

HARMFUL TAX COMPETITION

*An
Emerging Global Issue*



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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CONCURRENCE FISCALE DOMMAGEABLE

Un problème mondial

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FOREWORD

In May 1996 Ministers called upon the OECD to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998”.

In response to the Ministers’ request, the OECD’s Committee on Fiscal Affairs launched its project on harmful tax competition. The results of this project are now available.

This Report addresses harmful tax practices in the form of tax havens and harmful preferential tax regimes in OECD Member countries and non-Member countries and their dependencies. It focuses on geographically mobile activities, such as financial and other service activities. The Report defines the factors to be used in identifying harmful tax practices and goes on to make 19 wide-ranging Recommendations to counteract such practices.

In approving the Report on the 9 April 1998, the OECD Council adopted a Recommendation to the Governments of Member countries and instructed the Committee to pursue its work in this area and to develop a dialogue with non-member countries (see Annex I). Luxembourg and Switzerland abstained in Council on the approval of the Report and the adoption of the Recommendation (see Annex II).

The Report was also submitted to Ministers when they met at the OECD on 27-28 April 1998.

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INTRODUCTION

1. The Ministerial Communiqué of May 1996 called upon the Organisation to:

“develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.”

2. This request was subsequently endorsed by the G7 countries, which included the following paragraph in the Communiqué issued by the Heads of State at their 1996 Lyon Summit:

“Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998.”

At their 1997 meetings, OECD Ministers and the G7 Heads of State reaffirmed the importance of combating harmful tax competition.

3. The Committee on Fiscal Affairs (hereinafter referred to as “the Committee”) created the “Special Sessions on Tax Competition” in response to the Ministerial Communiqué. The Special Sessions prepared this Report under the joint Chairmanship of France and Japan. The Committee adopted the Report at its session on the 20th January 1998.

4. The Report is intended to develop a better understanding of how tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems. The Report recognises the distinction between acceptable and harmful preferential tax regimes and carefully analyses the features of both residence and source country tax systems that may lead to the damaging impact of harmful preferential tax regimes. The Report recognises that there are limitations on unilateral or bilateral responses to a problem that is inherently multilateral and identifies ways in which governments can best establish a common framework within which countries could operate individually and collectively to limit the problems presented by countries and fiscally sovereign territories engaging in harmful tax practices. By discouraging the spread of tax havens and harmful preferential tax regimes and encouraging those countries which presently engage in harmful tax practices to review their existing measures, the Report will serve to strengthen and to improve tax policies internationally.

5. The Report and Recommendations address harmful tax practices in both Member and non-member countries and their dependencies.

6. The Report focuses on geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Tax incentives designed to attract investment in plant, building and equipment have been excluded at this stage, although it is recognised that the distinction between regimes directed at financial and other services on the one hand and at manufacturing and similar activities on the other hand is not always easy to apply. The Committee intends to explore this issue in the future. The Committee also recognises that there are many economic, social and institutional factors that affect the competitive position of a country and the location of economic activities. These factors, however, are not the focus of this study.

7. The Report examines provisions found in the general income tax systems, as well as those taxes levied on certain types of income. The Committee is undertaking work separately on the issues raised by tax competition in relation to consumption taxes.

8. This study needs to be seen in the context of the OECD's role in a world where the pace of globalisation is accelerating. The OECD believes that

the progressive liberalisation of cross-border trade and investment has been the single most powerful driving force behind economic growth and rising living standards. The Organisation seeks to safeguard and promote an open, multilateral trading system and to encourage adjustments to that system to take into account the changing nature of international trade, including the interface between trade, investment and taxation. The Committee believes that the proposals set out in this Report, although not covering all aspects of tax competition, will further promote these objectives by reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby promoting fair competition for real economic activities. If governments can agree that these location decisions should be driven by economic considerations and not primarily by tax factors, this will help move towards the “level playing field” which is so essential to the continued expansion of global economic growth.

9. The Committee’s view is that the problems addressed in this Report are already posing challenges for governments and will become increasingly important. Therefore, there is a need both for immediate measures and for an ongoing process to strengthen further internationally co-ordinated action in this area.

10. To address these problems the Report sets out a number of proposals:
- to establish Guidelines on Harmful Preferential Tax Regimes;
 - the creation of a Forum on Harmful Tax Practices;
 - the development of a list of tax havens to be completed within one year of the first meeting of the Forum;
 - a number of Recommendations for action at the level of national legislation and in tax treaties; and
 - areas for follow-up work.

11. These proposals are a significant step in the on-going process of addressing the issue of harmful tax competition. The Recommendations deal with the most urgent and crucial aspects of the challenge to policymakers posed by geographically mobile financial and other service activities. The Committee accepts that more work will be required to implement some of these Recommendations and that in addition there will be other areas in which the issues of harmful tax competition must be explored.

12. The tax treatment of interest on cross-border saving instruments, particularly bank deposits, is not considered in this first stage of the project

since the Committee is currently examining the feasibility of developing proposals to deal with cross-border interest flows, including the use of withholding taxes and exchange of information. It has given a mandate to its Working Party on Tax Evasion and Avoidance to examine how exchange of information and withholding taxes can be used to ensure that cross-border interest flows do not escape taxation. The Committee attaches considerable importance to this issue and a first report will be available in 1999.

13. The Committee recognises that since the problems discussed in this Report are of an inherently global nature, it is critical that as many countries as possible are involved in the dialogue. The broader the economic grouping of countries engaged in this dialogue, the greater the effectiveness of any solutions proposed, since this would minimise any displacement of activities to jurisdictions with harmful tax practices outside of the participating countries. Any displacement of activities may put more pressure on the implementation of counteracting measures if such activities are re-established in jurisdictions which operate non-transparent harmful tax practices. It is for these reasons that the Committee has attached particular importance to associating non-member countries with its analytical and policy discussions on harmful tax competition.

14. Over the last 18 months, the Committee has used its extensive outreach programme to engage in a dialogue with non-member countries. Three regional seminars have been organised. The first seminar took place in Mexico and was attended by Argentina, Bolivia, Brazil, Chile, Colombia, Jamaica, Peru and Venezuela. A second seminar was held in Istanbul with participants from Albania, Azerbadjian, Estonia, F.Y.R.O.M., Georgia, Latvia, Lithuania, Moldova, Mongolia, Romania, Slovak Republic and Ukraine. The third regional seminar was held in co-operation with the Asian Development Bank in Singapore and was attended by China, India, Indonesia, Malaysia, Philippines, Singapore, Sri Lanka, Chinese Taipei and Thailand.

15. An important aspect of the work of the proposed Forum will be to intensify this dialogue, with the aim of encouraging interested non-member countries to become more closely associated with the Recommendations set out in Chapter 3. The Committee also recognises that some non-member countries may not agree with some of these Recommendations. These potential differences in country positions are another reason to engage in a dialogue. The Committee proposes that in early 1999 a high level meeting should be organised by the Forum which would be open to all interested non-member countries.

16. The Committee notes that many tax havens have chosen to be heavily dependent on their tax industries. To the extent that a tax haven provides a

clear signal that it wishes to curtail its harmful tax practices, the Committee would be prepared to engage in a dialogue with such tax havens taking into account the need to encourage the long term development of these economies.

17. Work on harmful tax competition has also been carried out in the European Union (EU). The EU Council agreed on 1 December 1997 to a package of measures to tackle harmful tax competition in order to help to reduce distortions in the Single Market, to prevent excessive losses of tax revenue and to develop tax structures in a more employment-friendly way. The package includes a Code of Conduct on business taxation, taxation of savings income and the issue of withholding taxes on cross-border interest and royalty payments between companies. The Code of Conduct identifies potentially harmful regimes in the field of business taxation and gives factors for the assessment of harmful regimes. It includes a commitment not to introduce new harmful tax regimes and to rollback existing regimes.

18. Whilst the EU Code and the OECD Guidelines are broadly compatible, particularly as regards the criteria used to identify harmful preferential tax regimes, and mutually reinforcing, the scope and operation of the two differ. The OECD Guidelines are clearly limited to financial and other service activities, whereas the Code looks at business activities in general, although with an emphasis on mobile activities. The review procedure reflects the different institutional frameworks within which each Organisation operates and the OECD Guidelines are explicitly aimed at a much broader geographical grouping. The OECD work also goes beyond harmful preferential tax regimes to encompass tax havens and also focuses on exchange of information. In addition, as noted above, the EU Code is part of a package of measures whereas the OECD Guidelines are accompanied by 19 detailed Recommendations relating to the specific issues of harmful tax competition. For all of these reasons, the Committee considers that each Organisation is responsible independently for the interpretation and application of its respective instruments.

19. The Report is in three parts. Chapter 1 provides an overview of the basic principles underlying the existing international taxation arrangements and the ways in which the process of globalisation has put pressures on these arrangements. Chapter 2 analyses the factors that can lead to conclusions that tax havens and certain preferential tax regimes are harmful and presents the concerns that governments have about the impact of such regimes on the integrity of their tax systems. Both transparent and non-transparent regimes are covered. Chapter 3 recommends some measures that can be used to counteract tax havens and harmful preferential tax regimes. These measures can be taken

through domestic legislation, in tax treaties and in the context of intensified international co-operation. The Chapter also sets out the Guidelines on Harmful Preferential Tax Regimes and a procedure to identify tax havens and proposes the creation of a Forum on Harmful Tax Practices under the auspices of the Committee.

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CHAPTER 1

TAX COMPETITION: A GLOBAL PHENOMENON

20. Historically, tax policies have been developed primarily to address domestic economic and social concerns. The forms and levels of taxation were established on the basis of the desired level of publicly provided goods and transfers, with regard also taken to the allocative, stabilising and redistributive aims thought appropriate for a country. Whilst domestic tax systems of essentially closed economies also had an international dimension in that they potentially affected the amount of tax imposed on foreign source income of domestic residents and typically included in the tax base the domestic income of non-residents, the interaction of domestic tax systems was relatively unimportant, given the limited mobility of capital. The decision to have a high rate of tax and a high level of government spending or low taxes and limited public outlays, the mix of direct and indirect taxes, and the use of tax incentives, were all matters which were decided primarily on the basis of domestic concerns and had principally domestic effects. While there were some international spillover effects on other economies, those effects were generally limited.

21. The accelerating process of globalisation of trade and investment has fundamentally changed the relationship among domestic tax systems. As noted in paragraph 8 above, the removal of non-tax barriers to international commerce and investment and the resulting integration of national economies have greatly increased the potential impact that domestic tax policies can have on other economies. Globalisation has also been one of the driving forces behind tax reforms, which have focused on base broadening and rate reductions, thereby minimising tax induced distortions. Globalisation has also encouraged countries to assess continually their tax systems and public expenditures with a view to making adjustments where appropriate to improve the “fiscal climate” for investment. Globalisation and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows and to modernise their tax

systems to reflect these developments. Many of these reforms have also addressed the need to adapt tax systems to this new global environment.

22. The process of globalisation has led to increased competition among businesses in the global market place. Multinational enterprises (MNEs) are increasingly developing global strategies and their links with any one country are becoming more tenuous. In addition, technological innovation has affected the way in which MNEs are managed and made the physical location of management and other service activities much less important to the MNE. International financial markets continue to expand, a development that facilitates global welfare-enhancing cross-border capital flows. This process has improved welfare and living standards around the world by creating a more efficient allocation and utilisation of resources.

23. As indicated in paragraphs 8 and 21 above, globalisation has had a positive effect on the development of tax systems. Globalisation has, however, also had the negative effects of opening up new ways by which companies and individuals can minimise and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital. These actions induce potential distortions in the patterns of trade and investment and reduce global welfare. As discussed in detail below, these schemes can erode national tax bases of other countries, may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals. Pressure of this sort can result in changes in tax structures in which all countries may be forced by spillover effects to modify their tax bases, even though a more desirable result could have been achieved through intensifying international co-operation. More generally, tax policies in one economy are now more likely to have repercussions on other economies. These new pressures on tax systems apply to both business income in the corporate sector and to personal investment income.

24. Countries face public spending obligations and constraints because they have to finance outlays on, for example, national defence, education, social security, and other public services. Investors in tax havens, imposing zero or nominal taxation, who are residents of non-haven countries may be able to utilise in various ways those tax haven jurisdictions to reduce their domestic tax liability. Such taxpayers are in effect “free riders” who benefit from public spending in their home country and yet avoid contributing to its financing.

25. In a still broader sense, governments and residents of tax havens can be “free riders” of general public goods created by the non-haven country. Thus on the spending side, as well, there are potential negative spillover effects from increased globalisation and the interaction between tax systems.

26. The Committee recognises that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments. Depending on the decisions taken, levels of tax may be high or low relative to other states and the composition of the tax burden may vary. The fact that a country has modernised its fiscal infrastructure earlier than other countries, for example by lowering the rates and broadening the base to promote greater neutrality, is principally a matter of domestic policy. Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so. This study is designed, in part, to assist in that regard.

27. Tax competition and the interaction of tax systems can have effects that some countries may view as negative or harmful but others may not. For example, one country may view investment incentives as a policy instrument to stimulate new investment, while another may view investment incentives as diverting real investment from one country to another. In the context of this last effect, countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. Similarly, within countries, peripheral regions often experience difficulties in promoting their development and may, at certain stages in this development, benefit from more attractive tax regimes or tax incentives for certain activities. This outcome, in itself, recognises that many factors affect the overall competitive position of a country. Although the international community may have concerns about potential spillover effects, these decisions may be justifiable from the point of view of the country in question.

