The Economic and Social Review, Vol. 44, No. 3, Autumn, 2013, pp. 401–424

POLICY PAPER

What Makes a Country a Tax Haven? An Assessment of International Standards Shows Why Ireland Is Not a Tax Haven

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Abstract: This paper explores the issue of tax havens and tax competition. The recent intensified debate on tax havens is summarised, as is the important work of the OECD, the EU and the G-20 in this area and the ongoing research on the economic effects of tax havens. Ireland does not meet any of the OECD criteria for being a tax haven but because of its 12.5 per cent corporation tax rate and the open nature of the Irish economy, Ireland has on a few occasions been labelled a tax haven. There are three primary reasons for this identified, each addressed in the paper: a failure to distinguish between legitimate and abusive transfer pricing; a misunderstanding of the role and regulation of IFSC; and a dated but influential academic paper from 1994 that incorrectly included Ireland in a list of tax havens, based on a reason that has long since lost any validity.

I INTRODUCTION

For a variety of reasons the issue of tax havens has been receiving worldwide attention of late. In 2008, a global tax scandal erupted after a former employee of a Liechtenstein trust company provided tax authorities around the world with account data on about 1,400 clients of the company. Since then, a number of similar scandals have broken. There have been

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We are grateful to colleagues and an anonymous referee for comments. All opinions expressed in this paper are the personal views of the authors and the authors alone are responsible for the conclusions.

increased investigations by both governments and non-governmental organisations into the role of tax havens.

In response, actions by the Organisation for Economic Cooperation and Development (OECD) and the G-20 group of industrialised and developing nations began to target more attention on tax havens. In 2009, a so-called "black list" of territories that refused to exchange tax information was published by the OECD. Since the publication of this list events have moved quite rapidly. This can be seen in European Commission proposals, published in 2012, that aim to tackle tax fraud and aggressive tax planning.

In February 2013, the OECD published a new report on Base Erosion and Profit Shifting (BEPS – OECD, 2013a). In July, the OECD published an Action Plan on BEPS that will be developed over the coming months (OECD, 2013b). Also recently, the so-called 'off shore leaks' story by the International Consortium of Investigative Journalists has further sharpened the focus on this issue.

Tax transparency remains at the top of the global economic agenda. On occasions in recent years, this debate has focused attention on Ireland's tax system. While Ireland does not display any of the characteristics of a tax haven, it has sometimes been incorrectly labelled as one. This was seen again in the recent coverage of a US Senate subcommittee. But as this paper demonstrates, this labelling is wrong and misleading.

A central problem in 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 or territories that offer favourable tax regimes for foreign investors.[1] Low income or corporate tax rates are often a feature, but there are a variety of other elements, such as bank secrecy laws, that are equally or more important.

This paper explores the policy debate on the issue of tax havens, both in Ireland and internationally. The aim is to provide an overview of the current state of play in policymaking and academic understanding. The paper does not take any ideological perspectives but rather focuses on the evidence based arguments around the definition of tax havens.

The next section examines internationally recognised definitions of tax havens and the impact of tax havens from an economic perspective. The recent intensified debate on tax havens is summarised in Section III. Finally, in light of the above, the paper discusses whether Ireland can reasonably be labelled

[1] The term 'offshore financial centre' is used to describe some countries with tax haven characteristics. Notwithstanding that there may be technical differences between a tax haven and an offshore centre, in this paper the term tax haven is used throughout.

a tax haven. Three key topics are examined: the tax practices of multinational companies (including transfer pricing issues), the role of the IFSC and academic research on tax havens.

II THE IMPACT OF TAX HAVENS

2.1 *Definitions of Tax Havens*

Given the importance of the issue and the international commitments in this area, it might be expected that identifying tax havens would be straightforward, but this is not the case. There is no agreed definition of what the term "tax haven" actually means.

Probably the best known definition of a tax haven is that used by the OECD (1998). Four key indicators of tax havens are identified:

1. No or only nominal taxes (and offering, or being perceived as offering, a place for non-residents to escape tax in their country of residence);
2. Lack of transparency (such as the absence of beneficial ownership information and bank secrecy);
3. Unwillingness to exchange information with the tax administrations of OECD member countries; and
4. Absence of a requirement that activity be substantial (transactions may be "booked" in the country with no or little real economic activity).

The US Government Accountability Office (GAO, 2008) conducts an extensive review and finds no agreed definition of a tax haven. However, in broad terms the GAO finds that the OECD definition to be representative.[2] As a consequence of the lack of an agreed upon definition of the term tax haven, it is not surprising that lists of tax haven countries also differ quite widely.

Gravelle (2013) in a report on tax havens by the US Congressional Research Service includes a long list of countries with tax haven characteristics including: the UK, Denmark, the Netherlands and Portugal among others. Gravelle also notes that in the US the states of Delaware, Wyoming and Nevada, have certain features of tax havens.

Shaxson (2011) focuses on the UK and connected tax havens from a more historical context. Shaxson identifies a "spider's web" of havens, centred around the City of London: Britain's crown dependencies (Jersey, Guernsey and the Isle of Man), overseas territories that are substantially controlled by

[2] In addition to the criteria listed by the OECD, the GAO found that self-promotion as an offshore centre was another commonly found characteristic of tax havens.

Britain (e.g., the Cayman Islands) and a more diverse array of havens outside Britain's direct control but with strong links (e.g., Hong Kong).

