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Harmful Tax Competition, Past and Future

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Abstract

Addressing harmful tax competition has been a priority for the Organisation for Economic Co-Operation and Development (OECD) since the late 1990's. Its focus has been sharpened recently because of the global financial crisis and the clamorous media and public debate around the issue of Multinational Enterprises (MNEs) avoiding paying their fair share of taxes, often employing extreme and complex avoidance tactics. In part as a result of this public pressure, the topic has been revisited by the OECD in its base erosion and profit shifting (BEPS) project. In order to address the harmful effects of tax competition, the OECD published three reports in 1998, 2000 and 2001, respectively. Since then, the OECD has changed its tactics, now focusing more on transparency and the multilateral exchange of information. The latest OECD BEPS project action plan addresses many of the major issues associated with the harmonisation of international taxation; one key pillar is Action Plan 5 which deals with harmful tax competition.

In this thesis, it will be argued that the effect of harmful tax competition can be both good and bad. The three OECD reports will be analysed, and it will be demonstrated how and why they fell short of accomplishing their goals. Action Plan 5 will be scrutinised, and the reasons that it may struggle to achieve its goal of combating harmful tax competition will be argued. It is likely that tax harmonisation will be achieved only through multilateral instruments that include not only OECD member countries, but also the rest of the world, including both countries and MNE's that, in their own right, contribute a great deal to the world economy.

Introduction

Recent ubiquitous newspaper headlines have targeted Multinational Corporations engaged in highly structured and aggressive tax planning, in particular taking advantage of different national tax regimes in order to minimise their tax bills. However, these media stories have invariably failed to recognise that part of the problem lies within individual countries that are competing fiercely in what is known as the ‘race to the bottom’.

Historically, governments have imposed tax on their citizens to fulfil domestic economic needs and improve social welfare. But with the increased level of globalisation of trade and investments, governments have been forced to reassess their tax systems in order to take into account the impact their own domestic tax policies has on other economies. Countries now make adjustments to their tax policies and public expenditure with a view to improving the ‘fiscal climate’ to attract foreign investment and cross-border capital flow.

Although globalisation has had some positive effects on the development of tax systems around the world, it has had negative effects too. It has inadvertently opened up new loopholes which Multinational Enterprises (MNEs) and individuals have used to their advantage in order to reduce their tax bills. Moreover, many countries have developed tax systems primarily aimed at exploiting new opportunities to attract mobile capital and this has led to economic distortions and reduced global welfare. Because of the increased level of cross-border transactions and the globalisation of trade, tax policies in one country are more likely than ever to affect other economies, with the inevitable effect that other countries modify their tax bases accordingly.

Eighteen years ago, the G7 Heads of State recognised that the only way to combat harmful tax competition is through international co-operation. In May 1996, Ministers called on the Organisation for Economic Co-Operation and Development (OECD) to “*develop measures to counter the distorting effects* *of harmful tax competition on investment and financial decisions and the consequences for national tax bases, and report back in 1998*."[1] The following statement was issued by the G7 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."[2]]

The OECD published three reports in 1998, 2000, and 2001, addressing this phenomenon of harmful tax competition. The first report, published in April 1998, was titled "*Harmful Tax Competition: An Emerging Global Issue".*[3] This report focused on geographically mobile activities, i.e. financial and other service activities, and highlighted some of the features used to identify harmful tax practices. It went on to recommend nineteen steps that should be used to counteract such practices. However, two member countries, Luxembourg and Switzerland, abstained from approval of the report.

Fifteen years later, the OECD acknowledges that the distorting effects of harmful tax competition have expanded to include not only financial and investment decisions, but also digital goods and e-commerce activities. The OECD has readdressed the issue of 'harmful tax competition' in its campaign

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1 *OECD (1998), Harmful Tax Competition: An Emerging Global, OECD Publishing. http://www.oecd.org/tax/transparency/44430243.pdf*

2 *OECD (1998), Harmful Tax Competition: An Emerging Global, OECD Publishing. http://www.oecd.org/tax/transparency/44430243.pdf*

3 *OECD (1998), Harmful Tax Competition: An Emerging Global, OECD Publishing. http://www.oecd.org/tax/transparency/44430243.pdf*

against base erosion and profit shifting (BEPS).[4] The fact that it has had to do so is a clear indication that its previous work, reflected in its 1998, 2000, and 2001 reports, has failed to achieve all of its goals.

In its BEPS Action Plan, the OECD intends to revamp the work on harmful tax practices that it has undertaken since the 1990s. Action 5 reads:

["*Counter Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance. Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.*"[5]]

In this thesis, I will discuss the concept of 'tax competition', and the distinction between 'good' and 'harmful' tax competition, distinguishing between tax havens and preferential tax regimes. I then will address the OECD Reports and analyse which objectives have been achieved; in doing so, I will highlight what I believe the OECD BEPS project should do in order to address harmful tax practices more effectively.

Tax Competition

So called 'good' tax competition occurs in the form of a country reducing the tax burden in order to improve its economy and welfare by increasing the competitiveness of domestic business and attracting foreign investment. This should not be confused with harmful tax competition which is aimed at attracting mobile capital and foreign investment at the expense of other

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4 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. *http://dx.doi.org/10.1787/9789264202719-en*

5 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. *http://dx.doi.org/10.1787/9789264202719-en*

countries' economies. When considering tax competition, a fundamental distinction must be made between vertical (or intra-governmental) tax competition and horizontal (or inter-jurisdictional) tax competition. Vertical tax competition occurs at the domestic level within a country's constitutional hierarchy. In federal countries such as the USA, tax competition occurs between the federal government and state governments, constituting an example of vertical tax competition. On the other hand, horizontal (or inter-jurisdictional) tax competition occurs between sovereign countries at international level. Horizontal, inter-jurisdictional tax competition will be the focus of this thesis.

Another critical distinction regarding the subjective aspect of tax competition is between tax incentives aimed at boosting exports of domestic business (which gives rise to 'outbound' tax competition) and tax incentives aimed at attracting mobile capital and foreign investment, known as 'inbound' tax competition. Inbound tax competition is the most significant form of horizontal tax competition and is responsible for many of the harmful effects from which many countries' economies have been suffering in recent years. Distinguishing between good and harmful tax competition is not an easy task; economists, scholars and politicians all agree that the consequences of tax competition can be both beneficial and harmful.

Positive aspects of tax competition

There is an argument that governments and politicians have long used their discretion to manipulate tax in order to promote their popularity and influence voters; that they overburden less vocal sections of their electorate while favouring the wealthy who in turn finance their election campaigns. It has been shown that politicians, in the process of influencing voters, will promise higher public spending than their budgets can afford, a problem that they solve by imposing higher taxes. Furthermore, some governments' public spending fails to produce an efficient public service or improve domestic welfare; instead it is wasted on corruption and ill-conceived and poorly implemented projects. Against this background, international tax competition has been regarded by some as a very positive weapon against wasteful spending by imposing limits on the taxes available for poorly managed budgets.

Among the other positive aspects of tax competition is the observation that countries differ in the way they view tax competition; what some countries view as harmful, others may not. For example, countries with a geographical disadvantage, lack of natural resources, etc, may have no option other than the use of tax incentives to encourage foreign investment. In such countries, tax competition is justified. Moreover, tax is not the only element considered in international competition for the allocation of investment and capital. In their book "In Praise of Tax havens: International Tax Planning and Foreign Direct Investment" Hong and Smart point out that the existence of tax havens and preferential tax regimes may improve the allocation of capital:

["*the availability of tax havens for the purpose of business structuring makes the location of real investment less responsive to a pure difference in tax rates between two countries*".[6]]

'Good' tax competition

If a reduction in the tax burden by a sovereign government results in greater tax efficiency and helps to maintain a reasonable level of public expenditure and improve the efficiency of public administration, public services and infrastructures it provides, then this should be encouraged. Broadening the taxable base and reducing the tax rate will lead to greater neutrality and fairness in countries' tax systems, a better and more equitable system of distributing the tax burden and wealth among taxpayers. Other benefits, such as economic growth, increased employment and overall domestic welfare, should follow. In a scenario where tax competition is desirable, each country

[6] Q. Hong and M. Smart, "In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment"

would have its own tax incentives which reflect the needs of its public services, and taxpayers, be they individuals or MNEs, would be free to opt for the one that best caters to their needs.