28. Harmful effects may also occur because of unintentional mismatches between existing tax systems, which do not involve a country deliberately exploiting the interaction of tax systems to erode the tax base of another country. Such unintentional mismatches may be exploited by taxpayers to the detriment of either or both countries. The undesirable effects of such mismatches may be dealt with by unilateral or bilateral measures. If, however,

an issue cannot be resolved at this level it may be examined on the basis of the criteria set out in Chapter 2.

29. Unlike the situation of mismatching, where the interaction of tax systems is exploited by the enactment of special tax provisions which principally erode the tax base of other countries, the spillover effects on the other countries is not a mere side effect, incidental to the implementation of a domestic tax policy. Here the effect is for one country to redirect capital and financial flows and the corresponding revenue from the other jurisdictions by bidding aggressively for the tax base of other countries. Some have described this effect as “poaching” as the tax base “rightly” belongs to the other country. Practices of this sort can appropriately be labelled harmful tax competition as they do not reflect different judgements about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country’s sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries’ taxes.

30. Tax havens or harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries have the potential to cause harm by:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all taxpayers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

31. Clearly, where such practices have all of these negative effects they are harmful. However, in other cases, for example where only some of these effects are present, the degree of harm will range along a spectrum and thus the process of identifying harmful tax practices involves a balancing of factors. If the spillover effects of particular tax practices are so substantial that they are concluded to be poaching other countries’ tax bases, such practices would be doubtlessly labelled “harmful tax competition”.

32. The Committee is aware that many of the preferential tax regimes referred to in this Report have been put in place in response to pressures by the business community on those parts of government that have the responsibility for economic development. It is hoped that the analyses set out in this Report will assist tax policymakers in their discussions with their colleagues in these other government departments and with the business community.

33. While the focus of the analysis so far has been on source country taxation, the interaction between source and residence taxation is also involved. To some extent, the residence country can protect itself against the negative effects and economic behaviour caused by harmful tax practices in other countries by modifying its own tax rules. For example, certain modifications and adjustments of the currently applicable regimes for taxing foreign income may be possible as a targeted response to some of these problems. These matters are discussed in more detail in Chapter 3.

34. The Committee recognises that some investors may seek to invest in a location with lower rates (and greater after tax return) even if only low public services are available, while others may seek to invest in a location with higher public services even if they have to endure a higher tax burden to finance them. Investors will favour different locations for these reasons but these genuine location decisions have to be distinguished from the type of behaviour which is the focus of this Report.

35. The available data do not permit a detailed comparative analysis of the economic and revenue effects involving low-tax jurisdictions. It has also proven difficult to obtain data on activities involving preferential tax regimes, given the problems in separating their effects from aggregate data in countries with otherwise normal tax systems, and the fact that such regimes often are non-transparent. However, the available data do suggest that the current use of tax havens is large, and that participation in such schemes is expanding at an exponential rate. For example, foreign direct investment by G7 countries in a number of jurisdictions in the Caribbean and in the South Pacific island states, which are generally considered to be low-tax jurisdictions, increased more than five-fold over the period 1985-1994, to more than \$200 billion, a rate of increase well in excess of the growth of total outbound Foreign Direct Investment. The Committee continues to attach importance to collecting additional data on developments in tax havens and in the use of preferential tax regimes.

36. A regime can be harmful even where it is difficult to quantify the adverse economic impact it imposes. For example, the absence of a

requirement to provide annual accounts may preclude access to the data required for an analysis of the economic effects of a regime. Yet, despite the inability to measure the economic damage, countries would agree that such regimes are harmful and should be discouraged.

37. Globalisation and the intensified competition among firms in the global marketplace has had and continues to have many positive effects. However, the fact that tax competition may lead to the proliferation of harmful tax practices and the adverse consequences that result, as discussed here, shows that governments must take measures, including intensifying their international co-operation, to protect their tax bases and to avoid the world-wide reduction in welfare caused by tax-induced distortions in capital and financial flows.

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CHAPTER 2

FACTORS TO IDENTIFY TAX HAVENS AND HARMFUL PREFERENTIAL TAX REGIMES

I. INTRODUCTION

38. This Chapter discusses the factors to be used in identifying, within the context of this Report, tax-haven jurisdictions and harmful preferential tax regimes in non-haven jurisdictions. It focuses on identifying the factors that enable tax havens and harmful preferential tax regimes in OECD Member and non-member countries to attract highly mobile activities, such as financial and other service activities. The Chapter provides practical guidelines to assist governments in identifying tax havens and in distinguishing between acceptable and harmful preferential tax regimes.

39. The Chapter takes a necessary and practical step towards explaining further why governments are concerned about harmful tax competition. It does this by first identifying and discussing factors that characterise tax havens. It then discusses factors that may identify preferential tax regimes that can be considered to lead to harmful tax competition.

40. At the outset, a distinction must be made between three broad categories of situations in which the tax levied in one country on income from geographically mobile activities, such as financial and other service activities, is lower than the tax that would be levied on the same income in another country:

- i)* the first country is a tax haven and, as such, generally imposes no or only nominal tax on that income;
- ii)* the first country collects significant revenues from tax imposed on income at the individual or corporate level but its tax system has preferential features that allow the relevant income to be subject to low or no taxation;

- iii) the first country collects significant revenues from tax imposed on income at the individual or corporate level but the effective tax rate that is generally applicable at that level in that country is lower than that levied in the second country.

41. All three categories of situations may have undesirable effects from the perspective of the other country. However, as already noted in paragraph 21 above, globalisation has had a positive effect on the development of tax systems, being, for instance, the driving force behind tax reforms which have focused on base broadening and rate reductions, thereby minimising tax induced distortions. Accordingly, and insofar as the other factors referred to in this Chapter are not present, the issues arising in this third category are outside the scope of this Report. Any spillover effects for the revenue of the other country may be dealt with by a variety of means at the unilateral or bilateral level (see, for example, paragraph 98). It is not intended to explicitly or implicitly suggest that there is some general minimum effective rate of tax to be imposed on income below which a country would be considered to be engaging in harmful tax competition.

42. The first two categories, which are the focus of this report, are dealt with differently. While the concept of “tax haven” does not have a precise technical meaning, it is recognised that a useful distinction may be made between, on the one hand, countries that are able to finance their public services with no or nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence and, on the other hand, countries which raise significant revenues from their income tax but whose tax system has features constituting harmful tax competition.

43. In the first case, the country has no interest in trying to curb the “race to the bottom” with respect to income tax and is actively contributing to the erosion of income tax revenues in other countries. For that reason, these countries are unlikely to co-operate in curbing harmful tax competition. By contrast, in the second case, a country may have a significant amount of revenues which are at risk from the spread of harmful tax competition and it is therefore more likely to agree on concerted action.

44. Because of this difference, this Report distinguishes between jurisdictions in the first category, which are referred to as tax havens, and jurisdictions in the second category, which are considered as countries which have potentially harmful preferential tax regimes. This distinction is particularly relevant for the application of the Recommendations in Chapter 3 since, for example, Recommendation 16 applies only to tax havens, whereas the

Guidelines apply only to harmful preferential tax regimes. The following sections II and III present the factors to be used to identify each category.

45. Many factors may contribute to the classification of the actual or potential effects of tax practices as harmful. Any evaluation should be based on an overall assessment of the relevant factors.

46. The absence of tax or a low effective tax rate on the relevant income is the starting point of any evaluation. No or only nominal taxation combined with the fact that a country offers itself as a place, or is perceived to be a place, to be used by non-residents to escape tax in their country of residence may be sufficient to classify that jurisdiction as a tax haven. Similarly, no or only nominal taxation combined with serious limitations on the ability of other countries to obtain information from that country for tax purposes would typically identify a tax haven. With respect to preferential tax regimes, key factors, other than no or low effective taxation on the relevant income, include: whether the regime is restricted to non-residents and whether it is otherwise isolated from the domestic economy (*i.e.*, ring-fencing), non-transparency and a lack of access to information on taxpayers benefiting from a preferential tax regime. Other factors that may be relevant to characterise a preferential tax regime as harmful are identified in Section III below. It is the combination of no or low effective taxation and one or more other factors set out in Box II and, where relevant, in Section III below on which the classification is based.

II. Tax havens

a) Introduction

47. Many fiscally sovereign territories and countries use tax and non-tax incentives to attract activities in the financial and other services sectors. These territories and countries offer the foreign investor an environment with a no or only nominal taxation which is usually coupled with a reduction in regulatory or administrative constraints. The activity is usually not subject to information exchange because, for example, of strict bank secrecy provisions. As indicated in paragraph 42 and 43, these jurisdictions are generally known as tax havens.

48. Tax havens generally rely on the existing global financial infrastructure and have traditionally facilitated capital flows and improved financial market liquidity. Now that the non-haven countries have liberalised and de-regulated their financial markets, any potential benefits brought about by tax havens in this connection are more than offset by their adverse tax effects.

Since tax and non-tax advantages tend to divert financial capital away from other countries, tax havens have a large adverse impact on the revenue bases of other countries. This section describes the factors that can be used to identify tax havens for the purpose of this Report.

49. Because tax havens offer a way to minimise taxes and to obtain financial confidentiality, tax havens are appealing to corporate and individual investors. Tax havens serve three main purposes: they provide a location for holding passive investments (“money boxes”); they provide a location where “paper” profits can be booked; and they enable the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries.

50. All of these functions may potentially cause harm to the tax systems of other countries as they facilitate both corporate and individual income tax avoidance and evasion.

51. A 1987 Report by the OECD recognised the difficulties involved in providing an objective definition of a tax haven. That Report concluded that a good indicator that a country is playing the role of a tax haven is where the country or territory offers itself or is generally recognised as a tax haven. While this is known as the “reputation test”, the present Report sets out various factors to identify tax havens.

b) Factors to identify tax havens

52. The necessary starting point to identify a tax haven is to ask (a) whether a jurisdiction imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence. Other key factors which can confirm the existence of a tax haven and which are referred to in Box I are: (b) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; (c) lack of transparency and (d) the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, *i.e.* these jurisdictions are essentially “booking centres”). No or

Box I

**KEY FACTORS IN IDENTIFYING TAX HAVENS FOR THE
PURPOSES OF THIS REPORT**

a) No or only nominal taxes

No or only nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven.

b) Lack of effective exchange of information

Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction.

c) Lack of transparency

A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens.

d) No substantial activities

The absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven.

only nominal taxation is a necessary condition for the identification of a tax haven. As noted in paragraph 46 above, if combined with a situation where the jurisdiction offers or is perceived to offer itself as a place where non-residents can escape tax in their country of residence, it may be sufficient to identify a tax haven. In general, the importance of each of the other key factors referred to above very much depends on the particular context. Even if the tax haven does impose tax, the definition of domestic source income may be so restricted as to result in very little income being taxed.

53. Beyond no or only nominal taxation, other key factors in identifying a tax haven are the lack of transparency in the operation of the jurisdiction's administrative tax practices and the existence of provisions --- whether

legislative, legal, or administrative --- that prevent (or would prevent) effective exchange of information. Because non-transparent administrative practices as well as an inability or unwillingness to provide information not only allow investors to avoid their taxes but also facilitate illegal activities, such as tax evasion and money laundering, these factors are particularly troublesome. Some jurisdictions have enacted laws (*e.g.*, providing anonymous accounts) that prevent financial institutions from providing tax authorities with information about investors. Thus, tax administrators lack the power to compel such information from institutions, and they cannot exchange information under tax treaties or under other types of mutual assistance channels. The most obvious consequence of the failure to provide information is that it facilitates tax evasion and money laundering. Thus, these factors are particularly harmful characteristics of a tax haven and, as discussed later, of a harmful preferential tax regime.²

54. Some progress has been made in the area of access to information, in that certain tax haven jurisdictions have entered into mutual legal assistance treaties in criminal matters with non-tax havens that permit exchange of information on criminal tax matters related to certain other crimes (*e.g.* narcotics trafficking) or to exchange information when criminal tax fraud is at issue. Nevertheless, these tax haven jurisdictions do not allow tax administrations access to bank information for the critical purposes of detecting and preventing tax avoidance which, from the perspectives of raising revenue and controlling base erosion from financial and other service activities, are as important as curbing tax fraud. Thus, the lack of effective exchange of information is one of the key factors in identifying a tax haven since it limits the access by tax authorities to the information required for the correct and timely application of tax laws.

55. In addition, the absence of a requirement that the activity be substantial is important because it suggests that a jurisdiction may be attempting to attract investment and transactions that are purely tax driven. It may also indicate that a jurisdiction does not (or cannot) provide a legal or commercial environment or offer any economic advantages that would attract substantive business activities in the absence of the tax minimising opportunities it provides. The determination of when and whether an activity is substantial can be difficult. For example, financial and management services may in certain circumstances involve substantial activities. However, certain services provided by “paper companies” may be readily found to lack substance.

56. In addition to the above tax factors many other non-tax factors, such as a relaxed regulatory framework and the presence of a solid business infrastructure may contribute to a tax haven's success. The attractiveness of these features may be accentuated by the haven's close ties with non-haven countries (a form of "free-riding"). For example, a tax haven which is a dependency benefits at no cost to itself from the diplomatic, financial and other infrastructure provisions provided by the home country.

