Key Financial Secrecy Indicator 9: Avoids Promoting Tax Evasion

What is measured?

KFSI 9 indicates whether a jurisdiction includes worldwide capital income in its income tax base and if it grants unilateral tax credits for foreign tax paid on certain foreign capital income. The types of capital income included are interest and dividend payments.

Three different payment scenarios are considered. First, payments received by an independent legal person. Second, payments received by a related party legal person. Third, payments received by a natural person.

A 50% transparency score is awarded for jurisdictions which grant unilateral tax credits for all payment scenarios for one type of payment (dividend or interest). If unilateral tax credits are granted only in some payment scenarios, for each single payment scenario with a tax credit, a 10% transparency score is awarded.

No points are awarded where a jurisdiction effectively exempts foreign income from domestic taxation, be it through a) a pure territorial tax system, or through exemptions; for b) specific payments (such as dividends); for c) specific legal entities (such as International Business Companies); through d) deferral rules which disable taxation unless income is remitted; or through e) zero or near zero tax rates (e.g. on corporate income).[1]

Similarly, in payment scenarios where countries only offer the option to deduct foreign payments from the tax base, or provide no unilateral double taxation relief whatsoever, no points are awarded.

The data[2] has been collected primarily through the IBFD-database[3]. In some instances we have also consulted the Worldwide Tax Summaries from PricewaterhouseCoopers[4] and other websites.

Why is this important?

In a world of integrated international economic activity and cross-border financial flows, the question about who taxes what portion of income has become increasingly complex. A conflict exists between the emphasis on taxing the income where it arises (i.e. at source), or taxing it where its recipient resides[5]. A mixture of both principles is implemented in practice.

However, this may lead to instances of so-called double taxation, when both countries claim the right to tax the same income (tax base). While the concept of "double taxation" is theoretically plausible, the real life occurrence is exceptionally rare[6] , especially since many

countries have adopted unilateral relief provisions to avoid double taxation. In addition, countries also negotiate bilateral treaties to avoid double taxation, so-called double taxation avoidance agreements (DTA). A potential third option, a multilateral legal platform for the taxation of transnational corporations' income is currently being explored by the OECD's BEPS[7] project, but is unlikely to come into effect in the foreseeable future.

Assuming that cross-border trade and investment can be mutually beneficial, the problem of overlapping tax claims (double taxation) needs to be addressed in one of both ways because it hinders cross-border economic activity. Bilateral treaties are expensive to negotiate, and often impose a cost on the weaker negotiating partner which is frequently required to concede lower tax rates in return for the prospect of more investment[8].

Home countries of investors or transnational companies offer unilateral relief from double taxation because they want to support outward investment. They do this primarily through two different mechanisms[9]:

a) By exempting all foreign income from tax liability at home (exemption);

b) By offering a credit for the taxes paid abroad on the taxes due at home (credit).

As the tables included in the database[10] indicate, in most cases it is a myth that bilateral treaties are necessary to provide relief from double taxation. Countries that are home to investors and transnationals typically offer provisions in their own laws to prevent or reduce double taxation.[11]

Where (especially capital exporting) countries refrain from providing unilateral relief, or only provide deduction of foreign taxes from the domestic tax base, they contribute to a problem of double taxation and thus indirectly exert pressure on capital importing countries to conclude bilateral treaties with the other country. These treaties in turn can expose capital importing countries to risks and disadvantages (see Note 8 above).

In addition, with more than 3000 double tax treaties currently in operation, the system has become overly complex and permissive, encouraging corporations to engage in profit shifting, treaty shopping and other practices at the margins of tax evasion (see here[12] for ways to address these issues and the various reports of the BEPS Monitoring Group[13]). This is the context in which we review unilateral mechanisms to avoid double taxation in the first place. However, not all such mechanisms are equally useful[14].

