



The Offshore Institute

MEMORANDUM

TITLE: A position paper dealing with the OECD Report released in April 1998 entitled “Harmful Tax Competition: An Emerging Global Issue” (The Report)

AUTHORS: Edmund (Ben) Bendelow – President (CV attached)
Samuel (Sam) Lohman – Deputy President (CV attached)

PURPOSE: To make the position clear of the Offshore Institute in relation to the aforementioned OECD Report and to comment on some of the inconsistencies contained therein.

DATE: November 1998

Introduction

In April 1998 the OECD released a report entitled “Harmful Tax Competition: An Emerging Global Issue” (The Report). The contents of the Report were considered by the Executive Committee of the Institute in some detail at its meeting prior to the Annual Conference of the Institute in Vancouver in October 1998. The Executive Committee of the Institute was concerned at a number of the assumptions made in the Report, and also at a number of recommendations for action contained therein.

As a result of these concerns, the President and Deputy President of the Institute were requested to provide a position paper on the OECD Report, the contents of which could then be made available both to our membership and other interested parties.

General Comments

The OECD Report contains a number of interesting generalised statements about the “globalisation” of the World’s economy – “a process which breaks down economic barriers between nations and leads enterprises to develop global strategies”. Presumably, in a mixed capitalist economy, the purpose of these global strategies is to maximise stakeholder returns. (NB Stakeholders include owners, employees, suppliers, local and central governments). These maximised returns are, of course, earned through selling at the highest price with the lowest possible cost base. Clearly, therefore, in a “global” economy managers are also seeking to minimise taxation costs as part of their overall cost reduction or containment strategy. However, according to the OECD, only a cost containment strategy, which does not include a “minimisation of payment to governments” sub strategy, is acceptable!

The Report then goes on to state “If nothing is done governments may increasingly be forced to engage in competitive tax bidding”. Alternatively, they could of course globalise their own expenditure plans and themselves adopt a strategy of lower direct taxation rates. However, to even begin to adopt this strategy, it would be necessary to review their own revenue and cost elements in a radical way. (Presumably this is not politically acceptable?)

The Report then states “financing decisions become primarily tax (ie cost) driven and capital flows may become distorted and it will be more difficult to achieve fair competition for real economic activities.” (Nowhere does the Report define or explain the term “real economic” activities. (Presumably this is some reference to onshore economic activities being real). Basically, the position of the OECD Ministers is that a cartel which fixes the government costs for economic activity is healthy and desirable, while any other similar cartel for the suppliers of other cost elements would be a heresy

and generally against public policy under the GATT provisions. The Report then goes on to make a number of recommendations.

Recommendations

In total 19 recommendations are put forward to deal with harmful tax practices. They are listed under the following categories.

I Recommendations concerning domestic legislation and practices.

- 1 **Recommendation concerning Controlled Foreign Corporations (CFCs)** - Countries that do not have CFC rules consider adopting them.
- 2 **Recommendations concerning foreign investment fund or equivalent rules** – Countries that do not have such rules adopt them to entities covered by practices considered to be harmful tax competition.
- 3 **Recommendations concerning restrictions on participation exemptions and other systems of exempting foreign income in the context of harmful tax competition** – Countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income benefiting from harmful tax competition practices does not qualify for the application of the exemption method.
- 4 **Recommendation concerning foreign information reporting rules** – Countries that do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting such rules and that countries exchange information obtained under these rules.
- 5 **Recommendation concerning rulings** – Countries offering advanced rulings concerning the particular position of a taxpayer make public the conditions for offering or denying such rulings.

- 6 **Recommendations concerning transfer-pricing rules** – Countries follow the guidelines set out in the OECD 1995 guidelines on transfer-pricing and not promote harmful tax competition.
- 7 **Recommendations concerning access to banking information for tax purposes** – Countries review their laws, regulations and practices which govern the access to banking information with the view to removing impediments to the access to such information by tax authorities.

II Recommendations regarding tax treaties.

