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**DRAFT RECOMMENDATION ON COUNTERACTING HARMFUL TAX
COMPETITION**

(Note by the Secretary-General)

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TABLE OF CONTENTS

A. BACKGROUND 3
B. GLOBALISATION: BENEFITS AND CHALLENGES FOR GOVERNMENTS 3
C. IDENTIFYING HARMFUL TAX PRACTICES 5
D. RECOMMENDATIONS FOR ACTION 6

ANNEX: DRAFT RECOMMENDATION OF THE COUNCIL ON COUNTERACTING
HARMFUL TAX COMPETITION 8

APPENDIX: RECOMMENDATIONS AND GUIDELINES FOR DEALING WITH HARMFUL
TAX PRACTICES 10

1. On 20th January 1998, the Committee on Fiscal Affairs discussed a Report [DAFFE/CFA(97)29/REV4/CORR1] “Harmful Tax Competition: An Emerging Global Issue” and agreed to submit it to the Council with a Recommendation that it be derestricted and passed to the OECD Council meeting at Ministerial level to be held on 27-28 April 1998. The Minutes [DAFFE/CFA/M(98)1] to that meeting record the position of those countries which were unable to endorse the Report. [See DAFPE/CFA/M(98)1/ANN4.]

A. BACKGROUND

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

3. The G7 Heads of State endorsed this request at their 1996 Lyon summit, urging 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”.

4. 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 ready for consideration by the Council (see DAFPE/CFA(97)29/REV4/CORR1).

5. The Report addresses harmful tax practices in the form of tax havens and harmful preferential tax regimes in OECD countries and non-Member countries and their dependencies. It focuses on geographically mobile activities, such as financial and other service activities.

6. The Report defines the factors to be used in identifying these harmful preferential tax practices and goes on to make 19 wide-ranging Recommendations to counteract such practices.

7. Some of the Recommendations build on and reinforce existing national and bilateral measures designed to counteract harmful tax practices. But an important new focus is on intensifying international co-operation. As well as advocating the co-ordinated application of defensive measures, a set of Guidelines is proposed to deal with harmful preferential tax regimes in Member countries. The framework for implementation of the Guidelines will be provided by a new OECD Forum on Harmful Tax Practices. The Forum will also oversee the implementation and development of the other Recommendations and engage in a dialogue with non-Member countries which share the concerns of OECD Members.

B. GLOBALISATION: BENEFITS AND CHALLENGES FOR GOVERNMENTS

8. Globalisation is one of the great economic events of the 20th century. It is the process which breaks down economic barriers between nations and leads firms to develop global strategies. Liberalisation of national economies opened the way for globalisation and the new technologies made that globalisation happen. This, in turn, has translated into greater prosperity for many citizens around the world.

9. But globalisation has also raised challenges for governments: how to distribute the cost of structural adjustments required to reap the benefit of globalisation; how to provide the necessary shelter to

the weaker segments of society; how to ensure that governments maintain sufficient sovereignty to determine the revenue and expenditure structure that is best suited to their political, institutional and social conditions.

10. Liberalisation is at the core of the Organisation's work and is aimed at facilitating cross-border flows of trade and investment. The OECD has made considerable efforts to eliminate double taxation, which is an obstacle to cross-border activities, and is prepared to undertake similar efforts to curb harmful tax practices which can have detrimental effects on world economic growth.

11. Globalisation has had a positive effect on the development of tax systems, being, for instance, the driving force behind tax reforms that have focused on base broadening and rate reductions, thereby minimising tax-induced distortions.

12. OECD Member countries are committed to maintaining the efficiency gains of these reforms while recognising that there are no particular reasons why any two countries should have the same level and structure of taxation.

13. Similarly, increased liberalisation of financial markets has improved the international allocation of savings and capital and reduced the cost of capital to enterprises. But it has also widened opportunities for tax evasion and avoidance. In this new environment, tax havens have thrived and some governments have adopted preferential tax regimes specifically targeted at attracting mobile activities.

14. If nothing is done, governments may increasingly be forced to engage in competitive tax bidding to attract or retain mobile activities. That "race to the bottom", where location and financing decisions become primarily tax-driven, will mean that capital and financial flows will be distorted and it will become more difficult to achieve fair competition for real economic activities.

15. Furthermore, it will become more difficult to collect taxes on income from mobile activities. If spending is not reduced to make up for this revenue loss there is a real risk that taxes on labour, consumption and non-mobile activities will need to be increased. This shift will make tax systems less equitable and, by narrowing the tax base, will introduce further distortions. By increasing non-wage labour costs, it may also have a negative impact on employment.

16. There is no reason why taxpayers that do not or cannot take advantage of harmful tax practices should have to pay the taxes avoided by those who have easy access to tax havens and harmful preferential tax regimes.

17. The potential impact of these developments is significant. It is estimated, for example, that foreign direct investment from 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.

18. Governments have not remained idle in face of these challenges but, until now, most governments have generally acted independently, or at best bilaterally, to protect their tax bases and fiscal policies. In this new global environment, such actions need to be reinforced but also complemented by intensified multilateral cooperation.

19. Developments within the G7, the EU, the OECD and beyond suggest that the political climate is now ripe for a common approach against harmful tax practices.

