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Report on International Standards for the States of Jersey in connection with a Business Tax Consultation

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REPORT ON 'INTERNATIONAL STANDARDS' FOR THE STATES OF JERSEY IN CONNECTION WITH A BUSINESS TAX CONSULTATION

1. Summary and Conclusion

1.1. The States of Jersey is consulting as part of a review of its business tax regime by reference to a number of key principles including compliance with international standards and has asked Deloitte for this opinion on whether such standards can be identified on seven particular aspects of business taxation.

1.2. The Organisation for Economic Cooperation and Development ('OECD'), particularly through the Global Forum on Harmful Tax Practices and the Forum on Tax Administration ('FTA') have made a number of pronouncements bearing on the content of business tax systems although the clearest example of international standards emerging are in relation to transparency and information exchange.

1.3. European Union ('EU') legislation as well as the EU Code of Conduct on Business Taxation, although constitutionally of less general direct application has had a significant impact on tax systems and, together with the OECD initiative, these have made inappropriately differential treatment (whether positively or negatively) of outside investors within a national tax regime, and the disincentivisation or particular incentivisation of cross-border as compared to domestic transactions, very questionable.

1.4. Arguably implications might be capable of being drawn for the development of international standards from the implicit assumptions about the nature of national tax systems in the OECD Model Treaty and in the emerging consensus model of business taxation noted in the Deloitte Report to the Foot Review, albeit that the drivers of these are predominantly economic and pragmatic rather than attempts at standard-setting.

1.5. In conclusion:

- there is an international standard under which tax jurisdictions should not discriminate inappropriately in the tax treatment of business by reference to the nationality, residence or similar feature of the owners; and
- arguably there is an implicit standard emerging under which tax jurisdictions should refrain from deliberately creating opportunities for tax arbitrage - this is an inference that can be drawn from a number of features of the OECD and EU initiatives though not all countries would consider themselves bound by it; but

- on balance the five other matters specified – whether tax jurisdictions should ensure worldwide taxation of residents; whether 'source' countries should exercise primary taxing rights over active business profits; the taxation of passive income; the tax rate applicable to business profits; and the definition of the tax base – appear to be primarily matters determined by economic and other pragmatic considerations.

2. Introduction and Scope

2.1 As part of a public consultation exercise, the States of Jersey is setting out a number of key principles which will underpin its business tax regime.

2.2 The first of these, compliance with international standards, is important but difficult to define, especially as it interacts with the second principle, of remaining internationally competitive. There are currently few standards for the content of a business tax system (in the sense of features of the system which an authoritative body, representing all or part of the international community, requires or expects tax jurisdictions to have). Traditionally most tax jurisdictions enjoyed almost unfettered tax sovereignty, and gave each other only limited help in enforcing their tax regimes. But there has been a trend toward more extensive bilateral and multilateral cooperation between tax authorities, with some instances in which the international community does seek to impose particular standards.

2.3 The States of Jersey has asked Deloitte to consider whether there is evidence that such standards are emerging in relation to seven key specific areas (itemised in section 5 below) of business taxation (that is, the taxation of profits of businesses especially those of incorporated businesses). In raising this question, it is acknowledged that the future cannot be predicted with certainty, that some evidence may be inconclusive and that the content of an emerging standard cannot always be precisely specified.

3. Statements by international bodies

3.1. The OECD is the leading body in this area and formed The Global Forum on Harmful Tax Practices in 1998 ('the Global Forum') to promote greater tax transparency. Through its work the OECD has now established an internationally agreed standard for tax information exchange agreements

('TIEAs') and produced a model agreement which implements these standards[1]. Territories which have not signed the requisite number of agreements are placed on a list of non-compliant jurisdictions. Whilst it is possible to implement bilateral agreements separate to the model agreement (for example, through transparency clauses in a double tax treaty), the reality is that the terms will need to be very close to those of the model agreement in order to avoid 'blacklisting'. Although not specifically related to business taxation, this is noteworthy as being a strong example of an international tax standard as defined in paragraph 2.2 above.