- 8 **Recommendations concerning greater and more efficient use of exchanges of information** – Countries should undertake programs to intensify exchange of information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition.
- 9 **Recommendations concerning the entitlement to treaty benefits** – Countries consider including to their tax convention provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices.
- 10 **Recommendation concerning clarification of the status of domestic anti-abuse rules and doctrines in tax treaties** – That the Commentary on the Model Tax Convention be clarified to remove any ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.
- 11 **Recommendations concerning a list of specific exclusion provisions found in treaties** – The Committee should prepare a list of provisions used by countries to exclude from the benefits of tax conventions certain specific entities and types of income.
- 12 **Recommendation concerning tax treaties with tax havens** – Countries consider terminating their tax conventions with tax havens and consider not entering into tax treaties with such countries in the future.

- 13 **Recommendations concerning co-ordinated enforcement regimes (Joint audits, etc)** – Countries consider undertaking joint enforcement programs such as simultaneous audits and examinations in relation to income of taxpayers benefiting from practices constituting harmful tax competition.
- 14 **Recommendation concerning assistance in recovery of tax claims** – Countries should review the current rules applying to the enforcement of tax claims of other countries for the addition to tax conventions.
- III Recommendations to intensify international co-operation in response to harmful tax competition.
- 15 **Recommendation for guidelines and a forum on harmful tax practices** – Member countries endorse the guidelines set out in the following list dealing with harmful preferential tax regimes.

Guidelines for Dealing with Harmful Preferential Tax Regimes in Member Countries

The report goes beyond identifying tax havens as culprits in stealing away tax revenues from the high-tax member nations. It adopts further measures designed to “level the playing field” between member nations to allow continued expansion of global economic growth and “to avoid an aggressive competitive bidding by countries for geographically mobile activities.”

Six guidelines are put forward to encourage and insure compliance of all nations to adhere to the recommendations of the report. They include an agreement to not adopt harmful taxation measures, a review of existing harmful tax measures, the removal within 5 years of the harmful feature of preferential tax treatment, an examination by member countries of any measures that are considered to be harmful tax competition, co-ordination

of a forum to discuss such practices and the use of the forum to promote non-member nations to associate themselves with the guidelines.

- 16 **Recommendation to produce a list of tax havens** – The Forum mandated to establish within one year of the first meeting of the Forum, a list of tax havens on the basis of factors identified in this report.
- 17 **Recommendation concerning links with tax havens** – Countries that have links to tax havens ensure that these links do not contribute to harmful tax competition and in particular, that countries with dependencies that are tax havens ensure that the links with these territories are not used to promote or increase harmful tax competition.
- 18 **Recommendation to develop and promote Principles of Good Tax Administration** – The Committee be responsible for developing and promoting a set of principles to guide tax administrations in the enforcement of guidelines in this report.
- 19 **Recommendation on associating non-member countries with the Recommendations** – The Forum engage in dialogue with non-member nations to promote these recommendations.

Switzerland and Luxembourg participated with the OECD in discussions leading up to ratification of the report but both abstained from ratifying the document.

Commentary

A number of the individual recommendations give rise to certain points of discussion:

- 1 **Controlled Foreign Corporations (CFC) Rules: that countries that do not have such rules consider adopting them and that countries that have such rules ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices.**

Commentary: is the absence of CFC rules a proper issue for discussion when considering harmful tax practices? Those countries which do not have such rules, eg Italy, the Netherlands, have taken a policy decision affecting not just enterprises which may be tempted to relocate to those countries but also home-based enterprises.

- 2 **Foreign Investment Fund (FIF) Rules: that countries that do not have such rules consider adopting them and that countries that have such rules consider applying them.**

Commentary: the US has FIF rules but not many other countries have adopted them. Instead, tax is often imposed on any profit made on the sale or redemption of units in such funds. Can the failure to tax unit holders on their share of current income within such a fund truly be designed as harmful tax competition undermining the tax base of countries which do have FIF rules?

- 3 **Participation Privilege and other Exemption Systems: that such systems not apply in the case of foreign income that has benefited from tax practices deemed to constitute harmful tax competition.**

Commentary: does not the same comment apply here as to the proposals with regard to CFC rules and FIF rules in 1 and 2 above?

- 4 **Foreign Information Reporting Rules: that countries that do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting such rules and that countries exchange information obtained under these rules.**

This recommendation follows from the first three. Clearly, if a country adopts world-wide taxing rules it will require information sufficient to enable it to enforce those rules. Once information is obtained in this way, the Report

recommends that it then be available for exchange on the basis of the provisions of Article 26 of the OECD Model Tax Convention.