III. Harmful preferential tax regimes in OECD member and non-member countries

57. Many OECD Member and non-member countries have already established or are considering establishing preferential tax regimes to attract highly mobile financial and other service activities. These regimes generally provide a favourable location for holding passive investments or for booking paper profits. In many cases, the regime may have been designed specifically to act as a conduit for routing capital flows across borders. These regimes may be found in the general tax code or in administrative practices, or they may have been established by special tax and non-tax legislation outside the framework of the general tax system. This section discusses factors that may help identify harmful preferential tax regimes, without targeting specific countries.

58. The preferential tax regimes discussed in this part of the Report are usually targeted specifically to attract those economic activities which can be most easily shifted in response to tax differentials, generally financial and other service activities. Such tax regimes can be particularly successful if targeted to attract income from base company activities and from passive investment rather than income from active investment. The existence of these preferential tax regimes may encourage the relocation of activities for which there is little or no demand or supply in the host country's domestic market. In many cases the scheme is merely a conduit and absent the regime the investment flow would be unlikely to go through the country providing the regime.

59. Four key factors assist in identifying harmful preferential tax regimes: (a) the regime imposes a low or zero effective tax rate on the relevant income; (b) the regime is "ring-fenced"; (c) the operation of the regime is non-transparent; (d) the jurisdiction operating the regime does not effectively exchange information with other countries (See Box II below). Although a low or zero effective tax rate is the necessary starting point of an examination of a preferential tax regime, any evaluation should be based upon an overall assessment of each of the key factors identified in Box II and, where relevant, the other factors referred to in section (a) below. Once a regime is identified as

potentially harmful, the economic considerations set out in section (b) would also have to be examined. A harmful preferential tax regime will be characterised by a combination of a low or zero effective tax rate and one or more other factors set out in Box II and, where relevant, in this section.

a) Features of harmful preferential tax regimes

60. This section discusses certain features of tax regimes which suggest that they have the potential to constitute harmful tax competition. First the four key factors identified in Box II are elaborated upon and then the other factors which can assist in identifying harmful preferential tax regimes are discussed. As previously noted, in assessing whether a particular tax regime is harmful, all of the relevant factors must be evaluated.

Key factors

i) No or low effective tax rates

61. A low or zero effective tax rate on the relevant income is a necessary starting point for an examination of whether a preferential tax regime is harmful. A zero or low effective tax rate may arise because the schedule rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied. A harmful preferential tax regime will be characterised by a combination of a low or zero effective tax rate and one or more other factors set out in Box II and, where relevant, in this section.

ii) “Ring-Fencing” of Regimes

62. There are good reasons for the international community to be concerned where regimes are partially or fully isolated from the domestic economy. Since the regime’s “ring fencing” effectively protects the sponsoring country from the harmful effects of its own incentive regime, that regime will have an adverse impact only on foreign tax bases. Thus, the country offering the regime may bear little or none of the financial burden of its own preferential tax legislation. Similarly, taxpayers within the regime may benefit from the infrastructure of the country providing the preferential regime without bearing the cost incurred to provide that infrastructure. Ring fencing may take several forms.

Box II

**KEY FACTORS IN IDENTIFYING AND ASSESSING HARMFUL
PREFERENTIAL TAX REGIMES FOR THE PURPOSES
OF THIS REPORT**

a) No or low effective tax rates

A low or zero effective tax rate on the relevant income is a necessary starting point for an examination of whether a preferential tax regime is harmful. A zero or low effective tax rate may arise because the schedule rate itself is very low or because of the way in which a country defines the tax base to which the rate is applied. A harmful preferential tax regime will be characterised by a combination of a low or zero effective tax rate and one or more other factors set out in this Box and, where relevant, in this section.

b) “Ring fencing” of regimes

Some preferential tax regimes are partly or fully insulated from the domestic markets of the country providing the regime. The fact that a country feels the need to protect its own economy from the regime by ring-fencing provides a strong indication that a regime has the potential to create harmful spillover effects. Ring-fencing may take a number of forms, including:

- a regime may explicitly or implicitly exclude resident taxpayers from taking advantage of its benefits.
- enterprises which benefit from the regime may be explicitly or implicitly prohibited from operating in the domestic market.

c) Lack of transparency

The lack of transparency in the operation of a regime will make it harder for the home country to take defensive measures. Non-transparency may arise from the way in which a regime is designed and administered. Non-transparency is a broad concept that includes, among others, favourable application of laws and regulations, negotiable tax provisions, and a failure to make widely available administrative practices.

d) Lack of effective exchange of information

The lack of effective exchange of information in relation to taxpayers benefiting from the operation of a preferential tax regime is a strong indication that a country is engaging in harmful tax competition.

a) *Regimes that restrict the benefits to non-residents*

Regimes that explicitly or implicitly exclude resident enterprises from taking advantage of their benefits shift the revenue-reducing impact of the policy to other countries and can provide a strong indication that a tax regime has harmful spillover effects.

b) *Investors who benefit from the tax regime are explicitly or implicitly denied access to domestic markets*

This feature of a preferential tax regime also serves the purpose of insulating the domestic economy from the adverse effects of a regime. Enterprises established under such regimes may be explicitly prohibited from operating in the domestic market. Market access may be denied on a de-facto basis through the special tax privileges not applying or being otherwise neutralised insofar as the enterprises carry on business in the regime-country's domestic market.

In other cases, the regime may not permit transactions in the domestic currency, thus ensuring that the domestic monetary system is not affected by the regime.

iii) Lack of transparency

63. The lack of transparency in the operation of a regime will make it harder for the home country to take defensive measures. To be deemed transparent in terms of administrative practices, a tax regime's administration should normally satisfy both of the following conditions: First, it must set forth clearly the conditions of applicability to taxpayers in such a manner that those conditions may be invoked against the authorities; second, details of the regime, including any applications thereof in the case of a particular taxpayer, must be available to the tax authorities of other countries concerned. Regimes which do not meet these criteria are likely to increase harmful tax competition since non-transparent regimes give their beneficiaries latitude for negotiating with the tax authorities and may result in inequality of treatment of taxpayers in similar circumstances. A lack of transparency may arise because:

- Favourable administrative rulings (*e.g.*, regulatory, substantive, and procedural rulings) are given, allowing a particular sector to operate under a lower effective tax environment than other sectors. As an example of a favourable administrative ruling, tax

authorities may enter into agreements with a taxpayer or may agree to issue advance tax rulings in requested cases. However, where these administrative practices are consistent with and do not negate or nullify statutory laws, they can be viewed as a legitimate and necessary exercise of administrative authority. To assure equality in treatment, the ruling criteria should be well-known or publicised by the authority granting the ruling and available on a non-discriminatory basis to all taxpayers.

- Special administrative practices may be contrary to the fundamental procedures underlying statutory laws. This may encourage corruption and discriminatory treatment, especially if the practices are not disclosed. Such practices can also make it more difficult for other countries to enforce their tax laws. Thus, a regime where the tax rate and base are not negotiable, but where administrative practices and enforcement do not conform with the law or do not stipulate the conditions of applicability, may be considered as potentially harmful.
- If the general domestic fiscal environment is such that the laws are not enforced in line with the domestic law, this could make an otherwise legitimate regime harmful. Thus, although in general the domestic fiscal environment would not make an otherwise legitimate regime harmful, it may be a factor to evaluate in conjunction with other factors. A specific example of this issue is where the tax authorities deliberately adopt a lax audit policy as an implicit incentive to taxpayers not to comply with the tax laws. Such behaviour may give these taxpayers a competitive advantage.

iv) Lack of effective exchange of information

64. The ability or willingness of a country to provide information to other countries is a key factor in deciding upon whether the effect of a regime operated by that country has the potential to cause harmful effects. A country may be constrained in exchanging information, for the purpose of the application of a tax treaty as well as for the application of national legislation, because of secrecy laws which prevent the tax authorities from obtaining information for other countries on taxpayers benefiting from the operation of a preferential tax regime. In addition, even where there are no formal secrecy laws, administrative policies or practices may impede the exchange of information. For example, the country may determine as a matter of

administrative policy that certain transactions or relations between an enterprise and its customers are a business secret which need not be disclosed under Article 26 paragraph 2 (c) of the OECD Model Tax Convention, or the country with the preferential tax regime may simply be uncooperative with other countries in providing information. Such laws, administrative policies, practices or lack of co-operation may suggest that the preferential tax regime constitutes harmful tax competition.

65. The limited access that certain countries have to bank information for tax purposes (*e.g.*, because of bank secrecy rules) is increasingly inadequate to detect and to prevent the abuse of harmful preferential tax regimes by taxpayers. The Committee has commissioned a survey of country practices regarding access to bank information for tax purposes.

66. Exchange of information may be a constraint in situations where a non-transparent regime allows the tax authorities to give a prior determination to an individual taxpayer and where that tax authority does not inform the foreign tax authority affected by such a decision. This failure to notify the foreign tax authority may curtail the ability of that tax authority to enforce effectively its rules.

67. Other factors that reflect a difficulty in obtaining the information needed to enforce statutory laws, and which may make a preferential regime harmful, include the absence of an annual general audit requirement for companies, no requirement for a public register of shareholders and the use of shares and financial instruments issued in bearer form.

Other factors

68. The following paragraphs describe factors, other than the key factors, that can assist in identifying harmful preferential tax regimes.

v) An artificial definition of the tax base

69. The tax laws in most countries have various provisions that narrow the tax base. Many of these rules have legitimate purposes, such as offsetting the impacts of inflation or reducing the double taxation of certain types of income. However, such provisions may exceed the provisions necessary to achieve stated tax policy goals. These provisions may include unconditional rules for the avoidance of double taxation (built in the exemption or the credit method)

that go beyond the ordinary scope of the instruments to avoid double taxation - economic as well as judicial - (*e.g.* unconditional participation exemption or capital gains rules, full credit), as well as other rules that allow costs to be deducted even though the corresponding income is not taxable, rules allowing deductions for deemed expenses that are not actually incurred, and rules that permit overly generous reserve charges or that otherwise restrict the tax base for particular operations. Provisions applying a margin to certain expenses or to certain revenue while at the same time excluding a portion of those expenses or of that revenue when calculating the margin are also relevant in this context, especially if they are non-transparent.

70. A further potential difficulty with measures which modify the tax base is that they are often non-transparent. Non-transparency in the application of laws and regulations makes it difficult to determine whether all companies investing in a country face the same effective tax rate. The tax system is no longer neutral as between taxpayers when tax rates vary in these ways. Moreover, non-transparency reduces a regime's exposure to defensive measures, such as CFC legislation, so that there is a need for greater concern about such regimes.

vi) Failure to adhere to international transfer pricing principles

71. The transfer pricing principles established for intra-firm transactions are important considerations in determining a multinational enterprise's overall tax burden and the division of the tax base across countries. The OECD 1995 Guidelines³ set out how countries are to apply the arm's length principle. The 1995 Guidelines recognise that transfer pricing is not an exact science and that countries will have to take into account the facts and circumstances of each case in deciding upon how to apply the 1995 Guidelines in practice. The tax authorities views on appropriate arm's length prices, which underlie the transfer pricing principles, can indirectly affect the competitive position of an enterprise. If a tax authority fails to apply consistently the 1995 Guidelines, this may have an impact on the competitive position of a subsidiary of a MNE. Such misapplication may consist, for example, in setting a level of profit which does not correspond to the functions actually performed by the entity in question or conversely, excess allocation of earnings to a firm that engages in no activity or in activity which, if not undertaken by a legally independent company, would not constitute a permanent establishment. Deviations from the arm's length principle can also take the form of accepting certain pricing arrangements, such as the application of cost-plus pricing, which does not reflect the true arm's length value added because the adjustment is negotiable or calculated on a

restricted base. This risk of competitive distortions is particularly present where the treatment accorded to a taxpayer is non-transparent, where an individual taxpayer can negotiate a transfer price with the tax authorities (where, for example, the principles for the allocation of income are not clearly stipulated in the laws and regulations of the relevant taxing authority), and where the principle of equal treatment is not embedded in the legal system. Such practices may discourage a consistent and well enforced application of the 1995 Guidelines and enable certain taxpayers to obtain benefits which are not applicable to other taxpayers.

72. Inappropriate use of advance rulings and similar individually negotiated agreements, can also distort the competitive position of countries, where the treatment accorded the taxpayer is non-transparent, not based on a full and detailed examination of the facts and circumstances and attempts to give the taxpayer complete certainty of tax treatment by determining actual transfer prices, rather than an appropriate transfer pricing methodology. Such distortions may also occur if tax authorities ignore the recommendation against the use of “safe harbours” at 4.123 of the Guidelines and use their administrative discretion to set “safe harbour” prices or margins.⁴ Such practices may discourage a consistent and well enforced application of the Guidelines.

vii) Foreign source income exempt from residence country tax

73. A country that exempts all foreign-source income from tax, *i.e.*, the regime is a territorial system, may be particularly attractive since the exemption reduces the effective income tax rate and encourages the location of activities for tax rather than business purposes. Since entities which take advantage of these regimes can be used as conduits or to engage in treaty shopping, they may have harmful effects on other countries.

viii) Negotiable tax rate or tax base

74. The tax provisions found in a host country’s regime may be potentially harmful if the tax rate and/or tax base is negotiable or the rate depends on where the investor is a resident. This flexibility allows the taxpayer and tax authority of the country sponsoring the regime to either negotiate a “soak-up” tax when the home country allows a foreign tax credit or allows the taxpayer to avoid being subject to the home country’s CFC regime when application of the CFC regime depends upon the host country tax rate.