When using a **unilateral exemption mechanism** to exempt all foreign income from liability to tax at home, the residence country may be forcing other jurisdictions to compete for inwards investment by lowering their tax rates. Because investors or corporations will not need to pay any tax back home on the profit they declare in the foreign jurisdiction (source), they will look more seriously at the tax rates offered. This encourages countries to reduce tax rates on capital income paid to non-residents, such as withholding taxes on payments of dividends and interest.

Many countries provide tax exemption on capital income payable to non-residents, especially on interest payments on bank deposits and government debt obligations, or dividends. This may have an important collateral effect: countries not offering an exemption mechanism to their residents nonetheless may see their resident taxpayers move their assets and legal structures (such as holding companies) into those countries where capital income is not taxed or taxed lowly. By doing so, and because information sharing between states is weak, taxpayers can easily evade the taxes due at home on their foreign income. As a consequence, a country offering low or no taxes to non-residents promotes tax evasion in the rest of the world.

To summarise the logic:

First, unilateral tax exemption on foreign income puts pressure on source countries to reduce tax rates on investments by non-residents in a process of tax war (or competition).[15] Second, citizens and corporations from other countries make use of the low tax rates by shifting assets into these low-tax countries for the purpose of committing tax evasion. Third, in the medium term, the tax exemption of foreign income acts as an incentive for ruinous tax wars that will eventually lead to the non-taxation of capital income.

In contrast, a unilateral **tax credit system** does not promote tax evasion and does not incentivise the host countries of investments to lower their tax rates. A tax credit system requires that income earned abroad must be taxed at home as if it was earned at home, **unless** it has already been taxed abroad. In the latter case, the effective amount of tax paid abroad on the income will be subtracted from the corresponding amount of tax due at home.

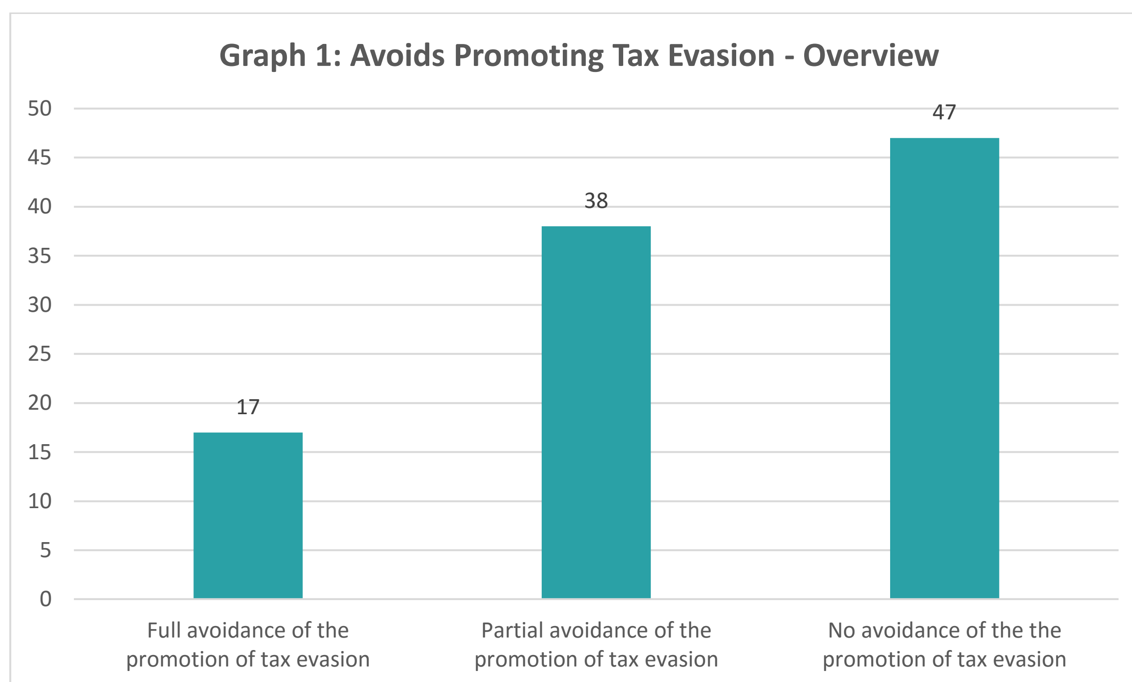
Therefore, for an investor the tax rate in a host country is no longer relevant to her investment decisions. Countries wishing to attract foreign investment will not feel compelled to lower the tax rates in the hope of increasing their inward stock of foreign investment. As a consequence, the tax evading opportunities of investors are reduced because fewer countries offer zero or very low taxation on capital income.