3.2. The Global Forum's establishment followed an extensive report from the OECD Committee on Fiscal Affairs: 'Harmful Tax Practices, An Emerging Global Issue' ('the OECD 1998 Report').[2] This was commissioned by and approved by OECD Ministers. The Report argued that while tax policies (primarily to finance public goods but also for other purposes) were a matter for each country, globalisation had increased the scope for companies and individuals to avoid tax while continuing as 'free-riders' to have access to some benefits of public spending. Although tax competition could bring benefits, it was more likely to be harmful where 'tax havens' or 'preferential tax regimes' were in play. The 'starting point' for defining these was, respectively, 'no or nominal taxation' or a 'low or zero effective tax rate'. To be classified as a haven or preferential regime, at least one of the following factors should also be present:

- offering itself, or being perceived to be, a place where non-residents can escape tax in their country of residence; or the absence of a requirement that an activity be substantive (in the case of a haven);
- lack of transparency; or of effective exchange of information (in the case either of a haven or of a preferential regime);
- 'ring- fencing' of the regime from domestic markets (in the case of a preferential regime); and
- (also in the case of preferential regimes), a number of 'non-key' factors though it is not clear that any one would normally be conclusive: artificial definition of the tax base, failure to adhere to international transfer pricing principles, exemption of foreign source income, negotiable tax rate or tax base, existence of secrecy provisions, access to a wide range of tax treaties, regimes which are promoted as tax minimisation vehicles, and the encouragement of purely tax-driven operations or arrangements. (In terms of our current enquiry, we would not view any of these

[1] OECD, *Agreement on Exchange of Information on Tax Matters* (2002), online version.
[2] OECD, *Harmful Tax Practices: An Emerging Global Issue* (1998), online version.

criteria in isolation, being generally indicative rather than conclusive, as sufficient evidence of an international standard, especially given the inclusion of access to a wide range of tax treaties on the list - and given that further tests are required for classifying a preferential regime as harmful – see next paragraph.)

3.3. Where there is a preferential tax regime, the report sets out a number of criteria for establishing whether it is harmful: whether it shifts activity between jurisdictions rather than generates new activity; whether the presence and level of activity in the host country is commensurate with the relevant investment or income; and whether the regime itself is the prime motivation for the location of an activity.

3.4. To counteract harmful tax practices, the report recommends that individual countries consider a number of changes (where needed) to domestic law and practice, including:

- adopting and making more appropriate 'controlled foreign company' rules (to attribute the income of such companies resident outside the relevant country to, and tax them in the hands of, resident controlling shareholders);
- adopting or making more appropriate foreign investment fund rules to counteract deferral of income through use of such funds;
- denying the benefit of exemption methods of tax relief to foreign income that has benefited from harmful tax practices;
- and adopting rules requiring the reporting of international transactions and foreign operations of resident taxpayers and exchanging information under them.

Countries are also recommended:

- where advance rulings are given, to publicise the conditions for granting, denying or revoking them;
- to follow the principles set out in the OECD's Guidelines on Transfer Pricing (on which see section 5.7 below);
- and to review laws and practices to remove impediments to access to banking information by the tax authorities.

There were also recommendations as regards the content of bilateral tax treaties; and recommendations for multilateral action which led to the work of the Global Forum. As with the non-key factors for identifying preferential tax regimes, it cannot strictly be said that a list of seven measures (in four cases to 'consider' and in three cases to adopt) necessarily constitute of themselves international standards as to the content of a tax regime. This seems particularly so, as these are recommendations to countries who potentially suffer from harmful tax competition for the purpose of counteracting it, rather than recommendations of good practice per se. Although many of the measures listed are adopted in many countries, few are overwhelmingly common and in many cases the measures apply without targeting 'tax havens' as such, and appear to be directed to more general protection of the tax base of the country concerned. To the extent, though, that such measures are linked to defined aspects of 'harmful tax competition' they might be taken as limited evidence that an international standard may be emerging.