‘Harmful’ tax competition

It has been proven that tax competition may also cause harmful economic effects. The most undesirable effect is the loss of tax revenue caused by the reduction of taxes on income derived from inbound investment. This effect is known as fiscal degradation. In a bid to secure inbound foreign investment and highly mobile capital, countries end up eroding their own taxable bases. As a result of this ‘poaching’, also known as the ‘race to the bottom’, countries that implement this approach gain little tax revenue among other benefits, whereas countries that fail to attract these inbound investments lose out on large amounts of potential tax revenue. In the end, the only winner in this game of ‘race to the bottom’ is the taxpayer usually referred to as “free rider”, often a wealthy internationally-mobile individual or MNE that is able to take advantage of all the public services provided in the countries in which they primarily operate, without contributing their fair share towards the cost. Jurisdictions outbidding each other lose their fiscal sovereignty and surrender to internationally mobile capital.

Fiscal degradation caused by harmful tax competition has many negative effects. It reduces the tax revenue available to governments to fund their public spending. This in turn requires them to identify alternative sources of revenue and can shift the tax burden to less mobile individuals and corporations. This undermines the fairness of tax systems, thus affecting taxpayers’ compliance, and increases the administrative costs of tax authorities. The main economic inefficiency caused by harmful tax competition is the distortion of economic resources and mis-allocation of capital flows.

Foreign direct investment versus portfolio passive investment

Foreign Direct Investment

Foreign direct investment (FDI) describes the situation in which an investor based in one country engages in substantial activity in a foreign country which offers him attractive advantages and incentives compared with his home country. FDI is normally a medium-to-long-term business investment. It has a low degree of mobility and entails substantial presence of the investor in the foreign country (e.g. a branch, an office, a production plant, etc.). Countries that offer these incentives, often referred to as 'production tax havens', are not necessarily involved in harmful tax competition. They offer a low tax rate on income from production activities to both residents and foreign investors. Due to the limited mobility of productive activities, investors consider many factors other than tax before locating in a specific country. Furthermore, in trying to attract FDI, countries hope to enhance development and increase employment.

However, there is a trend among less economically developed and smaller countries to offer tax incentives for FDI which is available only to foreign multinational enterprises. This deprives local investors of these incentives and shifts the tax burden to active income earned by resident investors, which leads to inequity between domestic and foreign taxpayers. Another harmful effect is that MNEs can enjoy the host country's public services without contributing towards their provision.

Another problem is that MNEs may take advantage of tax holidays provided by the host country. These normally last for between five and ten years; once they have expired, MNEs may wind down their operation in the host country and move on to another competing production tax haven. This practice is widely known as 'round-tripping'.

These problems have been exacerbated in recent years by increasing globalisation and the increased level of cross-border transactions. Within the EU, Ireland was an obvious example of a production tax haven, offering a special ‘manufacturing relief’ as a 10% corporate tax rate on income earned from production operations, as opposed to a general corporate tax rate of 30%. Ireland has now abolished this 10% manufacturing relief and offers a general low corporate tax rate on active income of 12.5%.

Portfolio Passive Investment

The problem is different when it comes to tax incentives offered to highly mobile activities performed by MNEs on foreign portfolio investment, generating passive income. These incentives normally target, inter alia, management, insurance, financial and other service centres. Countries that offer these incentives are referred to as ‘headquarters tax havens’. They are considered to be involved in harmful tax practices because they offer incentives to attract mobile capital without stimulating real economic growth, causing negative spill-over effects on countries’ revenues. Headquarters tax havens gain very little revenue from this practice, compared to what the MNEs would have had to pay in tax elsewhere, but the countries from which the activities are relocated lose out substantially. This practice causes the fiscal degradation mentioned above and, as the subsequent passive income earned by MNEs escapes being taxed anywhere, tax becomes the main consideration for MNEs when deciding where to invest. This gives rise to tax competition between countries that try to offer specific tax incentives so as to attract FDI and passive investment. Countries found guilty of offering tax incentives in order to attract this type of inbound investment include the Netherlands, Luxembourg and Ireland.

In theory, it should be easy to distinguish between good and harmful tax competition. Good tax competition should have desirable economic effects, including reducing the tax burden and improving efficiency in the public sector. On the other hand, harmful tax competition causes fiscal degradation which leads to shifting the tax burden on to alternative bases. In practice, however, drawing a line between good and harmful tax competition is a difficult task. In his book “Tax Competition and EU Law”[7], Pinto identifies a number of additional criteria that may be needed to define a tax as being harmful, as follows:

- Tax which is limited to certain taxpayers only (e.g. non-residents or local subsidiaries of MNCs), which is known as ‘ring-fencing’
- Tax which is limited to specific forms of income (e.g. active or passive income)
- Tax which is limited to specific business activities (e.g. financial and other service activities)
- Tax that does not have any substantial economic benefits
- A tax measure that is non-transparent and is applied based on a discretionary agreement between the taxpayer and the tax authority
- Tax that does not comply with the internationally accepted principles (e.g. the OECD guidance of transfer pricing rules)
- Tax that does not have inbuilt anti-avoidance measures forbidding taxpayers from exploiting it.

When setting their tax policies, jurisdictions should be able to distinguish between good and bad tax practices, and to identify tax havens and other harmful tax regimes in non-haven jurisdictions.

In its 1998 Report, the OECD placed emphasis on harmful tax regimes and tax havens. Unless governments and tax administrators have the ability to identify unacceptable harmful tax competition, they cannot be criticised for competing fiercely in what seems to be a ‘race to the bottom’ in order to attract foreign investment, geographically mobile financial activities and other service activities.

Generally speaking, there are two situations in which the tax levied in one jurisdiction on income from mobile activities is lower than the tax that would be levied on that same income in another jurisdiction:

[7] Tax Competition and EU Law, Carlo Pinto, P. 19&20

1) The first jurisdiction is a tax haven that imposes no or minimal tax on that income.
2) The first jurisdiction is not a tax haven, in the sense that it does collect significant revenues from income taxes levied on individuals and corporates, but its tax policies have preferential features that exempt the mobile income from tax or subject it to nominal tax.

It should be easy to distinguish between the two types of jurisdiction mentioned above. In the first scenario, the country offers a haven for the non-resident taxpayer seeking a place to shelter his wealth and escape paying tax in his country of residence. This country normally has no (or nominal) income tax. On the other hand, the country in the second scenario raises significant revenues from income and corporate tax but its tax system has features considered potentially to represent harmful tax competition.

The 1998 OECD Report entitled 'Harmful Tax Competition - An Emerging Global Issue' recognises the distinction between tax havens and countries with harmful preferential tax regimes, in the sense that it has different recommendations for each category. This report does not provide a precise definition for the term 'tax haven'. It identifies tax havens as '*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*'[8]. The other group of countries with which this report is concerned are those with 'preferential tax features that allow the relevant income to be subject to low or no taxation'[9]. When identifying harmful tax competition, whether performed by a tax haven or a harmful preferential tax regime, the starting point is the 'no or lower effective' tax rate criterion, coupled with one or more of the following four criteria as highlighted in the 1998 Report**:**

[8] OECD 1998 Report, http://www.oecd.org/tax/transparency/44430243.pdf, P. 20.
[9] OECD 1998 Report, http://www.oecd.org/tax/transparency/44430243.pdf, P. 19.

