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Optimal fiscal barriers to international economic integration in the presence of tax havens☆

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ABSTRACT

This paper develops a model where firms can shift profits to tax havens by means of intra-firm loans and countries can protect themselves against profit shifting by taxing cross-border interest flows. The model considers two countries with a scope for welfare improving economic integration. The first-best tax system has two important characteristics: (i) the tax rate on interest flows to the other country is zero to ensure the optimal level of economic integration; (ii) the tax rate on interest flows to tax havens is high enough to deter profit shifting to tax havens. In second-best environments, countries face a trade-off between economic integration and protection against tax havens, which causes protection to be suboptimally low. The key to the result is that economic integration makes it easier for multinational firms to circumvent taxes on interest payments to tax havens with conduit loans. The paper thus provides an explanation for the empirical puzzle that many countries do not tax interest payments to tax havens despite the scope for profit shifting.

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1. Introduction

Multinational firms face strong incentives to shift profits from countries with high corporate taxes to tax havens. A common profit shifting technique uses intra-firm loans from finance subsidiaries in tax havens to operating subsidiaries in high-tax countries. Such loans generate a tax saving because the interest payments shift taxable profits from operating subsidiaries facing a high tax rate to finance subsidiaries facing a zero tax rate.

Recently, an interesting controversy has emerged about the welfare implications of profit shifting facilitated by tax havens. The conventional view that tax havens are harmful is formalized by Slemrod and Wilson (2009) in a model where tax havens provide tax evasion services to firms. In this setting, tax evasion reduces welfare due to unproductive use of resources by tax havens facilitating evasion and by tax administrations combating evasion. The alternative view that tax havens are beneficial is developed by Hong and Smart (2010) in a model where the corporate tax falls on both perfectly mobile capital employed by multinational firms and immobile capital employed by domestic firms. In this framework, profit shifting allows multinational firms to reduce their effective tax rate and thus improves efficiency by establishing a *de facto* differentiated capital tax with a lower effective rate on mobile capital than on immobile capital.[1]

Interestingly, Mintz (2004) notes that governments have access to a tax instrument capable of eliminating the scope for this type of profit shifting: Withholding taxes on interest payments to foreign entities effectively reduce the tax savings from intra-firm loans and thus constitute a fiscal barrier to profit shifting. Arguably, a general withholding tax on cross-border interest payments would place multinational firms at a disadvantage relative to other firms and therefore also constitute a fiscal barrier to economic integration. Under the view that tax havens are harmful, this suggests that optimal withholding taxes should be differentiated with a high rate applying to interest payments to tax havens and a zero rate applying to interest payments to other countries. Intuitively, such a tax system offers protection against profit shifting without impeding economic integration between countries.

Table 1 reports withholding tax schedules applying to intra-firm interest payments in 28 OECD countries. The first column lists the withholding tax rate stipulated by domestic law, which is the rate

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[1] Johannesen (2010a) points to a positive general equilibrium effect of tax havens. When tax competition for profits is imperfect in the sense that not all profits are shifted to the jurisdiction with the lowest tax rate, the tax game between *ex ante* identical countries may result in an asymmetric equilibrium with an endogenous fraction of high-tax and low-tax countries. In this setting, tax havens can potentially improve the welfare of countries by strengthening tax competition for profits, which induces low-tax countries to become high-tax countries.

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Table 1
Withholding tax rates on interest flows between related corporations (source country in rows, residence country in columns).
Source: PriceWaterhouseCoopers, Global Tax Summaries, Data extract on 2 March 2009.

	Domestic law	AT	BE	CZ	DK	FI	FR	GE	GR	HU	IE	IT	LU	NL	PL	PT	SP	SW	UK	AU	CA	JP	KO	MX	NZ	NO	CH	TR	US
Austria	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Belgium[a]	15	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	10	10	10	10	10	10	15	0	15	15
Czech Republic	15	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	10	10	10	10	10	10	0	0	20	0
Denmark	30	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Finland	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
France	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Germany	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Greece[b]	25	10	10	10	8	10	10	10	X	10	5	10	8	10	10	15	8	10	0	25	25	25	8	10	25	10	10	12	25
Hungary	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Ireland	0	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Italy	0	0	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Luxembourg	0	0	0	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Netherlands	0	0	0	0	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Poland[b]	20	10	10	10	5	0	0	5	10	10	10	10	10	5	X	10	0	0	5	10	15	10	10	15	10	0	10	10	0
Portugal[b]	20	10	10	10	10	10	10	10	10	10	10	10	10	10	10	X	10	10	10	20	10	20	15	10	20	15	10	15	10
Spain	18	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	X	0	0	10	15	10	10	15	10	10	0	15	10
Sweden	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	X	0	0	0	0	0	0	0	0	0	0	0
United Kingdom	20	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	X	10	10	10	10	15	10	0	0	15	0
Australia	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	X	10	10	10	10	10	10	10	10	10
Canada	25	10	10	10	10	10	10	10	25	10	10	10	10	10	15	10	15	10	10	10	X	10	10	10	15	10	10	25	0
Japan	20	10	10	10	10	10	10	10	20	10	10	10	10	10	10	20	10	10	10	10	10	X	10	10	20	10	10	15	10
South Korea	25	10	10	10	15	10	10	10	8	0	0	10	10	10	10	15	10	15	10	15	10	10	X	15	10	15	10	10	12
Mexico	28	10	15	10	15	15	10	15	10	28	10	10	10	15	15	10	15	15	15	15	10	15	15	X	10	15	15	28	15
New Zealand	15	10	10	10	10	10	10	10	15	15	10	10	15	10	10	15	10	10	10	10	15	15	10	10	X	10	10	15	10
Norway	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	X	0	0	0
Switzerland	35	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	10	10	10	10	15	10	0	X	35	0
Turkey	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	X	10
USA	30	15	15	15	15	15	15	15	30	15	15	15	15	15	15	15	15	15	15	15	15	10	15	10	15	15	15	20	X

