

ISSUES IN INTERNATIONAL TAXATION

No 1

International Tax Avoidance and Evasion

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TABLE OF CONTENTS

GENERAL INTRODUCTION

I. SCOPE OF THE REPORTS	10
II. RELEVANT WORK IN OECD ON TAX AVOIDANCE AND EVASION	11
III. GENERAL CONSIDERATIONS	11

Annexes

I. Recommendation of the Council on Tax Avoidance and Evasion	15
II. Tax Evasion, Tax Avoidance and Tax Planning (Edited extracts from a 1980 report by the Committee on Fiscal Affairs)	16

TAX HAVENS: MEASURES TO PREVENT ABUSE BY TAXPAYERS

I. INTRODUCTION	20
II. CHARACTERISTICS AND USE OF TAX HAVENS	21
A. General	21
B. Main characteristics of classical tax havens	22
1. None or low taxes on all or certain types of income and capital	22
2. Bank and commercial secrecy	22
3. Lack of exchange controls	23
4. Relative importance of banking	23
5. Communications	23
6. Tax treaties	23
7. Other aspects	23
C. Main types of uses of tax havens	24
1. Emigration and shifting of residence	24
2. Base companies	24
3. Conduit companies	26
4. Insurance	26
5. Shipping	26
6. Service companies	26
D. The size of the tax haven problem	27
III. COUNTERACTING MEASURES AGAINST THE USE OF TAX HAVENS: AN OVERVIEW	29
A. General provisions against international tax avoidance	29
1. Transfer pricing legislation	29
2. General provisions on tax avoidance	30
3. "Substance over form"	30
4. Maintaining withholding tax on income paid to non-residents	31
B. Legislation directed against the use of tax havens	31
1. Shifting the burden of proof	31
2. Subpart F-type provisions	32
3. Other tax provisions	34
4. Foreign exchange control – non-tax measures	36

IV. EXPERIENCES WITH COUNTERACTING MEASURES	36
A. Attitudes towards tax havens and counteracting legislation	36
1. Business' attitudes	36
2. Attitudes of tax administrations	38
3. Court attitudes – substance versus form	38
B. Information gathering	39
1. Reporting requirements with respect to resident taxpayers' foreign transactions	40
2. Reporting requirements with respect to foreign affiliates	40
3. Specific information gathering on transfer pricing	41
C. Assessment of the implementation of subpart F-type legislation	42
1. Direct results of implementation	42
2. Reaction to the introduction of the legislation	43
3. Administration	43
4. Some difficulties in implementation	44
D. Role of criminal enforcement in attacking tax haven abuses	45
V. OPTIONS FOR INTERNATIONAL CO-OPERATION	45
A. Co-operation through legal instruments	45
1. Facilitating exchange of information	45
2. General treaty policy with regard to tax havens	46
3. Multilateral approaches	47
B. Administrative co-operation	47
Notes and references	48
Annexes:	
I. Statistical data indicating the level of tax havens use	52
II. An outline of subpart F-type counteracting legislation	55
 DOUBLE TAXATION CONVENTIONS AND THE USE OF BASE COMPANIES	
I. THE PROBLEM STATED	60
A. Base companies	60
B. Relevant considerations	60
C. Terminology	61
II. ANALYSIS OF FUNCTIONS AND USES OF A "BASE COMPANY"	62
A. Sheltering of income	62
B. Types of base companies	63
III. COUNTERACTING MEASURES IN NATIONAL TAX LAWS	64
A. General surveillance measures	64
B. "Substance-over-form" provisions	65
C. Subpart F type counteracting legislation	65
IV. IMPLICATIONS OF A CONVENTION BETWEEN THE STATE OF THE TAXPAYER AND THE STATE OF THE BASE COMPANY	67
A. Treaty implications of general surveillance measures	67
B. Treaty implications of "substance-over-form" provisions	68
C. Treaty implications of counteracting measures	71
V. IMPLICATIONS OF CONVENTIONS WITH THIRD STATES	73
A. Third country income: basic approaches	73
B. Third country income: conclusions and recommendations	75
C. Relationships with non-source countries	76
VI. QUESTIONS OF SECONDARY SHELTERING	78
VII. COMBATING TAX AVOIDANCE AND TAXPAYER PROTECTION	81
VIII. FINAL REMARKS	83
Annex:	
International counteracting measures – an overview	85

DOUBLE TAXATION CONVENTIONS AND THE USE OF CONDUIT COMPANIES

I. THE PROBLEM STATED	88
A. General	88
B. Conduit companies	88
C. Examples	89
D. Main characteristics of conduit configurations	90
E. Other aspects of the problem	90
F. Bona fide transactions	91
G. Similar cases	91
H. Search for solutions	91
II. THE 1977 OECD MODEL CONVENTION: GENERAL APPROACH AND SPECIFIC PROVISIONS	92
A. The general situation	92
B. Anti-avoidance provisions	92
III. BILATERAL TREATIES: PROBLEMS FOR NEGOTIATIONS	94
A. General policy approaches	94
1. Treaty policy vis-à-vis low-tax countries	94
2. Specific provisions relating to low-tax countries	94
B. Specific provisions relating to conduit companies	95
1. The "look through" approach	96
2. The exclusion approach	96
3. The subject-to-tax approach	97
4. The channel approach	99
5. Bona fide provisions	100
IV. APPLICATION OF EXISTING TREATIES	101
A. General considerations	101
B. Handling of artificial tax avoidance	101
V. FINAL REMARKS	102
<i>Annexes:</i>	
I. Description of "conduit" situations	103
II. Examples of bilateral clauses	104

TAXATION AND THE ABUSE OF BANK SECRECY

I. INTRODUCTION	108
II. TAX AND NON-TAX ASPECTS OF BANK SECRECY	108
III. SCOPE FOR IMPROVED INTERNATIONAL CO-OPERATION	110
IV. SUMMARY OF SUGGESTIONS	111
V. FINAL REMARKS	112
Notes and references	112

GENERAL INTRODUCTION

GENERAL INTRODUCTION

1. This introduction summarises the scope of the reports and related work already undertaken in the Committee on Fiscal Affairs and then raises some general issues about international tax avoidance and evasion.

I. SCOPE OF THE REPORTS

2. The first report outlines the reasons why international tax avoidance and evasion through the use of tax havens is a concern to the tax authorities of OECD Member countries and examines measures introduced to combat such use. Views expressed by the business sector, tax administrations and the courts in respect of tax havens and the counteracting legislation are reviewed, as well as countries' experiences with information gathering and the implementation of targeted counteracting legislation. Finally, some options for further international co-operation on the tax haven issue are outlined.

3. The second report sets out the problems posed for tax administrations by the fact that their resident taxpayers make use of base companies (generally subsidiary companies) in tax havens to shelter their income derived from source countries (which may in some cases be the residence country itself) and in that way to escape tax normally payable to the country of residence. This report considers, in particular, measures taken by the State of residence for the purpose of counteracting tax avoidance or evasion of this kind. It is closely connected with the report on tax havens and may in large part be regarded as an extension of it, especially in relation to the treaty implications of domestic counteracting measures as they apply to tax havens and the protection of taxpayers.

4. The third report deals with the problems created for tax authorities in source countries by the mechanism of "treaty shopping". It is inter-linked with the tax haven and base company reports but highlights the ways in which source countries may react to these practices. Since the difficulties arise from the use of international tax treaties the emphasis is on possible bilateral solutions.

5. The final report deals with taxation and the abuse of bank secrecy. The tax and non-tax aspects of bank secrecy are considered and the scope for improving international co-operation reviewed.

6. As the reports in this volume deal with the same range of issues but from different perspectives, some repetition is unavoidable but this has been kept to a minimum. In addition, the different reports were drawn up by different groups and consequently style and structure may vary between them. Rather than attempt to standardize them, the Committee has preferred to let each report remain independent and self-contained.

II. RELEVANT WORK IN OECD ON TAX AVOIDANCE AND EVASION

7. The Committee on Fiscal Affairs received a mandate from the Council of the OECD in its Recommendation on Tax Avoidance and Evasion of 21st September 1977 (reproduced in Annex I to this introduction) to pursue a programme of work to facilitate the anti-avoidance and evasion procedures of Member countries and improve the means available for international co-operation and exchanges of information and experiences. An early question which arose was what should be the scope of the work to be undertaken, given the tenuous distinctions between tax evasion, tax avoidance and tax planning. Annex II to this introduction reproduces edited extracts from a 1980 report, derestricted but not published, on this question. The reports in this volume are the most recent published results of the Committee's on-going work under that mandate.

8. Much of the earlier work of the Committee on Fiscal Affairs is relevant to the present reports. Double taxation brought about by implementation of domestic anti-avoidance devices and appropriate safeguards for taxpayers are among the main issues considered in the reports in this volume. The OECD 1977 Model Double Taxation Convention on Income and Capital (hereafter referred to as the OECD Model Convention or sometimes simply as the OECD Model) and the Recommendation of the Council concerning the avoidance of double taxation adopted on 11th April 1977 (both contained in a report published in September 1977) provide the basic framework for considering taxation issues arising internationally as dealt with in the present reports. Of special relevance in this respect is the commentary to Article 1 of the OECD Model Convention (paragraphs 7 to 10) concerning the improper use of conventions. To the extent that transfer pricing practices may be used for shifting income between countries, the work done by the Committee on Fiscal Affairs in this area is of relevance (c.f. the 1979 and 1984 reports on Transfer Pricing and Multinational Enterprises).

9. Some aspects of the ongoing work of the Committee on Fiscal Affairs in the area of tax avoidance and evasion of particular relevance to the reports discussed in this volume are:

- Preparation, in co-operation with the Council of Europe, of a multilateral convention on mutual administrative assistance in tax matters, to be followed by a bilateral model convention on the same topic;
- Regular meetings of tax auditors and inspectors from OECD Member countries to discuss specific control problems.

III. GENERAL CONSIDERATIONS

10. Tax avoidance and evasion are of concern to governments because such practices are contrary to fiscal equity, have serious budgetary effects and distort international competition and capital flows. In this context each of the issues discussed in these reports poses the same problems, although, in a variety of guises. For example, the use of a base company, generally located in a tax haven, to redirect income from a high tax country to a low tax one

has an obvious detrimental effect on the revenue of the country whose tax base has been diminished. The inequity which results from the opportunity that some but not other taxpayers have of taking advantage of international fiscal manoeuvres is also rather clear. What may not be so evident is the effect tax avoidance in particular has on international competition.

11. In an increasingly interdependent economic world a common theme which has emerged in many countries is the desire to remove distortions to investment decisions brought about by tax systems, though it remains a fact that differences in countries tax systems may influence investment behaviour. For instance, differences in tax rates and in the availability of tax reliefs are inevitably factors which will be taken into account in determining the location of an investment. Indeed, some features of a country's tax system may be specifically designed to attract particular kinds of investment.

12. The decision not to tax, or to tax at an incentive rate is, of course, the exercise of a sovereign right of each State. Where States are in agreement about the objectives of their taxation systems, it may be argued that mutual assistance is an obvious way of proceeding between such States. International mutual assistance under conventions helps to ensure compliance with each country's domestic laws, especially through the international exchange of information and co-operation in tax matters. In such way, boundaries of national States do not provide opportunities for taxpayers to conceal or misrepresent the real economic facts on which taxation is to be based. Distortions from tax avoidance stimulated by fiscal differences between countries may thereby be offset.

13. There is a distinction (as elaborated in Annex II to this Introduction) between legitimate tax planning – to enjoy the benefit of consciously-designed features of a country's tax system – and tax avoidance of the kind discussed in the reports that follow. The opportunities for avoidance may often be greater for the taxpayer with interests in more than one territory than for his counterpart whose interests are confined to one country.

14. In considering the effects of taxation on investment decisions a distinction can be made between inward and outward investment. In relation to inward investment by foreign-based enterprises, the approach of capital-import neutrality is widely accepted and in fact has been incorporated in the OECD Model (non-discrimination). According to this approach, the profits from such investments should be, as far as possible, taxed in the same manner as those from an equivalent investment by a domestic investor. This may not result in the same taxation of the investor, as his tax position is also determined by the laws of his country of residence (cf. paragraphs 17 to 20 below). However, double taxation agreements based on the OECD Model contribute to the attainment of the goal of neutrality in the treatment of the income from the investment through the distribution of taxation rights, by furthering the general application of the arm's length principle to the profits of a branch or subsidiary of foreign enterprises and by relieving double taxation.

15. Even where tax neutrality exists in the country where the investment takes place, a foreign investor who succeeds in sheltering profits from taxation in ways which are not open to purely domestic enterprises will nevertheless enjoy a competitive advantage: such an advantage may be reflected in the terms and prices offered by the foreign investor to its customers. Countries may be willing to accept this situation in order to attract investment from abroad. However, where foreign investors exploit a country's tax system and treaty networks in ways which are unintended by the legislators, remedial measures may be considered. Furthermore, countries which aim at neutrality in the taxation of domestic and foreign investment will normally closely scrutinize the transfer pricing and other conditions

agreed between the foreign investor and his domestic enterprise or other related enterprises. Erosion of the taxable base through artificial transfer pricing and thin capitalisation are of special concern to these countries.