- ‘no or only nominal taxes’ for tax havens; ‘no or lower effective tax rates’ on income from mobile activities with regard to harmful tax practices (HTPs) due to a narrow definition of the tax base
- lack of effective exchange of information and the implementation of a bank secrecy policy which prevents the supply of taxpayers’ financial information
- ‘no substantial activities’ seen in tax havens in the form of ‘booking centres’ where there is hardly any presence of the taxpayer activity in the jurisdiction. With regard to HTPs, ‘ring-fencing’ is an example of when the tax incentive is available exclusively to non-resident taxpayers
- Lack of transparency where tax authorities conclude favourable advance rulings, normally inconsistent with the statutory tax law, without publishing them.

In addition to these four main criteria, the 1998 OECD Report defines additional factors that should be taken into consideration, for both tax havens and harmful preferential regimes, when identifying harmful tax competition. These include:

- Failure to comply with OECD guidance on transfer pricing rules, such as the inappropriate use of advance rulings, the use of ‘safe harbour’ prices, and the ability of certain taxpayers to negotiate a “transfer price” with the tax authorities that is not consistent with the OECD guidelines, which increases the risk of competitive distortions.

  The OECD transfer pricing guidelines explain how countries should apply the arm’s length principle in determining an MNE tax bill and the allocation of the tax share of each country in which the MNE and its subsidiaries operate. Determining the exact transfer price is challenging and there is no simple formula or answer. It all depends on the facts and circumstances of each case. However, if incorrectly calculated, it can change the competitive position of subsidiaries of an

MNE. Miscalculation may occur when tax authorities allocate profit to a subsidiary which does not reflect the functions, assets and risks carried out by the entity. Another deviation from the arm's length principle may occur when accepting certain pricing methods, such as the application of cost-plus pricing which may not reflect the correct arm's length value added because the adjustment added to the cost can be easily manipulated to boost profits.

- The adoption of the exemption method on all foreign-source passive income can be harmful as it reduces the effective tax rate and creates economic distortion by attracting mobile activities for tax, rather than business, purposes.
- An artificial definition of the tax base. Most tax laws have inbuilt provisions that narrow the tax base. These provisions allow for deductions to reflect certain economic impacts such as inflation; others allow for exemptions to avoid double taxation on certain incomes. Sometimes, these provisions go beyond the scope of the instruments (e.g. unconditional participation exemption, deductions for deemed expenses that have not been incurred, computing the taxable base using the cost-plus or resale-minus methods). Other examples include policies that allow the deduction of costs even though the corresponding income is not taxable. A key issue with provisions that narrow the tax base is that they are normally non-transparent and they are not offered to all taxpayers operating in a country, which leads to unfairness in the tax system; a tax rate and/or tax base that is negotiable in a non-transparent regime can be potentially harmful. Taxpayer and tax authority are able to negotiate a 'soak-up' tax when the residence country gives the taxpayer a foreign tax credit. Other harmful provisions are the secrecy provisions which rely on bank secrecy and lack of exchange of information.
- Treaty shopping may lead to harmful tax competition. Originally, countries were encouraged by the OECD to sign up to tax treaties to harmonise tax and eliminate double taxation. However, access to wider treaty networks may be harmful as it opens up access to many harmful

preferential tax regimes and may lead to double non-taxation. Countries can minimise treaty abuse by including specific exclusion provisions and comprehensive anti-abuse provisions in their treaties, as well as exchange of information provisions to enhance co-operation between treaty countries' tax authorities.

Countermeasures against HTPs and tax havens recommended by the 1998 OECD Report and the establishment of the Forum on Harmful Tax Practices

The 1998 OECD Report "Harmful Tax Competition - An Emerging Global Issue" sets out 19 non-legally-binding recommendations to counter tax havens and HTPs in both OECD and non-member countries.

- One of the main tasks of the Forum is to supervise the implementation of the 'standstill and rollback' provisions enacted in the guidelines under recommendation No. 15. The guidelines to the 'standstill' provision state that OECD countries must refrain from engaging in new harmful tax practices or from widening the scope of already existing practices in their legislation. The 'rollback' guidelines state that OECD countries must amend any existing tax practices in their legislation that are considered by the Report to be harmful.

Following its 1998 Report, the OECD issued a second report in June 2000 entitled 'Towards Global Tax Cooperation - Progress in Identifying and Eliminating Harmful Tax Practices'. This report was approved by all member countries except Luxembourg and Switzerland. It is divided into four sections and includes the progress of the member countries and tax havens with regards to HTPs, a summary of the work achieved since the 1998 Report, and the development of the OECD project.

- In the 2000 Report, 47 potential HTPs are identified; these include income from financial and insurance activities, ‘headquarters’ and ‘intra-group centres’ functions, as well as shipping activities and other miscellaneous regimes. The OECD 2000 Report blacklists some of the regimes included in these 47 HTPs; among those blacklisted are the Netherlands’ and Luxembourg’s finance companies and finance branches regimes, France and the Netherlands’ service and distribution centre regimes, and Ireland’s international financial service centre. The 2000 Report gave those member countries harbouring these HTPs the opportunity to repeal their HTPs before April 2003; failure to do so would result in the imposition of comprehensive defensive countermeasures by other member countries. As for tax havens, the 2000 Report blacklisted 35 countries that met the criteria defined in the 1998 Report. The 2000 Report invited all 35 jurisdictions to make a ‘public commitment’ before July 2001 to comply with the recommendations of the 1998 Report; failure to do so would result in inclusion in a published list of ‘uncooperative tax havens’. Countries mentioned in this list would be subject to a number of sanctions and countermeasures imposed by other member countries.

The 2000 Report called for increased engagement from co-operative tax havens that made the public commitment; this would include engagement in the harmful tax competition project, including participation in the Forum and involvement in the development of a model convention for effective exchange of information. The Report also recognised the strain and negative effect on the economies of those countries that made this commitment, and highlights the need for OECD Member countries to guide and assist these jurisdictions, both financially and technically, in order to help them through the initial transitional period. The Report also called on non-OECD members affected by HTPs of OECD countries and tax havens to comply with the guidelines and recommendations of the 1998 Report and to participate in the Forum.

In addition, the 2000 Report advised countries that wished to avoid being included in the list of uncooperative jurisdictions, subjected to the above sanctions and being excluded from the Forum, to participate in a ‘public political commitment‘. This should contain a ‘scheduled commitment’ with a timetable and milestones in order to effectively and steadily remove the harmful features from their tax regimes. The details of this public political commitment were set out in November 2000 in a Memorandum of Understanding (MoU). The core principles of this MoU are effective exchange of information and transparency. With regard to the exchange of information, the MoU required that by the end of 2003 any information that related to criminal tax matters should be made available and could be exchanged without being subject to the ‘dual criminality’ principle (which requires that the matter being investigated constitutes a tax criminal offence in both the country enquiring and the country providing the information). Furthermore, the MoU called for the removal of any legal impediment, such as bank secrecy legislation, that could affect the exchange of information or prevent the local authorities from gathering the information. Moreover, the MoU requested that the information should be obtained and exchanged regardless of whether the home country had any interest in gathering the information for domestic tax purposes. With regards to transparency, the MoU required that by December 2002, information about the beneficial owners of companies, trusts, partnerships and all other entities should be available to local tax authorities, and that the accounts held for these entities should comply with generally accepted accounting principles. It also stipulated that by 2003, other non-transparent characteristics of tax havens, such as advance rulings that failed to comply with the OECD transfer pricing principles, and secret negotiations of reduced tax rates, should be repealed.