3.5. Notwithstanding this detail, and the work done subsequently to identify and eliminate preferential tax regimes within OECD Member States, the main focus of subsequent activity especially with those classified as tax havens has been to promote transparency and exchange of information rather than aspects of the content of any business tax regime.[3]

3.6. The OECD Forum on Tax Administration ('FTA') brings together the Heads and Deputy Heads of Revenue Bodies from (in January 2008) 45 economies. In 2006 the FTA issued the Seoul Declaration[4] commenting on the difficulties of enforcing national tax laws as trade and capital liberalisation and advances in communications technologies have opened the global marketplace. They also spoke of the need to curb aggressive tax planning (and indeed the inclusion of combating what may be entirely legal tax planning within the concept of compliance has been criticised). The Seoul Declaration led to a study into the role of tax intermediaries[5] which broadened into a review of the tripartite relationship between revenue bodies, taxpayers (particularly large corporate taxpayers) and tax intermediaries. Subsequently there were reports on banks[6] and high net worth individuals ('HNWIs')[7]. On 11 January 2008 the FTA issued the Cape Town Communique[8], which included a summary of the 'intermediaries' report calling for Revenue Bodies to offer an 'enhanced relationship' to large corporate taxpayers 'based on co-operation and trust'. It was noted that

[3] OECD See for example paragraph 26 of the OECD's April 2010 Background Information Brief: 'Promoting Transparency and Exchange of Information for Tax Purposes' online version
[4] OECD, *Third Meeting of the OECD Forum on Tax Administration* (2006), online version.
[5] OECD, *Study into the Role of Tax Intermediaries* (2008), online version.
[6] OECD, *Building Transparent Tax Compliance by Banks* (July 2009).
[7] OECD, *Engaging with High Net Worth Individuals on Tax Compliance* (Sept 2009).
[8] OECD, *Fourth Meeting of the OECD Forum on Tax Administration* (2008), online version.

some such taxpayers may choose not to enter this type of relationship and that 'by continuing to refine our risk management processes to identify these taxpayers and to allocate the necessary level of resources we can ensure they meet their obligations under the law. Large corporate taxpayers, and their advisers, who are unwilling to embrace transparency must learn they cannot expect to prosper at the expense of others'. Although the concepts of 'obligations under the law' and 'transparency' can be interpreted narrowly, reading the text as a whole there is a clear implication that legal but (in the Revenue Bodies' eyes) aggressive tax planning should not be allowed to deliver more favourable tax outcomes to the corporates that engage in them. The Communique covered other matters including the need for greater international co-operation between the authorities.

3.7. This statement is concerned with enforcement (as noted in a broad sense including combating certain tax planning) rather than the content of tax systems. However, it may be reasonable to infer from the call for international co-operation in this regard that at the very minimum for a tax jurisdiction to introduce or maintain provisions positively to enable taxpayers to engage in tax arbitrage that amounted to aggressive planning would be to fall short of a standard of behaviour which the FTA would expect tax jurisdictions to have.

3.8. The European Union ('EU') Code of Conduct on business taxation[9] provided a mechanism for freezing and rolling back 'harmful tax measures' which potentially are those that provide for a significantly lower - including zero - effective taxation than that generally applying in the Member States in question. A key feature is that tax rules should not give advantages either to non-residents or ring-fenced from the domestic market. (In principle, generally applicable low or zero effective taxation across a Member State does not seem to be within its scope, a fact which may have been controversial within the EU Council and which is qualified by the comments which follow.) The Code is expressed in very general terms (including references to 'principles underlying the code') and subsequently reference has been made to the spirit of the Code in interpreting it. The EU Council Resolution adopting the Code established a Group to assess tax measures that may fall within the Code (in the sense of being within the range of measures targeted by it) so arguably it is left to the workings of the Group itself to give greater definition over time. This inevitably makes it very difficult to say what the 'spirit' of the Code is, or what are the 'principles' underlying

[9] Ecofin Council, *Conclusions of the Ecofin Council Meeting* (December 1997), Annex 1, http://ec.europa.eu/taxation_customs/resources/documents/coc_en.pdf.

it, at any one time. Although the EU is more of a 'regional' European than an 'international' (in the sense of global) authority, arguably the Code has had more influence than the OECD in driving substantive changes to tax regimes. The European Union attempts to influence non-Member States to conform to the Code.