16. As regards outward investment, capital-export neutrality is often the aim of governments and this can be manifested in the operation of a credit system for the relief of double taxation. In such a system foreign profits of domestic enterprises are taxed but a credit given for foreign taxes generally limited to the amount of domestic tax. An objective of such a system is to equalise the post-tax rate of return to an investor on equivalent domestic and foreign opportunities. In practice, this means that the tax borne on those profits will be the higher of the foreign tax and the domestic tax; and capital export neutrality will be breached if the foreign tax is the greater of the two. One effect of double taxation agreements is to reduce the level and extent of tax charged in the country of source, thus improving the prospect of attaining capital export neutrality. Specific departures from this result may arise from "matching credit" arrangements, where a developed country agrees to give credit for tax spared under fiscal investment incentives in a developing country. Where the foreign profits are earned through a foreign subsidiary, credit countries will normally not tax them until they are remitted to the parent company in the form of dividends or interest.

17. As regards inward investment capital impact neutrality is often the aim of countries applying an exemption system, under which by domestic law or tax treaties or a combination of the two, they exempt profits derived from abroad, including usually – through the "affiliation exemption" – dividends remitted by a foreign subsidiary of a domestic company. The rationale is that enterprises with operations in a foreign country should be able to compete on equal fiscal terms with local businesses in that country: and they believe that this result is best achieved by leaving the foreign country with sole taxing rights thus avoiding double taxation. Consequently, where other economic conditions are equal lower tax rates in foreign countries may attract investments from countries applying an exemption system.

18. A country's attitude to and perception of the economic distortions created by international tax avoidance will vary according to whether it adopts a credit or exemption system for relieving double taxation. Credit countries experience tax avoidance on outward investment largely in the form of either:

- i) Accumulating profits from the foreign investment in an intermediate foreign vehicle which will pay little or not tax on its profits – e.g. a tax haven company, or;
- ii) Arranging to remit profits in ways which do not generate tax liability in the credit country, or generate a reduced liability (e.g. through the conversion of income into capital gain), or;
- iii) Artificial allocations of costs (so that a disproportionate share of costs falls on the parent company), or;
- iv) The interposition of a foreign company to mix income from different foreign sources in order to maximise double taxation relief, or;
- v) A combination of i) to iv).

To the extent that enterprises succeed in these devices, the post-tax return on investment abroad may be more attractive than that on investment in the home country and the goal of capital-export neutrality denied.

19. Countries react in different ways to restore the balance of their system. The first type of arrangement, accumulation of profits in an intermediate foreign vehicle, is countered in a number of countries by provisions which subject to domestic tax all or some part of the

accumulated income of a foreign subsidiary. The second route, the remittance of profits in ways which generate little or no tax liability, involves exploiting particular features of individual countries' tax systems and the defences vary according to the nature of the provisions concerned. Artificial allocation of costs is tackled by transfer pricing adjustments. The fourth device is a treaty shopping problem and countries may adopt a variety of approaches to deny the advantages of the treaty to the interposed entity (these are described in the conduit company report).

20. The concerns of the tax authorities in exemption countries are likely to be:
- i) To ensure that costs which are attributable to the foreign operations are not allocated against domestic profits. Rules for the deductibility of interest and for transfer pricing are particularly relevant here, and;
 - ii) To avoid creating double non-taxation. Double non-taxation may be accepted where (e.g. because of depreciation or incentive allowances) there are no taxable profits under the foreign country's tax system; but an exemption country may, for instance, be less willing to give up in a tax treaty a charge on capital gains on assets in the treaty partner country if there is no capital gains tax in the foreign country.
 - iii) To counteract the shifting of profits to low tax countries, the allocation of such profits bearing no relationship to the level of business carried on in those countries.

21. As follows from the previous three paragraphs diversion of profits abroad is of as much concern to exemption countries as to credit countries. Domestic profits are by a number of means artificially directed to, for example, offshore mutual funds or tax haven subsidiaries thereby avoiding the imposition of domestic tax. An obvious means by which profits may be diverted abroad is the improper use of transfer pricing between associated enterprises. Also, such devices involve straightforward tax avoidance (or in some cases, particularly with individuals, evasion) and in a number of countries provisions exist to counter them by taxing the profits as if they arose from a domestic source.

22. The foregoing considerations indicate that although measures against international tax avoidance have traditionally been justified in purely fiscal terms, the need to stop a tax loss to national treasuries, there are also strong economic arguments to support governments' actions. In particular, to the extent that enterprises operating internationally succeed in avoiding tax in ways not generally available to other businesses, they may have a competitive advantage over enterprises operating entirely within one country.

23. These considerations are also of relevance for the future work programme of the Committee on Fiscal Affairs. One objective of the Committee is to form a consensus between OECD Member countries on an internationally acceptable approach to tax avoidance and evasion. In pursuing this objective account has to be taken of these wider economic factors. It is also noted that the approach taken by the Committee to tax avoidance and evasion is consistent with the stated position of the United Nations Ad Hoc Group of Tax Experts which is set out in the *Guidelines on International Co-operation in Tax Matters* (published in 1984).

Annex I

**RECOMMENDATION OF THE COUNCIL
ON TAX AVOIDANCE AND EVASION**

Adopted by the Council on 21st September 1977

The Council,

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

Considering that tax avoidance and evasion are contrary to fiscal equity, have serious budgetary effects and distort international competition;

Noting that tax avoidance and evasion schemes involving international transactions have become increasingly complex and more difficult to detect;

Considering that effective action against such schemes requires strengthened co-operation between OECD Member countries;

I. RECOMMENDS the Governments of Member countries:

- a) To strengthen, where necessary, their legal, regulatory or administrative provisions and their powers of investigation for the detection and prevention of tax avoidance and evasion, with regard to both their domestic and international aspects, and to exchange experiences with respect to such action;
- b) To facilitate, improve and extend exchanges of information between their national tax administrations, with a view to combating tax avoidance and evasion, notably by making more intensive use of international conventions or instruments in force and by seeking new arrangements of a bilateral or multilateral character, with due regard to the provision of adequate safeguards for taxpayers.
- c) To exchange experiences on a continuing basis on tax avoidance and evasion practices, on techniques for detecting and preventing them and on ways and means of improving tax compliance in general.

II. INSTRUCTS the Committee on Fiscal Affairs to pursue its work with a view to facilitating the achievement of the above aims and to submit to the Council, as appropriate, specific proposals for increased co-operation between Member countries in this field.

Annex II

TAX EVASION, TAX AVOIDANCE AND TAX PLANNING

Edited extracts from a 1980 report by the Committee on Fiscal Affairs

Action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax, is covered by the term "tax evasion". Within tax evasion proper a distinction is sometimes made between the less serious offence of omission, e.g. failure to submit complete returns of income, and more serious offences, such as false declarations, fake invoices, etc. In most countries, "tax evasion" is usually quite unequivocal, although in a few countries, where the courts are prepared to take the view that the law is already broken if it can be shown that its spirit or the intention of the legislator is infringed, the distinction between evasion and avoidance may not be altogether meaningful. For most countries, however, the difficulty is not so much of distinguishing between "evasion" and "avoidance" but rather of delimiting what is to be covered by "tax avoidance".

It is possible to reduce or remove tax liability by perfectly acceptable tax planning (e.g. choosing among tax reliefs and incentives the most advantageous route consistent with normal business transactions), or even by refraining from consuming a taxed product, and it is clearly not the intention of governments to combat activities of this kind. To describe tax planning or abstention from consumption as "tax avoidance" is, however, to strain the meaning of language, as ordinarily used, and governments tend to take an operational approach towards tax avoidance to cover those forms of tax minimisation which are unacceptable to governments. Alternatively, a wider definition of "tax avoidance" which would cover all forms of reducing one's tax liability, could be used and a distinction made between "acceptable" and "unacceptable" avoidance. This is only a question of semantics, because under either definition, the same problems of identification arise. It is considered that using "tax avoidance" in the sense of this note – that is, as by definition, unacceptable, is closer to normal usage and this is certainly the case with the nearest French equivalent, "évasion fiscale". Use of words like "unacceptable" can raise the issue of whether moral judgements are being made. While moral attitudes may indeed be taken towards tax avoidance, it is not appropriate for tax authorities to do so: in combating tax avoidance the tax authorities, in their official capacity, are simply administering the law in accordance with what they understand to have been the intention of the legislature.

The scope of what is considered as tax avoidance may vary from country to country depending not only on the form a particular scheme may take, but also on attitudes of governments, parliament, public opinion and the courts, which may themselves change within one country and over time. However, this does not imply that OECD governments are not generally in agreement on what constitutes the range of tax avoidance they wish to combat or that they have problems in identifying it.

While details of tax avoidance schemes vary according to the law of the particular country, or countries concerned and, if more than one country is involved, the terms of any relevant double taxation treaty, activities would typically have the following characteristics:

- Almost invariably there is present an element of artificiality or, to put this another way, the various arrangements involved in a scheme do not have business or economic aims as their primary purpose;
- Secrecy may also be a feature of modern avoidance. In some cases tax advisers sell ready-made avoidance devices, one term of the contract of sale being that the taxpayer keeps the facts secret for as long as possible. It is in the interest of the avoiders to keep the administration from learning about new schemes because official and public knowledge may be followed by legislation to counter that kind of avoidance;
- Tax avoidance often takes advantage of loopholes in the law or of applying legal provisions for purposes for which they were not intended (e.g. provisions designed to encourage manufacturing of equipment being used for leasing of motor vehicles).

It should be added that successful tax reduction is neither a sufficient nor a necessary test of tax avoidance. It is not sufficient because this would cover acceptable tax planning and it is not necessary because an avoidance scheme designed to reduce tax may not succeed.

A typical illustration of the application of the criteria mentioned above may be cited. Some countries allow a taxpayer to deduct interest from his income, on the grounds that interest payments reduce taxable capacity, provided that there is a genuine loan with a normal rate of interest. It may be advantageous, in some countries, particularly in a period of inflation, for a taxpayer who is liable to tax at a high marginal rate to borrow money to purchase an asset, even though he could obtain the purchase money in a different way, for example by selling other assets. But if a taxpayer takes advantage of the relief given to loan interest by setting up a series of transactions which "manufacture" an abnormal amount of interest on which relief is claimed, although no greater expense is incurred than would have been the case had the transaction been arranged in the normal way, this would constitute a tax avoidance arrangement because:

- a) It offends the spirit of the law which allows relief on genuine interest;
- b) The main benefit from the transaction is the obtaining of a tax benefit not the obtaining of a loan;
- c) The whole scheme is artificial; it is not carried out in a normal commercial manner.

Secrecy may or may not be present, but in any case most tax administrations would have no difficulty in arriving at the conclusion that the whole transaction constituted tax avoidance and that action should be taken against it.

**TAX HAVENS: MEASURES TO PREVENT
ABUSE BY TAXPAYERS**

I. INTRODUCTION

1. International tax avoidance and evasion through the use of tax havens is one of the most important and long-standing concerns of the tax administrations of most OECD Member countries. The use of tax havens by various types of taxpayers (individuals and firms) has been increasing over the past decades to the detriment of both tax revenues and tax morale. Insofar as investment decisions are influenced by tax motives, the use of tax havens leads to decisions at variance with what a neutral tax system would command, and results in undesirable economic distortions, particularly in capital flows. Also, competition is being distorted between those taxpayers who make use of tax havens and those who do not.

2. The concept of a "tax haven" is a relative one as any country can be a tax haven in relation to a particular operation or situation. Operations through tax havens are not always tax-motivated and a wide variety of uses are made of tax haven areas. Nevertheless, large differences in levels of tax burdens between high-tax countries and tax havens, together with some special features of tax havens such as strict secrecy rules and refusal to co-operate with foreign tax administrations, open many opportunities for using tax havens for avoiding or evading taxes. Even though countries' views may differ as to what activities should be taxed and how, or on what is acceptable tax planning as opposed to unacceptable tax avoidance¹, tax authorities of Member countries share the basic concern that use of tax havens should not undermine the basic principles of domestic tax systems.

3. There is growing concern in Member countries on this issue, which has taken the form, *inter alia*, of new counteracting legislation in France, Japan and the United Kingdom and of new incentives made available by the United States to the Caribbean Basin countries as a counterpart for concluding exchange of information agreements². In 1982, the Committee on Fiscal Affairs therefore decided to embark on a specific study on tax havens.

4. The Business and Industry Advisory Committee to the OECD (BIAC) which is generally responsible for representing the views of the private sector to the OECD was asked to present its views on the reasons for, and the extent of, the use of tax havens and the impact of counteracting legislation on economic activities. BIAC's response, together with the views expressed at a joint meeting in October 1984, have been taken into account in preparing this report (see Part IV).

5. The emphasis in this report is on the legislative reactions of OECD Member countries to the use of tax havens. A brief description of the more important characteristics of classical tax havens and the type of use regarded as unacceptable by tax authorities is provided in Part II. The rest of the report concentrates on how tax administrations counter the unacceptable use of tax havens. Part III surveys the counteracting legislative measures in OECD Member countries and Part IV experiences of operating such measures, including information-gathering with respect to international transactions. Both Part III and Part IV

refer in detail to subpart F-type provisions which now exist in six countries (see definition in paragraph 46 below). Part V outlines options for international co-operation, bilaterally or multilaterally, through legal or administrative instruments.