Others have examined the common characteristics of tax haven countries. Many of the most recognised tax havens are very small in size and often island states (Dharmapala, 2008). Dharmapala and Hines (2009) find that tax havens are on average substantially more affluent than non-havens. Tax havens are likely to be well governed and are more likely to have British legal origins (many remain dependent territories as opposed to sovereign states). In addition to being smaller in population and more likely to be island countries, havens' geographical characteristics also lead them to be more inclined towards economic openness.

2.2 *The Potential Costs of Tax Havens Are High*

The Tax Justice Network (TJN), an NGO that seeks to promote transparency in international tax and finance matters, argues that tax havens undermine the interests of poor countries. They estimate the cost of tax havens to the global economy to be in the trillions of dollars. TJN (2012) argues that secret bank accounts and offshore trusts in tax havens provide wealthy elites and companies with the means to escape their tax obligations. This deprives poorer nations of the tax revenue they need and allows multinationals to substantially lower their taxable income by routing capital flows through mailbox companies in tax havens to gain unfair advantage over competitors. 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 the drugs trade.

The use of havens for tax avoidance and evasion can fall into two broad categories. The first is 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. In the Irish case, there tends to be more focus on the latter but it is important to note the relative sizes of each in the global context.

Gravelle (2013) surveys the literature and finds that the estimated tax revenue cost to the US from the use of tax havens by companies is in the range of \$10 billion to \$90 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.

Tax avoidance and evasion is potentially very important in monetary terms. By its nature, measuring the scale of tax evasion and avoidance activity in tax havens is difficult. If the estimates above are accurate, they represent significant tax revenue losses to governments that could otherwise be used to alleviate poverty or redistribute welfare in societies affected.

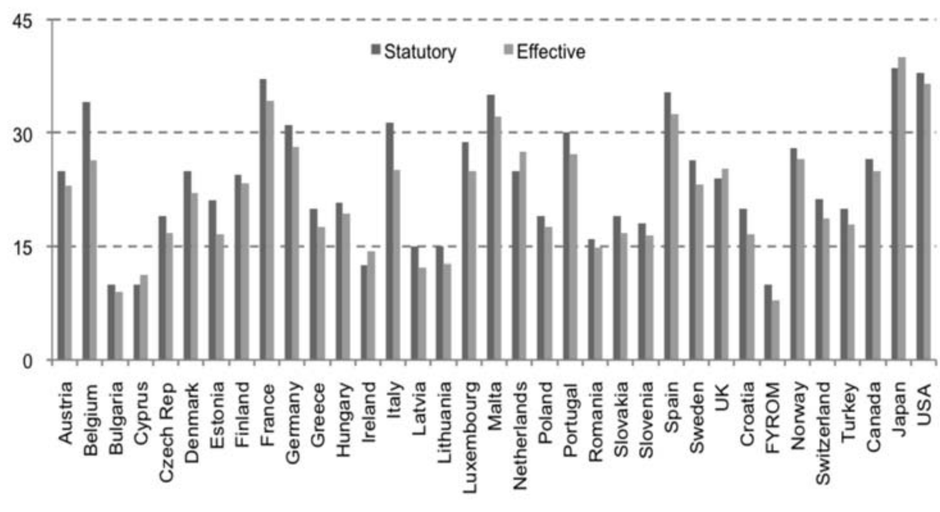
2.3 *Tax Competition: Rates, Effective Rates and Tax Complexity*

From a theoretical perspective, the standard approach to tax havens, for example as modelled in Slemrod and Wilson (2009), is based on the belief that tax havens encourage or intensify international tax competition. This forces countries to compete on declining tax rates to attract investment (encouraging a "race to the bottom") and, therefore, lowers tax revenue in affected countries.

Corporation tax rates do impact on investment. In a review of empirical studies, de Mooij and Ederveen (2003) find an average semi-elasticity of –3.3 (i.e., a 1 per cent reduction in a country's corporation tax rate increases inward foreign direct investment (FDI) by 3.3 per cent). An OECD study (2008) finds an elasticity of –3.7.

Figure 1 compares the statutory and effective tax rates in several countries.[3] Ireland is unusual in that its effective rate is above the statutory rate – the result of a low rate applied to a broad tax base. In many countries a high statutory rate is mitigated by its application to a relatively narrow base and so producing a lower effective rate. In terms of tax havens and their impact on tax competition, it is clear that looking at the statutory rate alone is not sufficient.

Figure 1: *Effective and Statutory Corporation Tax Rates*

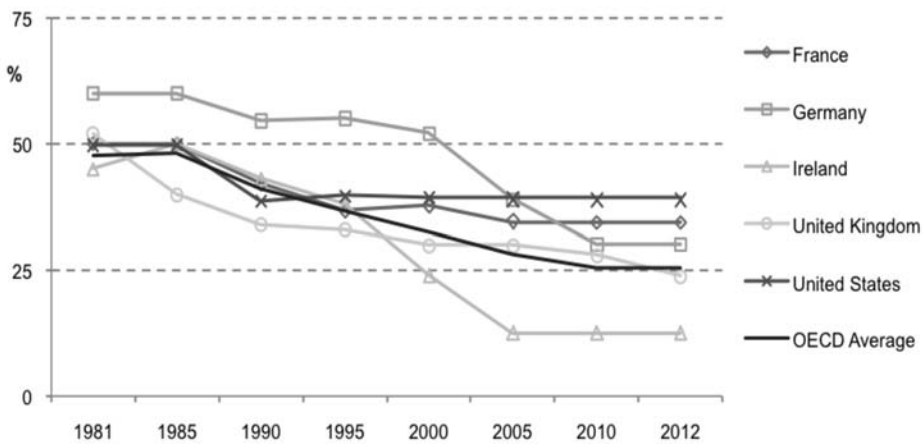


Source: Spengel *et al.* (2012) data and authors' calculations.

