

Key Financial Secrecy Indicators

9: Avoids Promoting Tax Evasion

What is being measured?

This indicator shows whether a jurisdiction grants unilateral tax credits for foreign tax paid on certain capital income. The types of capital income include interest and dividend payments.

Three different payment scenarios are analysed. 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, 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.

The data has been collected primarily through the IBFD-database¹. A secondary source was our TJN-Survey 2011. In addition, the Worldwide Tax Summaries from PricewaterhouseCoopers² have been consulted on some occasions.

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 the income is increasingly difficult to answer. A basic conflict exists between the emphasis on taxing the income where it arises, or taxing it where its recipient resides ([background here](#)³). A mixture of both principles is implemented in practice.

However, this may lead to instances of double taxation, when both countries claim the right to tax on the same income (tax base). In order to remedy such instances, countries have taken resort to unilateral relief provisions to avoid double taxation. In addition, countries may also conclude bilateral treaties in order to avoid double taxation, so-called double taxation avoidance agreements (DTA).

Assuming that cross-border trade and exchange can be mutually beneficial, the problem of double taxation needs to be addressed in one of both ways because it hinders cross-border economic activity. Treaties are expensive to negotiate, and often impose a cost on the weaker negotiating partner which frequently concedes lower tax rates in return for the prospect of more investment⁴.

Home countries of investors or multinational companies offer relief from double taxation because they want to promote outward investment. They do this primarily through two different mechanisms:

- 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](#)⁵ 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 multinationals typically offer provisions in their own laws to prevent double taxation⁶. Instead, these treaties can expose capital importing countries to risks and disadvantages. In addition, with more than 2500 double tax treaties in place today, the system has become overly complex and has offered corporations wide discretion with respect to their tax payments, inviting a practice called treaty shopping and other practices resting on abuse at the margin of tax evasion. These are the reasons why we analysed unilateral mechanisms to avoid double taxation in the first place. However, not all such mechanisms are equally useful⁷.

When using a **unilateral exemption mechanism** to exempt all foreign income from liability to tax at home, this residence country is inviting other jurisdictions to compete for the location of investments 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 has an important collateral effect: countries not offering an exemption mechanism to their residents nonetheless see their resident taxpayers move their assets and legal structures (such as holding companies) into these 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 creates incentives for host countries to reduce tax rates on investments by non-residents in a process of tax competition. Second, other country's citizens and corporations 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 competition 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.

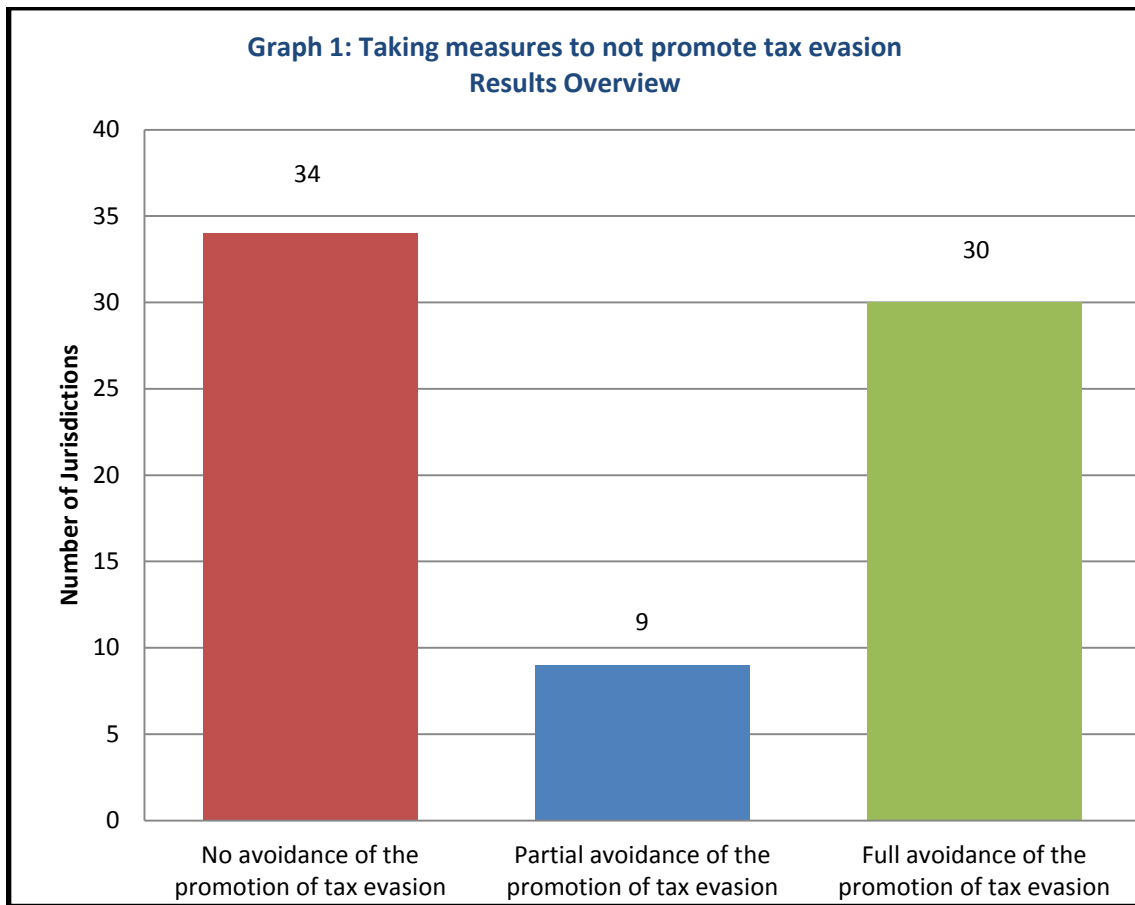
Therefore, for an investor the tax rate in a receiving country is no longer of relevance for her or his investment decisions. Countries wishing to attract foreign investment will not feel compelled to lower the tax rates in the hope of increasing their inward stock of foreign investment. As a consequence,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