II. CHARACTERISTICS AND USE OF TAX HAVENS

A. General

6. Attempts to provide a single definition of a "tax haven" are bound to be unsuccessful. It is, therefore, widely recognised that "there is no single, clear, objective test which permits the identification of a country as a tax haven"³. It can be argued that the "tax haven" concept is such a relative one that it would serve no useful purpose to make further attempts to define it. Clearly, any country might be a tax haven to a certain extent, and there are many instances where otherwise relatively "high tax" countries provide opportunities or devise policies to attract, by means of incentives, economic activities of certain types or in certain locations.

7. Another aspect of the situation is that tax savings frequently do not result from the use of tax havens only but rather from the combined effect of making use of tax havens and of certain features of the general tax provisions in relatively high tax countries (e.g. a participation exemption). Furthermore, "stepping stone" strategies have been devised to take advantage of the tax treaty networks of highly taxed countries, "laundering" by the same token the income flowing originally from tax havens.

8. However complex the picture may be, discussions on "tax havens" usually concentrate on situations involving a limited number of countries, which are regarded as "classical" tax havens. In most OECD Member countries, neither a definition of tax havens nor criteria to identify them exist in the law or in administrative practice. However, a number of countries which have passed counteracting measures have set criteria, in terms of the level of taxation for identifying "tax havens". Reference is made by Belgian law to countries where taxation is "substantially more favourable" ("notablement plus avantageux") than that in Belgium and, in the case of holding companies, to countries where they enjoy a special tax treatment ("exorbitant du droit commun"). In France, the legislation refers to the concept of a foreign country or territory with a "privileged" tax regime (Article 238A of the General Tax Code) where profits are either not taxed or subject to taxation substantially lower than that in France. The same criterion is followed by Japan. Under the German provision, tax havens are defined as jurisdictions with less than 30 per cent taxation on intermediate income. The United Kingdom legislation refers to "a lower level of taxation", which is defined as meaning a tax charge which is less than one-half of that of the United Kingdom tax which would be payable by a non-resident company if it were resident in the United Kingdom.

9. To clarify the application of these rules, some OECD Member countries have established lists of countries considered to be tax havens and to which specific provisions apply (e.g. in Australia, France, Germany, Japan and the United Kingdom). In effect the United Kingdom list is one of non-havens, and no charge under the United Kingdom's counteracting measures will arise in respect of companies resident and carrying on business in a country named on the list. Countries which provide special reliefs for particular kinds of

income or activity are identified separately, and the exclusion from the charge applied accordingly.

10. The following paragraphs concentrate on describing the principal characteristics of "classical tax havens". For this purpose, the "classical tax haven" may be regarded as a jurisdiction actively making itself available as a tax haven for avoidance of tax which would otherwise be paid in relatively high tax countries. Usually, the aim of the legislation of a classical tax haven is to attract income from activities which are to be carried on outside the territory of the tax haven.

11. The question then arises of in which cases there is a real income-producing activity in the country concerned. The position is normally clear in the case of income from manufacturing activities. The main problem lies with passive investment income and income from services. In the case of a pure base company which consists of little more than the legal instrument testifying its creation, it is evident that there are no activities. Where, however, a financial enterprise based in a tax haven jurisdiction is effectively staffed and that enterprise and its management operate independently, there are clearly economic activities which generate income. Between these two extreme examples, there is a rather large grey area where it may be very difficult to decide whether or not any real economic activity is being carried on.

B. Main characteristics of classical tax havens

12. As noted in the United States Gordon Report (see note 2), a number of factors are generally accepted as characteristic of tax havens. These include: relatively low rates of tax; high levels of bank or commercial secrecy which the country is generally unwilling to breach; a disproportionately large financial sector; modern communications facilities; the absence of currency controls on foreign deposits of foreign currencies; and self promotion as an offshore financial centre. These characteristics are described below.

1. None or low taxes on all or certain types of income and capital

13. As the main purpose in locating the management of passive income or service activities in "classical" tax havens is to obtain a relative advantage in taxation, the difference in the level of taxation between jurisdictions will have a major impact on the decision as to whether a tax haven should be used and, if so, which one. Many of the jurisdictions that are considered to be tax havens do impose some taxes. All, however, impose either no income tax or impose a tax at an effective rate substantially lower than that in countries whose resident taxpayers use the tax haven on all or certain categories of income (e.g. from special types of business).

2. Bank and commercial secrecy

14. Tax havens generally allow secrecy or confidentiality to persons transacting business in or through them. Such rules are based either on statutes, common law precedent, or administrative practice. Many jurisdictions follow common law precedent which accords privilege to information which a banker receives from his customer and this has evolved into a standard basis for protecting banking affairs and other financial transactions from divulgence to foreign tax authorities. Often these jurisdictions do not require the production of companies' annual accounts. Some tax havens have also enacted secrecy or confidentiality

provisions. These domestic features, combined with the exchanges of information with other countries (see paragraph 18 below), have major consequences for foreign tax authorities.

3. Lack of exchange controls

15. Many tax havens have a dual currency control system, which distinguishes between residents and non-residents, and between local currency and foreign currency, under which residents are subject to currency controls whereas non-residents are subject only to controls with respect to the local currency. These rules are designed to facilitate the use of the tax havens. A company formed in a tax haven, which is beneficially owned by non-residents and which conducts most of its business outside the tax haven, is generally treated as non-resident for exchange control purposes. Accordingly, the company's operations is not subject to the tax haven's exchange controls as long as it is dealing in a foreign currency and is not doing business in the tax haven.

4. Relative importance of banking

16. Classical tax havens typically increase the relative importance of the banking sector and most follow a policy of encouraging offshore banking business. This is done by distinguishing between resident and non-resident banking activity. Generally, non-resident activity does not have reserve requirements, and is taxed more lightly (if at all), and is not subject to foreign exchange or other controls. It also enjoys the guarantees of secrecy discussed above. Tax havens thrive largely because of the presence of foreign banks. Financial activity generates revenue for the tax haven which also benefits to some extent from the employment of local personnel and the rental of local facilities. The financial activities create an infra-structure which can be utilized both by fraudulent and legitimate businesses.

5. Communications

17. Communications refer to both physical transportation (such as air or sea connections) and networks such as post, telephone, cable and telex which is especially important to financial and banking activities in tax havens. It lessens the importance of distance, even if distance is not without influence in the choice of a tax haven. Thus some tax havens have mainly been developed as regional tax havens or as tax havens for taxpayers from a specific part of the world.

6. Tax treaties

18. Most tax havens do not have tax treaties and for those that do, the network is limited and such treaties provide for none, or very limited, exchanges of information or that no information is provided in practice. Because of the combination of treaty benefits granted by the treaty partner and favourable internal provisions in the tax haven, these jurisdictions may be particularly attractive for certain kinds of transactions (see paragraphs 28 and 29).

7. Other aspects

19. Among other aspects may be mentioned political and economic stability of the country in question; a favourable disposition towards foreign capital particularly by the provision of liberal commercial laws; availability of competent professional advisors (e.g. accountants and lawyers). Tax haven officials may publicise these advantages by conducting seminars, etc.

C. Main types of uses of tax havens

20. The extensive use of "classical" tax havens is probably best explained by the tax advantages they offer even though there are instances where such transactions may have very little impact on taxation imposed by the taxpayer's country of residence. However, the distinction between tax motivated and non-tax motivated operations is a difficult one to make, as tax haven countries are also used in some cases for genuine trade or business reasons.

21. There also exist transactions with tax haven countries which are fraudulent or criminal. While many such transactions are not principally intended to have tax consequences (for example, "laundering" of criminally-obtained funds, disguising illegal corporate activities such as "insider trading" and the covert or illegal export of funds from certain countries), they may frequently lead to significant losses of revenue in the residence country (see also paragraph 112). The main uses of havens for tax purposes are reviewed in the following paragraphs.

1. *Emigration and shifting of residence*

22. Taxpayers in countries with a relatively high level of taxation may be tempted to avoid being subjected to tax in their own countries either by manipulating fiscal residence tests provided for under domestic legislation or by moving their residence abroad altogether⁴; e.g. winding up of all attachments to the territory of a certain tax jurisdiction⁵. However, emigration to another country is unlikely to take place unless it offers a better environment or at least one equivalent to that left behind. As tax savings can frequently be obtained in more convenient ways than through emigration, the tax motivation is probably not the only or even the main reason for emigration.

23. Rules concerning "fiscal residence" vary as between jurisdictions. This is the case in particular for short-term absence. Residents of relatively high tax countries may attempt to manipulate these rules to avoid taxes by changing residence frequently. Individuals may also claim that they have transferred residence, for a long period, to a tax haven, even though, in practice they have retained essential links with their country of origin. Artificial shifting of residence raises special difficulties in the case of companies, as company residence can be a difficult concept to define, and especially to verify where is the place of effective management of a company and whether it has been moved.

2. *Base companies*⁶

24. Tax havens can be used in a numerous ways to shelter income from taxation in a relatively high tax country. One popular device is to set up a base company in a tax haven jurisdiction suitable for this purpose⁷. For tax purposes the most important function of a base company is to collect income which otherwise would arise directly to the taxpayer and to shelter such income from taxation in the taxpayer's country of residence. Apart from taxation factors, base companies are used to retain flexibility for financing international operations by avoiding domestic constraints and costly procedures (e.g. currency controls and permission systems).

25. Initially, the income is sheltered from taxation in the taxpayer's country of residence because the base company is an entity with its own legal personality and is recognised as such in the state of residence, so that the income no longer falls under the normal worldwide taxation regime to which the taxpayer is subject in his country of residence.

Although it may be taxed in the country of source under a system of “territorial taxation”, usually in the form of withholding, this taxation for a number of reasons (such as the application of a treaty), may be non-existent or rather low so that a substantial saving of taxes may result.

26. The tax advantage exists only as long as the sheltered income is not distributed. Taxpayers, therefore, may claim that this is merely a tax deferral. However, tax authorities may find such an advantage objectionable if the base company is being used to route income away from the residence country or block income from foreign sources which would otherwise arise directly to the resident taxpayer. Furthermore, the distribution by the base company may be indefinitely deferred so that the deferral is prolonged on a medium-term or even a long-term basis by means of the secondary sheltering mechanisms referred to in the next paragraph.

27. Taxation of income shifted to a base company but beneficially enjoyed by the taxpayer may be avoided by “secondary sheltering”. This involves changing the character of income to make use of exemptions provided for under tax treaties or domestic rules in the taxpayer’s country of residence or by use of other techniques, such as reploughing of the income by loans to the shareholder or alienating a holding in the base company to realise the capital gain which may be exempted or taxed at a lower rate.

28. The choice of location for a base company is likely to be governed predominantly by the tax rates levied in competing countries. However, another important consideration is the treaty network of the tax haven. Although most tax havens have either no or a very limited treaty network, favourable treaties with major industrial countries do exist which allow normal withholding tax rates to be reduced or eliminated altogether. Such arrangements are very attractive, especially for “holding companies”.

29. For example, a base company may be used to steer through it income from copyrights, patents and knowhow. From the taxpayer’s point of view, it is important to collect the income derived from such intangible assets in a low-tax country without being subject to high withholding taxes in the source country. In this context, understanding the network of tax treaties between various fiscal jurisdictions is of utmost importance. The royalty income which arises in a country can be routed through another or several other jurisdictions before ending up at the final destination, i.e. a tax haven. In order for such a system to work, the intermediary or conduit company has to qualify for the application of the double tax treaties involved. In some cases the tax advantage obtained by using such a device occurs because the benefits of tax treaties have been granted to persons not entitled to them.

30. As far as the functions fulfilled by a base company are concerned, the most common one is “asset administration”. Base companies also form “financial pivots” for broad international activities. This usually concerns holding companies, e.g. the regional centres for multinational enterprises and companies formed to issue loans or to bundle together other activities. Companies of this kind may even take the form of banking or insurance enterprises and it may then be doubtful whether one can still regard them as “base companies” receiving passive income, though their functions may be very similar.

31. Other base companies may be related to a commercial or professional activity carried on outside the base company’s country. The base company “feeds” on the profits derived from these activities so that this income can at least partly be sheltered in the tax haven company. These activities are more fully described in paragraph 16 of the report on base companies.

32. Finally the base company may be used to obscure the real character of a transaction. Due to difficulties in obtaining information from tax havens it is often difficult for tax authorities to prove that a transaction is a sham and that in consequence there exists an unreported tax liability.

3. Conduit companies

33. Some companies will be established with purely channelling objectives in mind. A taxpayer resident of one State will use such a company to direct flows of income originating in a third country, through a tax haven which has a suitable network of bilateral tax conventions. The objective is to take advantage of the more favourable tax treatment in the source countries made available by the tax treaties. The tax advantage sought will be in the source country and not the residence country. These issues are dealt with in the report on conduit companies.