What harms might be cause by a lack of unilateral tax credits?

The indirect effect of an absence of unilateral tax credits is the promotion of tax wars and tax evasion in the rest of the world, as well as the facilitation of all other crimes (such as hiding the proceeds of bribery, drug trafficking, illegal arms trading) through reduced tax and reporting obligations in countries with no taxation of capital income. In addition, if a country promotes double tax treaties, the proliferation and number of bilateral tax treaties today is creating complexity to an extent that it is acting as corporate and financial secrecy. Under the cloak of such secrecy abusive treaty shopping and profit shifting can flourish.

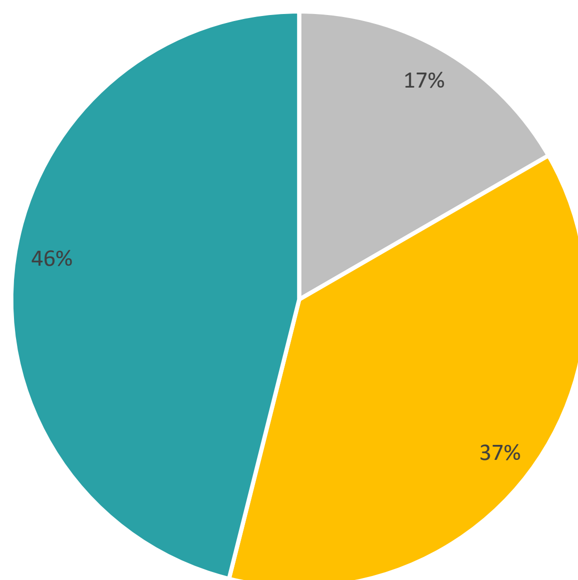
Results Overview

Table 1: Avoids Promoting Tax Evasion – Overview	
Full avoidance of promoting tax evasion	17
Partial avoidance promoting tax evasion	38
No avoidance of promoting tax evasion	47



Results Detail

Graph 2: Avoids Promoting Tax Evasion - Details



- Full avoidance of the promotion of tax evasion: BW, BR, CN, DK, DO, FI, GM, GR, IN, IL, KR, MK, MX, ME, PH, PL VE
- Partial avoidance of the promotion of tax evasion: AU, AT, BE, CA, CL, CK, CY, DM, EE, DE, GH, GG, HU, IS, IE, IM, IT, JP, LV, LU, MT, MC, NZ, NO, PT, RU, WS, SM, SI, ZA, ES, SE, TW, TZ, TR, GB, VI, US
- No avoidance of the the promotion of tax evasion: All other jurisdictions

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Table 2: Unilateral Tax Credits and Cross-Border Payment Scenario – Details	
Unilateral tax credit given for dividends paid to an independent person	30
Unilateral tax credit given for dividends paid to a related party legal person	22
Unilateral tax credit given for dividends paid to a natural person	40
Unilateral tax credit given for interest paid to an independent person	45
Unilateral tax credit given for interest paid to a related party legal person	45
Unilateral tax credit given for interest paid to a natural person	44