3.9. The EU Treaties and EU legislation[10] made under them do clearly constrain EU Member States' ability to impose tax laws – most fundamentally to prohibit both discrimination on grounds of nationality or similar criteria and the establishment of tax rules which would disincentivise cross-border compared to purely domestic economic activity.

4. Other documents which may imply the emergence of international standards

4.1. There are other documents which would not in their nature contain international standards as defined above but which might possibly be taken to imply the emergence of international standards over time.

4.2. For example, traditionally many tax jurisdictions impose withholding tax, particularly on cross-border flows of passive income. Under bilateral Treaties and some multilateral agreements such tax is reduced or eliminated (for entities entitled to benefit under the Treaty or agreement). It could be argued that where country A exempts from withholding tax a flow of income to country B it has an expectation that country B will tax it. Such an argument is not clear cut and country A might explicitly deny that it sees itself as a kind of 'world tax policeman'. But in the typical case it is unlikely that country A would have negotiated such a Treaty with country B unless country B had some kind of developed tax regime – most bilateral Treaties, after all, exist primarily to eliminate double taxation. And, although a bilateral agreement does not constitute an international standard, the fact that there is a developed network of such agreements between large numbers of countries with very similar provisions raises the question as to whether they may be taken to some extent to imply an international standard.

[10] Currently the consolidated versions of the Treaty on European Union and of the Treaty on the Functioning of the European Union, Official Journal of the European Union C115/13 and C115/47, of 9 May 2008. http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2010:083:SOM:EN:HTML

4.3. In this respect, the OECD's Model Tax Convention[11] may be seen as a potential source of emerging international standards. As noted the argument is not straightforward because the Model Treaty exists to help tax jurisdictions by providing a starting point for negotiation of bilateral Treaties – agreed departures from the Model Treaty are intended to happen and cannot therefore be viewed as a kind of lapse from a standard. However, there are some key features of the Model Treaty, that are followed by almost all actual bilateral Treaties based on it, which raises the question as to whether these can be viewed as emerging standards, relevant to business taxation. These include:

- the implied assumption that both parties have direct tax systems affecting both individuals and companies;
- that some categories of persons are taxed in each country by reason of residence, domicile, nationality or some similar criterion, rather than solely by reference to the source of any income (but see the discussion of this point in section 5.3 below, which also reflects on the immediately preceding one);
- that it is desirable to reduce the incidence of double taxation (by both 'source' and 'residence' country) by allocating taxing rights between them;
- that in the case of active business income, the residence of a company or individual business owner as well as where it has a permanent establishment are key to this allocation;
- that the two tax authorities will exchange certain categories of tax information to assist each other with enforcement; and
- that discrimination should not be applied in the tax system by reference to the nationality of the owners of businesses.

4.4. The question may also arise, whether the extent of a jurisdiction's bilateral treaty network is itself related to conformity to an international standard. The main purpose of a bilateral treaty network is to reduce double taxation to promote international trade and competitiveness. The extent of a jurisdiction's network will reflect a range of factors including the openness of its economy and the extent of its tax system (bearing as they do on the need for such treaties and the incentivisation of potential treaty partners to negotiate), and the skilled resources available to be deployed in negotiation. The extent of individual jurisdictions' treaty networks varies widely and some jurisdictions with few treaties have tax regimes which largely conform to the assumed key features of tax systems noted above. A jurisdiction whose tax system has very limited extent may, for

[11] OECD, *Model Tax Convention on Income and on Capital* (August 2008). http://www.oecd.org/dataoecd/52/34/1914467.pdf,

reasons associated with this fact, need to consider whether it conforms to international standards, and such a jurisdiction will likely have a small or non-existent treaty network, but it is not possible to say that any international standard requires a treaty network per se. As noted earlier (paragraph 3.2.), the 1998 OECD Report suggested that access to a *wide* range of tax treaties could be indicative of a preferential tax regime.