4. Insurance

34. The use of "captive" insurance companies seems to be increasing. A captive insurance company is usually established to deal with insurance of the risks of the parent company, since no deduction is usually allowed in the source country for self insurance. Such a company may be set up in the same country as the parent company, but the tax advantage (as well as the advantages in the form of liberal operational requirements) often influences the choice of locating the captive in a tax haven. As the insurance premium is deductible in the "high tax" jurisdiction, the enterprise tries to obtain an "optimal" pricing policy of the premium. The amount of deduction for the premium is probably more important than minimizing tax on the profit of the captive in the tax haven.

35. Where there exist domestic restrictions on the use of foreign insurance companies, similar tax advantages may be obtained by forming a domestic captive insurance company which then reinsures in a captive insurance company situated in a tax haven.

5. Shipping

36. Expressions such as "open registration" or "flags of convenience" refer to the opportunity that non-resident enterprises have to register a ship in certain countries and to carry that country's flag although the administrative headquarters is sited and real business carried on elsewhere. There are a number of significant non-tax reasons for using flags of convenience such as low registration fees, lower wage costs, reduced technical standards required and a lack of other operational controls from government.

37. However "open registration" may also give rise to significant opportunities for tax avoidance. Generally, low or no income taxes are paid in the country of registration on profits from shipping operations. The "open registration" country may be a tax haven, or the profits can be routed through a tax haven jurisdiction commonly by using leasing and chartering arrangements.

6. Service companies

38. Service companies ostensibly performing management functions for non-trading activities are set up in tax havens to avoid taxes, reduce operating costs and avoid government controls. The usual technique used to shift profits from the "high tax" country to the tax haven involves payment of a fee for services rendered.

D. The size of the tax haven problem

39. This report is concerned with losses of revenue to tax authorities caused by the use of tax haven facilities. There are a number of reasons why it is extremely difficult to determine how much tax is lost by relatively high tax countries. Data presently available on the use of tax havens are limited and may well be difficult to interpret. Furthermore, it is often difficult to define precisely which countries are to be regarded as tax havens. The very characteristics sought by tax haven users, in particular, confidentiality and secrecy with respect to financial information, make reliable estimates difficult to formulate.

40. Nevertheless some published material is available which gives some indication of the size of the problem faced by certain Member countries. Generally, the data shows that certain types of financial activities, such as direct investment and bank deposits, are found at disproportionately high levels when compared with the actual economic base of the country. Some of these materials relating to a number of countries widely regarded as classical havens are considered in the following paragraphs and reproduced in Annex I.

41. Much of the available material is derived from two major reports on tax haven activities prepared by the American government, the Gordon Report and the Tax Havens in the Caribbean Basin Report [see note²]. Both present comprehensive indirect data to indicate the level of activities in tax haven jurisdictions for the purposes of providing an impression of revenue losses. Dealing with a 9-year period to 1979, the Gordon Report concluded from an analysis of available financial data that:

- i) the use of tax havens by American taxpayers was large and apparently growing;
- ii) direct investment in tax havens was growing much faster than that in non-havens;
- iii) the increase in investment was more pronounced in some of the better-known havens, e.g. a 5-fold increase in the Bahamas and 37-fold increase in Bermuda during the period;
- iv) the level of increase in assets of American-controlled corporations in tax havens outstripped that of those in non-havens by a rate of 5:3;
- v) activities conducted by American-controlled corporations in the jurisdictions examined were predominantly those expected to be encountered with haven usage; generally being financial, insurance, real estate, wholesale trade, constructional, services and transportation (essentially shipping);
- vi) banking deposits in tax havens had escalated rapidly (from \$11 billion in 1968 to \$385 billion in 1978);
- vii) gross dividend, interest and other income payments to tax haven residents from sources in the United States constituted for 1978 42 per cent of all such payments to non-resident recipients.

42. The second of the reports updated the material presented in the Gordon Report in particular in respect of Caribbean tax havens. The conclusions it reached were that:

- i) the level of foreign financial activity represented by foreign assets in banks in Bermuda, the Cayman Islands and Panama far exceeded their needs for foreign trade (see Table I reproduced in Annex I): in fact, by some \$300 billion;
- ii) the level of off-shore banking activities in these countries rose sharply during the period 1978 to 1982;

- iii) U.S. direct investment in Caribbean countries other than the Netherlands Antilles increased by over 43 per cent during the same period;
- iv) financial activities through the Netherlands Antilles increased during the period with net United States borrowings from affiliates in that country increasing from \$1 billion to \$16 billion and reported income paid to Antillian residents increasing from \$191 million to \$1 400 million;
- v) reported currency transactions with the Caribbean havens revealed a considerable imbalance in respect of net flows to and from certain havens. Such imbalances may indicate a high level of illegal activities such as "laundering" of criminally-obtained funds, deposits of funds from drug-related and other criminal dealings.

The overall conclusion of this second report confirms the trend detected in the Gordon Report on the escalating use of tax havens. The report noted that a substantial part of those activities were likely to be motivated by tax factors and that even where non-tax factors were important (e.g. illegal activities), this would also lead to revenue losses. There is nothing to suggest (except perhaps in respect of the Netherlands Antilles where there are treaty adjustments in course) any abatement in these trends.

43. Data available from the Development Assistance Committee (DAC) of the OECD confirms the disproportionate level of financial activities observed in some of the tax haven countries subjected to scrutiny in the US reports. Tables 2 and 3 in Annex I show that both the stock and flow of private direct investment to some of the "classical" havens from the 17 Members of the DAC is far out of proportion to the real size of their economies. Table 2 shows that as at the end of 1981 five of the havens considered (the Bahamas, Bermuda, Liberia, the Netherlands Antilles and Panama) had approximately 14.3 per cent of total estimated investment stock which had flowed from DAC Members to all developing country recipients even though their economies accounted for less than 0.3 per cent of the total GNP of all developing countries. Similar disproportionality exists in the figures for private sector net investment flows set out in Table 3.

44. Figures taken from the foreign investment statistics of the Japanese Ministry of Finance which are reproduced as Table 4 in Annex I, show that Japanese private direct investment has been concentrated in a limited number of "classical" tax havens. Although there is no smooth trend exhibited, such investment in the three most popular havens (Panama, Hong-Kong and Liberia) has grown substantially in recent years, having quadrupled by 1983 as compared with that in 1978, whereas total Japanese direct investment has increased in the same period only by approximately 80 per cent. These three economies accounted for more than one quarter of all Japanese direct foreign investment in 1983, though this may in large part be explained by geographical and historical connections or the predominance of certain types of activities, such as shipping in Liberia and Panama. Data for some other well-known havens (Bermuda, the Bahamas, the Netherlands Antilles and Cayman Islands), also reproduced in Table 4 show the relative unimportance of these countries for Japanese investment and the absence of any clear trend.

45. Estimating the degree of use of tax havens to conceal illegal activities and revenue losses associated with them poses even greater problems. Official statistics on funds flowing into and out of tax havens does not necessarily reveal many of the transactions connected with criminal activities⁸. A report prepared in 1983 for the United States Congress' Permanent Sub-Committee on Investigations of the Committee on Governmental Affairs⁹ on the criminal use of tax havens "guessed" that the amount of criminal funds flowing from the

United States into tax havens was somewhere within the range of \$9 billion to \$43 billion. The upper limit was determined as a proportion of the estimated size of the underground economy in the United States (taken to be \$330 billion). Of course, estimates of the size of the underground economy are themselves subject to considerable uncertainties and to the fact that no agreed methodology for measurement is available.

III. COUNTERACTING MEASURES AGAINST THE USE OF TAX HAVENS: AN OVERVIEW

46. Domestic legislative measures aimed at curbing the abuse of tax havens exist in many forms. Some of them are general in character and may apply to all types of tax avoidance or evasion. But these general measures tend not to be effective enough, and more “targeted” measures have been felt necessary, either for strengthening the tax authorities’ hands (e.g. reversal of burden of proof, “extended” residence) or for submitting persons dealing with tax havens to stronger reporting requirements or new tax liability. The most sophisticated form of such specific legislation, which now exists in Canada, France, Germany, Japan, the United Kingdom and the United States, provides liability to tax on certain types of unremitted income of companies set up in tax havens and controlled by residents (this type of legislation is hereafter referred to as “subpart F-type provisions”). Other forms of legislation, whether or not tailored to this particular problem are also reviewed in this chapter.

A. General provisions against international tax avoidance

1. Transfer pricing legislation

47. Most Member countries have transfer pricing legislation giving their tax administrations the authority to scrutinise international transactions between related persons and to reallocate income or disallow costs that are not determined on an arm’s length basis. Though these provisions are not focused particularly on transactions with tax havens, they are an important instrument in preventing the artificial shifting of income to base companies established in tax havens.

48. Transfer pricing provisions are in some countries very detailed such as Section 482 of the United States Internal Revenue Code and its related regulations. A number of countries rely on more general provisions enabling them to correct transfer prices to figures which would have been agreed between unrelated persons dealing at arm’s length. Since the publication of the 1979 OECD report on “Transfer Pricing and Multinational Enterprises”, however, there has been a tendency (e.g. in Canada, Denmark, Germany, Italy and Japan) to supplement such general provisions by more detailed administrative guidelines to be applied in specific cases of transfer pricing. Explicit reference to transactions with low-tax countries is in particular made in the German guidelines. Related measures in certain countries include thin capitalisation provisions under which diversion of funds to low-tax countries can be counteracted.

49. Specific steps taken by some administrations for improving efficiency in dealing with transfer pricing cases – such as the centralised auditing of large companies by specialised

auditors, or industrywide investigations – are also relevant and are dealt with in paragraphs 92 to 97 below.

2. *General provisions on tax avoidance*

50. Some countries have general anti-avoidance provisions that are in principle applicable to the whole of their tax legislation. An example is the Swedish general clause whereby the effect of a transaction would be disallowed if the taxpayer obtained a tax advantage contrary to the basic principle of the tax law which would have been applicable had he used the most natural way of carrying out the transaction. Another example of a general provision is the so-called “annihilation provision” found in New Zealand. According to this type of provision, any agreement shall be absolutely void insofar as “directly or indirectly, it has or purports to have the purpose or effect of in any way, directly or indirectly” avoiding tax. Australia until recently also used an “annihilation provision” but as from 28th May 1981 new general anti-avoidance provisions were introduced to overcome deficiencies found to exist in the previous legislation. Broadly speaking the new provisions apply to arrangements that are blatant, artificial or contrived and enable denial of a tax benefit obtained by a taxpayer as a result of entering into a scheme designed predominantly to achieve that benefit.

51. Though these general provisions may have their advantages, the courts of many countries are unwilling to look beyond the letter of the law, in which case recourse has to be made to specific legislation. This possible weakness of general provisions probably still exists, but there are indications in some countries that the attitudes of the courts may have changed somewhat in recent years (see paragraphs 83-85). Nevertheless, general provisions are unlikely to be the main legislative weapon used by tax authorities to counter the abuse of tax havens.

3. *“Substance over form”*

52. The concept of “substance over form” which, in broad terms, can be defined as the prevalence of economic or social reality over the literal wording of legal provisions, has been used to counter the attempted circumvention of tax laws. This approach can be adopted by the courts as a principle of interpretation or explicitly set out in a statute. In many European countries, including France, Germany, the Netherlands and Switzerland, it is embodied in the judicial concept of “abuse of law”. In common law countries and Belgium the approach is a well-recognised principle of statutory interpretation which may be applied in certain circumstances to tax laws. Statutory forms of the principle of substance over-form are found in a number of countries; Australia, Belgium, Germany, Luxembourg, the Netherlands, Switzerland and the United States.

53. Taking the French legislation (Article L.64 of the Livre des Procédures Fiscales) as an example, any transaction made in the form of a contract or any kind of legal instrument, the provisions of which conceal profits or income arising or transferred, cannot be invoked against the tax administration. To reinstate the true nature of the disputed transaction and determine the basis for taxation accordingly, the tax administration may seek the opinion of a special consultative committee on the abuse of legal provisions. If tax is assessed in accordance with the opinion delivered by the committee, the burden of proof lies with the taxpayer in the event of a subsequent appeal.

54. This type of legislation can be effective only if the tax authorities are able to establish the economic reality of transactions or a series of transactions. Such a process

requires information on international transactions which may be available only from sources such as foreign exchange control or international exchanges of information.

4. Maintaining the withholding tax on income paid to non-residents

55. High rates of withholding tax on income such as interest, royalties, dividends, rents, management fees and other similar payments, paid to non-residents may also be used as a general weapon in the arsenal of counteracting measures. The withholding tax is usually reduced or removed only under the terms of tax conventions and in some cases in return for a guarantee of administrative assistance.

56. The maintenance of withholding tax also prevents companies in a tax haven country from being used as "conduit companies", particularly for the collection of interest and royalty payments between a resident of a treaty partner and a resident of a third country¹⁰. Tax would be withheld, in the absence of the tax convention, at the rate chargeable under ordinary law on the relevant amounts paid through the conduit company to the resident in the third country. Obviously, the effectiveness of this measure depends either on the refusal to conclude tax conventions with tax havens or on having safeguarding clauses introduced into the conventions with tax haven countries so as to enable withholding tax reductions or exemptions to be refused in certain circumstances.