[3] Comparing effective tax rates is difficult and the subject of an entire literature of its own. For the analysis here (Figure 1), data are sourced from a recent study for the European Commission.

The theory of tax competition suggests that tax havens may have a negative impact by intensifying tax competition and encouraging the lowering of tax rates. Globalisation of flows of investment and the increasingly international structure of supply chains of multinational companies has been a factor in falling corporation tax rates (Figure 2).

Figure 2: *Statutory Corporation Tax Rates Over Time – Selected Countries*



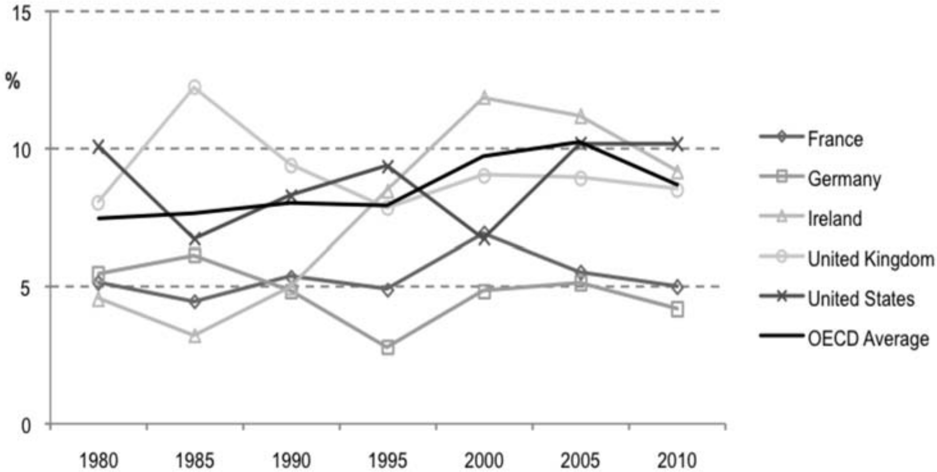
Source: OECD data and authors' calculations.
Note: Rate is combined central and regional rate for countries with federal systems.

Despite reductions in rates, the empirical evidence shows that increased tax competition has not resulted in an erosion of the US or EU corporate tax bases. Figure 3 shows the share of total tax revenue from corporation taxes in several countries over recent decades.

OECD countries have made considerable reductions in their statutory corporation tax rates. However, revenues from corporation tax have remained relatively stable in the OECD and EU over that period and actually increased in some cases (Nicodeme, 2006).[4] Dharmapala (2008) notes that the share of US tax revenue from corporate taxes 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 corporation tax rate did not change). Aside from the tax rate, the other key tax-related determinants of company behaviour are the tax base (affecting the effective tax rate) and tax complexity.[5]

[4] Base broadening and increased rates of incorporation have contributed to this effect (OECD 2013a).
[5] There are other important, non-tax determinants but the focus in this paper is on tax havens.

Figure 3: *Share of Total Taxation from Taxes on Corporate Income*



Source: OECD data and authors' calculations.

The relative size of an economy's tax base depends on the rules defining what constitutes taxable income. Given the international nature of FDI, flows of money into or out of a country can also affect the absolute size of the base. These flows are affected by tax rates and can themselves have significant impacts on the effective rate in a country. De Mooij (2005) finds a semi-elasticity of –2 for the tax base (i.e., a 1 per cent reduction in a country's corporation tax rate increases the tax base by 2 per cent), suggesting that taxable profit increases in a country as tax rates decrease. One potential source for an increase in tax base is profit shifting via transfer pricing (explored in detail in Section 5.3 of this paper). Tax havens or low tax countries may be used to facilitate base erosion, as the OECD BEPS report shows (OECD, 2013a).

Tax complexity, or the ease of fulfilling a company's tax obligations in a country, plays a role in tax competition also. Lawless (2009) finds that a 10 per cent reduction in tax complexity has an equal effect on FDI to a 1 per cent reduction in the effective corporation tax rate.[6] When examining competition between countries, this is an important element to consider, as the operating environment can be as important as the tax rate in determining the attractiveness to investment. In the annual World Bank / IFC and PWC (2012) *Doing Business* study, Ireland is ranked as the sixth easiest place to pay taxes globally (the only EU country in the top ten).

[6] Tax complexity is measured as the time required dealing with tax obligations and the number of tax returns needed for a representative company in each country.

In all three of these areas (corporation tax rates, bases and complexity), tax havens may accentuate tax competition, by advantaging some companies that use the features of havens to reduce their tax liabilities, and the negative consequences that occur if that causes a damaging "race to the bottom".

2.4 *Are There Factors that Mitigate the Effects of Tax Competition?*

Two papers by Desai, Foley and Hines (2006a, 2006b) offer insights into why tax havens may not intensify tax competition to the extent that might be expected. Desai *et al.* (2006a) model demand for tax havens. As would be expected, demand arises from companies' desire to reduce their taxes and is found to be highest with larger, more complex companies. However, Desai *et al.* (2006b) show that increased use of tax havens does not appear to divert activities from non-haven countries. Investments in haven and non-haven countries are found to be complimentary rather than substitutes. Hong and Smart (2010) also find evidence that tax havens allow multinational companies to lower their investment costs in both haven and non-haven countries (lower costs encourage further investment in both types of country).