4.5. The Deloitte Report to the Independent Review of British Offshore Financial Centres[12] (the 'Foot' Review) identified an 'emerging international consensus' as regarding direct business taxation (as well as regarding information exchange and VAT). Although in the consensus model identified, tax is imposed on companies incorporated, managed and controlled, or having a permanent establishment in a territory, the main practical objective of such a tax system is to tax locally-generated active business profits. There is a competitive rate of tax, and a number of features of the tax base including reliance on accounting profits, the arms' length principle, and certain common international reliefs and exemptions. This report was of course provided for the Independent Review which itself reported to the UK Treasury, for a different purpose than this opinion which is for the States of Jersey. Such an emerging consensus reflects decisions by numerous individual countries which might be for a mixture of reasons of both principle and pragmatism - including the pressure which all countries face, to some degree, to remain competitive. However, for similar reasons as those applying to the OECD Model Treaty, a consensus raises the question as to whether implied standards are emerging.

5. Areas in which the possible emergence of international standards of business taxation has been considered

5.1. Should tax jurisdictions not discriminate inappropriately (whether positively or negatively) in the tax treatment of business by reference to the nationality, residence or similar feature of the owners?

5.1.1. Although slightly differently formulated in each, the EU Treaties and Code of Conduct and the OECD 1998 Report and Model Treaty all embody a principle along these lines. The

[12] Foot, Michael, *Final Report of the Final Report of the Independent Review of British Offshore Financial Centres* (2009) online version. *Independent Review of British Offshore Financial Centres* (2009).

main difference is that in the EU Code and (in considering preferential tax regimes) OECD 1998 Report the accent is on discrimination against residents in the course of attracting foreign investment, whereas in the other cases the accent is on discrimination against non-residents.

5.1.2. The main limitation on this principle is the fact that the tax position of non-residents is to some degree objectively different from that of residents. (For example, the European Court of Justice has decided that, as individuals may be given personal allowances in their country of residence, a 'source' country need not also always give such an allowance.) However, for incorporated businesses it is clear enough that while the business entity may be taxed according to where it is resident, the authorities should not discriminate as regards its taxation by reference to the residence or nationality of its shareholders.

5.1.3. Although it seems clear that a directly discriminatory provision would be contrary to an emerging international standard reflected in these documents, the position is less clear as regards indirect discrimination - where for example discrimination is made by reference to a factor such as business sector which is not formally linked to nationality, residence or a similar feature but may in practice be correlated with it. (In an EU jurisdiction such an approach might anyway be problematic due to the 'State Aid' rules.) No standard has been formulated to the detailed extent necessary to indicate just how much of a correlation would be needed to say that a lapse from a standard had occurred. Many jurisdictions (such as the UK) have differential rates of tax applying to companies in groups with smaller levels of profit: it has not been suggested that this is unacceptable. Ireland's practice of having different rates for active and passive income is another variant on the theme of differential rates.

5.2. Should tax jurisdictions refrain from deliberately creating opportunities for tax arbitrage?

5.2.1. For the reasons covered in paragraphs 3.6. and 3.7. above it is arguable that the Seoul Declaration and Cape Town Communique imply an emerging standard that tax jurisdictions should not create opportunities for tax arbitrage. In principle one could perhaps go further and talk of co-operating in pursuing tax policies, but it would be difficult to give any granularity to such a principle relating to the content of tax systems since the Seoul Declaration and Cape Town Communique focussed on enforcement rather than content.

5.2.2. Any tax jurisdiction can be vulnerable to tax arbitrage and the mere fact of its existence does not necessarily imply that the jurisdiction is deliberately creating opportunities for it.