B. Legislation directed against the use of tax havens

1. Shifting the burden of proof

57. Usually the "burden of proof" (or the "burden of persuasion") lies with the tax authorities but in some countries it will normally rest with the taxpayer, who has to provide detailed evidence when claiming the benefit of tax provisions or challenging the assessment made by the tax authorities, for instance, in Australia, the Netherlands, New Zealand and the United States. However, even when the burden of proof is imposed on the tax authorities, in some instances it will be reversed to the taxpayer's side in the case of certain types of transactions with low-tax countries. Such provisions aim mainly at discouraging disguised transfers of profits abroad and the accumulation of income in tax havens. Measures taken for this purpose were introduced in Belgium in 1938 (reinforced in 1973) and in France in 1974. A Special Council, created to consider the issues of organized and economic crime, proposed in 1980 that a similar requirement should be introduced in Sweden. However, the proposal was rejected by the government largely because of the difficulty of defining what should be regarded as a low-tax country, especially in view of frequent changes in foreign tax legislation and tax rates¹¹.

58. The measures taken in Belgium and France provide that interest, royalties and licence-fee payments, or consideration for services paid by a person resident or established in Belgium (or France) to a person resident or established in a country or territory situated outside Belgium (or France) giving "preferential taxation treatment"¹² shall not be deductible for tax purposes "unless the payer furnishes proof that the expenses correspond to genuine transactions and are not abnormal or excessive". In France, this provision also applies to payments made from accounts held by financial institutions set up in a country with a "privileged tax treatment", irrespective of the residence of the recipient of the payment (Article 238 of the C.G.I.). Where it has not been possible to establish that the operation had

actually taken place, the expenses which cannot be justified are fully added back to taxable income. If the amount of such expenditure merely appears excessive, then it is the excess which is added back.

59. In contrast to subpart F-type legislation, these provisions do not place any additional burden on the taxpayer when he is making his return of income tax. They allow the production of documentary evidence at this stage, but do not require it. In general, if individual cases are examined, the tax authorities will require such evidence. On the other hand, the subpart F-type legislation is usually more exacting in that it makes the taxpayer automatically render a detailed return of his transactions with related persons abroad.

60. These provisions have been found to be particularly effective in countering evasion techniques which use tax havens, since the person making the payments must both establish the genuineness of the purported transaction, and show that the amount of the payments is not abnormal or excessive. Evidently they deal only with one part of the problem, as in many cases the point of using tax havens is to avoid taxation on income generated by transferred property rather than to obtain a deduction for facilities provided or services rendered by the foreign entity. The burden they impose on the taxpayer is, however, likely to complicate his task considerably if the transactions in which he engages aim at tax avoidance. Tax authorities in Belgium and France have found that these provisions have succeeded in deterring tax avoidance through the medium of tax havens.

61. Belgian and French transfer-pricing legislations provide examples of the shifting of the burden of proof in cases where enterprises established in those countries have related enterprises located in tax havens. Under Article 24 of the Belgian Code des Impôts sur le Revenu (and Article 57 of the French Code Général des Impôts), the tax administration has authority to include in the profits of Belgian (or French) enterprises which control, or are controlled by, enterprises located outside Belgium (or France), profits indirectly transferred to the latter, whether through overcharging or undercharging on purchase or sale prices or by any other means. To bring this legislation into play the tax administration must furnish proof that a dependence relationship with the foreign enterprise exists and then, that there has been a transfer of profits for the latter's benefit. However, in the case of transactions with firms established in a country or territory with preferential taxation treatment, the tax administration is not required to prove the existence of a dependence relationship.

2. Subpart F-type provisions

a) Background

62. This is the most significant type of tax legislation directly aimed at counteracting the tax advantages derived from the deferral possibilities offered by the use of tax haven subsidiaries. Broadly, this is achieved by taxing the subsidiary's income in the hands of its domestic shareholders. This type of legislation was initially enacted in the United States in the 1930s (personal holding company provisions in 1934 and foreign personal holding company provisions in 1937). Then Subpart F legislation was enacted in 1962 and expanded in 1975, 1982 and 1984. Subpart F legislation provides for the taxation of the United States shareholders of controlled foreign corporations on their pro rata share of certain categories of undistributed profits from tax haven activities and certain other activities of the foreign corporation. The German "Foreign Tax Law" (Aussensteuergesetz) of 1972 introduced detailed rules on the attribution to resident shareholders of base companies' passive income derived by a controlled intermediate company. Comparable provisions were enacted in

Canada as part of the tax reform of 1972 [Foreign Accrual Property Income (FAPI) – these provisions came fully into force in 1976]. Japan introduced counteracting measures in 1978 as part of the Special Taxation Measures Law with an exhaustive list of 27 tax havens¹³ in three categories¹⁴. France enacted legislation in 1980 (now Article 209B of CGI) and the United Kingdom in the 1984 Finance Act. An outline of all these provisions is presented in Annex II and their implementation is assessed in paragraphs 99 to 114 below.

b) Scope of the legislation

63. The approach taken in the provisions of the six countries described above is basically the same. However, reflecting the variety of their fiscal and economic concerns, there are differences in detail. Subpart F-type legislation generally refers to three factors (see Annex II).

i) Participation held by residents

The tax haven company must be owned to a large extent by residents of the State where the legislation is in force. Minimum ownership formulae vary and one of the main problems is apparently how to counter strategies used by taxpayers to avoid these criteria (e.g. by indirect participation and other specific devices);

ii) Nature of the income

Under the United States, German and Canadian provisions, particular types of activities are regarded as “tainted” and only the income derived from such activities is attributed to the resident shareholders (so-called “shopping approach”). On the other hand, the Japanese, French and United Kingdom provisions subject to tax all of the retained income of certain subsidiaries set up in tax havens as long as they do not satisfy certain criteria of exemption (so-called “exemption approach”)¹⁵. Even in the latter approach, the nature of the activities of the tax haven subsidiary is crucial in determining whether or not the criteria for exemption are satisfied, so the two approaches reach substantially the same result¹⁶.

Income covered under the “shopping approach” is normally “passive income”, that term usually being defined in the legislation. It would normally comprise dividends, interest, royalties, capital gains and profits arising from administrative and management functions as well as payments of convenience (bribes, etc.). However, some non-passive income from, for example, the following activities is also included under some domestic laws, for example:

- Administration of assets: income from this type of activity is generally included in the legislation, insofar as the income is not effectively connected with “active” business (such as production, etc.);
- Financial pivots: income is generally included (see paragraph 30 above). There evidently exist, however, differences and “grey areas”, especially where such pivots take the form of banks, insurance companies, etc.;
- Operational base companies: income seems to be included where they have a clearly auxiliary character, carrying out only administrative or management functions or receiving payments of convenience. Specific problems may arise in the field of trading or service companies where the respective scope of the legislation and of arm’s-length pricing rules may be unspecified.

iii) *Low taxation*

While low taxation is a characteristic of tax havens, it proves difficult to define it for the purposes of applying subpart F-type provisions. Countries, therefore, approach this problem in a variety of ways, which are summarised in Annex II below.

c) *Specific provisions of relevance*

64. The United States provisions concerning "foreign personal holding companies" were introduced with corporations domiciled in low-tax countries very much in mind. They provide that the United States shareholders of a foreign personal holding company are taxed on their proportionate share of the corporation's undistributed foreign personal holding company income (such as dividends, interest, royalties and capital gains from securities). A foreign corporation is a foreign personal holding company if at least 60 per cent of the corporation's gross income for that year is foreign personal holding company income, and if more than 50 per cent in value of the corporation's outstanding stock is owned (directly or indirectly) by not more than five individuals who are citizens or residents of the United States. After 1984, the Subpart F provision takes precedence over the Foreign Personal Holding Company provisions.

3. *Other tax provisions*

a) *Emigration*

65. Under German law, a new concept of "extended non-resident tax liability" has been introduced in the individual income tax, the general wealth tax and the inheritance tax. This concept (Sections 2 to 5 of the Foreign Tax Law) applies to German citizens or former German citizens who transfer their residence from Germany to a low-tax country and who, for five out of the last ten years, were German citizens or subject to German tax as residents. If such an individual retains a significant economic interest in Germany after transferring residence to a low-tax country (a country imposing less than two-thirds of the tax imposed in Germany), then he is subject to German income tax for ten years after the year of emigration on all income that would not be considered as foreign source income for the purpose of the foreign tax credit provision in the hands of a person subject to unlimited liability to German income tax. The income tax liability is thus narrower than for residents but wider than for non-residents. The most important effect of this provision is that the progressive income tax scale is applied to income for which tax of 25 per cent will otherwise be withheld. Although not directed at emigration to low-tax countries, special provisions also apply in Canada, Denmark, Sweden and the United States, to taxpayers leaving the country on a permanent basis. Such taxpayers remain subject to taxation in their country of origin for a prescribed period after they leave. The United Kingdom also has special provisions which apply to companies ceasing to be resident in the United Kingdom.

b) *"Rent-a-star" company*

66. France has a specific provision aimed at dissuading artistes (entertainers or sportsmen) from incorporating themselves ("Rent-a-star" company) in low-tax countries and rendering services in France. Under Article 155A of CGI, persons can be taxed, regardless of whether they are resident in France for tax purposes or not, on the basis of the services they render for which remuneration is collected by an individual or corporate third party established in a country giving preferential tax treatment. The effect is to remove any interposed screen, whether by an individual or an entity, established in a tax haven.

c) Transfer of assets abroad

67. Ireland and the United Kingdom have some relevant provisions which although not expressly concerned with tax havens, in general terms are designed to stop the avoidance of tax through individuals transferring assets abroad and arranging for what is in substance their income to be paid to a person resident or domiciled outside Ireland or the United Kingdom. Typically the arrangement would result in income or a capital benefit being paid to a company or discretionary trust in a tax haven, either indirectly for the benefit of the individual who transferred the assets (or accruing for his benefit), or for the benefit of someone else ordinarily resident in these countries. The legislation taxes the relevant income concerned. If the benefit is for someone other than the transferor, the charge is limited to the benefits that person actually receives; if it is for the transferor, all the income as it arises outside the country is subject to tax. But before the rules can apply, the tax authorities have to establish a tax avoidance motive.

68. Belgium also has provisions in its law to prevent artificial transfer of assets although they are not exclusively directed at tax havens. Sales or contribution of shares, bonds, debt-claims, patents, etc. to a foreign holding company, an individual or an enterprise subject to an abnormally favourable tax treatment as concerns the income derived from the transferred assets or rights, are deemed to be shams. According to these provisions, the taxpayer cannot invoke the argument that he is no longer owner of the transferred shares, bonds, debt-claims and patents. The taxpayer would be subject to tax on income from the transferred assets as if the transfer had not taken place unless he proves that:

- The transfer has been made for a genuine financial or economic reason;
- The taxpayer has received normal consideration as a counterpart for the transfer and the income flowing from that consideration is effectively taxed in Belgium at a level which is normal as compared with the tax burden which would have existed if the transfer had not taken place.

69. The United States has two provisions which allow the tax administration to consider the motives of persons transferring assets abroad. In a number of cases the Internal Revenue Code excludes from tax gains on transfers of property between corporations or corporations and their controllers in specific circumstances, for instance, property distributed to a corporation upon liquidation of another corporation (section 332). Broadly speaking, section 367 of the Code makes the exclusions ineffective by deeming a recipient foreign corporation not to be a corporation for these purposes unless it is established that the transfer was not made in pursuance of a plan having as one of its principal purposes the avoidance of income tax. The second provision, section 1491, imposes a special tax at a rate of 35 per cent on the adjusted value of property (less any gain taxed as income) transferred by a United States citizen or resident, domestic corporation or partnership or a trust or estate (which is not a foreign trust or estate) to a foreign corporation as paid-in surplus or as a contribution to capital, a foreign trust or estate or a foreign partnership unless it is established that the transfer is not principally for tax avoidance purposes. Amongst other exemptions, this latter provision does not apply to a transfer subject to section 367.

d) Offshore investment funds

70. Financial institutions frequently set up mutual funds, unit trusts and similar investment vehicles in tax havens. The investment concern itself pays no, or nominal, tax in the haven. If income were totally distributed to the investors, they would pay tax on it year by year in the countries in which they are resident. However, the income is often not distributed,

instead being accumulated and increasing the value of investors' holdings so that, when the investor eventually disposes of his holding, he has a capital gain which will reflect the accumulated income. In many countries less tax will be paid on a capital gain than on income. In the absence of counteracting legislation, investment vehicles in tax havens can therefore be used to convert income into capital gain, with a substantial tax saving for the investor.

71. The popularity of such investment vehicles has caused a number of countries to take legislative action. These include the Netherlands, the United States and Germany and they have been followed more recently by Canada [see paragraph 108 and note²⁶] and the United Kingdom. These counteracting measures reveal two basic approaches to the problem: first, in Canada, the Netherlands and Germany investors are taxed annually under rules for calculating the amount of income relating to the year in question; second, the United Kingdom and the United States tax the investor's gain as income at the time when the holding in the investment concern is disposed of.