A particular example of this effect is the structure of the US tax system, which taxes income on a residency basis (rather than a source basis) and taxes US companies on their total worldwide income. As Barry (2008) explains, with reference to Hines and Rice (1994), US multinationals are provided with a credit by the US tax administration for their aggregate tax paid abroad. This tax credit does not provide any rebate for taxes paid above the US corporation tax rate. If a US company operates in a country with a higher corporation tax rate, the option of paying tax in a low tax country (lower than the US rate) reduces the disincentive of the company to invest in the higher tax country.

On the broader issue of low corporation tax rates and their impact on growth, there is evidence of a "tax and growth ranking" (Johansson, Heady, Arnold, Brys and Vartia, 2008). Johansson *et al.* (2008) show that some taxes are more harmful than others to economic growth (measured as GDP per capita). From most to least harmful: corporate income, personal income, consumption and property taxes. If tax competition encourages lower corporation taxes, the other taxes that may be increased to provide alternative revenue sources are less harmful to overall economic growth.

Baldwin and Krugman (2004) show differences in corporation 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, for a "peripheral" country, such as Ireland, a lower tax rate attracts investment and compensates for other limitations that would not impact a centrally located or "core" European country.

III INTERNATIONAL INITIATIVES TO REDUCE THE HARMFUL EFFECTS OF TAX HAVENS

As Section II discusses, the impact of tax havens may not be universally negative. Nevertheless, 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. More recently, other international organisations, such as the G-20 and the EU, have taken an increasing interest in the area.

The OECD started the process with its 1998 report *Harmful Tax Competition: An Emerging Global Issue.* The report established a recognised OECD definition of tax havens (described in Section II). This definition, which remains in force, includes the existence of no or only nominal taxes but also a lack of transparency and an unwillingness to exchange information between tax administrations.

Following this report, a dialogue commenced between the OECD members and other jurisdictions. In 2002, a working group developed the OECD model Tax Information Exchange Agreement (TIEA).[7,8] Afterwards, a number of OECD members, including Ireland, commenced negotiations with other committed jurisdictions with a view to concluding bilateral TIEAs based on the OECD model. Progress was initially slow. However, the position recently changed dramatically.

In April 2009, the G-20 countries issued a list identifying jurisdictions that were not in compliance with the OECD standard on exchange of information. The G-20 communiqué set a threshold of 12 international agreements being in place, either TIEAs or double taxation agreements (DTA) that allow for information exchange.[9] Until a country reaches this threshold, it will not be regarded as having substantially implemented the OECD standard.

A number of countries that previously wanted to maintain bank secrecy in relation to tax matters (Switzerland, Luxembourg, Austria and Belgium) committed to the OECD standard in the wake of the G-20 communiqué. So too have important non-OECD financial centres such as Singapore and Hong Kong.

[7] Ireland was a member of this working group

[8] A TIEA, based on the OECD model, allows the tax authorities in both countries to request their counterpart to provide information relevant to a tax investigation. Typical information requests relate to bank accounts and ownership information for companies and trusts. The information is exchanged directly between the tax authorities. Similar exchange provisions are found in double taxation agreements but those in a TIEA are spelt out in more detail. The agreement does not provide for automatic or spontaneous exchange of information. Requests must be specific and trawling exercises are not allowed.

[9] A DTA, sometimes known as a tax treaty, is a bilateral agreement between two countries to prevent double taxation of an individual or entity on the same income in both countries.

The OECD made it clear that 12 international agreements was just a starting point and jurisdictions will be required to sign agreements with all countries that ask them in the future. In 2009/10 the OECD 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 transparency for tax purposes globally.[10]

The new organisation, the *Global Forum on Transparency and Exchange of Information for Tax Purposes*, comprises over 100 countries and is responsible for implementing robust and transparent peer reviews of countries to ensure they meet the OECD standards on exchange of information. All information on the peer reviews is made public, including recommendations, actions to address deficiencies and material on exchange of information agreements. Table 1 shows the jurisdictions that are judged to have substantially implemented the internationally agreed tax standards at the end of 2012.

At European level, in March 2012, the European Council invited Member States, to "… review their tax systems with the aim of making them more effective and efficient, removing unjustified exemptions, broadening the tax base, shifting taxes away from labour, improving the efficiency of tax collection and tackling tax evasion" (European Council, 2012a).

The European Commission published a Communication in June 2012 to combat fraud and tax evasion (European Commission, 2012a). The Council of Finance Ministers (European Council, 2012b) responded with Council conclusions in November 2012 and in December the Commission published an Action Plan and two Commission Recommendations dealing with Good Governance and Aggressive Tax Planning (European Commission, 2012b). During the recent Irish Presidency, agreement was reached by EU Finance Ministers on comprehensive Council conclusions on tackling aggressive tax planning, tax fraud and evasion (European Council, 2013).

The OECD has also made the issue of Base Erosion and Profit Shifting (BEPS) a central concern of its work in the area of tax. A report on BEPS was published in February 2013 (OECD, 2013a). The report provides an overview of the root causes of BEPS, and highlights the key areas to be considered in formulating a comprehensive action plan. The BEPS report makes clear that,

[10] The Global Forum is a multilateral framework within which work on transparency and exchange of information has been carried out by OECD and non-OECD members since 2000 (http://www.oecd.org/tax/transparency/abouttheglobalforum.htm). The Financial Action Task Force is an inter-governmental body established in 1989 to set standards and promote effective measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system (http://www.fatf-gafi.org/).