Negotiability of the tax rate and/or base may be particularly troublesome under a non-transparent regime for determining a taxpayer's taxable income.

ix) Existence of secrecy provisions

75. Lack of access to information, whether because of bank secrecy, anonymous debt instruments or bearer shares, may constitute one of the most harmful characteristics of a regime. The availability of protection from enquiries by tax authorities is one of the biggest attractions of many harmful regimes.

x) Access to a wide network of tax treaties

76. The OECD has encouraged countries to extend their treaty networks since an extensive network of treaties helps eliminate double taxation and encourages co-operation between tax authorities. Yet an extensive treaty network may open up the benefits of harmful preferential tax regimes offered by the treaty country to a broader array of countries than would otherwise be the case. One of the motivations for extending the treaty network in some countries may be to enhance the benefits of harmful preferential tax regimes. A wide treaty network is less vulnerable to abuse if the treaties involved contain self-protection measures, such as clear definitions of residence, specially designed and comprehensive anti-abuse provisions, and effective mechanisms for engaging in information exchange.

77. However, the impact, and whether the effect is harmful or not, depends on the type of regime and the contents of the treaties. For example, many regimes are clearly defined and, thus, can be carved out of treaty coverage through general or specific "exclusion" provisions based on tax rate comparisons or reference to specific sections of the tax law. Also, exchange of information provisions can under certain conditions enhance a country's ability to protect its revenue base when necessary. Since countries differ in their treaty policies, this issue will be more important for some countries than others.

xi) Regimes which are promoted as tax minimisation vehicles

78. Some of the most successful preferential tax regimes are those that are widely promoted by, or are promoted with the acquiescence of, the offering country. Whilst advertising is certainly not a requirement for determining whether or not a regime is harmful, the existence of promotional material

exhorting a regime as a tax minimisation vehicle may provide a useful indication of whether a regime is seen and used primarily as a means of engaging in international tax avoidance and evasion. Promotional material may also be a useful source of information for tax authorities.

xii) The regime encourages purely tax-driven operations or arrangements

79. Many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities.

b) ***Assessing the economic effects of a preferential tax regime in terms of its potential harmfulness***

80. When examining a regime it is helpful to pose a number of questions as to its economic effects, the answers to which may influence the evaluation of a regime in the context of the present study. It should be recognised, however, that it may be difficult to gather the information necessary to answer these questions, partly because some of the preferential tax regimes in question are non-transparent and the jurisdictions within which they operate do not provide the data required to carry out such an analysis. Also, although tax is only one of the factors which may influence investment decisions, mobile services are very tax sensitive so that companies may actively seek out tax breaks and encourage countries to match preferences available in other countries. In these cases governments may find themselves in a “prisoners dilemma” where they collectively would be better off by not offering incentives but each feels compelled to offer the incentive to maintain a competitive business environment.

i) *Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?*

81. Determining whether investment represents a new investment or a shift from another location to exploit tax differentials is a difficult empirical matter. Answering this question involves analysis of both the preferential tax regime in the host location and the tax and business environment of the home country or countries. On the margin, observed investment may be stimulated

either by the additional savings of individuals in response to lower taxes or by a distortionary reallocation of investment from one location to another to exploit tax differentials.

82. The Committee accepts that a company may wish to move out of an unfavourable economic or political environment into a more favourable business environment, regardless of the tax incentive offered. It is also accepted that domestic tax provisions in some countries may serve indirectly to discourage investment or to drive investment out, independent of the tax policies pursued in other countries.

ii) *Is the presence and level of activities in the host country commensurate with the amount of investment or income?*

83. Answering this question requires a subjective evaluation of whether the additional activities created in the country with the preferential tax regime are commensurate with the amount of investment or income generated, having regard to the nature of the activity. Where activities are not in some way proportional to the investment undertaken or income generated, this may indicate a harmful tax practice. However, even where this proportionality is present the international community may still be concerned about harmful effects created by preferential tax regimes in other countries.

iii) *Is the preferential tax regime the primary motivation for the location of an activity?*

84. If the preferential tax regime is the primary motivation as to where to locate an activity, this may indicate that the regime in question is potentially harmful. It is recognised that in practice it is not always easy for the tax authorities to evaluate the motivation of investors and that non-tax factors, such as the quality of the infrastructure, the legal and regulatory framework, labour costs, etc., may also influence location decisions. As stated in paragraph 27, it is also recognised that there are circumstances where special tax incentives or tax regimes may be needed from the perspective of the country in question to offset non-tax disadvantages.

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CHAPTER 3

COUNTERACTING HARMFUL TAX COMPETITION

I. Introduction

85. Governments cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to exploit tax havens and preferential regimes to reduce the tax that would otherwise be payable to them.

86. A variety of counteracting measures are currently used by countries that wish to protect their tax base against the detrimental actions of other countries that engage in harmful tax competition. The manner in which these measures apply varies widely from country to country.

87. These measures are typically implemented through unilateral or bilateral action by the countries concerned. A rigorous and consistent application of existing tools can go a long way towards addressing the problem of harmful tax competition. There are limits, however, to such a unilateral or bilateral approach to a problem that is essentially global in nature. First, the jurisdictional limits to the powers of a country's tax authorities restrict the ability of these authorities to counter some forms of harmful tax competition. Second, a country may believe that taxing its residents in a way that neutralises the benefits of certain forms of harmful tax competition will put its taxpayers at a competitive disadvantage if its action is not followed by other countries. Third, the necessity to monitor all forms of harmful tax competition and to enforce counter-measures effectively imposes significant administrative costs on countries adversely affected by such competition. Fourth, uncoordinated unilateral measures may increase compliance costs on taxpayers.

88. Residence countries can partly negate the effects of harmful preferential tax regimes in source countries, but even here such action is likely to be most effective if undertaken in a co-ordinated way. It should be emphasised, however, that the ability of one country to take defensive measures

cannot justify the enactment of harmful preferential tax regimes in another country, since it is difficult to fully nullify the harmful effect by such defensive measures, and that even if it were possible, the residence country would have to bear the implementation and administration costs associated with such defensive measures.

89. The need for co-ordinated action at the international level is also apparent from the fact that the activities which are the main focus of this report are highly mobile. In this context, and in the absence of international co-operation, there is little incentive for a country which provides a harmful preferential tax regime to eliminate it since this could merely lead the activity to move to another country which continues to offer a preferential treatment.

90. This Chapter examines how the measures already in place can be reinforced and new measures developed in a co-ordinated way, taking into account the different country approaches to taxing international transactions. The Committee concludes that there is a strong case for intensifying international co-operation when formulating a response to the problem of harmful tax competition, although the counteracting measures themselves will continue to be primarily taken at the national, rather than at the multilateral level. The endorsement of the Guidelines established below will provide a clear political message that the OECD Member countries are prepared to intensify their co-operation to counter harmful tax practices. This Chapter indicates how the Member countries intend to achieve that result by means of a series of Recommendations. The Committee emphasises that all of the Recommendations set out in this Report should be seen in the context of efforts to curb harmful tax practices. In deciding upon how to implement specific Recommendations, in relation to a particular country, countries should take into account the commitment of that country to the Guidelines.

91. Since unilateral measures are easiest for countries to adopt, as they do not require acquiescence of other countries, the Report begins by recommending action in this area and then elaborates on bilateral approaches, which occur through tax treaties. The Report then discusses multilateral responses to curbing harmful tax practices. These responses are the most difficult to adopt because countries must co-operate with each other in developing and implementing a response. Nevertheless, these multilateral responses are essential because, as this Report has explained, co-ordinated action is the most effective way to respond to the pressures created in the new world of global capital mobility. Even though the unilateral and bilateral responses require minimum co-ordination with other countries, this Report has also stressed that

these measures will be more effective if they conform to practices adopted at the international level.

92. Following this approach, these Recommendations are divided into the following three categories:

- *Recommendations concerning domestic legislation*: starting from various counteracting measures currently found in domestic laws, these Recommendations indicate how to increase their effectiveness;
- *Recommendations concerning tax treaties*: these Recommendations deal with ways of ensuring that the benefits of tax conventions do not unintentionally make policies constituting harmful tax competition more attractive or prevent the application of domestic counteracting measures, as well as ways to ensure that the exchange of information provisions of tax treaties are used in a more effective way;
- *Recommendations for intensification of international co-operation*: these Recommendations, including the Guidelines, put forward new ways through which countries will be able to act collectively against harmful tax competition.

93. In addition to these Recommendations, this Chapter identifies, in a final section, a series of topics where further study could result in additional recommendations, directed at harmful tax competition. It is intended that Member countries and the Committee will use the new Forum to examine these issues with the aim of developing new proposals.

94. The Recommendations included in this Chapter address the problem of tax competition from different angles. Some of them are aimed at encouraging countries to refrain from adopting practices constituting harmful tax competition. Others are aimed at offsetting the benefits for taxpayers of certain forms of harmful tax competition. Still others address the issue indirectly by focusing on tax avoidance and evasion, on the basis that many forms of harmful tax competition are aimed at taxpayers willing to engage in tax evasion (*e.g.* using bank secrecy provisions to avoid paying tax in the source or residence country) or tax avoidance (*e.g.* using certain offshore regimes). The Recommendations should be seen as mutually re-enforcing and, as noted in the Guidelines, countries may require a transitional period to implement some

of these Recommendations. Measures involving tax treaties or multilateral co-operation are complementary to those taken at the national level.

95. It must be emphasised that there are different forms of harmful tax competition and that different counter-measures may be appropriate in different circumstances. For example, a preferential tax regime which is intended and operated to facilitate the evasion of tax properly owing to other countries, which is non-transparent and with respect to which the country providing the regime does not exchange information is clearly harmful. Severe counter-measures are appropriate and indeed necessary to deal effectively with this extreme type of harmful tax competition. This may be contrasted with a country that provides a reduced rate of tax on certain activities and which co-operates with other countries in exchanging information. If such a regime were classified as harmful, less drastic counter-measures would be appropriate. A careful, and in many cases, as pointed out in Chapter 2, balanced evaluation will be required before determining the appropriate response to a harmful regime, taking into account non-tax factors and possibly wider economic and social implications. As this process requires an in-depth and on-going evaluation, the Committee places considerable emphasis on the need for Guidelines and to create a Forum where these issues can continue to be discussed, and the impact of the Recommendations in this Report can be evaluated.

96. Whilst many of the measures proposed are addressed towards counteracting the effects of both tax havens and harmful preferential tax regimes, the emphasis placed on the appropriate response may differ. In the case of tax havens, the emphasis will mainly be on defensive measures aimed at constraining their harmful effects, recognising that the existence of firm and co-ordinated countermeasures to activities carried out in tax havens may be a powerful deterrent to the development of new tax havens. Where a tax haven is a dependency of a Member country, it may, however, also be possible for the home country to exercise a moderating influence. In the case of harmful preferential tax regimes, counteracting measures will focus both on nullifying the benefits of such regimes for taxpayers and encouraging the countries which operate such regimes (particularly those within the OECD area) to modify or eliminate them.

II. Recommendations concerning domestic legislation and practices

1. Recommendation concerning Controlled Foreign Corporations (CFC) or equivalent 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.

97. Under Controlled Foreign Corporations (CFC) rules, certain income of a CFC is attributed to and taxed currently in the hands of its resident shareholders. Because CFC rules are intended to eliminate the benefits of the deferral of domestic tax on some or all of the foreign source income of a CFC in most countries that have already implemented CFC rules, the rules primarily serve the function to counter tax avoidance by discouraging the legal migration of certain types of income, *e.g.*, base company and passive income to non-resident companies. Many of them extend the rules to foreign trusts that are used for the same purpose.

98. CFC rules have been developed for a variety of purposes in the light of the overall international tax policies of Member countries. In some cases, the policy focus is on tax avoidance transactions and in others represents a broader limitation on the deferral of tax on income realized through foreign subsidiaries. Such rules are an effective tool to deal with harmful tax practices. However, their effectiveness is reduced by the fact that they are not applied by all countries and even in those countries that do apply them, they do not cover all situations of harmful tax practices. While the Recommendation only applies in the context of curbing harmful tax practices, CFC rules may also apply in situations which do not involve harmful tax practices as defined in this Report. It is recognised that countries retain their right to use such rules in such situations.

99. A 1996 OECD Report on Controlled Foreign Company Legislation showed that 14 OECD Member countries had CFC legislation.⁵ Although there is considerable variation in the technical details of this legislation, the objectives set for these regimes are remarkably similar in almost all countries and the structural features are quite similar in many countries.