What are the crimes that might hide behind a lack of unilateral tax credits?

While no crimes are directly covered up, the indirect effect of an absence of unilateral tax credits is the promotion of tax competition and tax evasion in the rest of the world, as well as the facilitation of all other crimes (such as hiding the proceeds of corruption, drug trafficking, illegal arms trade) 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 the numbers 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

No avoidance of the promotion of tax evasion	34
Partial avoidance of the promotion of tax evasion	9
Full avoidance of the promotion of tax evasion	30



Results Detail

Table 2: Unilateral Tax Credits and Cross-Border Payment Scenario - Some Details

Number of jurisdictions with unilateral tax credit for interest paid to related legal entity	39
Number of jurisdictions with unilateral tax credit for interest paid to independent legal entity	39
Number of jurisdictions with unilateral tax credit for interest paid to natural person	34
Number of jurisdictions with unilateral tax credit for dividends paid to related legal entity	32
Number of jurisdictions with unilateral tax credit for dividends paid to independent legal entity	36
Number of jurisdictions with unilateral tax credit for dividends paid to natural person	34

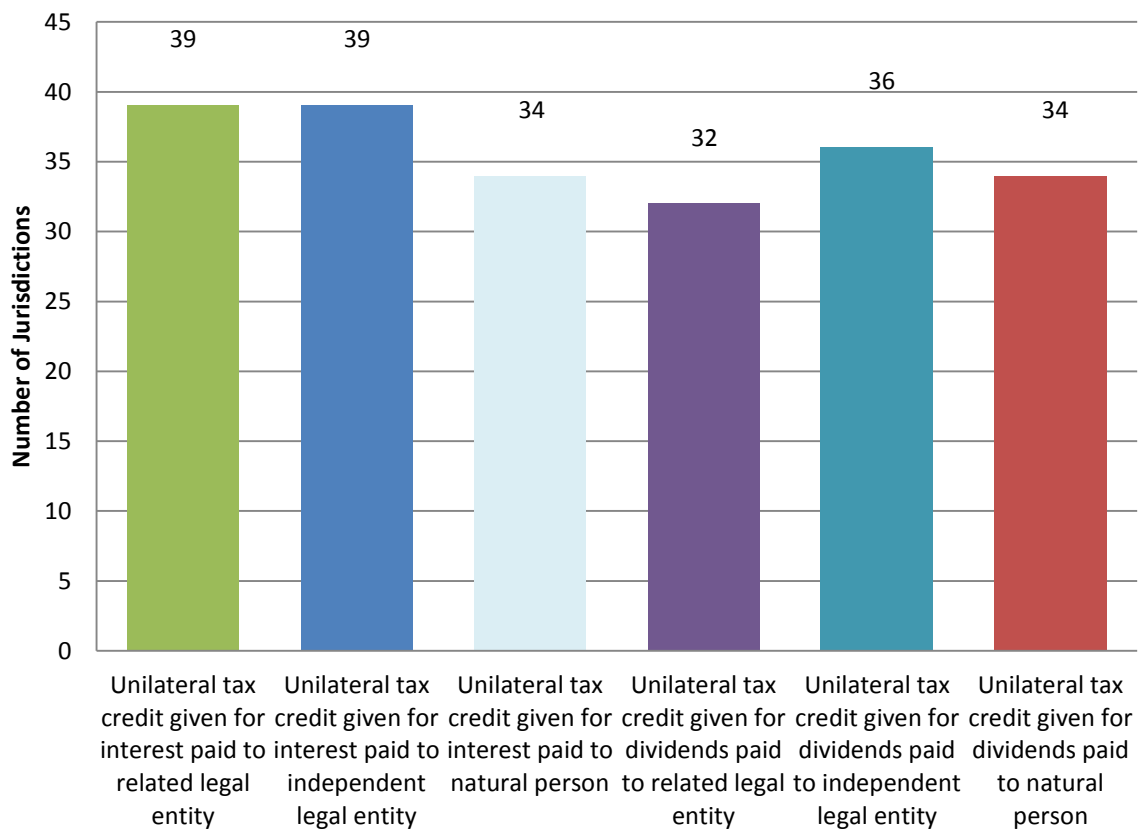
**Graph 2: Unilateral Tax Credits and Cross-Border Payment Scenario
Some Details**