Table 1: *Jurisdictions that have Substantially Implemented the Global Forum Tax Standard*

Andorra	Chile	Iceland	Netherlands	South Africa
Anguilla	China	India	New Zealand	Spain
Antigua &	Cook Islands	Indonesia	Norway	Sweden
Barbuda	Costa Rica	Ireland	Panama	Switzerland
Argentina	Curacao	Isle of Man	Philippines	Turkey
Aruba	Cyprus	Israel	Poland	Turks &
Australia	Czech Republic	Italy	Portugal	Caicos Islands
Austria	Denmark	Japan	Qatar	United Arab
The Bahamas	Dominica	Jersey	Russian	Emirates
Bahrain	Estonia	Korea	Federation	United
Barbados	Finland	Liberia	St Kitts & Nevis	Kingdom
Belgium	France	Liechtenstein	St Lucia	United States
Belize	Germany	Luxembourg	St Vincent &	Uruguay
Bermuda	Gibraltar	Macau, China	the Grenadines	US Virgin
Brazil	Greece	Malaysia	Samoa	Islands
British Virgin	Grenada	Malta	San Marino	Vanuatu
Islands	Guatemala	Marshall Islands	Seychelles	
Brunei	Guernsey	Mauritius	Singapore	
Canada	Hong Kong,	Mexico	Sint Maarten	
Cayman	China	Monaco	Slovak Republic	
Islands	Hungary	Montserrat	Slovenia	

Source: OECD (2012).

given the international nature of business and trade flows in the modern global economy, it is unlikely that any single country can address these issues. Multilateral and coordinated actions by governments lie at the heart of the approach proposed to tackle BEPS issues.

The Irish Government welcomed the initial report on BEPS (OECD, 2013a). Ireland, along with all other OECD members, was actively involved in developing the action plan on BEPS recently published (OECD, 2013b) and this engagement will continue as a coordinated effort at OECD level is the most appropriate response for Ireland to address the challenges that BEPS poses.

There is interaction between the BEPS project and work at EU level in the area of tax havens and aggressive tax planning. In its recently ended EU Presidency role, Ireland invited the OECD to participate in discussions on BEPS. Ireland also chaired meetings to consider many of these issues including proposals to coordinate measures to address mismatches of treatment in the case of "hybrid" business entities that enable the double *non*-taxation of income flows across borders, whether by deduction in one country with no matching taxable receipt in the other country or by obtaining a deduction for the same payment in more than one country. The exploitation of mismatches between countries of the treatment of entities for tax purposes also demonstrates the need for a coordinated response across countries to the avoidance opportunities presented to multinational corporations by their ability to operate across national borders.

The BEPS approach has been endorsed by the G-20. The April 2013 G-20 communiqué, re-iterating the fight against international tax evasion and emphasising the need for systematic exchange of information, confirms these issues remain highly topical.

IV WHY IRELAND IS NOT A TAX HAVEN

4.1 *An Open Economy with a Favourable Corporation Tax Regime*

By any measure with regard to exports or FDI relative to size, Ireland is a very open economy (Forfás, 2012; FitzGerald and Kearney, 2013). Due to strong growth in services, Irish exports of services and merchandise goods are now broadly equal. Ireland's share of global services trade is now nearly three times its share of goods trade.

Ireland's success in attracting investment is due to several factors. A favourable tax regime that makes Ireland an attractive location for multinational companies is one factor but there are a range of other advantages that all contribute to encouraging investment in Ireland. These include access to the European market, membership of the Euro, an English speaking population and an institutional structure that adapts rapidly. A good education system and the accumulation of agglomeration effects are also important (Barry, 2006). The concentration of industries such as pharmaceuticals and ICT related activities shows that a relatively small country can achieve significant agglomeration effects.

Ireland maintains a low general corporation tax rate by ensuring a wide tax base. The Irish 12.5 per cent corporate rate is a general rate on trading activity.[11] As such, it is centred on activities with real substance and is not focused on any particular sector or segment of Irish industry. There is no distinction between small and large enterprises or between enterprises that service the local economy and those that have a multinational focus.

As Figure 3 (in Section II) shows, corporation tax receipts in Ireland represent about the average collected by such taxes across the OECD, notwithstanding the importance of FDI in Ireland.

[11] The standard rate of Irish corporation tax rate on trading activity is 12.5 per cent. The corporation tax rate on non-trading income is 25 per cent. There is also a 25 per cent rate that applies to oil and gas exploitation.

4.2 *Why Is Ireland Sometimes Described as a Tax Haven?*

Ireland was on the OECD/G-20 white list of countries published in April 2009 (as it fully complies with OECD standards on exchange of tax information). As Table 1 shows, Ireland is also included in the list of countries that have substantially implemented Global Forum standards on transparency and exchange of information. The January 2011 *Global Forum Peer Review Report* on Ireland's legal and regulatory framework for transparency and exchange of information finds that Ireland has an effective system for the exchange of information in tax matters and is fully compliant with OECD standards.

Ireland is not regarded as a tax haven by the US or any of the major industrialised countries of the world. This is evidenced by the large and growing network of tax treaties that Ireland has in place with other countries.[12]

Ireland has fully implemented the EU Saving Directive, which collects and exchanges information on individuals in receipt of saving incomes between member states, since its inception in 2005.

