertake low-value, routine activities with genuinely low profitability (when measured at arm's length) in higher tax locations. They may simply invest more, and generate more profit, in low-tax jurisdictions. The differential in profitability may be related to such differences in investment levels, as profitability tends to be related to capital intensity, all else being equal, not simply due to abuse of transfer pricing to shift profit.

Hines and Rice

[8] Transfer pricing transactional detail may be "buried" within the aggregate macro financial data that are typically used for empirical analyses. There may be significant non-transfer pricing "noise" that hinders the ability to isolate transfer pricing effects (McDonald, 2008).

[9] See http://www.bea.gov/international/index.htm#omc. The BEA is an agency of the US Department of Commerce. The data on international investment by US companies are based on responses to surveys of those companies. See http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html.

[10] For example, Avi-Yonah and Clausing (2007) use BEA 2003 data and Ireland is ranked third in terms of the location of US profits. More up to date US BEA data for 2006, the latest available, shows a different ranking of countries with the Netherlands in first place, followed by Luxembourg, Bermuda, UK, Canada, and then Ireland. In the 2006 data, the value of income of US affiliates in Ireland is approximately half that of the Netherlands compared to about 75% of the Netherlands level in 2003. Another example of the volatility of the figures, the UK effective tax rate calculated from the BEA data goes from 20.1% in 2003 to 28.9% in 2005

Hines and Rice in a 1994 paper produce a list of tax haven countries, one of which is Ireland. Although an academic paper that is now 15 years old, it remains very influential today.[11] Because of its inclusion as a tax haven in this paper, Ireland has been included in later lists of tax havens that use Hines and Rice.[12] Unfortunately, Ireland's inclusion in the original paper is deeply flawed for several reasons:

- Firstly, the list effectively dates from the early 1980s with no significant attempt made to adjust or update it since.[13] Most of the later papers simply take the list as given. To assemble their tax haven list, Hines and Rice cite a paper by Glautier and Bassinger (1987). The Glautier and Bassinger paper uses a list of tax haven countries taken from the IRS *Internal Revenue Manual* (no year is given but it appears to date from the early 1980s). Ireland is included on this older IRS list.

- Secondly, as an extension of the first point, it is possible that Ireland may have been included on the *Internal Revenue Manual* list due to the zero rate of tax on income from export sales of manufacturing goods – export sales relief – introduced in the 1950s. This relief was phased out for new companies in 1980 and existing companies by 1990. If this was the reason for Ireland's inclusion on the list, it is clearly no longer valid. Glautier and Bassinger note that the IRS manual did not have a specific definition of a tax haven. Of the various criteria for tax havens presented in the paper, Ireland is noted as satisfying only one: taxing foreign income at a lower rate than domestic income.

- Thirdly, the only adjustment made by Hines and Rice (1994), to exclude several countries, is itself based on effective tax rate data from 1982. No attempt was made to use more recent tax data.

- Fourthly, Hines and Rice use a 20 per cent effective tax rate as a cut-off point. There is no explanation why 20 per cent was used. It seems arbitrary but clearly does impact on which countries are removed from the list. It may also have had the effect of excluding a country with banking secrecy laws (as an example of a common feature of tax havens) if its tax rate is above the threshold.

7. Conclusions

There is no single and agreed upon definition of a tax haven. The term tax haven means different things to different people. In some of the academic literature simply having a low tax rate as distinct from a zero or close to zero rate can constitute grounds for being a tax haven. However, for the OECD other issues such as transparency, willingness to exchange information and economic substance of operations are very important determining factors. Transparency and exchange of information are now the main focus of the G-20 and the OECD.

Ireland does not meet the OECD criteria for being a tax haven. But because of its 12 ½ % Corporation Tax rate, and strong flows of FDI, Ireland has on a few occasions been unfairly labelled a tax haven. There are two main reasons for this. Firstly because of the

[11] Using Google Scholar to search academic papers for "tax haven", Hines and Rice (1994) is the first result returned even today.

[12] For example, Ireland is recently included as a tax haven in GAO (2008) and Gravelle (2009), both of which trace back to Hines and Rice (1994).

[13] Even recent papers by the Hines have not sought to update and correct the paper, for example Dharmapala and Hines (2006), which is the direct source for GAO (2008) and Gravelle (2009), simply takes the list as given.

perceived interaction of Ireland's 12 ½ % corporation tax rate and the potential to abuse international transfer pricing regulations; and secondly because of an influential, but flawed, academic paper by Hines and Rice dating back to 1994.

As regards the first issue, a number of academic papers have examined the available empirical evidence to see if it provides evidence of profit shifting. In these papers, high profitability in low tax countries is assumed to result from profit shifting. Given that Ireland has a relatively low statutory corporate tax rate and has been a significant recipient of US outward investment for several decades, it is not surprising that Ireland features regularly in such analysis and as a consequence is drawn into the tax haven debate. However, there are several important shortcomings of the research on this topic, outlined in this paper, which should be taken into consideration.

Hines and Rice in a 1994 paper produce a list of tax haven countries, one of which is Ireland. Although an academic paper that is now 15 years old, it remains very influential today. Because of its inclusion as a tax haven in this paper, Ireland has been included in later lists of tax havens that use Hines and Rice. Unfortunately, as this paper outlines, Ireland's inclusion in the original paper is deeply flawed for several reasons.

Despite the flawed analysis and the perception it created we can confidently state that Ireland is not a tax haven. The international community does not regard Ireland as a tax haven. Ireland is on the OECD/G20 white list of countries published in April, 2009. We are not regarded as a tax haven by the United States or any of the other major industrialised countries of the world.[14] This is evidenced by the large and growing network of tax treaties that Ireland has in place with other countries.[15] However, perception and how Ireland is seen abroad is important and in framing policy we need to take a balanced approach that has due regard to wider international developments.

[14] Doggart (2002) discusses in detail the haven lists used by several countries.

[15] As of October, 2009 Ireland has 46 Double Taxation Agreements ratified with a further 13 signed awaiting ratification. Ireland has also signed 9 TIEAs. Ireland has a strong record of transparency in the exchange of information. Ireland has refused to sign Double Taxation Agreements with countries that would not agree to the recognised principles on the exchange of information.

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