100. The Recommendation is twofold. First, countries that do not have CFC rules are asked to consider adopting CFC rules or equivalent rules as one measure to counter harmful tax competition. Whether a country feels the need for such rules will depend in part upon its evaluation of the effectiveness of its existing measures. Second, countries are asked to consider applying their CFC or equivalent rules in appropriate cases to income and entities covered by tax practices considered, on the basis of the factors developed in Chapter 2, to constitute harmful tax competition. While the specificities of domestic tax systems do not allow for the harmonisation of CFC rules or for the development of model CFC provisions, greater co-ordination in targeting such domestic rules

will be a useful improvement. Accordingly, Member countries are urged, with the continued co-ordination by the OECD, to try for congruence of results of their respective CFC or equivalent legislation in a manner consistent with the objectives of this Report. Further work may enable the Committee to elaborate on some minimum standards for the design of such regimes in terms of their effectiveness in counteracting harmful tax practices. Moreover, it would also be useful to examine more closely the interrelationship between CFC, Foreign Investment Fund and Foreign Trust legislation in order to improve their overall effectiveness in combating harmful tax practices. However, this should not delay action on the part of countries which do not now have CFC or equivalent rules.

2. *Recommendation concerning foreign investment fund or equivalent rules: that countries that do not have such rules consider adopting them and that countries that have such rules consider applying them to income and entities covered by practices considered to constitute harmful tax competition.*

101. In general, CFC rules that subject the CFC's income to current tax apply only to foreign corporations controlled by resident shareholders that own a significant interest in a CFC (for example, 10 per cent or greater). Thus, residents may defer domestic tax by acquiring shares in foreign mutual funds. If such funds are widely owned, they will not be controlled by a small group of resident shareholders; nor will any one resident shareholder own a significant interest in the fund. Thus, owners of foreign mutual funds will not be subject to the anti-abuse protections afforded by resident countries' CFC rules. To counter this situation, several countries have adopted foreign investment fund (FIF) or equivalent rules to deal with this situation although they are not yet widespread in Member countries. In some countries, the underlying policy of the FIF rules is to supplement the CFC rules. In other countries, the policy of FIF rules is much broader; they are intended to eliminate the benefit of deferral for virtually all passive investments in foreign entities.

102. FIF rules constitute an effective tool against regimes that offer favourable tax treatment in order to attract foreign passive investment from resident individual, rather than corporate, shareholders. As such they should be encouraged as a way to address one form of harmful tax competition.

103. The Recommendation mirrors that related to CFC or equivalent rules. First, countries that do not have FIF or equivalent rules are asked to consider

adopting such rules. Second, countries are asked to consider applying such rules in appropriate cases to income and entities covered by tax practices considered, under the criteria developed in Chapter 2, to constitute harmful tax competition.

3. **Recommendation concerning restrictions on participation exemption and other systems of exempting foreign income in the context of harmful tax competition:** *that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method.*

104. Most, if not all, exemption countries have certain limitations applicable to their exemption system. These measures include, for example, restricting the exemption to active business income and taxing passive income regardless of its source.

105. On the basis of restrictions that already exist in the legislation of Member countries, possible “minimum” restrictions could be designed on the basis of:

- *the countries from which the foreign income originates:* for example, it could be decided that income originating from a country that is included in a list of tax havens or from listed harmful preferential tax regimes should not be granted exemption;
- *the type of income:* foreign income that clearly could be attributed to practices constituting harmful preferential tax regimes would not be entitled to exemption;
- *the effective rate of tax to which the income has been subjected:* restrictions based on a minimum rate of foreign tax effectively paid are often found in participation exemption systems. They should, however, be linked to the other aspects of harmful preferential tax regimes as set out in Chapter 2.

4. **Recommendation concerning 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.

106. This Recommendation aims at introducing measures that will assist countries in obtaining information about the foreign activities of their residents which may be relevant to counteracting harmful tax practices (e.g., transactions with related foreign payers, the ownership of foreign property such as financial accounts of any kind, transfers to and distributions from certain foreign entities, etc.). Tax authorities require information in order to be able to administer the income tax system properly. Obtaining information concerning taxpayers' foreign activities is especially difficult because such information is often located outside a country's jurisdiction and is often held by a separate legal entity. As a result, some countries have enacted special information reporting requirements with respect to international transactions and foreign operations of resident taxpayers.

107. The Recommendation is to the effect that countries that do not have such rules consider introducing them with respect to harmful tax practices and that the information obtained under these rules be shared with any other countries for which it is relevant through exchanges of information on the basis of the provisions of Article 26 of the OECD Model Tax Convention, due account being taken of administrative and compliance costs and the need to respect confidentiality.

5. *Recommendation concerning rulings: that countries, where administrative decisions concerning the particular position of a taxpayer may be obtained in advance of planned transactions, make public the conditions for granting, denying or revoking such decisions.*

108. The absence of details concerning certain administrative practices through which taxpayers' positions are determined, in particular on issues such as the arm's length value of certain services or the allocation of profits or losses between associated enterprises or between head offices and their permanent establishments, contributes to making a tax system non-transparent. This results in distortions in relation to States which, under their legal system, are required to apply their tax regimes in the same way vis-à-vis all taxpayers.

109. The ignorance of the existence of a regime for obtaining administrative decisions on specific planned transactions, or of the conditions for granting or denying such decisions, may result in unequal treatment of

taxpayers since the lack of public information on this regime may put taxpayers in different positions when determining their tax situation. Greater transparency concerning the conditions for eligibility to a particular regime will therefore favour a greater equality of treatment of taxpayers in a similar position.

110. The publication, in a way that protects taxpayer confidentiality, of the substantive and procedural conditions for granting or denying individual tax rulings, ensures a greater transparency of countries' tax policies concerning certain activities that may easily be re-located, and is essential to the application of measures to prevent harmful tax competition from being developed individually or collectively by countries. Without it, measures which are now "transparent" may well be transformed into non-transparent regimes.

6. *Recommendation concerning transfer pricing rules: that countries follow the principles set out in the OECD's 1995 Guidelines on Transfer Pricing and thereby refrain from applying or not applying their transfer pricing rules in a way that would constitute harmful tax competition.*

111. A country may decide to deviate from the arm's length principle as set out in the OECD 1995 Guidelines as a means of making that country a tax-favoured intermediary. Such action can constitute harmful tax competition. This Recommendation is directed at eliminating such behaviour and encourages all countries to follow consistently the principles set out in the 1995 Guidelines both for resident and non-resident taxpayers. It applies in particular to regimes under which the specific position of a taxpayer is determined by administrative decision. These considerations will be taken into account by the Committee in the process of monitoring the implementation of the 1995 Guidelines.

7. *Recommendation concerning access to banking information for tax purposes: in the context of counteracting harmful tax competition, countries should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities.*

112. Whilst recognising the confidential nature of the relationship between a bank and its clients, countries agree that, in the context of harmful tax competition, provisions which unduly restrict access by tax authorities to banking information required for the assessment of taxes are a serious impediment to the fair and effective implementation of tax rules and may distort the allocation of financial flows between countries by providing an unfair competitive advantage to those financial centres which operate such provisions

(see, however, paragraph 12 for a discussion of how withholding taxes interact with exchange of information). The new Forum will be used to review progress made in the removal of provisions that impede access to banking information in the context of counteracting harmful tax practices. The Committee will complete in 1998 a survey of provisions governing access to banking information by tax authorities in force in Member countries and has begun preparing a broad set of proposals on how to improve the access of tax authorities to banking information.

III. Recommendations concerning tax treaties

113. This section sets out a series of Recommendations by which countries can use their tax treaties to counter harmful tax practices. Recommendations, 8, 9, 10 and 11 are closely interrelated and are aimed at ensuring that tax treaties are not used to facilitate harmful tax practices.

8. ***Recommendation concerning greater and more efficient use of exchanges of information: that countries should undertake programs to intensify exchange of relevant information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition.***

114. Information on foreign transactions and taxpayers is essential for certain domestic counteracting measures to work properly, but is notoriously difficult to obtain with respect to tax havens and certain harmful preferential tax regimes.

115. The Recommendation aims at improving the situation by ensuring that information obtained by a country is shared with any other country that may be concerned. This can be done through making greater use of the exchange of information provided for in tax treaties, as well as through the Multilateral Convention for Mutual Assistance in Tax Matters recently developed by the OECD and the Council of Europe which is now signed and ratified by Belgium (signed but not ratified), Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden and the United States.

116. Countries should also make available to other countries information on preferential tax regimes defined by way of administrative decisions for which their taxpayers are eligible. Such information should indicate the

particular measure from which the taxpayer benefited as well as the regime under which the measure was granted.

117. As a first step to facilitate exchanges of information, the Committee has decided to amend Article 26 of the Model Tax Convention so as to extend its scope to taxes not otherwise covered by the Convention.

9. *Recommendation concerning the entitlement to treaty benefits: that countries consider including in their tax conventions provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices and consider how the existing provisions of their tax conventions can be applied for the same purpose; that the Model Tax Convention be modified to include such provisions or clarifications as are needed in that respect.*

118. Countries that have introduced regimes constituting harmful tax competition often view the development of their network of tax conventions as an asset that facilitates and encourages the use of these regimes by residents of third countries. A wide treaty network may therefore have the unintended consequence of opening up the benefits of harmful preferential tax regimes offered by treaty partners.

119. Various approaches have been used by countries to reduce that risk. In some cases, countries have been able to determine that the place of effective management of a subsidiary lies in the State of the parent company so as to make it a resident of that country either for domestic law or treaty purposes. In other cases, it has been possible to argue, on the basis of the facts and circumstances of the cases, that a subsidiary was managed by the parent company in such a way that the subsidiary had a permanent establishment in the country of residence of the parent company so as to be able to attribute profits of the subsidiary to that latter country. Another example involves denying companies with no real economic function treaty benefits because these companies are not considered as beneficial owner of certain income formally attributed to them. The Committee intends to continue to examine these and other approaches to the application of the existing provisions of the Model Tax Convention, with a view to recommending appropriate clarification to the Model Tax Convention.

120. There are, however, a number of additional provisions, such as limitation of benefits rules, which have been included in some tax treaties to specifically restrict access to their benefits. The Committee has also been reviewing these provisions with a view to propose changes to the Model Tax Convention aimed at denying the tax treaty benefits to entities and income covered by practices constituting harmful tax competition. The Committee intends to continue its work in this area with a view to modify the Model Tax Convention or the Commentary so as to include such provisions that countries will be able to incorporate in their tax treaties.

10. Recommendation concerning the 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 uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.

121. The domestic tax laws of Member countries include various anti-abuse rules and doctrines which are used to counteract harmful tax practices. CFC rules, for example, may be used to deny the benefits of deferral or exemption with respect to income accruing in a subsidiary located in a country that has introduced such practices and sham, *alter ego* or business purpose doctrines may be used to disregard the existence of an entity set up in such a country merely to act as a conduit.

122. Tax treaties generally include no general and few specific anti-avoidance rules. The issue sometimes arises as to whether domestic anti-abuse rules and judicial doctrines are compatible with tax treaties. For instance, where a transaction is ignored or re-characterised under domestic anti-avoidance rules or doctrines, the issue is whether such re-characterisation can be applied for purposes of the provisions of a tax treaty without resulting in a treaty override.

123. In various reports, the conclusions of which have been incorporated in different parts of the Commentary on the Model Tax Convention, the Committee has discussed the interaction of domestic anti-avoidance rules (*e.g.* thin capitalisation, CFC rules, general anti-abuse rules) with tax treaties and has generally concluded that these were compatible with tax treaties. These conclusions, however, are sometimes unclear or expressed in mitigated terms. For example, while paragraphs 22 and 23 of the Commentary on Article 1 indicate that a majority of countries considers that CFC rules do not violate tax treaties and paragraph 37 of the Commentary on Article 10 (Dividends) indicates that CFC rules are not contrary to paragraph 5 of Article 10, the issue

of whether such rules are compatible with Article 7 (Business Profits) is not discussed.

124. The Model Tax Convention does not deal with certain domestic anti-abuse provisions and it could be appropriate to provide that tax treaties should generally accommodate the application of such rules. This is an area that has been identified for further study (see section V).

125. The Recommendation is to the effect that the Commentary to the Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention. This Recommendation will help ensure that domestic anti-abuse and judicial doctrines are compatible with tax treaties.

11. Recommendation concerning a list of specific exclusion provisions found in treaties: that the Committee prepare and maintain a list of provisions used by countries to exclude from the benefits of tax conventions certain specific entities or types of income and that the list be used by Member countries as a reference point when negotiating tax conventions and as a basis for discussions in the Forum.

126. Various treaties include provisions denying specified entities or types of income the benefits of tax treaties. As these specific exclusion provisions vary considerably and different treaties treat similar entities or types of income differently, they show different ways to approach the same problems.

127. The Recommendation aims at ensuring greater co-ordination in the use of these provisions by having the Committee prepare and maintain a list of the exclusion provisions found in tax treaties concluded by Member countries. Member countries can then use the list as a reference point when negotiating tax conventions and, where appropriate, for purposes of obtaining agreement from a treaty partner to add similar provisions in an existing convention, such agreement to amend the treaty along the lines of what has been agreed with other treaty partners being presented as preferable to the termination of a treaty that facilitates harmful tax competition.

128. A preliminary version of the list has already been prepared by the Committee. This list will be finalised in June 1998 and periodically updated.

12. Recommendation concerning tax treaties with tax havens: that countries consider terminating their tax conventions with tax

havens and consider not entering into tax treaties with such countries in the future.