20. The concerns identified above are not limited to OECD countries. Countries in the Asian-Pacific region, Latin America, Africa and in the former Soviet Bloc share many of these concerns. In some ways these countries are more exposed to tax havens and competitive bidding for financial and service activities since many of them lack the administrative capacity to implement sophisticated counteracting measures. This is why the Committee on Fiscal Affairs has already engaged in a dialogue with these countries and intends to explore further how contacts with non-Member countries can be intensified in the context of the proposed Forum.

C. IDENTIFYING HARMFUL TAX PRACTICES

21. The Report makes a distinction between three situations in which the tax levied in one country on income from geographically mobile 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 is lower than that levied in the second country.

22. Each of these situations may have undesirable effects when seen from the perspective of the other country. However, insofar as the other factors referred to in the Report and set forth below are not present, the issues arising in situation (iii) are outside the scope of the Report. Thus, the Report is careful not to suggest that there is some general minimum effective tax rate on income below which a country would be considered to be engaging in harmful tax practices. The focus of this Report is instead on tax havens and harmful preferential tax regimes.

23. The necessary starting point to identify a tax haven is to ask whether a jurisdiction imposes no or only nominal taxes 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 are: practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; lack of transparency; and the absence of a requirement that the activity be substantial, since this would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven. No or only nominal taxation is a necessary condition for the identification of a tax haven and, if combined with a situation where the jurisdiction offers itself as a place where non-residents can escape tax in their country of residence, it may be sufficient to identify a tax haven.

24. Similarly, four key factors assist in identifying harmful preferential tax regimes: (i) the regime imposes a low or zero effective tax rate on the relevant income; (ii) the regime is "ring-fenced" (iii) the operation of the regime is non-transparent; and (iv) the jurisdiction operating the regime does not effectively exchange information with other countries. Although a low or zero effective tax rate is the necessary starting point for an examination of a preferential tax regime, any evaluation should be based upon an overall assessment of each of the factors identified in the Report. In this evaluation process,

harmful preferential tax regimes will be characterised by a combination of a low or zero effective tax rate and one or more other factors.

25. The Report elaborates on these key characteristics and also identifies a series of other factors and considerations which can be useful in identifying harmful tax practices.

D. RECOMMENDATIONS FOR ACTION

26. The Recommendations recognise that greater international cooperation is required in this area. It is increasingly difficult for individual countries to combat effectively the spread of harmful tax practices without the risk of putting their taxpayers and economies at a competitive disadvantage.

27. There is, therefore, a strong case to reinforce existing measures and to intensify international co-operation when formulating a response to the problem of harmful tax practices.

28. The Recommendations set out in the Report and the accompanying Guidelines address the problem of harmful tax practices from different angles. Taken together, they represent a comprehensive approach by Member countries for dealing with the problems of harmful tax competition created by tax havens and harmful preferential tax regimes. Some of the Recommendations encourage countries to refrain from adopting or to eliminate measures constituting harmful tax competition. Others are aimed at offsetting the benefits for taxpayers of certain forms of harmful tax practices. Still others address the issue indirectly by focusing on tax evasion and avoidance, because many forms of harmful tax competition are aimed at taxpayers willing to engage in tax evasion and avoidance.

29. The effectiveness of many of the Recommendations concerning domestic legislation and tax treaties depends in part upon whether they can be implemented in a co-ordinated way. This is why one of the main Recommendations is for the establishment of a Forum to monitor the application of the Guidelines and to undertake an on-going evaluation of existing and proposed regimes, to assess the effectiveness of counter-measures and to propose ways to improve their effectiveness. It will also be responsible for monitoring the implementation of the other Recommendations.

30. In addition to these Recommendations, the Report identifies a series of areas where further study could result in new Recommendations. The Forum will be used to examine these areas.

31. The Committee considers that the adoption of the Report by the Council will be a major step forward in counteracting harmful tax practices. Accordingly, the Committee decided to suggest to the Secretary-General that he recommend to the Council that it adopt the attached draft Recommendation, note the Report, agree to their declassification and include the Report as part of the documentation for the April Ministerial meeting. If the Council agrees to declassification, the Secretary-General intends to issue the Report as a publication.

32. The Secretary-General therefore invites the Council to adopt the following draft entry in its Summary Record:

THE COUNCIL

- a) noted document C(98)17;

- b) noted the Report by the Committee on Fiscal Affairs entitled “Harmful Tax Competition: An Emerging Global Issue” [DAFFE/CFA(97)29/REV4/CORR1] and agreed to its declassification at the Council meeting at Ministerial level which will be held on 27-28 April 1998;
- c) adopted the draft Recommendation on Counteracting Harmful Tax Competition attached to this note and agreed to its declassification at the time of the Council meeting at Ministerial level.

ANNEX

**DRAFT RECOMMENDATION OF THE COUNCIL ON COUNTERACTING
HARMFUL TAX COMPETITION**

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Cooperation 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 [C(97)195/FINAL];

Having regard to the Revised Recommendation of the Council dated 24 July 1997 on the Determination of Transfer Pricing between Associated Enterprises [C(97)144/FINAL];

Having regard to the Ministerial Communiqué issued on the 22 May 1996 which calls upon the Organisation to “develop measures to counter the distorting impact 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 [DAFFE/CFA(97)29/REV4/CORR1] (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;

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 cooperation, 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 cooperation 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 cooperation 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.