Commentary: Switzerland specifically dissociated itself from this recommendation. As noted for 1-3 above depends on the taxation philosophy of the country concerned.

5 **Advanced Rulings: that countries make public the conditions for granting, denying or revoking advance rulings.**

Commentary: this would appear to be a reasonable principle with greater relevance to the real issue of so-called harmful tax competition than the previous recommendations.

6 **Transfer Pricing Rules: that countries follow the principles set out in the OECD's 1995 Guidelines on Transfer Pricing.**

Commentary: this would appear to be a reasonable principle with greater relevance to the real issue of so-called harmful tax competition than the previous recommendations.

7 **Access to Banking Information: that countries should review their laws, regulations and practices governing access to banking information to make it available to tax authorities.**

Commentary: Luxembourg, in a dissenting statement, emphasised that it did not share “the Report’s implicit belief that bank secrecy is necessarily a source of harmful tax competition”.

8 **Exchange of Information: that countries should intensify exchange of relevant information concerning transactions in tax havens and preferential tax regimes.**

Commentary: Switzerland specifically disassociated itself from this recommendation.

- 9 **Limitation of Treaty Benefits:** that countries amend their tax treaties to restrict entitlement to benefits in the case of entities benefiting from harmful tax practices and that countries consider further how the existing provisions of their tax treaties can be applied for the same purpose. The Model Tax Convention is to be modified accordingly.

Commentary: the United States has, of course, embarked on a wholesale programme of including detailed “limitation of benefits” clauses in their tax treaties. The UK has included in a number of its treaties general provisions to the effect that if a particular clause is used for the purpose of obtaining the benefit of the treaty, that benefit will be denied. Another approach (eg Spain) has been to insist on more than 50% beneficial ownership of the entity in the treaty country being in the hands of residents of that same country. Other countries (eg Germany) have relied on changes in their domestic law to permit the non-application of their treaties in cases where the entity in the treaty country fails to meet certain tests. This is claimed by the German government not to be a treaty “override” but simply a clarification of the way in which Germany has always been entitled to interpret its treaties.

- 10 **Domestic Anti-Abuse Rules:** that the Commentary on the Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Convention.

This is to be studied further and no details are provided at this stage.

Commentary: see 9 above.

- 11 **List of Specific Exclusion Provisions in Treaties: that the Committee prepare and maintain a list of specific “limitation of benefits” provisions found in treaties.**

The Committee has prepared a list (due to have been finalised in June 1998) of specific “limitation of benefits” provisions found in tax treaties as a reference point for future treaty negotiators to ensure greater co-ordination in the use of these provisions.

Commentary: see 9 above.

- 12 **Tax Treaties with Tax Havens: that countries consider terminating their treaties with tax havens and not enter into such treaties in the future.**

Commentary: it is very unlikely that a country will terminate a tax treaty with a tax haven solely because the treaty may be used by an enterprise in a third country to reduce that enterprise’s tax liability in that third country. If there were good commercial or economic reasons for maintaining the treaty, the high-tax treaty partner would only terminate the treaty if its own tax base was seriously threatened by its continued existence. Even then, it is far more likely that a “limitation of benefits” clause would be introduced than that the treaty would be terminated altogether.

- 13 **Co-ordinated Enforcement Regimes: that countries consider undertaking co-ordinated enforcement programmes such as simultaneous examinations, specific exchange of information projects or joint training activities in relation to income or taxpayers benefiting from practices constituting harmful tax competition.**

Commentary: the implications of giving the tax officials of different countries blanket authority to conduct joint or combined operations in investigating taxpayers are worrying. It is true that the EU is now proposing to amend Council Directive 76/308/EEC to permit mutual assistance in the recovery of each other’s

direct tax claims but this relates only to the recovery of tax alleged to be due. Recommendation 13 in the Report advocates joint action in audit and investigation which is a much greater invasion of the rights of the taxpayer to confidentiality in his own private and business affairs.

- 14 **Assistance in the Recovery of Tax Claims:** that countries review their current rules preventing the enforcement of other countries' tax claims and in the future permit such enforcement through the inclusion of appropriate provisions in bilateral tax treaties.

Commentary: Switzerland specifically disassociated itself from this recommendation.

- 15 **Guidelines and a Forum on Harmful Tax Practices:** that the Member countries endorse the Guidelines on harmful preferential tax regimes set out in the Report and establish a forum to implement the Guidelines and other Recommendations of this Report.