4. Foreign exchange control – non-tax measures

72. Control of the use of tax havens may also be achieved through co-operation with non-tax authorities. Since 1974, Australia has dealt with the tax haven problem by means of a tax screening process based on the exchange control mechanism. Under the Banking Act, the Reserve Bank of Australia, which is responsible for administering exchange control, is required not to grant exchange control approval for most agreements, contracts or arrangements of a capital nature (as well as certain current payments with Vanuatu) with residents of 18 countries listed in a notice under the Act unless a tax clearance certificate has been issued by the Commissioner of Taxation. These arrangements are simply an administrative device for preventing tax avoidance and evasion and, if no tax avoidance or evasion is involved with a particular transaction, a tax clearance certificate is normally issued promptly on receipt of an application. Genuine transactions are, therefore, not hindered by the screening process. The Government of Australia decided in December 1983 to remove a major part of the restrictions imposed by means of exchange control. As a result of that decision the Reserve Bank will no longer be directly involved in granting approval for foreign exchange dealings. Instead, foreign exchange dealers and the general public have been authorised to deal in foreign currencies subject to adherence to certain conditions. These conditions form the basis of the revised tax screening arrangements¹⁷.

IV. EXPERIENCES WITH COUNTERACTING MEASURES

A. Attitudes towards tax havens and counteracting legislation

1. Business attitudes

73. Business attitudes to tax havens were conveyed by the Business and Industry Advisory Committee (BIAC) to the Committee (see paragraph 4) both in writing and orally at a joint meeting held in October 1984. BIAC gave examples of situations where, in its view, economic factors could be advanced for making use of tax havens, and where industry would regard the use of tax havens as legitimate, "provided that all the arrangements were operated

on a commercial basis and were not artificial contrivances". BIAC accepted that "fiscal authorities have a proper reason for concern where transactions are carried out at prices which cannot be justified on 'arm's-length' criteria or where profits are otherwise diverted without genuine business purposes or objectives".

74. The BIAC submission also stated that "much of the use of tax havens is not motivated by a desire to pay no, or little, tax so much as an economic necessity to reduce costs, including taxes, to a bearable level in circumstances where the laws of countries are unco-ordinated, and even the laws of individual countries are inconsistent, insofar as they relate to the treatment of international business".

75. The submission provided as examples the following instances where it was considered that the use of tax havens was felt to be useful or necessary:

- a) Fund-raising companies for international investments – to raise funds competitively on international markets and reduce financing costs (including taxes);
- b) Subsidiary shareholding companies – to receive income from dispersed overseas operations in the form of dividends;
- c) Licensing and patent-holding companies – to overcome the imposition of high withholding taxes in cases where in the absence of a treaty a residence country will not allow a credit;
- d) Service, wholesaling and construction companies – for co-ordinating dispersed commercial and industrial operations from a central or convenient operational base;
- e) International pension funds – to provide flexibility for members working internationally;
- f) Group insurance companies – for reducing costs by providing risk coverage within a group;
- g) Shipping companies – principally concerned with the difficulties of applying domestic labour laws to internationally-employed staff.

76. In particular, it was stated by BIAC that the use of subsidiary shareholding companies could often be justified on the grounds of:

- a) Avoiding costs and delays in repatriating funds which were destined only to be re-exported;
- b) Avoiding the high risk of devaluation in some source countries;
- c) Aggregating foreign income in order to avoid the intricacies of systems of country-by-country credits imposed by some countries;
- d) correcting misalignments between source and residence countries where the total tax burden varies year by year but is on average the same over a period of years;
- e) protecting investment incentives offered by some source countries.

77. As far as counteracting measures are concerned, BIAC found some difficulty in commenting on their impact because of the variety of forms taken by such measures but indicated "that faced with restrictive legislation, companies will either discontinue existing operations or more likely, change the method of conducting the operations so as to minimize the effect of legislation, the latter course often involving higher (non-tax) costs. Since not all competitors will be equally affected by the legislation, it may have unfortunate competitive effects". From BIAC's viewpoint, anti-avoidance legislation typically contains other objectionable features:

- a) The compliance burden on taxpayers as well as the enforcement burden on tax authorities is very costly;
- b) Profits from affected operations are subject to tax but losses are normally ignored. This can be questioned on fairness grounds;
- c) Such legislation often involves an element of "over-kill".

Taking into account these unfavourable effects, as well as the insignificant amount of additional revenue which accrues to countries imposing restrictive legislation (particularly when the secondary effects are taken into account), BIAC considered that "the correct way of tackling this problem is by singling out specific abuses and then devising legislation carefully aimed at the abuses in question. Evaluations can then be made case by case to ensure that the cure is not worse than the disease. It makes no economic sense to increase the costs of industry unless a definite decision has been made that the cost of allowing the 'status quo' to continue is a less attractive alternative".

2. *Attitudes of tax administrations*

78. The two basic concerns of tax administrations about the extensive use of tax havens by multinational enterprises (and others) are that first, by attracting capital for tax motives, the use of tax havens affects the neutrality of taxation in respect of economic decisions; secondly, competition between taxpayers is seriously distorted by the fact that some taxpayers can use tax havens to avoid or reduce their tax liability, while others do not or cannot.

79. The OECD Committee on Fiscal Affairs appreciates some of the problems raised by BIAC and recognizes that minimizing costs is a legitimate concern of business. However, the Committee considers that these problems do not justify the use of tax havens to shelter income from taxation in the country of residence which bears no relation to the activities carried out in the tax haven. Another important point is that one of the main tax haven characteristics, confidentiality or secrecy can itself be a significant inducement to use tax havens. There may also have been instances where BIAC may have underestimated the benefits that can be derived from double tax treaties. The overall impression was that the arguments put forward did not have general application but related only to special circumstances.

80. Tax administrations have considered the argument that counteracting legislation distorts competition. While recognising that the scope of such counteracting measures should not be so broad as to hit unintended targets, the Committee stressed that these measures were taken by legislators only after careful consideration and that tax administrators were entrusted with the task of applying them under the control of the courts. The use of tax havens itself distorts competition and the Committee hoped such arguments would not be used to justify attempts to avoid the impact of counteracting legislation.

3. *Court attitudes – substance versus form*

81. The attitude of the courts towards general provisions or specific legislation directed against tax avoidance exerts a great influence on the effectiveness of such legislation. Relatively few cases have dealt specifically with tax haven situations, but it is apparent that the attitude of courts generally towards anti-avoidance provisions (as summarised below) is relevant to the tax haven situation.

82. In the context of the application of anti-avoidance clauses, the courts of many countries are therefore prepared to look at the substance (i.e. the real economic content) rather than at the form (i.e. the legal form of a transaction)¹⁸. In certain countries,

transactions which are in the nature of a “sham” or “not for reasonable business purposes” may be disregarded. The concept of a “sham transaction” is close to the concept of substance over form. The difference seems to be that in a sham transaction the documents or actions are intended to give the appearance of a particular transaction having taken place but in fact another transaction has occurred, whereas substance over form operates so as to replace the effect of transactions which have taken place according to the form with results which are consistent with the underlying economic reality of the operations.

83. A literal approach, which emphasizes the legal form rather than the substance of transactions, has been followed until recently by courts in countries such as Australia, New Zealand and the United Kingdom, except where a transaction could clearly be shown to be a sham. As a result, in Australia, the general anti-avoidance provision was rendered largely ineffective and thus unable to be employed in combating the abusive use of tax havens. This literal approach by the Australian courts also meant that the effectiveness of the more specific anti-avoidance provisions was brought into doubt.

84. In recent years, however, Australian and British courts have adopted a less literal approach to the interpretation of income tax legislation and have tended to provide interpretations more consistent with the perceived intention of the legislature. In Australia, this was reinforced by a 1981 amendment to the Acts Interpretation Act to insert provisions stipulating that an interpretation promoting the purpose or object underlying an Act shall be preferred to an interpretation that does not promote its purpose or object, and by the introduction of new general anti-avoidance provisions in 1981 and of transfer pricing provisions in 1982. In the United Kingdom, the courts have adopted a new approach in a recent series of judicial decisions under which they look at the real nature of a scheme as a whole, and disregard the particular steps in the scheme which have no commercial purpose and are intended solely to produce a tax advantage.

85. Although the courts do not differ in principle as to whether the taxpayer involved is an individual or a company, they sometimes differentiate in practice. As an example, in the Netherlands there are cases where, in applying the general anti-avoidance provision, the courts have refused a deduction for interest payments on loans entered into for the purpose of setting up and making investments through a company located in a tax haven and have thus invalidated the whole scheme. Where a tax haven company belongs to a group of companies and can be said to serve some business purpose, it is recognised as such, but the allocation of profits to it will be closely scrutinized. In a number of such cases, the courts have allowed an allocation of 10 per cent or less of the total profits to related companies in tax haven countries, where such companies carried on certain activities or were not established solely for tax reasons. A different approach was followed in a recent case, where the place of effective management of a base company located in a tax haven owned by a resident of the Netherlands was deemed to be in the Netherlands and, in consequence, the total profit of the company was taxed in the Netherlands.

B. Information gathering

86. International transactions in general and tax haven-related transactions in particular present special difficulty for tax administrations who need to gather information to verify a return or to assess tax liability. The main difficulty in obtaining such information from abroad is that investigative efforts by the tax authorities of the residence country may be

hindered because they conflict with the interest of the other country, and this is particularly the case when tax havens are involved. There are two ways of dealing with this problem. The first is the unilateral measure of an extended reporting obligation for resident taxpayers with foreign interests and this is mentioned in the following paragraphs. The second possibility is to gather information through bilateral and multilateral channels as discussed in Part V.

1. Reporting requirements with respect to resident taxpayers' foreign transactions

a) General

87. Most countries generally do not require their resident taxpayers to report separately on foreign transactions (e.g. transactions through a foreign branch, or with a foreign affiliate), but in some cases a domestic company has to produce for inspection by the tax authorities balance sheets, profit and loss accounts, etc. and any necessary documents which make foreign holdings apparent.

88. In Spain, a taxpayer is required to notify the tax administration, for turnover tax purposes, of any client or seller with whom he had transactions of over Ptas 500 000 (excluding direct exports) in the previous year. Sweden recently passed an amendment to the Taxation Act whereby a taxpayer, seeking a deduction in his tax return for payments of interest, royalties, and in respect of patent rights, trade marks, etc., has an obligation to report the name of the country to which these payments have been made and the amount of the payment.

b) Burden of proof

89. In some countries [e.g. Austria¹⁹ and Germany], the taxpayer is required, in relation to foreign transactions, to substantiate any claims or co-operate more fully with the tax administration, than he would have to do for other transactions and this, a fortiori, covers the tax haven case. Business expenses relating to transactions between a German taxpayer and a foreigner subjected to low taxation may be disallowed if the taxpayer does not upon request fully disclose to the tax authorities the nature of the relationship with the person or enterprise.

2. Reporting requirements with respect to foreign affiliates

90. Special reporting requirements concerning relations with foreign affiliates are usually found in the countries with subpart F-type legislation. In Canada, a list of non-resident related or associated corporations with which there were transactions during the year must be filed with the corporate tax return. It must be indicated on the list, for each corporation, the approximate total of inter-company sales and purchases and amounts paid or received for services (but not including payments made or received that are subject to withholding tax). In Germany, taxpayers are requested to submit all information necessary to calculate their tax liability under Germany subpart F-type legislation. Japan introduced a reporting requirement with respect to foreign affiliates set up in tax havens as a part of its counteracting legislation of 1978. A taxpayer who has a foreign affiliate in a tax haven jurisdiction is required to attach the financial statements, such as the balance sheet, the profit and loss statement, and the name and address of shareholders of the affiliates to the annual tax return. Analogous provisions now exist in France where they are directed at enterprises subject to corporation income tax and which hold directly or indirectly 25 per cent or more of the share of a company established in a country or territory with a "privileged tax treatment".

91. The United States require that a United States taxpayer who owns, directly or indirectly, more than 50 per cent of a foreign corporation reports certain transactions that the foreign corporation had with the taxpayer (as well as transactions between the foreign corporation and corporations controlled by the taxpayer or any United States person owning 10 per cent or more of the stock of the foreign corporation). The transactions to be reported include sales and purchases of stock in trade, purchases of property rights (including patents, trademarks, etc.), and receipts from and payments of compensation, commissions, rents, royalties, licence fees, dividends, interest and premiums for insurance²⁰. Recent United States legislation while unrelated to subpart F, requires a United States corporation (or a foreign corporation engaged in a United States business) controlled by a foreign person, to report transactions it has with related corporations. There are also reporting requirements for acquisitions or dispositions of an interest in a foreign partnership by a United States partner, as well as the filing of a partnership return by a United States partner to report the income or loss of a foreign partnership. Although the United Kingdom now has subpart F-type legislation there are no automatic reporting requirements covering controlled foreign companies, although there is a special information power requiring the production of particulars of controlled foreign companies and the submission of their accounts when requested.

3. *Specific information gathering on transfer pricing*

a) Procedures for obtaining information from taxpayers

92. Transfer pricing information is usually extracted from tax returns or obtained in connection with a tax audit by making use of normal procedures under which the taxpayer, or in many countries third parties, may be required to answer any questions and to submit all information deemed to be relevant by the tax inspector to the determination of transfer prices. Such information (oral or written) may usually be obtained or checked on the taxpayers' premises, in the books and records of enterprises. Where available, powers of administrative subpoena, as in the United States, can be used.

