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Europe's Unexpected Tax Havens

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When one thinks of a tax haven, he probably pictures a small island, perhaps in the Caribbean, or an underdeveloped country which is attempting to develop its economy by offering tax holidays to foreign investors. Europe certainly does not reflect either of these images, traditionally having been considered a wealthy continent with well developed industrial and financial bases. In these days of depressed economies in the Western world, however, many European countries have been striving to attract foreign investment and have used tax incentives to bring foreign money to their countries.

The combination of sophisticated international financial structures that can be arranged in countries such as the Netherlands and the tax incentives that are offered to manufacturing companies by countries such as the United Kingdom and Ireland can result in little or no tax being paid by investors operating in those countries. The following is a summary of how some of these tax advantages may be obtained.

THE NETHERLANDS

A company formed in the Netherlands will pay no Dutch tax on the income it receives from an overseas branch or associated company. This "participation exemption,"as it is called, is subject to two main conditions: firstly, that the Dutch company has at least a 5 percent interest in the associated company and, secondly, that the foreign income is subject to a local tax on income. The exemption does not apply to interest, royalties, management fees, or similar income, but where such types of income are flowing through a Dutch company, it is possible to agree on a profit for tax purposes on a "turn"of, say, 3 to 5 percent.

The advantage of these low tax rates lies in the extensive network of double-tax treaties which the Netherlands has with other countries. It has approximately 40 such treaties, the majority of which require no withholding taxes on income paid to or out of the Netherlands, other than on dividends where the rate of withholding tax is normally reduced to around 15 percent. Accordingly, the Netherlands can provide a very cheap route for transfering funds between different countries.

IRELAND

In recent years, Ireland has been one of the most imaginative countries in Europe in its approach to attracting foreign investment. In 1967, manufacturing exports amounted to IR £78 million ($187.2 million); in 1980, they totalled IR £2.253 billion ($4.66 billion). These figures reflect the Irish government's successful attempts at attracting new industries to Ireland through the offer of tax incentives and cash grants. The normal corporate tax rate on profits from the wholesaling of goods manufactured in Ireland has been reduced from 50 percent to 10 percent, and this relief is guaranteed through December 31, 2000.

To qualify as a manufacturing company in Ireland, a company must, in some way, change the nature of the goods it processes, a provision the revenue authorities interpret very broadly. Certain activities are deemed to constitute manufacturing, including designing and planning services in connection with chemical, civil, electrical, or mechanical work carried on outside the European Economic Community. The 10 percent rate also has been extended to cover any trading activity carried on in the Shannon Free Airport Zone, which is regarded as contributing to the use of the airport.

To companies taxable at the 10 percent rate, the 100 percent capital allowances granted to trading companies are of little value. Therefore, the government has introduced other incentives for these companies in the form of capital grants paid to institutions that lease them equipment. The companies receive the benefit of the grants through reduced leasing payments.

If an Irish company is owned by a Dutch holding company, which many are, dividends may be distributed free of withholding tax, and they will not be taxed in the Netherlands if the conditions described earlier are met.

UNITED KINGDOM

The United Kingdom does not offer reduced corporate tax rates to certain businesses the way that Ireland does. But, like Ireland, the U.K. does offer very favourable tax incentives. Such incentives may, when combined with the ability to carry forward indefinitely unutilised capital allowances, reduce the tax liabilities of an expanding company to zero for a considerable number of years.

Probably the most attractive tax incentive offered by the U.K. is the 100 percent depreciation allowance given on the cost of plant and machinery in the year of their purchase. This incentive is noticeably more favourable than those of all other European countries (other than Ireland), where the depreciation rate is generally not more than 20 percent. Moreover, it is possible to obtain a 79 percent depreciation allowance, sometimes increased to 100 percent, on the purchase of industrial buildings. The economy gains advantages in two ways from these incentives: firstly, by attracting new businesses with the low cost of acquiring the tools of their trades, and, secondly, by increasing the profitability of the businesses that supply those tools.

The 1970s were a time of increasing inflation throughout Europe, and this was as true for the United Kingdom as for other European countries. One effect of inflation that hit businesses hard at this time was that the cost of carrying stocks became prohibitively expensive, while, at the same time, inflation-boosted profits resulted in larger tax bills. In response to the anguished cries of industry as its cash flow was squeezed, the government introduced legislation in the middle of the decade which gave businesses relief from the effects of inflation on stock levels.

Unlike other European countries, where similar relief was given on a tax deferral basis, the U.K. relief has been of a permanent nature. Incentives such as those outlined above, together with the unlimited period of time during which unutilised capital allowances may be carried forward, normally means that a newly formed business will not pay taxes for several years. This is the principal reason why many people think the United Kingdom is a tax haven almost without equal for manufacturing companies.

Conclusion

Attracting foreign investors is a competitive business. In the Western world the success of a government is generally measured by its ability to continually increase the standard of living of its citizens, and a prerequisite to this is a buoyant economy. Britain and Ireland in particular have developed a package of financial and tax incentives which many overseas investors consider to be the best in Europe. And if the current, steady upward trend of their economies is any indication, this policy of encouragement is succeeding.