Table 3: Taking measures to not promote tax evasion

ID	Jurisdiction	ISO	Transparency Credit	ID	Jurisdiction	ISO	Transparency Credit
1	Andorra	AD	0	38	Korea	KR	1
2	Anguilla	AI	0	39	Latvia	LV	0,7
3	Antigua & Barbuda	AG	0	40	Lebanon	LB	0
4	Aruba	AW	0	41	Liberia	LR	1
5	Austria	AT	1	42	Liechtenstein	LI	0
6	Bahamas	BS	0	43	Luxembourg	LU	1
7	Bahrain	BH	0	44	Macau	MO	0
8	Barbados	BB	1	45	Malaysia (Labuan)	MY	0
9	Belgium	BE	0,3	46	Maldives	MV	0
10	Belize	BZ	0	47	Malta	MT	1
11	Bermuda	BM	0	48	Marshall Islands	MH	0
12	Botswana	BW	1	49	Mauritius	MU	1
13	British Virgin Islands	VG	0	50	Monaco	MC	0,3
14	Brunei	BN	0	51	Montserrat	MS	0
15	Canada	CA	0,4	52	Nauru	NR	0
16	Cayman Islands	KY	0	53	Netherlands	NL	1
17	Cook Islands	CK	1	54	Netherlands Antilles	AN	0
18	Costa Rica	CR	0	55	Panama	PA	0
19	Cyprus	CY	0,6	56	Philippines	PH	1
20	Denmark	DK	0,7	57	Portugal (Madeira)	PT	1
21	Dominica	DM	1	58	Samoa	WS	1
22	France	FR	0	59	San Marino	SM	1
23	Germany	DE	0,6	60	Seychelles	SC	0
24	Ghana	GH	1	61	Singapore	SG	0,2
25	Gibraltar	GI	1	62	Spain	ES	1
26	Grenada	GD	0	63	St Kitts and Nevis	KN	0
27	Guatemala	GT	0	64	St Lucia	LC	1
28	Guernsey	GG	1	65	St Vincent & Grenadines	VC	1
29	Hong Kong	HK	0	66	Switzerland	CH	0
30	Hungary	HU	1	67	Turks & Caicos Islands	TC	0
31	India	IN	1	68	United Arab Emirates (Dubai)	AE	0
32	Ireland	IE	0,4	69	United Kingdom	GB	1
33	Isle of Man	IM	1	70	Uruguay	UY	0
34	Israel	IL	1	71	US Virgin Islands	VI	1
35	Italy	IT	1	72	USA	US	1
36	Japan	JP	1	73	Vanuatu	VU	0
37	Jersey	JE	0				

¹ <http://online.ibfd.org/kbase/>; 20.6.2011.² <http://www.pwc.com/taxsummaries>; 20.6.2011.

³ TJN-Briefing on source and residence-based taxation:

http://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf;
20.6.2011.

⁴ See, for instance 1) Neumayer, Eric 2007: Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?, in: Journal of Development Studies 43: 8, 1501–1519; and 2) Dagan, Tsilly 2000: The Tax Treaty Myth, in: New York University Journal of International Law and Politics 32: 939.

⁵ http://www.secrecyjurisdictions.com/sj_database/menu.xml.

⁶ It must be conceded, however, that unilateral provisions to avoid double taxation are not as comprehensively and totally preventing double taxation as double tax treaties do. 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 rather the exception 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.

⁷ 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>; 26.5.2011.