5.2.3. Any such standard needs to be balanced by the legitimate objective which all jurisdictions have to avoid creating unnecessary tax obstacles to business that a jurisdiction could reasonably seek to attract on a commercial basis. This objective can be cited to justify both 'broad-base-low-rate' tax policies; and the use of tax reliefs - such as research and development ('R&D') tax credits - which can be justified as tackling 'market failure' (in the case of that example, the inability of the unaided market to adequately incentivise R&D activity due to 'externalities', being the benefits of R&D activity which flow to the economy generally but not to the agent initiating it). This view is strengthened by considering the list of non-key factors relevant to establishing 'preferential tax regime' status and the list of recommendations for individual countries to consider, included in the 1998 OECD Report (see paragraphs 3.2. and 3.4. above), albeit that that Report is now 12 years old. Although none of the non-key factors appear conclusive, and most of the recommendations are to 'consider' only, the implication is that countries should assess numerous specific aspects of their tax regime at least in part by reference to avoiding participating in, and to counteracting, harmful tax practices. For this purpose 'harmful tax practices' are identified by reference to the scale of activity in the preferential tax regime relative to the investment or income, whether it is new or merely diverted activity, and whether its location is predominantly tax motivated (paragraph 3.3. above). There is evidence that many tax jurisdictions may feel reluctance to introduce specific targeted reliefs for competitiveness reasons where this cannot be justified as addressing market failure - which does give some support to the view that there is an emerging standard not to create opportunities for tax arbitrage per se. However, there is also evidence that not all jurisdictions consider themselves restricted in this way and some feel free to introduce measures which seem likely to attract mobile income without necessarily addressing 'market failure' as such.

5.3. **<u>Should tax jurisdictions ensure effective worldwide taxation of 'residents'?</u>**

5.3.1. The OECD Model Treaty assumes (paragraph 4.3. above) that each tax jurisdiction will impose direct taxation by reference to residence or a similar criterion, to some extent irrespective of the source of income, and most tax jurisdictions do this to some extent. (The United States is perhaps the most markedly distinct jurisdiction in primarily taxing individuals by reference to citizenship - and corporations by reference to incorporation - rather than by reference to residence, but in a broad sense these are comparable concepts to residence and quite distinct from taxing by reference to source.)

5.3.2. The bilateral tax treaty network also accommodates countries who apply direct taxation primarily by reference to the territorial source of income, although such countries are in a minority. There is however a trend among the theoretically residence-based countries (notwithstanding certain comments in the 1998 OECD Report noted in paragraph 3.4. above) toward broader exemptions and reliefs, either in domestic law or under tax treaties, for passive and/or non-local source profits, at least for corporates or funds (for example, 'participation' exemptions for dividends from, and capital gains on, disposal of subsidiaries and affiliates; similar exemptions for the activities of foreign branches or other permanent establishments; and exemptions for various forms of funds and investment trusts). The key factor at work here is that international businesses which wish to have a real business presence in a territory for commercial reasons (whether to access sales or labour markets or both in that territory) will typically tolerate a certain level of taxation on profits derived from this activity without fundamentally revisiting their commercial plans. By contrast the location of head office activity (which benefits from participation and permanent establishment exemptions) and, even more so, the investment of capital into funds and investment trusts, is typically much more highly internationally mobile and location decisions are more sensitive to differential tax costs.

5.3.3. The mobility of passive income has also led to a somewhat contrary trend outside the corporate sector, that such income increasingly falls to be taxed effectively, if at all, in the country of residence, rather than the country of source. This factor explains the growing importance ascribed to exchange of information (most typically, the provision of information by countries of source to countries of residence) which, as noted in paragraph 3.1., is an area of clearly emerging international standards.

5.3.4. However on balance we cannot conclude that there is, yet anyway, an international standard emerging whereby countries are expected to impose effective direct taxation on their residents (or citizens, or nationals) as such. Not only has no such principle been authoritatively stated, but also a number of countries (for example in the Middle East) do not impose direct tax comprehensively at all, yet this does not always prevent the same territories taking part in networks of double taxation treaties on the OECD Model Treaty or failing that at least in information exchange agreements in OECD approved form. The key drivers of the trends noted above are the pragmatic need to balance revenue raising requirements with international competitiveness. The most that can be said is that for the majority of countries which do have a theoretically residence-based system, but which seek to introduce exemptions and reliefs in relation to passive or to non-local source income, there is arguably a need to respect the emerging international standard noted in section 5.2. above, to refrain from doing so in a way which promotes use of their territory for international tax arbitrage.