Criticism of the 2000 OECD Report and the Memorandum of Understanding

The 2000 OECD Report and the follow-up MoU were heavily criticised, not only by the targeted jurisdictions but also by OECD Member countries and by a number of scholars. The main criticism concerned the intense interference by the OECD in the internal affairs of sovereign countries. It was perceived that the OECD was trying to tell countries how to run their own economies, ordering them to raise their tax rates which would make these jurisdictions no longer attractive for foreign investments and would therefore create huge deficits in these countries' budgets. In so doing, the OECD would protect high-tax Member countries and their inefficient large public spending. The fact that the OECD Member countries themselves were not prepared to comply with the obligations described in the MoU and imposed on tax havens was clear evidence of the OECD's unjust attitude towards the targeted tax havens. Most OECD Member countries do not require disclosure of information on beneficial owners for each entity or investment; preparing, filing and auditing financial accounts are required only for substantially large companies. As for the exchange of information around tax matters, Member countries were prepared to exchange information only when there was a tax treaty with specific provisions in regard to the exchange of information. Moreover, the tax legislation of a number of OECD countries contained bank secrecy rules preventing them from exchanging information in all 'civil' tax matters; these countries include Switzerland, Austria, Luxembourg and some of the USA states (e.g. Delaware). On the contrary, the MoU demands that tax havens cooperate unilaterally on exchanging information in both criminal and civil tax matters without taking into consideration the protection of taxpayers' rights or investors' data protection and confidentiality.

Another criticism arising from the sanctions recommended by the OECD was around the discrimination between the harsh countermeasures aimed at tax havens and less harsh measures for HTPs of OECD Member countries. The OECD 2000 Report offered tax havens the chance to participate in the Forum, and also offered them financial and administrative assistance in their transitional period towards becoming high-tax jurisdictions, but those offers depended on their commitment to the MoU. Tax havens rejected the OECD's attempts to interfere with their sovereignty, arguing that even tax havens

should have the right to run their own economies and not be dependent on financial support from OECD countries.
These criticisms, together with the altered strategy of the newly elected US administration, which urged respect for other countries' sovereignty, including their right to determine their own tax rates and the structure of their tax systems, forced the OECD to rethink its approach. It shifted its campaign to focus more on transparency and exchange of information. At the same time, tax havens agreed to more co-operation and involvement in the OECD project.

The 2001 Progress Report reflecting a milder approach of the OECD

Following the harsh criticism of the 2000 Report and its subsequent MoU, the OECD issued another report in November 2001 entitled, "The OECD Project on Harmful Tax Practices: The 2001 Progress Report" (hereinafter: "2001 Report)".[10] The 2001 Report reflected the change in the OECD approach towards tax haven jurisdictions. It stated: *"the dialogue between the OECD Members and tax haven jurisdictions has resulted in the OECD having a better understanding of the concerns of the jurisdictions regarding the commitment process".*[11]

The main focus of the 2001 Report was the OECD's attempt to encourage the remaining tax havens to make the public political commitment. Since only 12 of the 35 blacklisted jurisdictions had made the public commitment and were taken off the list of 'uncooperative jurisdictions', the OECD realised the need to change its approach towards tax havens. It decided that the only way forward was to engage in dialogue and negotiation with the remaining blacklisted tax havens in order to obtain their co-operation and agreement to make the public political commitment and then implement them.

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[10] OECD, the OECD Project on Harmful Tax Practices: the 2001 Progress Report, 14/11/2001, http://www.oecd.org
[11] OECD 2001 Report, Para. 23.

The 2001 Report contained four changes, three of which related to changing the timing of the commitment and the issuing of the final list of uncooperative jurisdictions; the fourth concerned the substantive activity criteria.

The 2001 Report extended the deadlines set in the 2000 Report for blacklisted tax havens to make the public political commitment. The new deadline became the 28th February 2002, seven months later than the previous deadline set in the 2000 Report. The final list of uncooperative jurisdictions would be released shortly thereafter. The 2001 Report also extended the period for tax havens to remove harmful practices from their tax regimes until 31st December 2005. The change concerning the substantive activity criteria was the most significant set out in the 2001 Report. This report dropped the ‘no substantial activity’ criterion to identify tax havens and, as a result, the OECD uses three main criteria to identify tax havens.

The criterion of no or low effective tax rate is still used but considered only a ‘gateway criterion’. Therefore, the 2001 Report focused on the other two criteria of lack of transparency and lack of effective exchange of information.

With regard to transparency, the 2001 Report highlighted the need to abolish secret advance rulings along with negotiating tax rates with local tax authorities. This would ensure that all tax payers are treated fairly and that tax administrations are not using their powers to favour certain tax payers by giving them hidden tax incentives. The 2001 Report highlighted the need to file and audit financial statements but, unlike the MOU, it recognised that it must allow for exceptions with respect to local entities engaged in purely local activities with no foreign beneficiaries, ownership, management or any other involvement. As for effective exchange of information, the 2001 Report stressed that information should be made available in both civil and criminal tax matters. The Report called for adequate procedures whereby tax authorities are well trained and equipped to gather and process the relative information including beneficial ownership of local transactions and entities.

And, unlike the MOU, the 2001 Report emphasised the need to safeguard the taxpayer's confidentiality; that information gathered and exchanged should be only for the purposes for which it was requested, and that it should not be made for 'fishing expeditions' exploited by tax authorities of high-tax countries. The Report also stressed that, when exchanging information in regard to civil tax matters, the requesting country must always declare whether the requested country gathering the information has any interest for domestic tax purposes.

The 2001 Progress Report: Remaining Unresolved Issues

When the OECD first issued its 2001 Report, it stated:

["*The objective of the tax haven work remains to obtain commitments from as many of the jurisdictions as possible. The modifications to the work contained in this Report are likely to facilitate this process by promoting an inclusive and constructive approach which emphasises the benefits of the initiative, including the opportunities for technical and capacity building assistance which OECD Member countries commit themselves to provide to jurisdictions who commit to the process. If all jurisdictions make a commitment prior to 28 February 2002, it will not be necessary to issue a list differentiating between those jurisdictions that have made a commitment and those that have not*."[12]]

However, although the aim of the 2001 Report was to address the issues criticised in the 2000 Report, it fell short on addressing all of the criticisms. Firstly, there was still conflict among the OECD Member countries, as evidenced by the fact that two more member countries, Belgium and Portugal, abstained from approving this Report. This was primarily due to their inclusion in the 2000 Report's blacklist. In addition, Luxembourg and Switzerland abstained from approving all three OECD reports. Both countries have been

[12] http://www.oecd.org/ctp/harmful/2664438.pdf, Para. 33.

included in the 2000 Report list of preferential tax regimes and the OECD criticised their bank secrecy laws.

Due to the abstentions of these four countries, they are not bound legally or politically by the OECD Reports and they do not have to change or amend their blacklisted tax regimes, a fact which angered both Member countries and non-OECD countries alike. OECD Member countries see it as fundamentally unfair that they are required to amend their own blacklisted preferential tax regimes, while those four Member countries refuse to do the same. They felt that this would result in either other member countries refusing to repeal their tax regimes or imposing tougher countermeasures against the four non-compliant Member countries. As for non-OECD countries, the OECD’s inability to force its own Member countries to comply with the Reports was perceived as a clear indication of the OECD’s failure. Another reason why these non-OECD jurisdictions felt they should not amend their tax regimes was their observation that four Member countries continued their preferential tax regimes and incentives in order to attract foreign investment and mobile capital, an advantage that other jurisdictions need in order to compete.