129. Some countries have terminated their treaties with certain tax havens. Most countries recognize that termination of a treaty may raise significant political and diplomatic difficulties both for the countries concerned and possibly for other countries as well. It may also raise broader economic considerations. Experience has shown that it is usually very difficult to take such action alone, despite the fact that most tax treaties explicitly provide for the possibility of termination. While termination of a treaty is a matter to be decided by each party to that treaty, the possibility that many countries could adopt the same position vis-à-vis treaties entered into by a tax haven would increase the credibility of such action.

130. The Recommendation is to the effect that countries consider terminating their treaties with tax havens and not entering into treaties with these countries. The criteria for identifying tax havens which are developed in Section II of Chapter 2 and the list of such jurisdictions would provide a consistent basis for countries to assist them in making that decision. The Forum referred to in Recommendation 15 will also be useful in providing a mechanism through which countries can exchange views in that respect.

131. In considering whether they should terminate, or not enter into, a tax treaty with a tax haven, countries should take account of all relevant factors, including the effect of their decision on exchange of information. If the exchange of information provision of a tax treaty with a tax haven can be used effectively to obtain information, if no other mechanisms (such as an agreement limited to the exchange of information) can be used to obtain that information and if the treaty includes safeguards to prevent it from being used to the detriment of other countries, the benefits of the treaty in relation to the exchange of information may offset the disadvantages of that treaty for countries as a whole.

132. The Recommendation implicitly requests countries to ensure that the territorial scope of their tax conventions does not extend to dependencies that constitute tax havens, whether these dependencies are their own or those of the countries with which they negotiate tax conventions.

13. ***Recommendation concerning co-ordinated enforcement regimes (joint audits; co-ordinated training programmes, etc.): that countries consider undertaking co-ordinated enforcement programs (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.

133. Since the late 1970s, a number of countries have developed simultaneous or joint audit programs under which the tax authorities of both countries audit the tax returns of affiliated corporations for the same taxation year. This form of co-operation should be intensified since such audit programmes can help achieve the objectives of this Report.

134. Other types of co-operation between tax authorities are also likely to be effective in improving international tax compliance. For example, the international features of a country's tax system are among its most technical and complex aspects. It is often difficult for tax departments to ensure that their international audit staff have the proper training to deal with the issues adequately. Joint training activities on topics such as audit strategies, transfer pricing, treaty issues, sophisticated transactions, the design and implementation of CFC and FIF rules etc. could improve compliance by disseminating successful audit practices and by promoting closer contacts between tax inspectors dealing with international transactions. These could take place under the auspices of the Committee and its subsidiary bodies.

135. The Recommendation is aimed at further developing collaboration in that respect. The efforts that will be taken under this Recommendation will typically result in countries combining their information and audit powers in order to better apply domestic tax rules vis-à-vis income from, or entities of, other countries from which such information cannot be obtained. Simultaneous examinations based upon the 1992 OECD Model Agreement should be encouraged.

14. Recommendation concerning assistance in recovery of tax claims: that countries be encouraged to review the current rules applying to the enforcement of tax claims of other countries and that the Committee pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose.

136. Harmful tax competition which leads to tax evasion by taxpayers of other countries may be encouraged if one country will not enforce the tax claims of another country. This position is based on concerns about the extra-territorial enforcement of tax claims, the lack of reciprocity, and procedural fairness. Also, the counteracting measures of some countries may be prevented from

applying where a taxpayer has moved assets from one jurisdiction to another for tax evasion purposes.

137. In an era of globalisation and increased mobility for taxpayers, traditional attitudes towards assistance in the collection of taxes may need to change. The purpose of the Recommendation is to encourage countries to review the current rules in this area with a view to encouraging the enforcement of tax claims of other countries. The Committee intends to speed up its work in this area.

IV. Recommendations to intensify international co-operation in response to harmful tax competition

138. Although one country's actions can be influential in curbing harmful tax practices, it is difficult for the actions of any single country to eliminate harmful tax practices. In fact, for many reasons, individual countries may not have a strong incentive to take action against harmful tax practices since, by so doing, they can worsen their position relative to where they would have been if they had not acted at all. For example, as a result of some of the defensive measures an individual country takes to counteract harmful tax practices, the targeted activity may simply move to another location that is not taking measures to combat such practices. Thus, individual actions do not completely solve the problem; they may merely displace it. For this reason, a multilateral approach is required and the OECD is the most appropriate forum to undertake this task.

139. The present Report provides a useful starting point for improving international co-operation to counter harmful tax competition. The effectiveness of many of the Recommendations concerning domestic legislation and tax treaties described in sections II and III will depend to a large extent on whether the measures concerned can be taken in a co-ordinated fashion. As explained in the introduction to this Chapter, a co-ordinated response to the problem of harmful tax competition will greatly reinforce the effectiveness of unilateral measures. Such a response will involve a number of elements, the most important of which are:

- The adoption of a set of Guidelines (reproduced in Box III) intended to ensure that Member countries refrain from adopting preferential tax regimes constituting harmful tax competition and

gradually eliminate those harmful preferential tax regimes that currently exist;

- The creation of a subsidiary body of the Committee, the Forum on Harmful Tax Practices, to allow, among other things, for an on-going discussion of experiences with the problems posed by tax havens and harmful preferential tax regimes and of the effectiveness of measures taken in response to such practices. The Forum will monitor the implementation of the Recommendations set out in the earlier sections of this Chapter and the accompanying Guidelines as well as;
- The preparation of a list of jurisdictions constituting tax havens; and
- The development and active promotion of principles of Good Tax Administration relevant to counteracting harmful tax practices.

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

140. The OECD has successfully developed guidelines in a number of areas including taxation. This Recommendation builds upon this successful experience. The Guidelines in Box III set out a general framework within which Member countries can implement a common approach to restraining harmful tax competition using the analysis set out in this Report. The Guidelines are non-binding and will form the basis for the review procedures outlined below and will evolve as the Committee gains experience in their application.

141. The Guidelines will in themselves provide the principles which would guide action in this area, with the other Recommendations in this Report translating these principles into concrete practices. The review procedures outlined below are seen as an essential feature of implementing the Guidelines.

142. At the same time as the Guidelines are endorsed, a Forum will be created under the auspices of the Committee to undertake an on-going evaluation of existing and proposed regimes in Member and non-member countries, to analyse the effectiveness of counteracting measures, including non-

tax measures, and to propose ways to improve their effectiveness and to examine whether particular jurisdictions constitute tax havens in light of the factors identified in Chapter 2.

143. The Forum will be a subsidiary body of the Committee and all the Member countries will participate in its work. To enable the Forum to have a truly global perspective on the issues discussed in this Report, it will engage in a dialogue with non-member countries using the well established procedures already available under OECD rules. The Forum will report directly to the Committee which, in turn, will report, when appropriate, to the OECD Council. The mandate of the Forum will be reviewed after five years and thereafter at three year intervals thereby enabling the Committee and the Council to evaluate periodically its role and effectiveness.

144. The operation of the Forum and the Guidelines would be governed by the normal procedural rules of the Organisation. At its first meeting, the Forum would decide upon how the general procedural rules would apply to the Guidelines, in particular for the application of paragraphs 2 and 4 of the Guidelines and for Recommendation 16, and the working of the Forum itself.

145. The Forum would be responsible for monitoring the implementation of the Guidelines and Recommendations set out in this Report and for taking forward the “Topics For Further Study” referred to in Section V of this Chapter. The Forum would, when necessary, seek technical opinions or documentation on the economic and revenue impact of preferential tax regimes from the other subsidiary bodies of the Committee. The Forum will be responsible for taking forward work on the wider aspects of the mandate referred to in the Introduction, including engaging in a dialogue with non-member countries. A priority task for the Forum would be to complete the list of tax havens referred to in Recommendation 16. It would also be responsible for improving international co-operation in this area by implementing the Recommendations set out in this section, by encouraging countries to develop mutually reinforcing responses to problems identified and thereby ensuring that no country gains an unfair competitive advantage by failing to comply with the Guidelines referred to above. The Forum will also assess the effectiveness of existing measures taken by countries.

146. In applying the Guidelines, the Forum would provide a focal point for discussion on harmful preferential tax regimes in specific countries which, where appropriate, would be undertaken on the basis of cross-country reviews of categories of such regimes which may give rise to harmful tax competition. In this respect the Forum would build upon the work already undertaken by the

Special Sessions in examining types of preferential tax regimes. These cross-country reviews will provide within the context of the Forum an overview of how different types of preferential tax regimes operate. This, in turn, will enable the Forum to put the reviews of specific preferential tax regimes in a broader context and thereby achieve the level playing field referred to in paragraph 8.

147. This work on establishing generic descriptions of harmful preferential tax regimes will be carried out in parallel with the review of such regimes in specific countries. In the context of the self reviews referred to in paragraph 2 of the Guidelines, each Member country will be encouraged to describe the operation of generic preferential tax regimes identified by the Forum as having the potential to cause harmful effects, including details on the operation of the regimes, their effects and why they do not in the opinion of that country constitute harmful tax practices. The Forum will elaborate on these procedures at its first meeting. The Committee considers that these cross-country reviews will assist countries in meeting the Guidelines.

148. The Forum would also encourage countries to examine the structural features of their tax systems which may accentuate harmful competition, including the balance of roles of resident and source countries in countering such behaviour.

Box III

**RECOMMENDATION 15 GUIDELINES
FOR DEALING WITH HARMFUL PREFERENTIAL TAX REGIMES
IN MEMBER COUNTRIES**

While recognising the positive aspects of the new global environment in which tax systems operate, Member countries have concluded that they need to act collectively and individually to curb harmful tax competition and to counter the spread of harmful preferential tax regimes directed at financial and service activities. Harmful preferential tax regimes can distort trade and investment patterns, and are a threat both to domestic tax systems and to the overall structure of international taxation. These regimes undermine the fairness of the tax systems, cause undesired shifts of part of the tax burden from income to consumption, shift part of the tax burden from capital to labour and thereby may have a negative impact on employment. Since it is generally considered that it is difficult for individual countries to combat effectively the spread of harmful preferential tax regimes, a co-ordinated approach, including a dialogue with non-member countries, is required to achieve the “level playing field” which is so essential to the continued expansion of global economic growth. International co-operation must be intensified to avoid an aggressive competitive bidding by countries for geographically mobile activities.

The Guidelines are:

1. To refrain from adopting new measures, or extending the scope of, or strengthening existing measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices as defined in Section III of Chapter 2 of the Report.
2. To review their existing measures for the purpose of identifying those measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices as defined in Section III of Chapter 2 of the Report. These measures will be reported to the Forum on Harmful Tax Practices and will be included in a list within 2 years from the date on which these Guidelines are approved by the OECD Council.
3. To remove, before the end of 5 years starting from the date on which the Guidelines are approved by the OECD Council, the harmful features of their preferential tax regimes identified in the list referred to in paragraph 2. However, in respect of taxpayers who are benefiting from such regimes on 31 December 2000, the benefits that they derive will be removed at the latest on the 31 December 2005. This will ensure that such particular tax benefits have been entirely removed after that date. The list referred to in paragraph 2 will be reviewed annually to delete those regimes that no longer constitute harmful preferential tax regimes.

Box III (continued)

4. Each Member country which believes that an existing measure not already included in the list referred to in paragraph 2, or a proposed or new measure of itself or of another country, constitutes a measure, in the form of legislative provision or administrative practice related to taxation, that might constitute a harmful tax practice in light of the factors identified in Section III of Chapter 2 of the Report, may request that the measure be examined by the Member countries, through the Forum on Harmful Tax Practices, for purposes of the application of paragraph 1 or for inclusion in the list referred to in paragraph 2. The Forum may issue a non-binding opinion on that question.
5. To co-ordinate, through the Forum, their national and treaty responses to harmful tax practices adopted by other countries.
6. To use the Forum to encourage actively non-member countries to associate themselves with these Guidelines.

16. *Recommendation to produce a list of tax havens: that the Forum be mandated to establish, within one year of the first meeting of the Forum, a list of tax havens on the basis of the factors identified in section II of Chapter 2.*

149. The Forum is instructed to prepare within one year from its inception a list of tax havens, taking into account the factors set out in Section II of Chapter 2. This initial list would be non-exhaustive and would be subject to review by the Forum.

150. To develop this list, the Forum would examine jurisdictions that seem, prima facie, to meet the factors identified in Section II of Chapter 2. This would enable the Forum to explore by all necessary means whether these jurisdictions should be identified as tax havens.

151. The list will enable Member countries to coordinate their responses to the problems posed by tax havens and to encourage these jurisdictions to re-examine their policies. This list will not constrain countries in applying anti-abuse measures to counteract harmful tax practices.

17. *Recommendation concerning links with tax havens: that countries that have particular political, economic or other links with tax havens ensure that these links do not contribute to harmful tax competition and, in particular, that countries that have*

dependencies that are tax havens ensure that the links that they have with these tax havens are not used in a way that increase or promote harmful tax competition.

152. Many countries have close legal, economic or political ties with tax havens. This is particularly true in the case of countries that have dependencies that engage in harmful tax competition: these dependencies often have links with and obtain assistance from various regulatory authorities in these countries.

153. At a minimum, these ties should not be used to assist the relevant countries or dependencies in engaging in harmful tax competition. Also, countries that have such ties should consider using them to reduce the harmful tax competition resulting from the existence of these tax havens.

18. Recommendation to develop and actively promote Principles of Good Tax Administration: that the Committee's existing Strategic Management Forum⁶ be responsible for developing and actively promoting a set of principles that should guide tax administrations in the enforcement of the Recommendations included in this Report.