5.4. Should 'source' countries exercise prime taxing rights over active business profits?

5.4.1. The OECD Model Treaty accords (see paragraph 4.3. above) prime taxing rights over active business income to the territory in which a business operates through a permanent establishment. The taxing rights of the territory in which the business entity is resident (if different) is subordinated by requiring it to exempt profits of the permanent establishment, or at least to give credit for the local territory taxation suffered.

5.4.2. The Deloitte report to the Independent (Foot) Review noted an emerging international consensus for the taxation of local source active business profits to be the objective of the consensus model tax system. As noted in section 5.3. however, the reasons for this appear to be the pragmatic balancing of revenue raising requirements with the need to preserve competitiveness. Failure to exercise the primary taxing rights afforded by the provisions of the network double tax treaties (and similar provisions in many domestic tax rules) may amount to the host jurisdiction 'leaving money at the table' but it is not at all clear that this is in any sense a lapse from a standard not least because the failure to exercise such taxing rights may very well be made good in the country of the business entity's residence, whether because it operates a credit rather than an exemption system, or for some other reason such as the operation of 'controlled foreign company' or similar rules.

5.5. Is there a standard requiring the taxation of passive income?

5.5.1. As noted in paragraph 5.3.4., some countries do not have comprehensive direct tax systems at all.

5.5.2 The majority of countries do have direct tax systems, and the coverage of direct tax systems, as well as the effective scope of these systems, is generally wider for corporations than it is for individuals - and frequently passive income associated with active business is taxed as if it were active business income where the systems makes a distinction. (This often applies for example to temporarily spare cash held for reinvestment, funds accumulated for decommissioning costs or set aside to meet regulatory requirements, and so on.) As a matter of economic theory, one might expect permanently excess cash held in widely held companies to be returned to shareholders in any event.

5.5.3 As noted in paragraphs 5.3.2. and 5.3.3., many funds and investment trusts, even if incorporated, enjoy significant exemptions - if there is effective direct taxation at all, it is that imposed on investors in their country of residence.

5.5.4. There is no evidence, however that the prevalence of exemptions targeted on funds and investment trusts rather than more widely expressed exemptions for passive income is a reflection of an international standard rather than the balancing of revenue-raising requirements against competitiveness bearing in mind the relative mobility of fund capital as compared with temporarily surplus business capital.

5.5.5. Closely held companies give rise to particular considerations. Since the individual owners typically have a degree of choice between operating through a taxable business entity or in some other way, it is economically quite difficult to subject them to a markedly different tax regime from that applying to individuals. Many tax systems therefore 'look through' certain types of business entity and tax the owners, where appropriate under individual taxation rules, rather than the business entity. This may happen either to all cases where the business entity is of a defined type and/or shows a defined pattern of ownership, or in some cases by taxpayer election. Where it happens, it potentially may result in the country concerned losing taxing rights if the owners are resident elsewhere or if that jurisdiction does not tax individuals. In the United States which is the major example of use of taxpayer elections, there are proposals to reverse this, given the potential use of the election for tax planning. However, this may reflect the fact that such planning can also be used within widely held corporate groups. In any event, there is no evidence that these issues reflect international standards for the content of tax systems rather than pragmatic considerations.

5.6. Is there an international standard regarding the tax rate applying to business profits (assuming a single generally applicable rate)?

5.6.1. Some tax systems only grant certain exemptions and reliefs to profits from (for example) permanent establishments, subsidiaries or affiliates, where these are subject to tax in another jurisdiction. It is open to debate whether such qualified exemptions are, or are intended to be, available where there is theoretically tax but the rate of tax is zero. Some countries are understood to believe that the imposition of a zero rate is incompatible with the spirit of the EU Code of Conduct.

5.6.2. Some years ago the UK experimented with setting a zero per cent rate of tax for companies in groups with small levels of profits. This was intended to promote small business activity but was abandoned after it led to the incorporation of large numbers of previously unincorporated businesses.