Another criticism of the 2001 Report relates to tax haven work. Although the 2001 Report extended the deadline and timing for the application of the countermeasures against uncooperative jurisdictions, it did not address the issue of the discrimination between tax havens and OECD Member countries shown in the harsh sanctions forced against tax havens compared with the milder limited defensive measures against OECD Member countries. Ultimately, the four Member countries faced milder sanctions while the OECD continues to press tax havens to fully commit to transparency of their tax systems, to abolish their bank secrecy laws and to cooperate with effective exchange of information in both criminal and civil tax matters.

OECD Wealthy Developed countries Versus Developing Tax Havens

The OECD is an organisation made up of the world's wealthiest and most politically influential nations while offshore tax havens are generally small developing countries whose economies survive on their highly tax motivated competitive financial centres. Most offshore tax havens are islands that were formerly European colonies whose economies are weak and rely mainly on tourism and agriculture trade which are insufficient to support their public spending. As a result, these islands suffered from poverty, flat fiscal growth and rising national debt. This prevented these nations from becoming financially independent and was the main reason for offering themselves as offshore financial centres.

It has been estimated that more than $200 billion of FDI had entered the Caribbean and South Pacific tax havens between the Eighties and the nineties. Some reports suggest that the amount of foreign capital held in these jurisdictions is around $8 trillion. Other statistics claim that the Cayman Islands alone hold foreign banking assets estimated at more than $670 billion. These reports and statistics confirm that the economies of these tax havens have become dependant on their highly competitive tax incentivised financial centres. They are able to provide better education and health services, create job opportunities, succour wealth and finance their public spending. It is estimated that 8% to 10% of the gross domestic product (GDP) of the offshore tax havens in the Pacific is acquired through their financial centres, while the small island of Vanuatu derives between $3 million and $4 million from its financial centres in addition to creating four hundred jobs in its banking sector. As for the Caribbean island of Nevis, it acquires more than 30% of its tax revenues from its offshore financial services, while financial services in Barbados brings in 5% of national income and 22% of government revenues. And, up to recent years, the Barbados economy had heavily relied on its offshore financial industry that is estimated to contribute one third of its revenue. Meanwhile, in Europe, it is reported that 80% of the Isle of Jersey's income is derived from its offshore financial services.[13]

Given the dependence of the economies of these tax haven nations on financial services, they are in a severe dilemma with regard to whether to follow the OECD guidelines and the Forum recommendations. It is estimated that these developing offshore tax havens could lose as much as 25% of their GDP should they comply with the OECD recommendations on harmful tax competition,[14] which would leave their economies in ruins.

These countries' economies have already experienced some setbacks due to the OECD Reports on harmful tax competition. For example, it is estimated that by changing their tax laws to comply with the OECD guidelines, the twin islands of Antigua and Barbuda lost 54 of the islands' 72 banks, and around 1500 businesses incorporated in their territory closed their offices. This resulted in a huge drop in the employment rate and GDP of both islands. Similarly, St.Vincent and the Grenadines suffered a high rate of unemployment following the closure of many insurance companies and banks.

Although some tax havens agreed to announce commitment to the OECD recommendations in order to avoid being included in the OECD 2000 Report's blacklist, these nations did not escape economic losses. For example, the Cayman Islands' agreement to change its tax policy on bank secrecy and provide for the exchange of financial information on taxpayers operating on the island resulted in it losing many of its financial services that did not comply with the OECD 'substantial activity' requirements. Many more tax havens stand to lose their financial industries, which are essential for their economic survival, should they comply with the OECD recommendations.

[13]http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1083&context=twlj
[14]Hull, *supra* note 14; Hoffman, *supra* note 5, at 513.

Ironically, fifteen years after the first OECD Report on harmful tax competition, and following two more reports naming and shaming offshore tax havens, resulting in many of these tax havens committing to the OECD recommendations, in the result has been a devastating effect on these nations' economies. Today the OECD finds itself revisiting the debate on harmful tax competition, a clear signal that the elimination of tax havens' competitive financial services did not have the outcome it had hoped for. Perhaps the OECD should look within its members more closely; in doing so it, would be able to identify some of the major hindrances to the success of its campaign on harmful tax competition.

Moving forward, the OECD initiative to discourage tax havens is not the solution to counter harmful tax competition for two major reasons. First, tax policies among the OECD member countries are very competitive and it has been proved that they are difficult to harmonise. Regardless of the OECD campaign against offshore tax havens, tax competition will continue to thrive among the member countries in which some practices would be harmful and would result in distortion of the allocation of economic resources. Second, valuable key members of the OECD refuse to agree to some of the OECD initiatives or to conform with a common multilateral agreement to counter harmful tax competition. Due to some members' abstentions and the lack of a multilateral approach, the OECD will remain ineffective in deterring harmful tax competition.

The OECD Member Countries' Differing Agendas and Conflicting Interests Concerning Tax Policy.

While the OECD likes to think that all its members are united in the fight against harmful tax competition, the facts paint a different picture. Most of the OECD member countries compete fiercely in order to attract foreign investment and mobile capital. According to the OECD 2000 Report, some members continue to develop tax regimes that have the potential to harbour harmful tax practices which could potentially erode foreign tax bases. It was reported that 21 of 30 members harboured financial services that potentially engage in harmful tax practices.[15]

The conflict of interests between member countries concerning tax policy can be demonstrated through the different corporate tax rates adopted by the members. For example, the fact that Ireland offered a competitively low rate of 12.5% resulted in the diversion of many foreign investors to operate in Ireland. Similarly, Hungary's introduction of a corporate tax rate of 18%, which is lower than the average rate of other members, has boosted its competitiveness as an alternative location for foreign investment. Another key member is the United States, considered by many scholars to be the world's largest tax haven. Delaware, for example, continues to offer corporate tax advantages similar to those of offshore tax havens the OECD has punished by naming and shaming in the blacklist issued in the 2000 Report.[16]

These low-tax Member countries are similar to offshore tax havens in the way they represent a major threat to the tax bases of high-tax jurisdictions. As a result, many high tax members were left with no option but to take both defensive and offensive[17] countermeasures to protect their economies against harmful tax competition within the OECD itself. For example, the Netherlands demanded that the OECD should determine a minimum corporate tax rate for all members to adopt. The Netherlands was concerned about the effect of other Member countries' low corporate tax rate on its own domestic tax base. Similarly, Denmark had to lower its corporate tax rate to 30% for fear of losing tax revenue to other OECD Members.

Another major issue with some of the OECD member countries is related to banking secrecy laws, for which Switzerland has long been famous. Switzerland is considered to have one of the strictest bank secrecy laws in the world; under Swiss law, any breach of financial secrecy is deemed a breach

[15] Towards Global Tax Co-operation, *supra* note 19, at 12–16 (providing list of countries harbouring potentially harmful preferential tax regimes); Progress Report,*supra* note 11, at 2 (listing the member nations of the OECD).

[16]Brittain-Catlin, *supra* note 2, at 79. Specifically, Brittain-Catlin notes how Delaware offers corporations numerous advantages including: inexpensive same-day company incorporation, low fees, minimal financial filing requirements, protection from hostile takeovers, freedom to operate companies anonymously, no required public disclosure of accounts, shareholder secrecy, no sales or inheritance tax, tax advantages for holding companies, and a court system that is seen as having unequalled expertise in complex cases involving multinational companies.