154. The effectiveness of many of the Recommendations set out in this Report will depend upon the ways in which they are administered in practice. It is proposed that the OECD, by means of its newly created Strategic Management Forum, should develop best practices in the enforcement of these measures. This approach would intensify co-operation between tax administrations, facilitate the co-ordination of enforcement measures and identify and counter harmful tax competition resulting from tax administration practices. Such an approach would emphasise the positive actions that tax administrations can take.

155. These practices should address the various aspects of the application of tax laws. They could include, for example, the suggestion that countries should not issue administrative decisions on planned transactions that are primarily aimed at taking advantage of tax conventions.

19. Recommendation on associating non-member countries with the Recommendation: that the new Forum engage in a dialogue with non-member countries using, where appropriate, the fora offered by other international tax organisations, with the aim of promoting the Recommendations set out in this Chapter, including the Guidelines.

156. To restrain the spread of harmful tax practices, non-member countries should be associated with the Recommendations set out in this Chapter. Whilst the Recommendations in relation to tax havens should reduce the amount of displacement to non-member countries, it will not eliminate it since it would still be possible to relocate to a non-member country with a harmful preferential tax regime. In order to minimise the scope for such displacement, non-member countries should be encouraged to dismantle harmful preferential tax regimes by promoting a broader acceptance of the principles set out in this Report and by engaging in a dialogue with the Member countries on how they could apply the Guidelines. Work on this Recommendation will continue in tandem with the Forum's work on the implementation of the Guidelines in Member countries.

V. Topics for further study

157. As indicated in paragraph 6 above, there will be other topics, apart from that of geographically mobile financial and other service activities in which the issues of harmful tax competition needs to be explored. This section is limited to the identification of topics on which further work should be done with a view to supplement the above Recommendations. These topics are briefly presented below, without any attempt to provide a comprehensive discussion. It is intended that in the context of the Forum, Member countries and interested non-member countries will continue to examine these issues with the aim of developing new Recommendations and to explore the wider mandate referred to in the Introduction.

a) Restriction of deduction for payments to tax haven entities

158. A number of countries have rules imposing restrictions on the deduction of payments made to tax haven countries or imposing a reversal of the onus of proof in case of such payments. For instance, Spain has rules according to which there is no deduction of expenses derived from services rendered in tax havens except where an effective transaction is proven to have taken place. Given Recommendation 12 above concerning the termination of treaties with tax havens, such action should not be considered to run counter to the non-discrimination provision in Article 24 of the OECD Model Tax Convention to the extent that no convention would then be applicable.

159. The denial of the deduction or a reversal of the onus of proof for certain payments to countries that engage in harmful tax competition, if associated with measures aimed at preventing the use of conduit arrangements,

would act as a deterrent for countries to engage in harmful tax competition and for taxpayers to use entities located in these countries.

b) *Imposition of withholding taxes on certain payments to residents of countries that engage in harmful tax competition*

160. Many countries currently have legislation that imposes withholding taxes on various types of payments to non-residents but substantially reduce or eliminate the rate of withholding tax on payments made to residents of treaty countries.

161. As with the denial of deduction for certain payments, the imposition of withholding taxes at a substantial rate on certain payments to countries that engage in harmful tax competition, if associated with measures aimed at preventing the use of conduit arrangements, would act as a deterrent for countries to engage in harmful tax competition and for taxpayers to use entities located in these countries.

c) *Residence rules*

162. Residence rules should be examined at both the domestic and treaty levels in order to determine whether they could be amended or clarified to better address harmful tax competition.

163. Revising the definition of corporate residence might be considered as a possible measure to counteract the use of foreign corporations to avoid domestic tax. Accordingly, one option would be to extend the domestic tax definitions of corporate residence so that a foreign corporation controlled by residents would be considered to be resident. Control for this purpose could be limited to the control of the affairs of a corporation as exercised by its board of directors or management or, alternatively, could be determined by reference to the ownership of its shares. As noted earlier, several countries already treat corporations as residents if their management and control are located in the country. However, this concept of control is easily manipulated by taxpayers, in contrast to the share ownership concept of control.

164. On the treaty side, the definition of “resident of a Contracting State” could be restricted to expressly exclude certain entities subject to no or little tax. One possibility would be to narrow the scope of the definition of resident in Article 4 to exclude other taxpayers who are liable to tax in a country but do not

in fact pay tax on all of their income like ordinary residents. Moreover, a specific rule might be adopted to deny certain treaty benefits to corporations resident in countries that exempt foreign branch income. For example, the benefit of reduced withholding taxes might be denied to such a corporation with respect to amounts attributable to a foreign branch located in a tax haven. Furthermore, the definition of resident in Article 4 could be revised to exclude legal entities that take advantage of specified regimes that constitute harmful tax competition.

165. Narrowing the scope of the residence article of the Model Tax Convention is similar to the adoption of limitation of benefit provision in that both measures are intended to deny treaty benefits to certain taxpayers. The difference between the two measures is that if a taxpayer is excluded from the definition of resident for purposes of the treaty, the taxpayer will not be entitled to any of the benefits provided by the treaty. In contrast, under a traditional limitation of benefits provision, a taxpayer will be denied only some benefits provided under the treaty, but will remain entitled to other benefits, for example, entitlement to relief from double taxation.

d) Application of transfer pricing rules and guidelines

166. Measures that constitute harmful tax competition often result in significant income being attributed to a foreign entity which performs few, if any, real activities. The application of transfer pricing rules, which typically start from an analysis of the true functions performed by each part of a group of associated enterprises, does, in that respect, constitute a useful counteracting measure.

167. It may be appropriate, however, that the Committee develop procedural rules that would address the specific circumstances of tax havens and regimes that constitute harmful tax practices. Rules effecting a reversal of onus of proof in certain cases (see subsection (a) above) would fall in that category. One action that could be taken in that respect would be for the Committee to supplement its transfer pricing guidelines with more guidance on the application of the Guidelines in relation to tax havens and regimes constituting harmful tax competition.

e) *Thin Capitalisation*

168. A large number of OECD countries apply general or specific legislative rules to address cases of base erosion attributable to the thin capitalisation of resident companies by non-residents. Such rules act as a safeguard against the tax-free repatriation of domestic profits to entities that may be located in tax havens or in countries that provide, directly or indirectly, favourable taxation of interest income from foreign subsidiaries. However, some domestic rules, such as the setting of safe harbour debt/equity ratios, may be misused and thereby facilitate harmful tax competition.

169. The Committee intends to explore whether it should recommend to Member countries that do not have such rules that they consider their introduction taking into account the previous work done by the Committee on this topic⁷ and the guidance in the 1995 Guidelines, especially with respect to safe harbours. The Committee also intends to review existing domestic rules.

f) *Financial innovation*

170. Financial markets are constantly evolving and innovative financial products are continually being created. Such instruments have the potential to be used to assist harmful tax competition, as well as being used for legitimate business purposes. Derivative products, for example, as well as hedging interest rate risk, can be used to create synthetic loans. Such “loans” give the taxpayer the same economic effect as if a loan had been made but with the potential to avoid withholding tax and thin capitalisation rules. The Committee intends to keep monitoring this area to ensure financial innovation is not used to assist harmful tax competition.

g) *Non-tax measures*

171. The various Recommendations included in this Chapter are all related to counter-measures involving taxation. There are no reasons, however, why the actions directed at harmful tax competition should be restricted to the tax area. It is therefore worth exploring the possibility of addressing harmful tax competition using a wide range of non-tax measures.

NOTES

1. International Tax Avoidance and Evasion, Four Related Studies No.1 p. 22 (OECD, 1987).
2. The source country can partially offset this negative effect by imposing a withholding tax which at least ensure that some tax is paid in cross-border income flows (see paragraph 12 for a discussion of this issue).
3. Transfer Pricing Guidelines For Multinational Enterprises and Tax Administrations (OECD, 1995) [hereinafter the “1995 Guidelines”].
4. Safe harbours are defined in para 4.95 of the Guidelines as “a simple set of rules under which transfer prices would be automatically accepted by tax authorities”. Although there are some benefits, including the provision of certainty and the simplification of compliance and administrative procedures, there are a number of important disadvantages. In particular, the implementation of a safe harbour by one jurisdiction also impinges on the tax calculations of associated enterprises in other jurisdictions as MNEs seek to comply with the safe harbour, and can have a negative impact on tax revenues by increasing the possibility of tax planning and diversion of income to tax havens. More importantly a safe harbour is by its very nature likely to be arbitrary and so not compatible with the facts and circumstances approach necessary to apply to arm’s length principle and the Guidelines. For these, and other considerations, the Guidelines at 4.123 state “the use of safe harbours is not recommended”.
5. Controlled Foreign Company Legislation, Studies in Foreign Source Income (OECD 1996). Korea and Mexico adopted CFC legislation in 1997.
6. The Strategic Management Forum was created by the Committee on Fiscal Affairs in 1997 to provide senior tax administrators with the opportunity to focus on strategic management issues, recognising that the sound administration of tax laws is as essential as the development of sound taxation policies.
7. Thin Capitalisation (OECD, 1986).

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ANNEX I

RECOMMENDATION OF THE COUNCIL ON COUNTERACTING HARMFUL TAX COMPETITION

*(Adopted by the Council on 9 April 1998)**

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14 December 1960;

Having regard to the Recommendation of the Council dated 23 October 1997 concerning the Model Tax Convention on Income and Capital;

Having regard to the Revised Recommendation of the Council dated 24 July 1997 on the Determination of Transfer Pricing between Associated Enterprises;

Having regard to the Ministerial Communiqué issued on the 22 May 1996 which calls upon the Organisation to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998”;

Having regard to the Report entitled “Harmful Tax Competition: An Emerging Global Issue” adopted by the Committee on Fiscal Affairs on 20 January 1998 (hereinafter referred to as “the Report”);

Recognising the OECD’s role in promoting an open, multilateral trading system and the need to promote the “level playing field” which is essential to the continued expansion of global economic growth;

* Luxembourg and Switzerland abstained.

Recognising that the process of globalisation and the development of new technologies has brought about prosperity for many citizens around the world, but also raises challenges for governments to minimise tax induced distortions in investment and financing decisions and to maintain their tax base in this new global environment;

Considering that if governments do not intensify their co-operation, a part of the tax burden will shift from income on mobile activities to taxes on labour, consumption and non mobile activities and that such a shift would make tax systems less equitable and may have a negative impact on employment;

On the proposal of the Committee on Fiscal Affairs:

I. RECOMMENDS that Member countries implement the recommendations, including the Guidelines for dealing with Harmful Preferential Tax Regimes, which are set out in an Appendix to this Recommendation, of which it forms an integral part.

II. INSTRUCTS the Committee on Fiscal Affairs:

1. to establish a Forum on Harmful Tax Practices;
2. to implement the relevant measures identified in the attached Appendix;
3. to report periodically to the Council on the results of its work in these matters together with any relevant proposals for further improvements in the co-operation to counter harmful tax practices;
4. to develop its dialogue with non-member countries, consistently with the policy of the Organisation, with the aim of assisting these countries to become familiar with the analysis and conclusions of the Report and, where appropriate, to encourage them to associate themselves with the recommendations set out in the Report.

APPENDIX

RECOMMENDATIONS AND GUIDELINES FOR DEALING WITH HARMFUL TAX PRACTICES

I. **Recommendations concerning domestic legislation and practices**

1. *Recommendation concerning Controlled Foreign Corporations (CFC) or equivalent 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.
2. *Recommendation concerning foreign investment fund or equivalent rules:* that countries that do not have such rules consider adopting them and that countries that have such rules consider applying them to income and entities covered by practices considered to constitute harmful tax competition.
3. *Recommendation concerning restrictions on participation exemption and other systems of exempting foreign income in the context of harmful tax competition:* that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method.
4. *Recommendation concerning 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.

5. *Recommendation concerning rulings:* that countries, where administrative decisions concerning the particular position of a taxpayer may be obtained in advance of planned transactions, make public the conditions for granting, denying or revoking such decisions.
6. *Recommendation concerning transfer pricing rules:* that countries follow the principles set out in the OECD's 1995 Guidelines on Transfer Pricing and thereby refrain from applying or not applying their transfer pricing rules in a way that would constitute harmful tax competition.
7. *Recommendation concerning access to banking information for tax purposes:* in the context of counteracting harmful tax competition, countries should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities.

II. Recommendations concerning tax treaties

8. *Recommendation concerning greater and more efficient use of exchanges of information:* that countries should undertake programs to intensify exchange of relevant information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition.
9. *Recommendation concerning the entitlement to treaty benefits:* that countries consider including in their tax conventions provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices and consider how the existing provisions of their tax conventions can be applied for the same purpose; that the Model Tax Convention be modified to include such provisions or clarifications as are needed in that respect.
10. *Recommendation concerning the 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 uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.
11. *Recommendation concerning a list of specific exclusion provisions found in treaties:* that the Committee prepare and maintain a list of provisions used by countries to exclude from the benefits of tax

conventions certain specific entities or types of income and that the list be used by Member countries as a reference point when negotiating tax conventions and as a basis for discussions in the Forum.

