Tax neutrality

Key points

- An environment is tax neutral if profits and gains arising there are not taxed there, but where tax liabilities in other jurisdictions are not reduced
- As tax neutrality does not limit tax liabilities in other jurisdictions, it is not a form of, and does not facilitate, tax evasion
- Tax neutrality maximises returns to investors and hence, potentially, maximises the tax revenues in their home jurisdictions

1. Tax neutrality is a widely-accepted principle, and is central to many small international finance centres (IFCs), but is widely misunderstood

Tax neutrality refers to an environment that does not subject profits or gains arising to entities resident in that jurisdiction to taxation. It recognises that tax may be owed where the assets that generate income are located and also that investors in the entity may be taxed on the returns where they reside.

Tax neutrality means that these centres do not levy additional taxes on business transacted through them. Such arrangements prevent an additional burden of taxation, provide certainty in tax treatment, and thus allow cross-border investments, which help to facilitate global capital flows. These tax systems strive to be neutral so that decisions are made on their commercial merits, not for tax reasons.

Many onshore centres – including the UK – create tax-neutral regimes for funds or rely on wide arrays of double tax treaties to gain a competitive advantage, but otherwise impose measures – such as withholding taxes – on capital flows. By making all income tax neutral, international financial centres (IFCs) reduce complexity while still not affecting investors' tax liabilities in other countries.

Tax neutrality should be distinguished from low-tax regimes where low rates of taxes or significant tax reliefs may be offered on specific categories of income, such as intra-group interest payments or royalties from intellectual property.

2. As tax neutrality does not limit liability to pay tax in other jurisdictions, it is not a form of, and does not facilitate, tax evasion

Tax neutrality does not limit tax liabilities in other jurisdictions. Both the source country – where an investment is made – and the country where the investor resides can still impose tax themselves. Jurisdictions that have tax treaties with one another grant tax credits for tax paid in the other to avoid both taxing the same income. However, as IFCs do not have such tax treaties, as onshore jurisdictions do, other countries – such as the UK – would not grant tax credits for income arising in the IFC, even if tax were paid there. As such, full tax is paid on income distributed from the IFC to the onshore jurisdiction. The IFC simply renounces its right to tax the returns flowing through it (see Figure 1).

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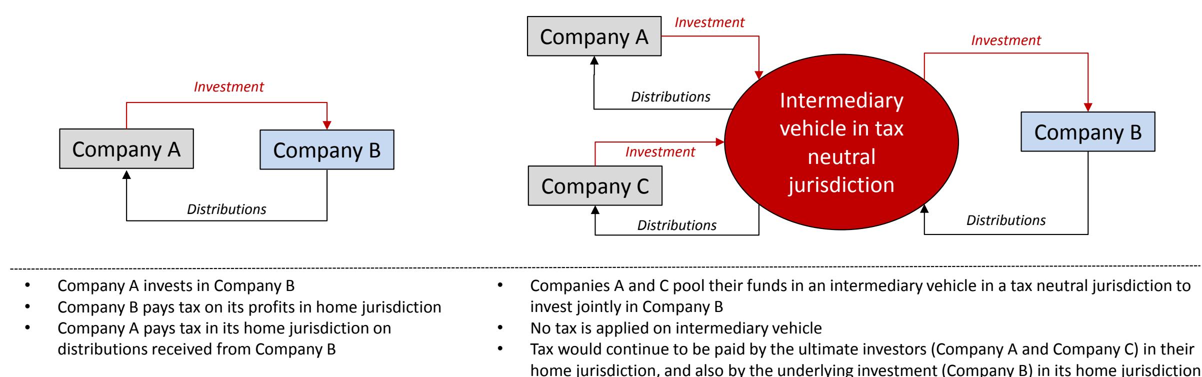
Figure 1: Illustrative example of tax neutrality



Sources: Capital Economics and Jersey Finance

As such, tax neutrality does not facilitate tax evasion. Lack of transparency, on the other hand, can facilitate this illicit behaviour. Tax neutrality therefore needs go hand-in-hand with transparency so that the jurisdiction in which the investor is located can seek to tax that investor on the profits distributed from the tax-neutral jurisdiction.

However, where the use of tax-neutral IFCs provides a tax advantage or the possibility to use purely tax driven structures, the benefits usually result from choices made by 'onshore' governments, such as allowing a tax deferral within their controlled foreign company regimes.

3. Tax neutrality maximises returns to investors and hence, potentially, the tax revenues in their home jurisdiction

Tax-neutral jurisdictions help to maximise returns to investors. Take, for example, a fund that is investing in a particular asset class, such as emerging market equities, and wants to attract investment from parties based in the United Kingdom, the United States, and the European Union. If this fund is not tax-neutral, investors in that fund may be subject to tax at the fund level *in addition to* their tax liability in their home country and in the jurisdiction where the fund has invested: potentially resulting in triple taxation of the same income.

Thus, tax neutrality is essential for international investment that involves participants in a number of countries. These legitimate activities will be primarily motivated by real economic concerns – such as raising finance – rather than for tax purposes, but locating them in a tax-neutral jurisdiction, whether onshore or offshore, allows them to reduce administrative burdens without incurring additional tax.

Tax neutrality is a vital component of the ability of funds to be able to pool investment from around the world. The ability of investors to channel funds through tax-neutral vehicles means that investors invest cross-border without additional tax liability. This maximises returns to onshore investors. As they pay full tax on this income, this maximises tax revenues in the home jurisdiction.

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