[17] Why Harmful Tax Practices Will Continue After Developing Nations Pay: A Critique of the OECD's Initiatives Against Harmful Tax Competition, Richard A. Johnson, 2006

of trust and is subject to criminal prosecution.[18] Swiss law is very supportive of bank secrecy even when the information requested is for cases of tax evasion.[19] Similarly, Luxembourg's tax regime supports strict banking secrecy, whereby the domestic tax authority is not entitled to information from banks regarding taxpayers' finances and only very limited exceptions may apply.[20] On the contrary, Sweden is one of the most cooperative OECD Members. It requires its banks and other financial institutions to exchange freely financial information of clients with foreign tax authorities. Sweden not only requires banks operating within its borders to exchange information with tax authorities regarding interest paid to resident clients, but has also given tax authorities permission to seek information from banks regarding their clients' finances. This has led to some criticism of Swedish law, and questions as to whether it should be altered so as to offer greater protect of tax payers information.

Clearly, these differences in tax practices concerning banks exchanging taxpayers' financial information with tax agencies among OECD member countries are a clear indication that harmful tax competition is a policy many OECD Members promote within their domestic tax laws and crushing offshore tax havens is irrelevant.

The Abstention and Lack of Support by Key Members of the OECD

The conflict of interest within the OECD has not only encouraged tax competition among member countries, but it is the reason behind many key members' abstention from agreeing the measures suggested by the OECD to counter harmful tax competition. For example, both Switzerland and

[18]Hans Bollmann, *Switzerland, in* International Bank Secrecy, *supra* note 83, at 661,669. Violations of Swiss banking secrecy laws are on par with breaches of silence in official matters such that violators are prosecuted at the initiative of the court, whereas violators of professional secrecy, such as doctors and lawyers, are prosecuted only at the initiative of the injured party.

[19]Hans Bollmann, *Switzerland, in* International Bank Secrecy, *supra* note 83 at 678. Exceptions to Switzerland's strict financial secrecy apply only to cases of tax fraud, which entail the "deception of the tax authorities by fraudulent means, especially by false or falsified documents which results in an underpayment of tax." *Id.* This high level of secrecy undermines the efforts of the OECD, which recommends that banking laws allow all client information to be shared with any country or tax authority freely and openly.

[20] Guy Harles, *Luxembourg, in* International Bank Secrecy, *supra* note 83, at 469,473. Tax authorities can intrude to garner information for the purposes of assessing inheritance taxes on deceased resident taxpayers. *Id.* Furthermore, in certain circumstances domestic tax authorities may make inquiries into registration and mortgage duties as well as assessments of the value-added tax. *Id.* Nonetheless, the limited scope of these exceptions ensures the overall insulation of banking secrecy from domestic tax authorities in Luxembourg.

Luxembourg abstained from signing the 1998 Report recommendations since they did not agree with the OECD measures to tackle banking secrecy, and they refused to agree to the exchange of taxpayers' financial information with foreign tax authorities. Following the release of the 2001 Report, two other member countries abstained; Belgium and Portugal did not agree with dropping the 'ring fencing' factor when labelling a jurisdiction as un-cooperative.

Another major blow to the OECD's efforts to combat harmful tax competition is the United States' uncooperative attitude towards global tax harmonization. The US is a key OECD member with huge global economic presence. Many members feel that, without full US support for the OECD campaign, the OECD stands to fail in its fight against harmful tax competition. The OECD feels the need to alter its rules and guidelines on harmful tax competition in order to fit with US tax needs and economic priorities, and this undermines the OECD's efforts against harmful tax competition. France's finance minister noted his disappointment over the US lack of support to the OECD campaign in his statement "[*t]he largest power in the world cannot disengage from the planet's problems*".

The OECD's failure to get all member countries to agree multilaterally to the same set of guidelines undermines the overall effectiveness of its fight. Non-compliance by member countries undermines the justification of its sanctions against offshore tax havens and creates a strong argument for tax havens not to comply with the OECD recommendations; after all, they ask, why should small offshore developing nations follow the OECD guidelines when its own members have refused to do so?

The campaign on harmful tax competition backed by the three OECD Reports had many limitations. It focused on geographically mobile activities, such as financial and other services, whereas manufacturing and other investments were left unaddressed. While the campaign targeted 'tax havens' worldwide and 'preferential tax regimes' in OECD member countries, non-OECD economies were largely neglected. The campaign focused on the lack of transparency and the absence of effective exchange of information when defining harmful tax practices, but failed to address the ‘substantial activity’ requirement. Moreover, implementation of the recommendations of the 1998 Report was non-binding.

Since the OECD initiatives to address harmful tax competition did not fully succeed, the OECD decided to adopt a different approach and, since 2001, has shifted its focus towards establishing the Global Forum on Transparency and Exchange of Information. In 2004, the OECD Committee on Fiscal Affairs decided to adopt the amendments to Article 26 of the OECD Model. These amendments introduced the standard for exchange of information; requested that bank secrecy should not act as a barrier to the process of exchanging information; and requested that a contracting state should be willing to use its information-gathering powers to obtain information for other states, even if the first state had no use for this information for its own domestic tax purposes.

Following the 2008 financial crisis, the G20 leaders were forced at their London Summit in April 2009 to issue a statement acknowledging the need for global co-operation on exchange of information. In its ‘Global Plan Annex: Declaration on Strengthening the Financial System’, the OECD issued the threat of unspecified sanctions against any jurisdiction that did not adopt the ‘foreseeable relevance’ standard for exchange of information. Many countries were fearful and, as a result, hundreds of agreements were signed and the principles in Article 26 became the new international standard that should be followed. However, at the time and under the new standard, the exchange of information was not an automatic exchange but only exchange on request.

Global Model for Automatic Exchange of Information

Following publication of the list of ‘uncooperative countries’ by the OECD-led Global Forum on “Transparency and Exchange of Information for Tax Purposes”[21], 120 countries have committed to amend their domestic tax laws

21 http://www.oecd.org/tax/transparency

to enable sharing and exchange of information. These countries are committed to the international standard of transparency and exchange of information. There are also a growing number of countries that have signed up to the OECD Convention on Mutual Administrative Assistance in Tax Matters. All of this is very encouraging, and engenders hope that the OECD might be successful in its endeavours.

There remain, however, many obstacles to success, one of which is the myriad of bilateral tax treaties already in existence. The OECD report, "*A Step Change in Tax Transparency"*, suggests establishing one multi-lateral tax treaty to replace all 3,000 bilateral tax treaties currently in place around the world. There have been growing demands, with which I agree, to follow the US-style cross-border tax information exchange. The provisions commonly known as the Foreign Account Tax Compliance Act (FACTA) were enacted into US tax law in March 2010. FACTA targets non-compliant US taxpayers in regard to foreign financial entities and offshore assets in which the US taxpayers hold a substantial ownership interest. In line with FACTA rules, the automatic exchange of information by financial institutions with the US is a requirement under the domestic rules of many territories. The UK, France, Germany, Italy and Spain have all signed up to a multi-territories pilot which demands the sharing of similar information, held by banks, brokers, insurance companies and other financial institutions, among the signatories.

Inter-governmental agreements (IGAs) represent a multilateral tax information exchange model that follows FACTA. Developed among a number of the G20 members and the United States, the aim is to improve international tax compliance. However, although IGAs represent a good initiative for building global bilateral information sharing agreements between tax authorities, it might prove difficult to develop these agreements into a comprehensive, effective multi-lateral system.

The OECD report*, "A Step Change in Tax Transparency"*, recognised another barrier to the success of their initiatives, namely that arrangements that are not coherent and comprehensive in terms of their reporting are more likely to fail. If information exchanging arrangements are not effective, the hiding of income and assets offshore will not be eradicated, but simply relocated. Non-compliant taxpayers will be able to exploit the different treatments of such entities by various tax regimes. I believe that it is essential that any such multilateral agreements are clear, comprehensive (both in terms of the scope of the tax transparency demanded and in terms of the numbers of nations included) and have teeth.