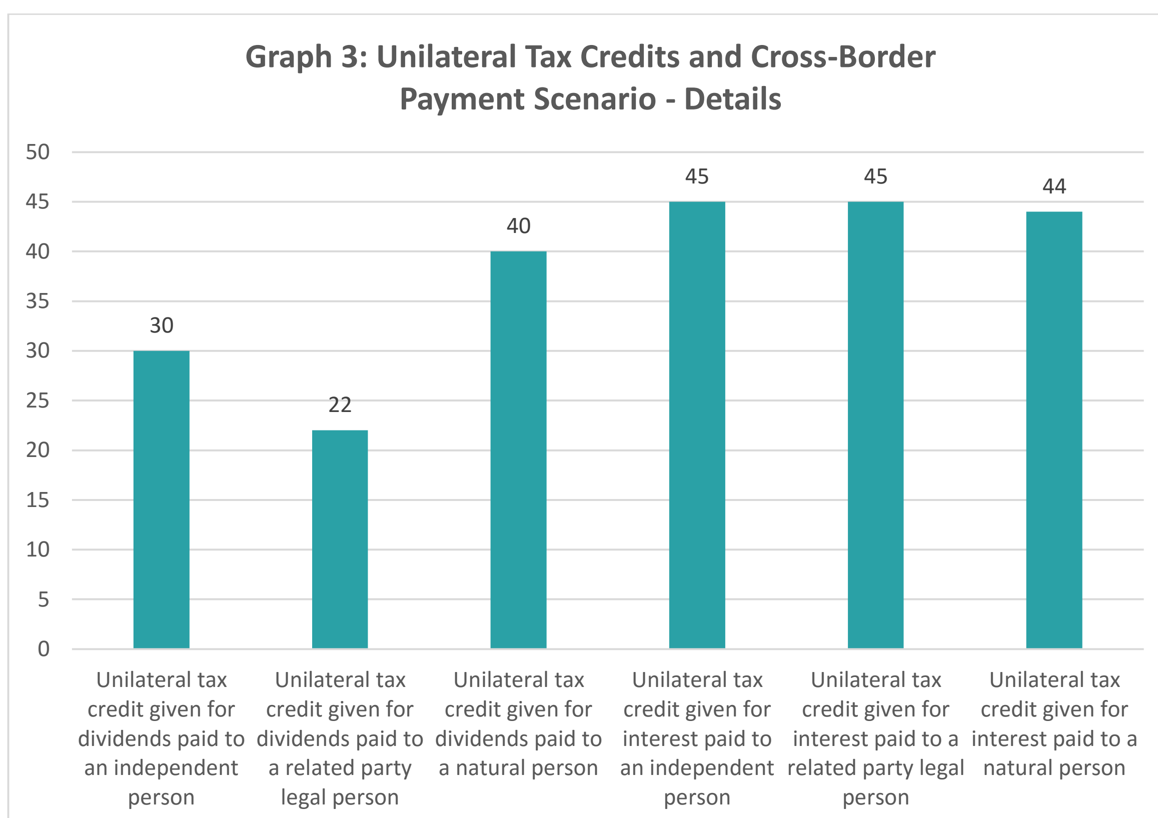

Table 3: Avoids Promoting Tax Evasion - Transparency Credits								
ID	**Country**	**ISO**	**Credits**		**ID**	**Country**	**ISO**	**Credits**
1	**Andorra**	AD	0		52	**Latvia**	LV	0.6
2	**Anguilla**	AI	0		53	**Lebanon**	LB	0
3	**Antigua & Barbuda**	AG	0		54	**Liberia**	LR	0
4	**Aruba**	AW	0		55	**Liechtenstein**	LI	0
5	**Australia**	AU	0.5		56	**Luxembourg**	LU	0.2
6	**Austria**	AT	0.7		57	**Macao**	MO	0
7	**Bahamas**	BS	0		58	**Macedonia**	MK	1
8	**Bahrain**	BH	0		59	**Malaysia (Labuan)**	MY	0
9	**Barbados**	BB	0		60	**Maldives**	MV	0
10	**Belgium**	BE	0.5		61	**Malta**	MT	0.2
11	**Belize**	BZ	0		62	**Marshall Islands**	MH	0
12	**Bermuda**	BM	0		63	**Mauritius**	MU	0
13	**Bolivia**	BO	0		64	**Mexico**	MX	1
14	**Botswana**	BW	1		65	**Monaco**	MC	0.3
15	**Brazil**	BR	1		66	**Montenegro**	ME	1
16	**British Virgin Islands**	VG	0		67	**Montserrat**	MS	0
17	**Brunei**	BN	0		68	**Nauru**	NR	0
18	**Canada**	CA	0.4		69	**Netherlands**	NL	0
19	**Cayman Islands**	KY	0		70	**New Zealand**	NZ	0.6
20	**Chile**	CL	0.5		71	**Norway**	NO	0.7
21	**China**	CN	1		72	**Panama**	PA	0
22	**Cook Islands**	CK	0.2		73	**Paraguay**	PY	0
23	**Costa Rica**	CR	0		74	**Philippines**	PH	1
24	**Curacao**	CW	0		75	**Poland**	PL	1
25	**Cyprus**	CY	0.6		76	**Portugal (Madeira)**	PT	0.7
26	**Czech Republic**	CZ	0		77	**Russia**	RU	0.2
27	**Denmark**	DK	1		78	**Samoa**	WS	0.2
28	**Dominica**	DM	0.2		79	**San Marino**	SM	0.2
29	**Dominican Republic**	DO	1		80	**Saudi Arabia**	SA	0
30	**Estonia**	EE	0.3		81	**Seychelles**	SC	0
31	**Finland**	FI	1		82	**Singapore**	SG	0
32	**France**	FR	0		83	**Slovakia**	SK	0
33	**Gambia**	GM	1		84	**Slovenia**	SI	0.6
34	**Germany**	DE	0.7		85	**South Africa**	ZA	0.6
35	**Ghana**	GH	0.2		86	**Spain**	ES	0.6
36	**Gibraltar**	GI	0		87	**St Kitts and Nevis**	KN	0
37	**Greece**	GR	1		88	**St Lucia**	LC	0
