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Comparative Taxation of Financial Services

Thank you. It is a delight to be here and an honor to join Ambassador and former Finance Minister Yen ChingChang and this distinguished panel. As an outsider on the panel, I think my responsibility is to look at tax policies towards the financial sector in an especially objective fashion and to bring out views that perhaps would be uncomfortable for experts who are closer to Taiwan's financial sector.

It seems safe to assume that all of us here want Taiwan to have a vibrant and globally competitive financial sector. But why? Financial services are important not in and of themselves, but because of the ways in which they generate efficiencies and provide support for the real economy. So, what is the role of taxation as applied to the financial sector? Just as we do not want taxes to unnecessarily discourage economically or socially desirable behavior in Taiwan outside of the financial sector, Taiwan's tax structure as applied to the financial sector should minimize harmful distortions. But the tax system also should not be unnecessarily generous towards those parts of finance that do not contribute to Taiwan's economic strength and vitality.

With that background, let's look at some of the tax issues involving financial services in the US, the UK, EU, Hong Kong and Singapore.

Income taxes on businesses and individuals.

If you contrast the income tax burden on individuals in Hong Kong, Singapore, the UK and the US, you have to conclude that a relatively high tax burden on individuals employed in financial services does not discourage the development of a large, prosperous financial sector. Hong Kong and Singapore impose low taxes on individuals of 15 and 20 percent respectively, but the UK's maximum tax rate is 45 percent and the US maximum tax rate (including state and local income taxes) is greater than 55 percent. So, the health of the financial sector does not seem to be related to the level of income taxes on individuals. Of course, the US does have a peculiar rule of taxing some very high services at 15 percent, but that loophole (based on a questionable administrative ruling) is likely to be closed by Congress. But this suggests that Taiwan's recent increase of the highest marginal tax rate from 40 percent to 45 percent is not likely to have a major impact on Taiwan's efforts to build up its financial sector.

One international norm that may be important for Taiwan is that capital gains on security transactions by non-residents often escape taxation. The US tax system, for example, allows foreign investors to maintain a very substantial presence in the US without the risk that their gains will be taxable in the US. It seems then that efforts to tax foreigners on their capital gains from security transactions may sharply limit the attractiveness of Taiwan's market.

On the other hand, gains from the sale of land or other real estate are often taxed in the country where the property is situated. As the presence of Chinese investors in Taiwan's real market grows, Taiwan may want to make certain any disposition by foreigners is not tax free.

For income taxes on businesses, Taiwan's 17 percent is comparable to Hong Kong's 16.5 percent, Singapore's 17 percent, and the UK's 21 percent (moving to 20 percent), but is far better than the US rate of 39 percent, which is the highest among the OECD countries. But the high US rate may be reduced as part of a corporate tax reform package that brings the US corporate tax more in line with international norms. The US corporate tax also may be modified so that it becomes more of a territorial system, which is consistent with international norms.

On corporate tax integration, I have to agree with our moderator that it is a shame Taiwan have moved from a full imputation system to a limited system. One of the main policy reasons for adopting an imputation system is to reduce the bias in favor of debt financing over equity financing and by moving away from full imputation Taiwan's income tax system is increasing the bias against equity financing and may be encouraging over-reliance on debt financing.

As countries move to a territorial system, they also are paying more attention to preventing an erosion of the territorial income tax base. But if you look at the current tax controversy involving Apple Computer and other major high tech companies with tax favored operations in Ireland, you will see that exempting outbound royalty payments for foreign patents and other technology plays an essential role in eroding the US and European tax bases. With this in mind, I wonder if Taiwan's recent restoration of the withholding tax exemption for outbound royalty payments hasn't created a significant opportunity for shifting Taiwan profits to tax havens, as the American high tech companies now are doing.

Value Added Taxes.

The members of the European Union commonly exempt financial services from VAT, but the members are finding the exemption system is not very satisfactory. Problems have arisen in the definition of financial services, the cascading effects from exempting financial services, and the distortions the exemptions cause by encouraging integration to avoid VAT applying to outsources peripheral services. Taiwan has increased the VAT on financial services from 2 percent to 5 percent, but the European Union's research on VAT and financial services may provide helpful guidance in dealing with such issues as the definition of financial services and alternatives to the current methods of treating financial services.