The OECD report represents a real commitment towards the automatic exchange of tax information between jurisdictions, but making this OECD action plan a reality is a formidable task. Even assuming that widespread agreement among nations can be achieved, there remains a huge logistical challenge. Tax codes, software databases and systems, and entities definitions differ enormously from one country to another. The OECD report recommendations focus on establishing relationships between jurisdictions, getting the legal basis clear for the exchange of information, and working on building common and compatible IT systems that will be able to cope with and analyse the information received. This is easier said than done.

The OECD report recognised the enormous practical difficulties facing even developed jurisdictions trying to implement the arrangements for automatic exchange of information. Building a reliable, effective and workable IT system to transmit the required information between the different tax authorities, each of which will have its own specialised software systems, will require a great deal of harmonisation between the different tax regimes. Tax authorities will need huge resources and sufficient funding in order to analyse the fundamental differences between jurisdictions' tax codes, tax classifications and treatments of different entities.

Building a Workable Tax System in Developing Countries

These challenges are even greater when it comes to building a sophisticated tax system in less economically developed (LED) countries. It is entirely possible that developing a system capable not only of gathering taxpayers' information and storing it securely, but also of processing this information and establishing which entities to report and exchange, might prove too difficult a task to achieve and will take many years. Many LED countries have as yet not even developed a tax system; they lack experience and expertise and tend to turn instead toward indirect taxes. Such countries need to broaden their tax base and shift the balance from indirect to direct taxes. Another issue facing LED countries is that they suffer from being in a weak position when trying to attract foreign investment; they lack the skills needed to deal with MNCs, joint ventures and commercial contracts. They often rely on foreign advisors to conduct these affairs and invariably suffer from being in a weak position when entering into tax treaties with more developed jurisdictions. Another concern expressed by LED countries relates to the effective administration of transfer pricing. Tax administrators in these countries struggle to compare prices and transaction information across jurisdictions, a process which is vital when computing transfer pricing, and a significant issue for reliable tax collection. The OECD report fell short of addressing how to include the developing world in the new arrangement on tax transparency. As pointed out in the G8 summit by one advisor, *"African countries are losing twice as much in tax avoidance as they receive in foreign aid from the west."*[22] It is the poorest countries in the world which lose out most from wealthy individuals and corporations hiding their assets in offshore tax havens. The agreement on automatic exchange of information for greater transparency must include developing countries from the start. The rich nations of the G8 must support and help developing countries to collect the taxes owed them. The G8 members should offer the developing countries the tax expertise they badly need to help them improve their tax systems and understand complex tax cases.

The most recent BEPS action plan demonstrates the OECD desire to move towards a more multilateral instrument in the fight against base erosion and profit shifting. After all, a multilateral problem can be solved only with a multilateral approach. It is believed that Governments could counteract the use of harmful tax practices by MNEs and individuals, if they had sufficient access to information.

[22]http://www.dailymail.co.uk/news/article-2343811/G8-summit-Tax-dodgers-face-trapped-plan-countries-share-data-profits-hidden-globe.html

The BEPS action plan addresses 15 issues considered by the OECD to be 'pressure points' in its campaign against base erosion and profit shifting. Two of these key pressure points are highlighted under Action 15 and Action 5 of the BEPS and are known as 'Develop a Multilateral Instrument' and 'Counter harmful tax practices more effectively, taking into account transparency and substance', respectively.

The Fight Against Harmful Tax Practices Under the BEPS Action Plan

Action 5 of the BEPS Project talks about revamping the work on harmful tax practices that has been undertaken by the OECD since the 1990's. Action 5 is not a new "conceptual rethinking"[23]; instead it will offer an upgrade to the current strategies against harmful tax practices. Action 5 focuses on transparency, including 'compulsory spontaneous exchange on rulings related to preferential tax regime', and the requirement of 'substantial activity' for any preferential tax regime. 'Substantial activity' requires real economic presence and substance for any foreign investment. Action 5 also aims to get non-OECD countries involved in the debate on Harmful Tax Competition.

The implementation plan is divided into three stages. By September 2014, the Forum on Harmful Tax Practices should complete a review of all OECD Member countries' tax regimes; then, by September 2015, the OECD should have developed a framework for institutional structures through which non-members can work in order to have close engagement with the OECD on harmful tax practices. And finally, by December 2015, the OECD work on 'substantive criteria' should be revised and completed, taking in consideration all other aspects of the BEPS context.

The main focus of Action 5 is on substance and transparency:

Substantial activity requirement

[23] The "Upgraded" Strategy Against Harmful Tax Practices Under the BEPS Action Plan, Joachim Englisch and Anzhela Yevgenyeva, B.T.R 2013, 5, 620-637

As mentioned above, the 1998 OECD Report considered ‘ring-fencing’ to be one of the key elements identifying a tax regime as harmful. Ring-fencing occurs when preferential tax incentives or benefits are available only to foreign investors while resident taxpayers are excluded from taking advantage of these incentives and benefits. It also may occur when enterprises that benefit from the tax regime are forbidden from operating in the domestic market. Ring-fencing is considered harmful because it can create economic distortion in the jurisdictions that harbour the practice; it also contributes to depriving other jurisdictions of tax revenue, thus affecting their citizens’ tax and social equity and welfare.

The Action Plan recognises that aspects of tax competition have evolved and, as a result the OECD plan, need to be adjusted accordingly. The ‘race to the bottom’ of corporate tax on mobile capital does not only depend on the more traditional method of ring-fencing but has expanded to include the form of across-the-board corporate tax rate reductions on certain types of income and activities.

Over the last five years we have seen many countries incorporating preferential practices and incentives within their tax laws that comply with the letter of the OECD rules but not with their spirit. Most of these preferential practices are related to intangibles. The latest example is the patent boxes being introduced into the tax regimes of many European countries, including the UK. A patent box as defined by HMRC: [“…enables companies to apply a lower rate of corporation tax to profits earned from its patented inventions and certain other innovations.”]

Why may patent boxes be considered as ‘harmful tax practice’?

A large proportion of MNEs’ profits are earned through their know how; it is the intellectual property that generates their wealth and therefore the tax base. Intellectual properties and patents can easily be mobile and there is a growing trend amongst MNEs to transfer these activities to subsidiaries that are located in jurisdictions with no or low tax rates. This practice distorts the allocation of economic resources; decisions regarding where to invest are purely tax-driven and involve no substantial activities.

The UK Government distanced itself from using harmful tax practices in introducing the patent box regime. A statement issued by HMRC made it clear that:
["*The UK supports the current work around Action 5 to ensure a better understanding of what constitutes economic substance when businesses carry out R&D activities, so as to effectively address those instances where preferential tax regimes might present an opportunity to shift profits. However, the exercise needs to be mindful of compatibility with existing international law and support fair competition, as well as to acknowledge legitimate commercial decisions on R&D within the framework of globalised markets and operations*."[24]]

Action 5 should broaden the definition of 'preferential harmful practices' to include other factors, beyond the four 'key' factors identified in the 1998 Report. Those factors were:

- Tax regimes that do not comply with international tax rules, especially on transfer pricing
- Tax regimes that promote themselves as tax mineralisation entities and are purely tax driven with no real economic value
- Tax regimes that offer a wide access to many tax treaties without anti-abuse provisions to stop treaty abuse
- Tax regimes that negotiate the tax bases and rates and offer secret rulings.

[24]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293742/PU1651_BEPS_AA_-_FINAL_v2.pdf

All of these factors are issues that the OECD is currently trying to resolve in its BEPS Action Plan 1 to 15; this is why all Actions should be addressed in a holistic approach since they all have an impact on one another.