12. *Recommendation concerning tax treaties with tax havens:* that countries consider terminating their tax conventions with tax havens and consider not entering into tax treaties with such countries in the future.
13. *Recommendation concerning co-ordinated enforcement regimes (joint audits; co-ordinated training programmes, etc.):* that countries consider undertaking co-ordinated enforcement programs (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.
14. *Recommendation concerning assistance in recovery of tax claims:* that countries be encouraged to review the current rules applying to the enforcement of tax claims of other countries and that the Committee pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose.

III. Recommendations to intensify international co-operation in response to harmful tax competition

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

RECOMMENDATION 15 GUIDELINES FOR DEALING WITH HARMFUL PREFERENTIAL TAX REGIMES IN MEMBER COUNTRIES

While recognising the positive aspects of the new global environment in which tax systems operate, Member countries have concluded that they need to act collectively and individually to curb harmful tax competition and to counter the spread of harmful preferential tax regimes directed at financial and service activities. Harmful preferential tax regimes can distort trade and investment patterns, and are a threat both to domestic tax systems and to the overall structure of international taxation. These regimes undermine the fairness of the tax systems, cause undesired shifts of part of the tax burden from income to consumption, shift part of the tax burden from capital to labour and thereby may have a negative impact on employment. Since it is generally considered that it is difficult for individual countries to combat effectively the spread of harmful preferential tax regimes, a coordinated approach, including a dialogue with non-member countries, is required to achieve the “level playing field” which is so essential to the continued expansion of global economic growth. International co-operation must be intensified to avoid an aggressive competitive bidding by countries for geographically mobile activities.

The Guidelines are:

1. To refrain from adopting new measures, or extending the scope of, or strengthening existing measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices as defined in Section III of Chapter 2 of the Report.
2. To review their existing measures for the purpose of identifying those measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices as defined in Section III of Chapter 2 of the Report. These measures will be reported to the Forum on Harmful Tax Practices and will be included in a list within 2 years from the date on which these Guidelines are approved by the OECD Council.
3. To remove, before the end of 5 years starting from the date on which the Guidelines are approved by the OECD Council, the harmful features of their preferential tax regimes identified in the list referred to in paragraph 2. However, in respect of taxpayers who are benefiting from such regimes on 31 December 2000, the benefits that they derive will be removed at the latest on the 31 December 2005. This will ensure that such particular tax benefits have been entirely removed after that date. The list referred to in paragraph 2 will be reviewed annually to delete those regimes that no longer constitute harmful preferential tax regimes.

4. Each Member country which believes that an existing measure not already included in the list referred to in paragraph 2, or a proposed or new measure of itself or of another country, constitutes a measure, in the form of legislative provision or administrative practice related to taxation, that might constitute a harmful tax practice in light of the factors identified in Section III of Chapter 2 of the Report, may request that the measure be examined by the Member countries, through the Forum on Harmful Tax Practices, for purposes of the application of paragraph 1 or for inclusion in the list referred to in paragraph 2. The Forum may issue a non-binding opinion on that question.

5. To co-ordinate, through the Forum, their national and treaty responses to harmful tax practices adopted by other countries.

6. To use the Forum to encourage actively non-member countries to associate themselves with these Guidelines.

16. *Recommendation to produce a list of tax havens:* that the Forum be mandated to establish, within one year of the first meeting of the Forum, a list of tax havens on the basis of the factors identified in section II of Chapter 2.

17. *Recommendation concerning links with tax havens:* that countries that have particular political, economic or other links with tax havens ensure that these links do not contribute to harmful tax competition and, in particular, that countries that have dependencies that are tax havens ensure that the links that they have with these tax havens are not used in a way that increase or promote harmful tax competition.

18. *Recommendation to develop and actively promote Principles of Good Tax Administration:* that the Committee be responsible for developing and actively promoting a set of principles that should guide tax administrations in the enforcement of the Recommendations included in this report.

19. *Recommendation on associating non-member countries with the Recommendation:* That the new Forum engage in a dialogue with non-member countries using, where appropriate, the fora offered by other international tax organisations, with the aim of promoting the Recommendations set out in this Chapter, including the Guidelines.

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ANNEX II

STATEMENTS BY LUXEMBOURG AND SWITZERLAND

The following statements were made by Luxembourg and Switzerland at the time the OECD Council approved the Report on the 9th April 1998.

Statement by Luxembourg

The Council, which met at the Ministerial level in May 1996, gave a mandate “to develop measures to counter the distorting effects introduced by harmful tax competition on investment and financing decisions and the consequences for national tax bases”.

Considering that tax competition—beyond its positive effects—can also present certain harmful aspects, Luxembourg approved this mandate and participated in the subsequent work.

In parallel with the work undertaken at the OECD, Luxembourg has co-operated actively in elaborating a comprehensive approach to this issue within the European Union, where an agreement was reached on 1 December 1997 on a code of conduct with respect to business taxation and on the issues to consider in the context of taxation of savings in order to guarantee a minimum level of taxation.

This EU agreement is the result of co-ordinated action, reflecting a balanced approach, based on:

- 1) recognition of the existence of inherently legitimate differences between national legal and fiscal frameworks;
- 2) recognition that these differences should not be at the origin of harmful tax competition, and;

- 3) recognition that such harmful tax competition is not due to a single member State in a single sector, and, thus, that the governments of all member States are invited to counter harmful tax competition in all sectors.

By voluntarily limiting itself to financial activities, excluding industrial and commercial activities, the Report developed by the Special Sessions on Harmful Tax Competition adopts a partial and unbalanced approach: it does not fulfil the 1996 mandate.

By taking an almost unilateral approach with respect to the prescribed measures, the Report gives the impression that its purpose is not so much to counter harmful tax competition where it exists as to abolish bank secrecy.

Luxembourg does not share the Report's implicit belief that bank secrecy is necessarily a source of harmful tax competition.

It cannot accept that an exchange of information that is circumscribed by the respect of international laws and respective national laws be considered a criterion to identify a harmful preferential tax regime and a tax haven.

Just as judicial co-operation in criminal matters is essential to counter any potential abuse of bank secrecy both in criminal law *per se* and in criminal violations of tax law, so should international administrative assistance in tax matters be subject to certain conditions and precise limits, in accordance with general legal principles and respective national legislation.

Furthermore, Luxembourg cannot accept that the underlying philosophy of the Report be extended to the taxation of savings, in respect of which the Committee on Fiscal Affairs has already mandated its Working Party on Tax Evasion and Avoidance to examine how exchange of information and withholding taxes could be used concurrently to prevent cross-border interest flows from escaping taxation. This approach ignores the validity of the so-called model of "coexistence", wherein withholding taxes constitute an alternative to exchange of information.

More generally, Luxembourg is concerned that the Report lends credence to the so-called criterion of reputation—a criterion without any objective basis.

Luxembourg is convinced that the desired effectiveness of international co-operation in countering harmful tax competition requires a strengthening of mutual trust between Member countries, as well as dialogue with OECD non-members. In this context, it appears essential that countries with dependencies contribute actively so that these territories do not in fact remain exempt from the fight against harmful tax competition. Similarly, harmful tax competition resulting from special ties that a country maintains with tax havens cannot remain out of bounds. These problems are not sufficiently covered in the Report.

Considering all the above, Luxembourg states its disagreement with the Report on harmful tax competition.

Hoping that this first approach does not necessarily prejudice future developments, in particular in the Forum, and confident in the ability of the OECD to deal with this important subject while respecting the major concerns of its Member countries, Luxembourg has decided to express its disagreement in the form of a general abstention in respect of the Report “Harmful Tax Competition: A Global Issue” and the Recommendation of the Council C(98)17.

Accordingly, Luxembourg shall not be bound by the Report nor by the Recommendation to counteract harmful tax competition.

Statement by Switzerland

1. Switzerland has an open and transparent tax regime characterised by a moderate tax burden. At the international level, judicial assistance works effectively to counteract tax fraud, and a system of withholding tax (the rate of which is the highest among OECD countries) aims to prevent tax avoidance.

Switzerland considers that a certain degree of competition in tax matters has positive effects. In particular, it discourages governments from adopting confiscatory regimes, which hamper entrepreneurial spirit and hurt the economy, and it avoids alignment of tax burdens at the highest level.

However, beyond its positive effects, tax competition sometimes can, if excessive, have harmful consequences. Switzerland, like any other country, is not immune to these effects. The Swiss government is determined to curb tax competition to the extent that it is harmful, and it remains convinced that broad and co-ordinated international tax co-operation is the best guarantee of effective and continuing progress in this area. This is why Switzerland subscribed in May 1996 to the mandate given by the OECD Council of Ministers¹ and has taken part in the work culminating in a Report on harmful tax competition and its Recommendations.

2. It is now time to take stock of two years of work. Switzerland recognises the efforts made by the OECD in preparing the Report on counteracting harmful tax competition. The Swiss authorities must however conclude with regret that the result of this work in no way lives up to their expectations: it is partial and unbalanced. The opposition of the Swiss authorities to the content of the Report and to the Recommendations on harmful tax competition is consistent with what has been expressed and emphasised repeatedly, in particular within the Committee on Fiscal

1 In the May 1996 Ministerial Communiqué, the OECD was asked to “monitor the implementation and extend the application of the OECD Transfer Pricing Guidelines and analyse and develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions, and the consequences for national tax bases, and report back in 1998”.

Affairs, the Executive Committee and the OECD Council. Our position is based, *inter alia*, on the following considerations:

- A. Since the beginning of the work, Switzerland has stressed the importance of adopting a comprehensive approach to tax competition and of circumventing its harmful aspects. However, the scope of the work was subsequently restricted to geographically mobile activities, such as financial activities and other services. From our point of view, State intervention that distorts competition must be considered in all sectors and in the economy as a whole. Moreover, financial and investment decisions depend on a multiplicity of economic, political and social factors. Whilst the Report recognises that there are effectively other important non-tax factors that play a role in economic competitiveness, it does not take them into account. Under the circumstances, one cannot help but make partial and erroneous evaluations of reality.
- B. The Report recognises that each State has sovereignty over its tax system and that levels of taxation can differ from one State to another. However, that same Report presents the fact that tax rates are lower in one country than in another as a criterion to identifying harmful preferential tax regimes. This results in unacceptable protection of countries with high levels of taxation, which is, moreover, contrary to the economic philosophy of the OECD.
- C. The Report ignores the reality of the structural diversity of existing tax regimes. For instance, the only solution adopted is administrative assistance by means of exchange of information, even though this presents certain limits, and the existence of withholding systems is not taken into account, even though such systems are viable alternatives which entail lower administrative costs. This is particularly difficult to understand since, up to now, the OECD had always considered withholding taxes as an alternative to exchange of information.

Switzerland considers that it is legitimate and necessary to protect the confidentiality of personal data. In this respect, the Report and Recommendations are, in certain aspects, in conflict with the Swiss legal system.

- D. Finally, the selective and repressive approach that has been adopted does not give territories that make tax attraction a pillar of their economies an incentive to associate themselves with the regulation of the conditions of competition and will therefore fail to combat effectively the harmful excesses of tax competition that develops outside of all rules. On the contrary, it could reinforce the attraction of offshore centres, with all the consequences that this implies.
3. For these reasons, among others, Switzerland cannot declare itself in agreement with the Report nor with the adoption of the Recommendations, and more particularly Recommendations No. 4, 7, 8, 14 and 15 included in the Report.

After having seriously considered the possibility of exercising its veto, Switzerland has finally decided to abstain when the Report and its Recommendations are adopted, in order not to prevent their adoption by other OECD Member countries wishing to do so. As far as Switzerland is concerned, it shall not be bound in any manner by the Report or its Recommendations.

ANNEX III

RELEVANT OECD REPORTS AND GUIDELINES

Publications related to national tax law

- Controlled Foreign Company Legislation: Studies in Taxation of Foreign Source Income (1996)
- Combating Bribery of Foreign Public Officials in International Transactions: The Role of Taxation (1996)

Publications related to tax treaties

- OECD Model Tax Convention (issued in loose-leaf format in 1992, updated in 1994, 1995 and 1997)
- The Tax Treatment of Employees' Contributions to Foreign Pension Schemes (1992)
- Triangular Cases (1992)
- The Tax Treatment of Software (1992)
- The 183 Day Rule: Some Problems of Application and Interpretation (1991)
- The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities (1987)
- International Tax Avoidance and Evasion: Four Related Studies (1987)
- Thin Capitalization (1986)
- The Taxation of Income from the Leasing of Containers (1983)
- The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment (1983)

Publications related to transfer pricing

- Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995)
- Attribution of Income to Permanent Establishments (1993)
- Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure (1982)

Publications related to the exchange of information

- The Use of Tax Payer Identification Numbers in an International Context (1997)
- OECD Manual on the Implementation of Exchange of Information Provisions For Tax Purposes (1994)
- Tax Information Exchange Between OECD Member Countries: A Survey of Current Practices (1994)
- The OECD Model Agreement for Simultaneous Exchanges of Tax Information (1992)
- The Revised Standard Magnetic Format (1992)
- OECD Standardised Form and Magnetic Standard for Automatic Exchange of Information (1992)
- Taxpayers Rights and Obligations: A Survey of the Legal Situation in OECD Member Countries (1990)
- The Joint Council of Europe OECD Convention on Mutual Assistance in Tax Matters (1988)
- Model Convention for Administrative Assistance in the Recovery of Tax Claims (1981).

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