Commentary: Switzerland specifically disassociated itself from this recommendation.

- 16 **List of Taxes Havens:** that the Forum produce a list of tax havens within one year of its first meeting.

Commentary: interestingly neither Luxembourg nor Switzerland are rumoured to be on the first draft of the list, which is said to have been produced by the OECD Secretariat. Only small and relatively weak nations appear to have been targeted in the first wave.

- 17 **Links with Tax Havens: that countries with political, economic or other links with tax havens ensure that these links do not contribute to harmful tax competition.**

Commentary: this presumably is some kind of veiled threat relating to providing aid to the tax haven governments in the event of some sort of civil disaster or in the health care fields.

- 18 **Principles of Good Tax Administration: the Forum is to develop and promote a set of principle to guide tax administrations in the enforcement of the recommendations included in the Report.**

Commentary: presumably the OECD Ministers agree some type of “staff college” where senior tax bureaucrats will develop a comprehensive strategy to defeat harmful tax competition for all time.

- 19 **Associating non-OECD – Member Countries with the Recommendations in the Report.**

Commentary: once we have forced OECD Members to see things our way we will then reach out to force weaker trading partners to follow suit.

Conclusion

In the body of the Report there is the interesting comment that “tax competition can be beneficial in stimulating the simplification of tax systems and reduction in tax rates”. What the Ministers object to is “harmful” tax competition. However, when tax competition ceases to be beneficial and starts to be “harmful” is not clear. It is admitted that many “tax havens” are simply taxing jurisdictions that have no taxes on income or capital gains, and they raise revenue from local user fees and consumption taxes. Such

countries or territories do not see to tax economic activity and assets overseas. Because they do not seek to tax overseas activities enforcement of taxes becomes a purely domestic issue for them.

The central issue is that of sovereignty. Nations and territories should be free to raise their government revenue requirements by whichever method suits them and their local needs best. The OECD is attempting to “impose” a single view of taxation, which is based on only one economic model, which may or may not be relevant to the majority of their individual members. It is notable that not all members of the OECD (ie Switzerland and Luxembourg) agree the purported model put forward. What is really worrying is that the OECD and its officials seem to be trying to win the argument that their model for revenue raising is appropriate by purposely muddling certain key legal concepts, notably tax avoidance, tax evasion and money laundering. The overall strategy being to get the non-specialist to agree that money laundering is wrong. Therefore, tax evasion and avoidance equal money laundering and should be equally suppressed in order to win the argument that sovereignty must and should be sacrificed in order that the OECD model of the world economy, and hence government revenues, is vindicated.

In order to highlight the fallacy in these arguments, we attach a list of definitions to show at least some of the errors in the underlying philosophy adopted by the OECD in its so-called “Harmful Tax Competition Report”.

DEFINITIONS

1 US Perspective

Black's Law Dictionary, abr. Fifth Edition, 1983 provides the following definitions:

Tax Evasion

Intentionally paying less in taxes than lawfully due; fraud in filing or paying taxes. Such act is a crime under IRC §7201.

Tax Avoidance

The minimisation of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion which entails the reduction of tax liability by using illegal means.

2 Swiss Position

The Federal Tribunal holds that tax fraud occurs when the 3 conditions are present:

- a) the form used by the taxpayer is unusual, inadequate or abnormal, in any event, not adapted to the circumstances.
- b) the choice of form is abusive and has no other substantial justification than to avoid tax which would have been due if the matter had been dealt with normally.
- c) the choice would indeed lead to a notable economy of tax if the authorities accepted it.

Contrary to tax evasion and tax avoidance, tax fraud constitutes an infringement (cf. HÖHN, Steuerrecht, p.333/334). The difference between tax fraud and tax evasion can be difficult (cf. HÖHN, Steuereinsparung und Steuerumgehung, in Revue fiscale 29/1974, p.141ss). The Federal Tribunal has held in the past that individuals may in principle organise their activities so as to pay the least tax; in particular, they may choose the legal structure which exposes them the least to being taxed. But the individual using an unusual construction of private law, or one that is not adapted to his economic situation is guilty of abusing his rights as far as tax law is concerned (ATF 98 Ib 323 ; Archives 43, 587, lt. 4b).