In late 2012 Ireland concluded a new intergovernmental 'FATCA' agreement with the United States.[13] FATCA provides for the automatic reporting and exchange of information in relation to accounts held in Irish financial institutions by US persons, and the reciprocal exchange of information regarding US accounts held by Irish people. The main purpose of FATCA is to combat international tax evasion, by preventing individuals from hiding money outside of either state in order to avoid paying tax. Ireland was only the fourth country in the world to have concluded such an agreement and it is a welcome opportunity to demonstrate Ireland's commitment to helping combat international tax evasion.

Despite the above, Ireland, just like many other countries, has on occasion been criticised for having characteristics similar to a tax haven. The following sections explore three main reasons why and consider the validity of the arguments. First, because of the perceived interaction of Ireland's 12.5 per cent corporation tax rate and the tax planning behaviour of multinational companies, in particular the potential to abuse international transfer pricing regulations. Second, the role of the International Financial Services Centre (IFSC) in attracting investment to Ireland. And third, because of a rather

[12] Ireland has signed 69 Double Taxation Agreements and 20 TIEAs.

[13] FATCA refers to the Foreign Account Transaction Compliance Act, US legislation that requires all financial institutions outside the US to report to the US tax authorities financial accounts held by US persons. The accompanying legislation was published and enacted in the Irish Finance Act, 2013.

obscure, but nonetheless influential, paper by Hines and Rice dating back to 1994.

4.3 *Tax Planning and Transfer Pricing*

OECD (2013a) notes that overlapping domestic tax systems can result in double taxation of companies or individuals (the taxation of the same incomes or corporate profit in separate countries). International rules seek to address overlaps to minimise such distortions. However, the interaction of domestic tax systems and international standards can also lead to gaps that provide opportunities to eliminate or significantly reduce taxation on income.

Double taxation of companies presents a serious disincentive to international investment and trade. The solution is that each jurisdiction in which a multinational operates should tax an "appropriate" share of the company's profits (McDonald, 2008). In practice it is difficult to determine the appropriate share directly related to the pricing of the transactions between the affiliates of a multinational group.

To provide a practical and workable solution to this problem, the arm's length principle has been adopted as the standard to which companies and countries aim in setting transfer prices. The OECD *Transfer Pricing Guidelines* (OECD, 2010, p. 17), quoting the OECD Model Tax Convention, describe the arm's length principle as follows:[14, 15]

> Where conditions are made or imposed between the two 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.

The arm's length principle requires that a multinational group of companies price its intra-group 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 (OECD, 2010) 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

[14] The OECD *Transfer Pricing Guidelines* are an agreed standard and a handbook for both tax administrations and multinational companies engaged in transfer pricing.
[15] The OECD Model Tax Convention is a template for bilateral tax treaties. All of Ireland's recent DTAs are based on this model.

attempting to find comparables for transactions involving intellectual property (IP). 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 IP-related transactions.

Section 42 of the Finance Act 2010 inserted a new Part 35A into the Taxes Consolidation Act (TCA) 1997 formalising Ireland's transfer pricing rules. It recognised the arm's length principle and its application to trading transactions between associated parties. Prior to this, Sections 81 and 1036 of the TCA reinforced the principle of transfer pricing in accordance with the arm's length standard. Ireland adheres closely to the OECD guidelines in dealing with transfer pricing cases and this is strengthened by the Finance Act 2010 provisions.

Across the world, multinational corporations have long been accused of utilising the difficulties in applying the arms length standard to facilitate so-called "income or profit shifting" from high tax countries to low tax countries so as to minimise their tax bills. 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 papers examine the available empirical data for evidence of profit shifting.

Typically, the approach uses aggregate level data. Barry (2005) notes that in Ireland, in the sectors with a significant foreign presence, the gross value added per employee is considerably higher than other western EU countries. Other studies have found that compared across locations, higher levels of profits tend to be reported in countries with low tax rates. The assumption made is that abuse of transfer pricing via profit shifting is driving the results.

One of the most commonly used data sources is the US Bureau of Economic Analysis (BEA) data.[16] For example, using BEA data for 2003, Clausing and Avi-Yonah (2007) compare where US multinationals report income outside the United States. Table 2 shows reported income as a share of total sales by location, updated from Clausing and Avi-Yonah (2007) to include more recent years. [17]

[16] 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.

[17] A point rarely noted in the US literature is that many US companies use Ireland (and other locations) as an export base to supply markets in other countries or regions. Looking at sales and profitability of Irish operations to compare to the size of the Irish market can be misleading in this respect. This is a point that has been developed in the debate surrounding the use of the destination sales factor in the CCCTB proposal (see Barry, 2008, for an overview on the CCCTB debate).

Table 2: *Income as a Share of US Multinational Sales by Location*

Country	*Income as a Share of Sales (%)*	*Country*	*Income as a Share of Sales (%)*
Greece	5.1	Belgium	13.4
Hungary	5.8	Austria	20.5
Czech Republic	6.3	Switzerland	20.9
Poland	6.5	Denmark	26.4
Russia	7.2	Portugal	26.8
United Kingdom	7.9	Ireland	27.8
Sweden	8.2	Netherlands	45.7
Spain	8.3	Bermuda	81.2
Norway	11.7	Luxembourg	386.0

Source: BEA data and authors' calculations. Average for 2003 to 2007 used.

Ireland receives considerable investment from US companies (relative to its size) and the effective tax rates calculated from the BEA data for Ireland appear to be low (Clausing and Avi-Yonah, 2007). The assumption made is that high levels of profit in Ireland are due to abuse of transfer pricing and profit shifting into Ireland. There are other approaches to estimating the cost of abusive transfer pricing but the main assumption appears to remain the same. High profitability in low tax countries is assumed to result from profit shifting.