93. In the United Kingdom, transfer pricing information may be obtained from taxpayers using general powers for obtaining information either by a local tax office in the course of its normal procedures, or by the special Head Office Unit dealing with major transfer pricing investigations. However, special information powers which exist as part of the United Kingdom transfer pricing provisions can also be used.

94. Special-purpose questionnaires are currently used to obtain transfer pricing information in Australia. Questionnaires enable more cases to be selected for investigation, which in turn may have a deterrent effect on attempts to avoid tax²¹.

95. Quite often it is necessary to have access to information located abroad such as the manufacturing cost of an item imported from a related foreign entity. In such a case, the Canadian tax authority asks the taxpayer either to provide the information or to permit the authority to examine the information at the foreign entity's office. If refused, the information may be sought from a treaty partner.

b) Industrywide transfer pricing studies

96. A number of countries²² have conducted industrywide transfer pricing investigation programmes or studies in certain industries. When resources permit, countries appear to

consider this approach worth following, for the purpose of making comparisons, obtaining evidence of arm's-length sales and improving the quality and quantity of transfer pricing information generally.

97. The United States has established, as part of its examination programme, an industry specialisation programme. This involves the concurrent examination of several principal taxpayers in an industry under the direction of an industry specialist. The case and group managers conducting examinations of taxpayers in those industries that are not the subject of the industrywide examination are kept apprised of developments in the industrywide examination, resolve "co-ordinated" issues consistent with the cases, participate directly in the examination, and receive the assistance of the industry specialist. Industries designated for industrywide examination programmes include aerospace, banking, chemical, commodities and grain, construction, data processing, insurance, petroleum, pharmaceutical, railroad transportation, steel, tractors and heavy equipment, utilities and forest products. The United States has expanded the industry specialisation programme into the international area with international specialists being used to examine cases with international issues. In addition, industrywide exchanges of information with United States' treaty partners are used to secure comprehensive data on worldwide industry practices and operating patterns.

C. Assessment of the implementation of subpart F-type legislation

98. This section considers how effective subpart F-type legislation has been as a weapon against the improper use of tax havens. Though this legislation has been in force for more than 20 years in the United States and for over 10 years in Germany and Canada, it is very difficult to make a definitive assessment of the deterrent and cautionary effects on the use of tax havens. This is even more the case for France, Japan and the United Kingdom where the legislation is very recent. In this section, therefore, emphasis is put on the direct consequences of enforcement, such as additional income collected by tax administrations, and experiences with the introduction and administration of the law.

1. Direct results of implementation

99. A direct consequence of implementing subpart F-type legislation is an increase in the amount of income made liable to tax. As to the effect of the United States subpart F provisions, recent statistics indicate that corporations reported over \$14 billion in subpart F income for the period 1978 to 1982.

100. German statistics show that²³, since its introduction in 1972 and up to 30th June 1979, additional income totalling some DM 170 million was made liable to tax under Sections 7 to 14 of the Aussensteuergesetz. During the peak year of 1973 (DM 50 million), the number of cases dealt with was about 500 – a figure which was not exceeded until 1977. During the first two years (1972-1973), the additional income made subject to tax was an average of about DM 180 000 per case but dropped sharply in subsequent years (1977: DM 37 000). This trend suggests that taxpayers either divested themselves of their interests in holding companies or made such profits liable to taxation in Germany by distributing them as dividends.

101. In 1983, six years after the Japanese provisions came into force, 428 domestic corporations (425 in 1982) lodged the required return under the counteracting legislation with respect to 1 914 (1 736 in 1982) subsidiaries located in 17 areas designated as tax havens

(such as Hong Kong, Panama and Liberia). Additional income made liable to tax with tax returns was Y 31.4 billion (Y 17.4 billion in 1982). The tax administration audited 386 cases for the period from July 1983 to June 1984, in 49 cases of which they detected errors in the tax returns. Additional income from these audits totalled Y 3.4 billion for this period.

102. As to the estimation of tax revenue derived from the introduction of the new legislation, the German experience has been that the number of cases falling under the Foreign Tax Law and the amount of income made liable to tax as a result was far below the estimates made at the time the law was passed. Germany considers that there are three possible explanations for this:

- a) It may be that the number of situations to which the law applied was over-estimated at the outset; this view is supported, amongst other things, by the comparatively large number of cases which can be dealt with on other grounds (e.g. under provisions regarding the improper use of legal procedures for establishing legal status);
- b) The introduction of the law itself may have led to the dissolution of some intermediary companies; there are several reasons for believing that this may have happened;
- c) It is possible that the true figures are in fact higher since the audit division had so far investigated only 15-25 per cent of the suspected cases.

2. Reaction to the introduction of the legislation

103. The first hurdle for subpart F-type legislation often came when the Government publicly announced its intention to introduce powerful counteracting legislation. With the exception of France where the government did not meet with strong objections, owing in part to a favourable press campaign, governments found varying degrees of opposition from industry and other pressure groups. As an example, the United Kingdom Government published three consultative documents and draft clauses prior to the enactment of the "controlled foreign companies" provisions, inviting comments from interested parties. Many comments were received, most of which criticised the government's detailed proposals and, as a result, a number of significant changes were made.

104. When Japan first attempted to introduce its counteracting legislation in 1978 there was a strongly adverse reaction from industry, but not from political circles. At the time a strict tax treatment of multinational enterprises was favoured. The initial draft was softened by incorporating significant exemption clauses in order not to discourage the overseas development of Japanese industry.

3. Administration

105. In general, countries which have introduced new legislation did not require additional staff to enforce it, but dealt with the additional work load by way of reallocating existing resources and reorganising functions, and by intensifying the training of tax inspectors on international tax matters. The United States enforces its subpart F legislation through its International Enforcement Program, which consists of over 300 specialised international examiners located in offices throughout the United States. Overall program direction of and policy considerations for the programme lies with the Office of the Assistant Commissioner (Examination) which is located in the National Office, Washington D.C. The Internal Revenue Service (IRS) has placed particular emphasis on tax haven issues and expanded its in-house training to promote tax haven awareness. This training is taken by all

examiners and not limited to international specialists. Additionally, an abbreviated international issues training course has been developed to provide IRS executives with an overview of international issues with a particular emphasis on tax haven use. Japan holds International Taxation Seminars to improve examiners' expertise on international taxation and foreign languages. The United Kingdom has introduced courses on international taxation for inspectors in those offices most likely to be involved with international issues in general and the controlled foreign company legislation in particular.

4. Some difficulties in implementation

106. As noted above (see paragraph 90), accurate disclosure of foreign affiliations and in some cases their trading results is a major requirement for the successful implementation of subpart F-type provisions. Some countries therefore impose heavy penalties for non-disclosure. This is done in Canada²⁴ and the United States²⁵ where the legislation contains penalty provisions which aim at discouraging taxpayers from delaying or refusing disclosure of information concerning foreign affiliates.

107. While subpart F-type legislation has been carefully drafted to avoid possible loopholes new tax avoidance schemes have been developed which require further counter-acting measures. For example, the Canadian FAPI legislation was introduced in 1972 but not implemented until 1976 so that Canadian taxpayers might appropriately re-organise their foreign investments. However, by 1976 some taxpayers had set up off-shore investment funds specifically designed to avoid taxation under the new rules. While these schemes initially adopted a low profile, in recent years they have become a very popular tax avoidance device to the extent of being publicly promoted by brokerage firms²⁶. It is estimated that at the end of 1983 \$200 million had been invested in such funds. Legislative changes proposed in February 1984 and effective from 1st January 1985 require Canadian participants in off-shore funds to include in their annual income an amount equal to the cost of their investment multiplied by a prescribed interest rate.

108. In the United States, income from manufacturing operations which meet certain statutory tests is excluded from subpart F income. Foreign base company sales income does not include income from the sale of property, manufactured, produced, grown, or constructed by a Controlled Foreign Company (CFC) in whole or in part from property which it purchased. The foreign base company sales income provisions could potentially be avoided by structuring an entity as an assembly operation rather than as a sales company. Thus, a United States company could form a tax haven subsidiary, sell components to the subsidiary for assembly, and claim that no foreign base company sales income is earned on the sale of the property which includes the components. Regulations do exist which attempt to distinguish genuine manufacturing from minor assembly operations for this purpose. Nevertheless, enforcement problems, concerning CFC's manufacturing for an export market, have centered upon the difficulties involved in securing adequate information to establish that the "substantial manufacturing test" has been met in order to determine whether the income can be included in subpart F income.

109. Also, in the United States, the services and construction industries have increased their use of tax haven entities. Subpart F income includes foreign base company services income, that being income from performing technical, managerial, engineering, architectural or other services outside the CFC's country of incorporation, if such services are performed for, or on behalf of, a related person. The enterprises which appear to be making the greatest use of tax havens are related to construction, natural resources exploration, and high

technology. However, in many cases, these functions are not being performed for a related party, but rather, for unrelated parties.

110. The United States recently introduced a new provision which prevents a taxpayer introducing into civil proceedings any foreign based information that had been requested under a Formal Information Request by the IRS, unless the taxpayer has substantially complied with the request or established reasonable cause for not doing so. It is anticipated that this will considerably aid the IRS enforcement efforts.

111. Japan has experienced two kinds of problems in implementing its subpart-F type legislation. The first results from the fact that their list of areas designated as tax havens is an exhaustive one. Unlike lists found in other countries, the Japanese list is legally binding on both taxpayers and the tax administration in order to afford complete legal certainty to taxpayers under the self-assessment system. Tax planners tend to try to use countries which are not on this list, that is, those which may be described as borderline jurisdictions falling between classical tax havens and "tax holiday" countries. It is not easy for the administration to keep up with tax developments in new attractive areas and to have the official list revised. The second difficulty is one shared by other countries, of determining whether a foreign subsidiary carries on real and significant economic activities.

D. Role of criminal enforcement in attacking tax haven abuses

112. As the use of tax havens does not necessarily involve tax evasion, or any criminal offence, criminal enforcement does not always play an active part in combating tax haven abuses. When tax evasion is involved, penal proceedings will play a part, as is frequently the case in Austria and Denmark. Section 482 of the United Kingdom Income and Corporation Taxes Act 1970, which prohibits companies from undertaking certain transactions unless they are carried out with the consent of the Treasury, is one of the rare examples of criminal penalties being applied to tax avoidance practices.

113. The United States tax authorities have sought criminal sanctions against taxpayers who use tax havens to evade United States taxation. Many of these cases involve evasion of tax with respect to income from illegal sources, including narcotics transactions²⁷. In Canada, when it has been perceived that fraudulent means are being used to suppress otherwise taxable income, criminal enforcement has been used to attack tax haven abuses. However, unless deceit or purposeful concealment of the facts can be established, it is nevertheless difficult to prove evasion.

V. OPTIONS FOR INTERNATIONAL CO-OPERATION

A. Co-operation through legal instruments

1. Facilitating exchange of information

114. Member countries have an extensive network of tax treaties containing exchange of information provisions, usually on the lines of Article 26 of the OECD Model Convention.

These provisions, however, do not always permit the gathering of information from tax havens. In some conventions, Article 26 can be used only for the correct application of the convention, and not for the application of domestic tax laws. Few tax treaties have been signed with tax haven countries, and even where a tax treaty exists, the tax haven treaty partner is obliged to give only such information as is obtainable under local law. Thus, if the jurisdiction has a bank secrecy law, bank account information may not be obtainable; if the jurisdiction has a commercial secrecy law, corporate ownership and business information may not be obtainable and, perhaps, even interviews with residents of the jurisdiction will be prohibited. In many tax havens, not only foreign governments but also the government of the jurisdiction itself are restricted in having access to such information. Even where secrecy laws are not a factor, the effectiveness of exchange of information depends significantly upon the attitude of treaty partners. Some countries take a very restrictive view of the exchange of information provision, and this attitude may affect the quality of information exchanged.

115. Nevertheless, exchanges of information frequently prove useful in enabling treaty partners to collect facts, in so-called "triangular" cases, on transactions with entities situated in a third (frequently tax haven) country.

2. General treaty policy with regard to tax havens

116. Member countries have few tax treaties with tax havens. While the United States had until recently treaties with about 15 jurisdictions generally considered, according to the Gordon Report²⁸, to be tax havens to some degree, this was mainly the result of the extension of the old 1945 United States-United Kingdom income tax treaty to the former British colonies²⁹. The reasons for the small number of treaties with tax havens are both that benefits granted by treaties are not balanced by corresponding tax in tax haven jurisdictions and that double taxation which may not be dealt with under domestic provisions hardly ever arises. The likelihood of tax haven areas becoming a base for conduit companies is another explanation for this tendency. The use of tax havens for tax treaty shopping could be substantially reduced by refusing to have new treaties with tax havens and by denouncing existing treaties with tax havens, though this may conflict with other policy objectives³⁰.

117. However, limited treaties with tax havens focusing on administrative assistance and non-discrimination could be useful instruments for dealing with the problems of abuse of tax havens, if they could be concluded on terms satisfactory to the non-tax haven treaty partner. The conditions to be satisfied would vary from case to case, but to assure both that the benefits of the treaties are received only by persons properly entitled to them (prevention of treaty shopping) and that the tax administration of the treaty partner of the tax haven has the information necessary to enforce its tax laws with respect to any transactions which may take place within its jurisdiction, any such treaty would require comprehensive exchange of information provisions possibly overriding secrecy laws in the tax haven. It has to be added, however, that unless the tax haven jurisdiction were offered some quid pro quo (e.g. economic aid, in particular with former colonies) it seems unlikely that the tax haven country would be willing to conclude such a treaty.