Unlike tax havens, most preferential tax regimes offer tax incentives in order to attract genuine economic activities with real substance and presence. Action 5 places the emphasis on economic substance in its fight against conduit companies, treaty shopping and abuse, and the shifting of profit into low tax jurisdictions through transfer pricing methods that do not fully comply with the OECD guidance. While these aspects are specifically addressed in Actions 6, 8, 9 and 10 of the Action Plan, they also need to be addressed when defining preferential tax regimes. This is why the OECD Action Plan talks about offering a new ‘holistic’ approach in the BEPS context, meaning developing all Actions 1 to 15 in the knowledge that they are all inter-connected and affect one another.

The OECD faces major challenges in trying to identify and develop the requirement for ‘economic substance’. It will have to develop different requirements for different categories of preferential tax practices. For example, jurisdictions that act as conduits for investments by offering not only a low tax rate but also access to a variety of attractive tax treaties, that offer low withholding tax rates on outbound payments and similar benefits on inbound earnings, will need to make sure that these entities have real genuine presence which cannot be justified by a mere brass sign or letterbox. The conduit entities must be able to demonstrate valid commercial reasons for them to operate in any jurisdiction, a real added economic value beyond merely taking advantage of the tax benefits offered.
Another assessment criterion, namely ‘economic substance’, will have to be developed to deal with profit shifting through transfer pricing. Some preferential regimes have lax transfer pricing adjustments which do not fully comply with the OECD guideline on the arm’s length standards. Profits should be allocated in accordance with functions performed, assets utilised and risks taken. For example, when looking at patent box regimes, the ownership of an

intangible, which could easily be transferred, is not sufficient to attribute more profits to the jurisdiction where the intangible is owned. The approach should be adjusted to include the core functional contribution beyond the creation value, such as the development, management and protection of the intangibles.

Transparency of tax regimes

The OECD 1998 Report sets out two conditions a tax regime must satisfy in order to be deemed transparent. 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.[25] Failure to satisfy both conditions may suggest that the preferential tax regime is considered 'harmful'. The OECD Report provides two justifications for its position. It states that non-transparent regimes offer some taxpayers the chance to negotiate with the tax authority preferential treatment which is not available to other taxpayers in a similar situation; this undermines the fairness and equality of the tax system and is likely to increase harmful tax competition. The Report goes on to add that the lack of transparency of any particular tax regime will make it impossible for the home country to develop countermeasures.

The OECD Action 5 of the Action Plan focuses on greater transparency through 'compulsory spontaneous exchange on rulings related to preferential tax regimes'. This is a step forward from the 1998 Report which focused on the exchange of information upon request. Automatic exchange of information has been argued for, for many years.

OECD Secretary-General Angel Gurria stated on June 18 2013:

[25] http://www.oecd.org/tax/transparency/44430243.pdf P.28

[*“Tax systems must be fair and be seen to be fair. The OECD is helping countries work together to put an end to offshore tax evasion by delivering a secure and cost effective system of a single global standard for automatic exchange of information.”]*

Ahead of the G8 summit in Northern Ireland in June 2013, the UK Prime Minister, David Cameron, wrote to 10 British overseas territories and crown dependencies, including the Cayman Islands and British Channel Islands, urging them to “get their house in order” and sign up to automatic information sharing agreements.

The issue with ‘compulsory spontaneous exchange of rulings related to preferential regimes’ is the huge cost of the associated administrative burden. Moreover, unless tax authorities cooperate with one another, there is no guarantee that the information exchanged will be of any relevance. Furthermore, some preferential regimes that grant discretion and secrecy to individual taxpayers; these taxpayers will not be subject to the compulsory spontaneous exchange of information. Another major obstacle is the fact that most non-OECD countries, including developing countries, lack an efficient tax system and some are frankly corrupt. It is difficult to imagine these countries being capable of exchanging the information whether ‘on request’ or ‘compulsory spontaneous’.

In order to eliminate harmful tax competition, a global political commitment is needed. Governments need to co-operate and favour the common interest over their individual fiscal sovereignties. The ongoing fight against harmful tax competition goes hand in hand with countering MNEs’ aggressive tax planning.

Voluntary Corporate Tax Reporting Approach

In the fight against tax avoidance and evasion, countries will struggle to act alone. Tax systems are extremely complex and will take many years to reform into an international tax system capable of dealing with the ever increasing volume of cross-border transactions. I would suggest an alternative measure, which is voluntary reporting. I believe that there needs to be a step change in the level of voluntary tax transparency disclosure, and that MNCs should seize the opportunity presented by the current climate and take the initiative to build an effective and workable long-term model. Individual organisations should consider additional tax transparency reporting in order to give stakeholders and society at large a better insight into their tax affairs, thus influencing the current debate about fair taxation and helping to repair MNCs' reputational damage.

An increased level of voluntary tax transparency reporting would help organisations to build a stronger relationship with tax authorities, an earlier tax planning schemes disclosure will lead to much greater certainty, less tax arbitrage and earlier business decision making.

The currently recommended OECD approach of multilateral automatic exchange of information and country by country reporting of tax payments is, for the moment at least, too complex and burdensome. It will take many years to implement and some believe it will not improve tax transparency, but will instead increase bureaucracy for the compliant while providing more loopholes for the non-compliant.

Moreover, country by country reporting will not show stakeholders whether an organisation has adopted aggressive tax planning schemes, albeit within the letter of the law. Nevertheless, it is now well supported by the EU and is set to become a requirement for extractive entities, banking and many other financial institutions.

Conclusion

While governments around the world are united when it comes to administrating large taxpayers, they are still very much in competition when it comes to attracting multinationals to move their headquarters and investments to their jurisdictions. Globalisation has been the main driver behind the trend seen in recent years, whereby countries have lowered their corporate income tax rates to less than 26% on average in 2011 compared with 45% in the 1980s.

OECD Member Countries recognise the need to protect local firms; in doing so, they have joined forces to address this phenomenon of harmful tax competition. In a statement issued by the G20 finance ministers following a presentation of the BEPS Report in Moscow in February 2013, they asserted that:

["*In the tax area, we welcome the OECD report on addressing base erosion and profit shifting, and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July*"].

This was followed by a statement in the *Financial Times* by the UK chancellor of the Exchequer, the finance minister of France and the German finance minister, who said:

["*Some multinationals are exploiting the transfer pricing or treaty rules to shift profits to places with no or low taxation, allowing them to pay as little as 5 percent in corporate taxes while smaller businesses are paying up to 30 percent. This distorts competition, giving larger companies an advantage over smaller, more domestic companies. In this difficult economic climate, it cannot be right that larger companies can avoid paying tax, with families and small businesses ending up paying more*"][26].

Despite the work of the OECD to address harmful tax competition, we have seen an increase in tax competition between countries. For example, the introduction of the patent box regimes is on the increase and is a clear indication that the issue is still very much present.

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[26] The Financial Times, 16 February 2013, < http://www.ft.com/cms/s/0/6b12990e-76bc-11e2-ac91-00144feabdc0.html#axzz3BzAuLPAn >

Continuing to reduce tax rates is not sustainable. In recent years, and in particular following the financial crisis, countries' budgets are under pressure and there are increasing demands for corporate social responsibility and more transparency.

Action 5 of the OECD BEPS Project will achieve its goals only if all of the other Actions are addressed too. For the BEPS project to succeed, a comprehensive and coordinated multilateral approach must be adopted among not only the OECD Members, but also non-OECD jurisdictions.

The problem with the OECD is that, it does not represent the countries of the world. It represents only some Thirty-four jurisdictions, most of which are wealthy developed countries. It is seen by other developing nations as a rich man's club.

International tax rules should aim to create a balanced and fair playing field for both countries and companies. The OECD fully recognises that much more work is needed and accordingly has revisited the issue of harmful tax competition in its BEPS project.

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