38	**Grenada**	GD	0		89	**St Vincent & Grenadines**	VC	0
39	**Guatemala**	GT	0		90	**Sweden**	SE	0.7
40	**Guernsey**	GG	0.2		91	**Switzerland**	CH	0
41	**Hong Kong**	HK	0		92	**Taiwan**	TW	0.4
42	**Hungary**	HU	0.6		93	**Tanzania**	TZ	0.5
43	**Iceland**	IS	0.6		94	**Turkey**	TR	0.6
44	**India**	IN	1		95	**Turks & Caicos Islands**	TC	0
45	**Ireland**	IE	0.1		96	**United Arab Emirates (Dubai)**	AE	0
46	**Isle of Man**	IM	0.2		97	**United Kingdom**	GB	0.2
47	**Israel**	IL	1		98	**Uruguay**	UY	0
48	**Italy**	IT	0.5		99	**US Virgin Islands**	VI	0.2
49	**Japan**	JP	0.7		100	**USA**	US	0.6
50	**Jersey**	JE	0		101	**Vanuatu**	VU	0
51	**Korea**	KR	1		102	**Venezuela**	VE	1

[1] Examples of pure territorial tax systems (a) include Panama and Hong Kong; examples of selective payment exemptions (b) include Cyprus and the United Kingdom; examples of specific legal entity exemption (c) include Luxembourg and Saint Kitts and Nevis; examples of exemption of income except if remitted (d) include the USA and Liberia; examples of countries applying a zero or near zero tax rate resulting in exemption (e) include Jersey and Guernsey. In practice, some of the aforementioned mechanisms may be combined to achieve non-taxation of foreign income.

[2] To see the sources we are using for particular jurisdictions please check out the corresponding information in our database, available at www.financialsecrecyindex.com/database/menu.xml.

[3] http://www.ibfd.org/IBFD-Tax-Portal/About-Tax-Research-Platform; 12.05.2015.

[4] http://www.pwc.com/taxsummaries; 12.05.2015.

[5] TJN-Briefing on source and residence-based taxation: http://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf; 12.05.2015.

[6] See pages 3 and 7 here: www.taxjustice.net/cms/upload/pdf/Unitary_Taxation_Responses-1.pdf; 12.05.2015.

[7] http://www.oecd.org/ctp/BEPSActionPlan.pdf; 19.7.2013.