Note: Rules are in some cases complex and the rates presented here are the rates that would – according to our judgment – apply to a finance structure as described in the paper. No data were available for Iceland and the Slovak Republic.

[a] Withholding tax exemption when the Belgium compamny acts as a conduit company for transactions between two non-Belgian companies.

[b] Temporary exemption from Council Directive 2003/49/EC abolishing taxes on intra-firm interest flows within the EU. Rates to EU countries will fall to 5% on 1 July 2009 and 0% on 1 July 2013.

applying to interest flows to tax havens. Subsequent columns list withholding tax rates applying to interest flows to other OECD countries as specified by bilateral treaties and other international agreements. Generally, interest flows between OECD countries are subject to very low tax rates, most notably a zero rate applies to interest flows between EU countries.[2] This is consistent with the standard argument that countries benefit from a joint elimination of barriers to economic integration. Perhaps more surprisingly, a considerable number of countries, in particular EU countries, do not tax interest payments to tax haven entities. Evidently, a zero tax rate on interest payments to tax havens maximizes the benefits associated with tax planning by allowing firms to shift profits to tax havens at no tax cost.[3]

The absence of fiscal barriers to profit shifting is clearly consistent with the Hong–Smart view of tax havens. If profit shifting improves efficiency, there is no reason to expect that countries would tax intra-firm interest payments. Moreover, the absence of fiscal barriers to profit shifting is, seemingly, incompatible with the Slemrod–Wilson view of tax havens. If profit shifting to tax havens leads to wasteful use of resources, it is puzzling that a large number of countries do not set sufficiently high fiscal barriers to eliminate the scope for this type of tax planning. An important contribution of the present paper is to expose a mechanism that causes fiscal protection against tax havens to be suboptimal (or entirely absent) even when tax havens are harmful. This reconciles the Slemrod–Wilson view of tax havens with observed features of real-world tax systems.

This paper analyzes taxation of cross-border interest flows in a model of international economic integration. The model considers two countries, Home and Foreign, with a scope for welfare improving economic integration. Each country has access to three tax instruments: a corporate tax, a tax on interest payments to entities in the other country, an *internal fiscal barrier*, and a tax on interest payments to entities in tax havens, an *external fiscal barrier*. Firms are heterogeneous with respect to productivity and optimally choose whether to produce only domestically or in both countries.[4] Firms also make optimal decisions on the following two interrelated dimensions of financial policies: Firstly, they choose the capital structure of their operating subsidiaries including the amount of financing with intra-firm loans. Secondly, they decide whether to provide the intra-firm loans through a subsidiary in a tax haven and whether these loans should be direct loans or conduit loans. For instance, if Home sets a high external barrier to deter profit shifting, it may be optimal for firms producing in both countries to let the tax haven subsidiary grant a loan to the operating subsidiary in Foreign, which passes on

[2] Council Directive 2003/49/EC known as the *Interest and Royalty Directive* abolished withholding taxes on interest flows between related EU companies as from 1 January 2004, however, Portugal, Greece and Poland were conceded transitory arrangements allowing for withholding taxes until 1 July 2013.

[3] Admittedly, many countries have rules applying to controlled foreign companies (hereinafter "CFC rules") under which income earned by a finance subsidiary established in a tax haven could be subject to domestic corporate tax. Such CFC-rules may, however, be circumvented in a number of relatively simple ways: (i) "De-controlling": the finance company issues preferred shares to a third party whereby the ownership share of the parent company is diluted making the finance company fall outside the scope of the CFC-rules whereas effective control is retained; (ii) "Swamping": profits from the real activities of the firm are channeled through the finance company whereby the fraction of passive income in the finance company is reduced so it does not fall under the CFC-rules; (iii) "Migration": the ultimate parent company of the firm is established in a tax haven and this parent directly owns the finance company in which case the CFC-rules of the countries where the firm operates do not apply.

[4] This feature of the model bears some resemblance to Helpman et al. (2004) except that firms can only enter foreign markets by way of direct investment and not by way of exporting.

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