Given that Ireland has a relatively low statutory corporation tax rate and has been a significant recipient of US outward investment for 50 years, 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 data sources used are mostly available only at an aggregated level (e.g., sectoral level data). This type of data 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.[18] Statistics such as those from the BEA discussed above or the US Internal Revenue Service (IRS) data on controlled foreign corporations, are notoriously volatile from year to year and in general one year's data should not be looked at in isolation.[19]

[18] Transfer pricing detail at the transactional level may be "buried" within the aggregate macro data used for empirical analyses that makes isolating transfer pricing effects impossible (McDonald, 2008).

[19] For example, the UK effective tax rate calculated from the BEA data goes from 20.1 per cent in 2003 to 28.9 per cent in 2005.

The BEA and IRS data are often used to calculate effective tax rates on US corporations registered in Ireland. The results suggest the effective rate is below the statutory rate in Ireland and thus used as further evidence for profit shifting. However, this contradicts the evidence, such as Spengel *et al.* (2012) in research for the European Commission (shown in Figure 1), that while Ireland may have a low tax rate, the tax base in Ireland is quite wide. This casts further doubt on the reliability of the data used in many studies suggesting very low effective corporation tax rates in Ireland. As Walsh (2012) shows, the BEA data inflate the profit levels of US companies in Ireland due to the inclusion of data on companies tax resident elsewhere and this distorts the effective rate calculations.

The underlying assumption that varying levels of profitability across locations are explained by abuse of transfer pricing is also questionable. Profitability across multinational companies is likely to differ depending on the activity (the good or service produced) and the stage of production. Multinational companies spread their operations across multiple locations. The activities of such companies are highly heterogeneous. Some functions are likely to be highly skilled and capital intensive while others will be low skilled (such as assembly or production type functions). Multinationals will choose location based on these characteristics (e.g., placing low skilled labour intensive stages in countries with low labour costs). Some activities will be more profitable and companies are likely to seek to locate them in lower tax countries.

The result 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 lower tax jurisdictions. The differential in profitability may be related to differences in investment levels, not due to abusive transfer pricing.

This reflects an important issue for many of the multinational companies in Ireland. Intellectual property is a key driver of profitability in the modern sectors of the economy and the location of ownership of IP (and the payment for use of that IP) are important determinants of profits in many industries. Under the arm's length standard, profits generated by the underlying IP should be taxed in the location of ownership of that IP. In the case of many multinationals with affiliates in Ireland, IP has not been developed nor is it owned in Ireland. In such cases, it is appropriate to tax only the profits proper to functions undertaken in Ireland.

These systematic differences in the characteristics of companies that invest in lower tax countries can distort simple comparisons (such as those described above using the BEA data). However, they also impact on complex studies using regression analysis (de Mooij, 2005). If a variable that affects profit is correlated with the tax rate, the estimated coefficient may be biased due to the effect of the omitted variables.[20]

There is no research currently available that adequately controls for these factors, and the limited data, to demonstrate conclusively the existence of abuse of transfer pricing rules.

Recent criticism of the Irish corporation tax regime has focused the apparently low rates of tax paid by mostly US multinationals in Ireland. As noted above, this issue is often confused by the use of data such as the BEA that combines profits of resident and non-resident companies to suggest low effective tax rates on activity in Ireland. Under Irish law, companies' residency is determined by the location of where they are managed and controlled.[21] Ireland does not impose tax on companies that are tax resident in other jurisdictions

There have also been suggestions of special tax rates for individual companies, for example during recent US Senate subcommittee hearings. Ireland's corporation tax regime is set out in statute and there is no provision for special rates for individual companies. All Irish tax resident companies are liable for corporation tax at the 12.5 per cent rate (25 per cent on non-trading income).

4.4 *The Role of the IFSC*

The IFSC was established by the Irish Government in 1987 to create an international financial centre that would generate quality sustainable employment and contribute to the renewal and regeneration of a derelict part of the city of Dublin (the Custom House Docks area).

The IFSC tax regime was initially approved by the European Commission under EU state aid rules as an exceptional measure to promote employment. In 1998, the EU Commission reviewed its approval of the IFSC regime, on the basis that the regime had achieved the objectives for which it had originally been approved. Agreement was reached in July 1998 between the Commission and the Irish authorities on arrangements for phasing out the preferential IFSC regime in an orderly manner, in conjunction with the introduction of a new general 12.5 per cent corporation tax rate from 1 January 2003.[22]

[20] De Mooij (2005) also notes two other possible issues. First, tax rates may be endogenous to profit levels and so bias OLS estimated parameters. Second, differences in tax rates have other implications on profit levels. For example, high tax rates with loss-offset provisions may encourage risk taking and, if the average rate of return rises, positive estimated coefficients could be wrongly taken as evidence of profit shifting.

[21] Under US law, a company is resident where it is established.

[22] Projects approved prior to end July 1998, the effective date of the agreement with the EU, would continue to benefit from the preferential 10 per cent rate until end 2005, while projects approved after July 1998 and before 1 January 2000 availed of this rate until end 2002 only. The preferential tax regime for qualifying firms located in the IFSC ended on 1 January 2006.

The Financial Centre has successfully attracted high-quality operations from amongst the most reputable and well-known companies in the world and now ranks amongst global locations of choice. Dublin is now established as a successful and reputable financial centre, providing substantial, high-quality employment over a broad range of services.