5.6.3. There is no evidence that these considerations amount to an international standard which has been promulgated by any international body. The discussion of the consensus model of business taxation in the Deloitte Report to the Independent (Foot) Review referred principally to the Irish tax rate as a relevant factor for the Crown Dependencies, pointing again to competitiveness as a key issue relevant to the setting of rates of tax.

5.6.4. The 1998 OECD Report did however set out (see paragraph 3.2. above) 'no or nominal' or 'low or zero' taxation as the starting points for defining tax havens or preferential tax regimes, whose tax competitive practices might be harmful (subject to applying a number of other tests). It is clear therefore that zero or potentially low (as somehow defined) rates can be viewed as giving rise to questions as to the status of a tax regime (as viewed by the OECD) which otherwise might not arise, albeit it is not of itself a lapse from a standard.

5.7. Is there an international standard as regards the tax base?

5.7.1. In defining the tax base, tax jurisdictions face similar pressures in balancing the needs to raise revenue, combat avoidance and erosion of the base, and promote competitiveness. It is not surprising if in dealing with similar problems they come over time to increasingly similar solutions - especially as differences between national tax bases create opportunities for tax arbitrage. The features of the consensus model identified in the Report to the Independent (Foot) Review – see paragraph 4.5. above - either protect the system from avoidance - following the arms' length principle - or protect the competitiveness of the jurisdiction by reducing compliance costs or providing internationally common reliefs - dividend exemptions, tax grouping and deductibility rules - or serve both purposes simultaneously - following accounting profits for example. There is no evidence however of any international standards at work other than those noted earlier on not discriminating and not opening up one's territory to promote arbitrage.[13] On the latter point, to the extent one's tax system conforms to an international consensus, the charge of promoting arbitrage simply does not arise, but conversely, the departure from such consensus does not inevitably amount to the promotion of arbitrage, or to a lapse from a standard. All countries face pressure and tension in raising more revenues and fighting avoidance while promoting competitiveness, and as noted earlier (paragraph 5.2.3.), there is a trend for this to result in more 'broad-base-low-rate' tax systems, combined with targeted reliefs such as for R&D, where these can be justified as addressing market failure.

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[13] For example, the OECD has invested considerable effort in developing Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration. Paragraph 7 of the July 1995 Guidelines explains their purposes as follows: 'These international taxation principles have been chosen by OECD Member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment. In a global economy, coordination among countries is better placed to achieve these goals than tax competition. The OECD, with its mission to contribute to the expansion of world trade on a multilateral, non-discriminatory basis and to achieve the highest sustainable economic growth in Member countries, has continuously worked to build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems.'

Thus, while the 1998 OECD Report lists failure to follow international transfer pricing principles as an indicative non-key factor in identifying preferential tax regimes, and recommends that countries conform with the 1995 Guidelines as a way of combating harmful tax practices, the Guidelines themselves emphasise the practical benefits of cooperation in following this approach, and indeed a country which departed in some respect from following the Guidelines for practical reasons other than enabling tax arbitrage to occur (dealt with under section 5.2 above) would likely not thereby find itself classified as a tax haven or preferential tax regime.

5.7.2. It is worth noting that although there is a tension between combating avoidance and competitiveness in some respects, there are some parameters of tax system design where they run in tandem. For example, 'broad-base-low-rate' approaches both avoid distorting the economy and also leave fewer 'loopholes' to exploit. Arguably also having a broad range of taxes is similarly desirable. For example, countries which just have labour-based taxes but no profits tax, risk attracting businesses which involve little local labour, so may be perceived of as diverting profits aggressively away from other jurisdictions but perhaps without actually maximising any benefit to the 'real' local economy or the living standards of the domestic population. (As noted in paragraph 3.2., according to the OECD 1998 Report, the absence of a requirement that an activity be substantive may be indicative of tax haven status, and similar criteria may indicate whether a preferential tax regime is harmful – paragraph 3.3.) Again, however, there is no formulated international standard standing alone on this point to which tax jurisdictions are expected to comply, only a shared need to take into account pragmatic consideration of revenue raising needs and competitiveness, and potentially, as argued above, a standard of refraining from deliberately creating opportunities for tax arbitrage.

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