[8] See, for instance, 1) a comprehensive analysis of the Netherlands double tax treaty network, here: somo.nl/publications-en/Publication_3958/at_download/fullfile; 12.5.2015; 2) the example of Switzerland renegotiating its DTAs with developing countries, pages 23-24, here: www.taxjustice.net/cms/upload/GlobalForum2012-TJN-Briefing.pdf; 12.05.2015, or for more details on this case (in German): http://www.alliancesud.ch/de/publikationen/downloads/dokument-24-2013.pdf ; 12.05.2015; 3) Neumayer, Eric 2007: Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?, in: Journal of Development Studies 43: 8, 1501–1519; and 4) Dagan, Tsilly 2000: The Tax Treaty Myth, in: New York University Journal of International Law and Politics 32: 939. A full literature review on the relationship between DTAs, development, growth and FDI can be found (in German) here: www.suz.uzh.ch/herkenrath/publikationen/workingpapers/FDI_EL-Forschungsnotiz-01-10.pdf; 12.05.2015.

[9] There is a third mechanism called “deduction” which is sometimes used to offer relief from double taxation. However, the deduction method does not offer full relief from double taxation. It allows deducting from foreign income (e.g. as a business expense) any taxes paid abroad before including this income in the domestic tax base. Therefore, we consider deduction to be similar to offering no mechanism for double taxation relief, since the incentives to conclude DTAs remain largely in place.

[10] http://www.financialsecrecyindex.com/database/menu.xml.

[11] It must be conceded, however, that unilateral provisions to avoid double taxation are not as effective at preventing double taxation as double tax treaties. For instance, there may be cases in which the rules determining the residency of taxpayers conflict between countries, leading to both claiming residence and full tax liability of one legal entity or taxpayer. However, for a number of reasons this argument is of limited relevance: a) these cases are the exception rather than the rule; b) pure economic “single taxation” is a theoretical concept derived from economic modelling that is only of limited value in real life. In many countries different types of taxes are levied on the same economic activity, for instance VAT is levied on the turnover of a company, then the profits stemming from the turnover are taxed through federal and state corporate income taxes, and in a third stage the investment income in form of dividends is again taxed in the hands of the shareholders. Nobody would reasonably speak about “triple taxation” in such a case. In a similar way, it is dubious to speak about double taxation in a cross-border context. To paraphrase Professor Sol Picciotto: “But double taxation is a dubious concept. First, it does not mean companies’ tax bills doubling: it means that there may (rarely) be some overlap between states’ taxing claims (think of this in terms of the overlap in a Venn diagram). Any overlap may result in a modestly higher overall effective tax rate, not a 'double' rate.” (See page 3, here: www.taxjustice.net/cms/upload/pdf/Unitary_Taxation_Responses-1.pdf; 12.05.2015). This “modestly higher overall effective tax rate“ could be higher than the corporate tax rate of one particular country, but it may still be lower than another country’s corporate tax rate. If one called this situation double taxation, then this implies speaking about double taxation

also in situations in which two unrelated companies operate in two different countries, with one country levying twice as high a corporate tax rate as the other country. This, of course, is non-sense and reveals the dubious and theoretically flawed nature of the concept of double taxation.

[12] www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf; 12.05.2015.

[13] https://bepsmonitoringgroup.wordpress.com/tag/bmg/; 12.05.2015.

[14] We are not looking at deduction in more detail because deduction of foreign taxes from domestic tax bases only provides partial relief from double taxation whereas the credit and exemption method both have in principle the capacity to completely avoid double taxation (see endnote 11 above for details). For details about the exemption and credit method, see for instance pages 19-22 in: United Nations Department of Economic & Social Affairs 2003: Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (ST/ESA/PAD/SER.E/37), New York, in: http://unpan1.un.org/intradoc/groups/public/documents/un/unpan008579.pdf; 12.05.2015.

[15] For a background on the terminology around tax competition and tax wars, see: http://foolsgold.international/fools-gold-rethinking-competition/; 12.5.2015.