A considerable share of Ireland's inward FDI flows into the IFSC. As this inward investment into the IFSC can be matched by similarly large outward investment, mostly between subsidiaries of financial companies and their foreign based parents, it can be argued that this investment has little impact on the rest of the domestic economy (Barry and O'Mahony, 2004). While this may be the case, there is still very substantial activity undertaken within IFSC companies, as reflected by the employment of over 25,000 people. It has always been the objective of the Irish government that the IFSC not become a base for "brass plate" operations. Low taxation is part of the package that attracts investment to the IFSC (and Ireland more broadly) but it is not the sole driver or applied at the expense of other factors.

4.5 *Hines and Rice (1994)*

Hines and Rice in a 1994 paper, produce a list of tax havens, one of which is Ireland. It may seem unusual to cite a 20-year-old academic paper as a reason to consider Ireland as a tax haven. While dated, the paper remains very influential today in policymaking circles. At least in part because of Hines and Rice (1994), Ireland has been included in lists of tax havens by the US Government Accountability Office (GAO) and the Congressional Research Service.[23] Ireland's inclusion in the original paper is deeply flawed for several reasons.

First, the list effectively dates from the early 1980s. Despite this, the list is assumed to be still accurate by later readers.[24] To assemble their tax haven list, Hines and Rice cite a paper by Glautier and Bassinger (1987). Glautier and Bassinger use a list of tax havens 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. It appears that Ireland may have been included on the 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, it is clearly no longer valid. Glautier and Bassinger (1987) note that the IRS manual did not have a specific definition of a tax haven. Of the various criteria for tax havens

[23] GAO (2008) and Gravelle (2013) respectively.

[24] Even recent papers by Hines have not sought to update and correct the 1994 paper, for example or Desai, Foley and Hines (2012) or Dharmapala and Hines (2009) simply take the list as given.

presented in Glautier and Bassinger (1987), Ireland is noted as satisfying only one: taxing foreign income at a lower rate than domestic income (presumably export sales relief). This is no longer accurate, nor has it been for many years.

Finally, an adjustment made by Hines and Rice (1994) uses a 20 per cent effective tax rate as a cut-off point to exclude several countries. There is no explanation why 20 per cent was used and it is based on data from 1982. 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.

The intended audience for Hines and Rice (1994) is tax scholars – as noted earlier academic research tends to focus on low corporation tax rates as the feature to identify tax havens and this is the basic reason for Ireland's inclusion in Hines and Rice (1994). However, the paper has been co-opted by others in the tax policy debate to brand Ireland as having characteristics similar to a tax haven even though Ireland does not meet any of the standard criteria based on the accepted definitions used in policymaking circles (such as the OECD criteria – a point accepted by Hines and Rice).

V CONCLUSION

There is no single and agreed definition of a tax haven. In some of the academic literature simply having a low tax rate can constitute grounds for being considered a tax haven. In the policymaking domain, criteria such as those of the OECD are important determining factors: no or nominal tax, lack of transparency, unwillingness to exchange information and absence of economic substance. Transparency and exchange of information are now a main focus of the G-20 and the OECD.

Ireland does not meet any of the OECD criteria for being a tax haven. But because of its 12.5 per cent corporation tax rate, and strong flows of FDI, Ireland has on a few occasions been incorrectly labelled as having characteristics similar to a tax haven. There are three main reasons for this.

First, transfer pricing and profit shifting. Given that Ireland has a relatively low statutory corporation tax rate and has been a significant recipient of US investment for 50 years, it is not surprising that Ireland features regularly in such analysis and as a consequence is drawn into the tax haven debate. In practice, Ireland adheres very closely to the standards agreed upon by the OECD for transfer pricing matters and companies operating in Ireland are also expected to meet this standard. Ireland is fully engaged in supporting the OECD BEPS project.

Second, due to the scale of investment into the IFSC and the nature of those flows, the IFSC has at times been described as having similar features to that of an offshore financial centre. Closer examination shows that this is not the case. The Irish government has always worked towards ensuring that the operations of the IFSC remain as open and transparent as possible.

Finally, Hines and Rice (1994) include Ireland in a list of tax haven countries. Although an academic paper that is now nearly 20 years old, Ireland has been included in recent lists of tax havens because of its inclusion in this paper. Ireland's inclusion is incorrect for several reasons.

The common theme running through these issues is Ireland's low corporation tax rate but this alone is not sufficient to consider Ireland a tax haven. For policymakers, issues related to transparency, exchange of information and economic substance are of more importance. These are not trivial matters and nor is Ireland's inclusion on lists that ignore these considerations.

Ireland is on the OECD/G-20 white list of countries published in April 2009 and has since been subject to peer-review under the *Global Forum on Transparency and Exchange of Information for Tax Purposes* process to implement robust standards on exchange of information.

The international community does not regard Ireland as a tax haven as evidenced by the large and growing network of tax treaties that Ireland has in place with other countries. These are bilateral agreements and other countries would not agree them if there were a perception that Ireland was not operating on a fair and level playing field in these matters. Ireland has a strong record of transparency in the exchange of information and has refused to sign tax treaties with countries that would not agree to the recognised principles on the exchange of information. The recent signature of a FATCA agreement with the US is a further example of Ireland's ongoing commitment to the exchange of information.

Recent events at the G-20 and OECD have vindicated Ireland's stance and Ireland's policy to seek full exchange of information provisions in its tax treaties. The OECD BEPS project emphasises the importance of multilateral and coordinated actions by governments. The issues raised by tax havens, in particular their use and abuse by multinational companies, arise from the limitations of domestic tax systems but can only be resolved by international co-operation.

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