118. The United States took this approach in the Caribbean Basin Initiative (CBI) legislation of 1983, the main purpose of which is to promote economic revitalisation and to facilitate expansion of economic opportunities in the Caribbean Basin region. The CBI legislation also makes 27 qualifying jurisdictions eligible for "North American area" status, that is, they can be the sites of business conventions for which expenses are deductible for the United States tax purposes if these jurisdictions enter into an exchange of information

agreement on tax matters with the United States. The exchange of information agreement would apply to both criminal and non-criminal matters and would override local secrecy laws. However, for non-criminal tax purposes, bearer share and bank account information are not a necessary part of the exchange of information agreement if the President of the United States determines that the exception to the standards in the case of a particular agreement is in the security interest of the United States, and it is determined that the modified agreement would assist in the administration and enforcement of United States tax laws. However, as to criminal tax matters, the agreement must include exchanges of bearer share and bank account information. The agreement also would impose on the officials of each country a duty not to disclose information other than to tax administrators. A Model for such exchange of information agreements has now been issued by the U.S. Treasury Department. However, so far there has not been much progress in concluding agreements on the exchange of information, except in the case of Barbados.

3. Multilateral approaches

119. Multilateral efforts are increasingly being made in this field, early examples of which are the Nordic Convention on Mutual Assistance in Tax Matters in 1973 and the EEC-Directive on Mutual Assistance by the Competent Authorities of Member States in the Field of Direct Taxation, dated 19th December 1977. The OECD/Council of Europe draft Multilateral Convention on Mutual Administrative Assistance in tax matters provides some forms of assistance which could be of special use in the tax haven situation. In its comprehensive provisions on exchange of information, the multilateral convention raises the possibility of participation in tax examinations abroad and simultaneous tax examinations.

B. Administrative co-operation

120. Within the present framework of exchange of information under double taxation agreements, tax administrations could improve international co-operation in the following ways to deal with tax avoidance and evasion involving tax havens:

- Spontaneous exchanges of information;
- Exchanges of information on specific industries;
- Regional co-operation schemes;
- Simultaneous examinations;
- Central pooling of relevant information.

121. Some Member countries have been working closely in regional co-operative groups exchanging views and experiences on the use of tax havens. The "Group of Four" (the United States, the United Kingdom, France and Germany) and "PATA" (Pacific Association of Tax Administrators: the United States, Canada, Japan and Australia) are cases in point. Exchanges of this kind help to detect avoidance schemes and to facilitate the use of exchange of information provisions in tax treaties to improve enforcement activities. As a result of examiners'/inspectors' meetings of the Group of Four and PATA, taxpayers using tax havens have been identified for bilateral simultaneous examinations. These examinations are based on the exchange of information provisions of the income tax treaties between the countries concerned. Industrywide exchanges of information could be extended both by considering additional industries and by more treaty partners taking part.

122. Simultaneous tax examinations have proved to be an important tool in auditing multinational companies with intra-group transactions involving tax havens, by enabling the tax authorities of the examining countries to see the transaction from both sides. The development of such procedures is likely to be cost-effective if restricted to major, well-selected cases.

123. At a national level, Germany has organised a central pooling system for information (Informationszentrale Ausland, foreign information centre) from national sources. In the United States a task force on information gathering was set up in May 1983 to identify taxpayers who are using business entities and bank accounts protected by stringent foreign secrecy laws for the purpose of avoidance and evasion³¹.

124. Pooling and sharing of relevant information at an international level does not yet exist but could constitute a new form of co-operation, and should be possible if the problems of secrecy and administration can be overcome. Improved co-operation may also come from organising tax inspectors' meetings to consider problems relating to gathering of information on tax havens and tax haven use, as is done from time to time in OECD.

NOTES AND REFERENCES

1. See above Annex II to the general introduction.
2. Several reports, reflecting countries' concern about the use of tax havens by their taxpayers, have been released in recent years. The most comprehensive one is "Tax Havens and Their Use by United States Taxpayers - An Overview", by Richard Gordon of the U.S. Department of the Treasury (1981) (hereafter referred to as the "Gordon Report"), which was supplemented by "Tax Havens in the Caribbean Basin", the U.S. Department of the Treasury (1984).
3. See U.S. Department of the Treasury Report (1984) referred to in footnote 2 above.
4. This is the case where taxation is based upon residence criteria. In the case of the United States which taxes on the basis of citizenship, a taxpayer might consider giving it up in order to avoid taxation.
5. Cf. extended non-resident tax liability in Germany (see paragraph 65 of this report).
6. Functions and uses of base companies are analysed in detail in the next report in this volume.
7. A base company may be a holding company, an investment company, a finance company, a trading company, etc.
8. See generally, Department of the Treasury (US), Internal Revenue Service: "Income Tax Compliance Research, Estimates for 1973-1981", Chapters II and VI.
9. United States Senate: "Staff Study of the Crime and Secrecy: The Use of Offshore Banks and Companies made by the Permanent Sub-Committee on Investigations of the Committee on Governmental Affairs": US Government Printing Office, Washington, 1983, p. 15.
10. See also the report in this volume on conduit companies.
11. Courts in Denmark and in Norway tend to have more onerous evidential requirements on the taxpayer where tax havens are involved.
12. For France, an Administrative Instruction of 26th June 1975 explains the term "privileged tax regime". The existence of a "privileged tax regime", as a matter of practice, is presumed if:

- An individual, married, having no dependent children and disposing of an overall net income of FF 100 000, is subject to a personal income tax lower by one third than the tax which would apply in France;
- The total tax due on a company's income is less than one third of the French tax which would normally apply to the company.

An Administrative Note of the 9th October 1975 sets out a non-exhaustive list of countries giving such preferential taxation treatment.

13. A further six areas were added to the list in 1979.

14. These three categories are:

- i) Areas with low rates of taxation on all income (17 areas);
- ii) Areas with low rates of taxation on income from foreign sources (5 areas);
- iii) Areas with low rates of taxation on income from specific businesses (e.g. income of international finance companies, income of shipping companies) (11 areas).

15. As an example of the "exemption approach", under the United Kingdom legislation, a controlled foreign company potentially subject to the charge may escape it if it can pass any one of the four exemption tests or the de minimis rule, namely:

- i) That the overseas company is engaged in activities which fulfil the conditions specified in the legislation. These include a significant physical presence in the company's territory of residence (exempt activity test);
- ii) That the overseas company remits by way of dividend to the United Kingdom a substantial proportion of its commercial profits within 18 months after the end of its accounting period. Trading companies are required to distribute at least 50 per cent of the United Kingdom shareholders' share of available profits. Other companies must distribute at least 90 per cent (acceptable distribution test);
- iii) That a substantial part of the shares of the overseas company are publicly quoted on a stock exchange in its country of residence, recognised for taxation purposes by the United Kingdom Inland Revenue (the public quotation test);
- iv) That the main purpose of any of its transactions was not to achieve a reduction of United Kingdom tax and that achieving a reduction of United Kingdom tax by a diversion of profits from the United Kingdom was not one of the main reasons for the company's existence (the motive test);
- v) That the profits of the company were below the de minimis level (£20 000).

In addition, to provide greater certainty about the application of the legislation, the United Kingdom Inland Revenue has published a list of excluded countries. This makes it clear that no charge will arise in respect of companies resident and carrying on business in a country on the list.

16. Under the exemption approach, however, potentially large amounts of passive income may escape attribution to the domestic shareholders because foreign subsidiaries primarily engaged in legitimate business activities in tax havens can be wholly exempt.

17. There are now two categories of Australian foreign exchange transactions subject to the new arrangements:

- a) Tax clearance certificates are required before the following transactions can take place with, or in respect of, residents of countries previously designated as tax havens:
 - A loan or repayment of a loan;
 - Payment for the acquisition of securities, land or other property;
 - Payment of any royalty or licence fee;
 - Payment for the performance of any service;
 - Payments associated with the creation or establishment of any trust in a designated country;
 - Payment of monies into a trust fund created, established, held, managed or operated in a designated country.
 - Emigrants' remittances in excess of A\$50 000 per person.

- b) Transactions not subject to the tax clearance certificate procedures but for which details are required to be forwarded to the Australian Taxation Office within one week of a transaction taking place are foreign currency transactions where payments in excess of A\$50 000 (whether or not with residents of designated countries) are made in respect of:
- Direct investment overseas;
 - Gifts, sustenance payments and trust distributions;
 - Loans to non-residents;
 - Portfolio investment overseas;
 - Repayment of borrowings from overseas;
 - Travel expenditure;
 - Remittances relating to future operations overseas;
 - Interest or dividends;
 - Service fees or royalties.
18. In many cases, courts would turn to "substance over form" only if the legislative intention is not clearly expressed in the text of the law.
 19. In Austria, according to several rulings of the Supreme Administrative Court, the taxpayer's obligation to co-operate with the tax administration overrides the obligation of the tax administration to investigate the case officially, where evidence is required concerning what happened outside Austria, in such cases the Austrian tax authorities are unable to carry out the necessary investigations.
 20. These transactions are reported a new international reporting form published in 1983 which replaces six forms previously used for reporting information with respect to certain foreign corporations.
 21. On the other hand, Canada has given up the idea of introducing a special transfer price reporting system because it would be a further burden on taxpayers.
 22. Australia, Canada, the Netherlands, New Zealand, the United Kingdom and the United States.
 23. Germany finds a special difficulty in analysing the direct consequences of its subpart-F type provisions, since, almost at the same time as the Foreign Tax Law was enacted, the Federal Finance Court clarified and consolidated its decisions regarding the use of intermediary companies in tax havens.
 24. Any person who fails to supply the information requested in the annual tax return, including information with respect to foreign affiliates and controlled foreign affiliates, is liable to a penalty of 1 per cent of the tax payable, but in any event not less than \$25 or more than \$100. The penalty for failure to file a return is a fine of \$25 per day. Any person who fails to provide information as demanded by the Minister is liable to a fine of not less than \$200 and not more than \$10 000 and imprisonment for up to six months.
 25. The penalty for failure to furnish information under section 6038 is now \$1000 per incident and if the failure continues for more than 90 days after notification there are additional penalties for each subsequent 30-day period up to a maximum of \$25 000. These penalties were increased in 1982 when legislation also stipulated that, if a taxpayer does not comply with an Internal Revenue Service's demand to produce documents held outside the United States, the documents cannot be used as evidence by the taxpayer in any subsequent civil tax proceeding unless the taxpayer can show reasonable cause for non-compliance. The existence of a foreign law precluding the disclosure of information is specifically excluded as a valid reason for refusing to comply with the Service's demand for documents.
 26. Most of the offshore investment funds in operation have the same basic characteristics; the corporations are incorporated usually in Panama and purportedly located in and operate from another no-tax jurisdiction (commonly the Bahamas or Bermuda); no investor may own more than 9.9 per cent of the fund's shares; the fund pays nominal or no cash dividends or it distributes earnings via non-taxable stock dividends; the fund invests in high quality fixed income securities,

the income from which is exempt from Canadian withholding taxes; the stated investment policy or practice of the fund is to accumulate and reinvest tax free income to increase the value of the fund's shares thereby converting what is essentially interest income into capital gains in the investor's hands on redemption of his shares in the fund.

27. In January 1984, the United States Department of the Treasury published the following statistics:

"The Internal Revenue Service's criminal investigation function has identified 464 cases for the period January 1978 through August 1983. An analysis of these cases shows that:

1. Approximately 55 per cent involve illegal income (161 cases involving narcotics traffic). Of that 55 per cent, 90 per cent involve four countries: the Cayman Islands (29 per cent), Panama (28 per cent), the Bahamas (22 per cent), and the Netherlands Antilles (11 per cent).
2. The remaining 45 per cent involve legal income (91 cases involving tax shelters, 25 involving tax protesters). Of that 45 per cent, 85 per cent involve five countries: the Cayman Islands (36 per cent), the Bahamas (19 per cent), Panama (15 per cent), Bermuda (9 per cent), and the Turks and Caicos Islands (6 per cent).

The status of the 464 cases is as follows:

1. 130 are under active investigation;
2. In 153, prosecution has been recommended;
3. In 81, prosecution has been successful on various tax charges including conspiracy and Bank Secrecy Act violations; and
4. 100 have been discontinued or declined for various reasons (including 36 instances because records from tax haven jurisdictions were unavailable).

Although some of the 81 cases in which prosecution was successful did not result in an increase in taxable income, and detailed information was not available for others, at least 42 of these cases resulted in an increase in taxable income. The average increase in taxable income for these 42 cases is about \$1.7 million, ranging from a high of about \$10 million to a low of about \$20 000."

28. Gordon, R. A. (1981), Section B of Chapter VIII.
29. The United States terminated the treaty with the British Virgin Islands as of January 1983 and in July 1983 it announced that notices of termination had been sent to a number of jurisdictions to which the United Kingdom and Belgian treaties had been extended, including nine United Kingdom extension treaties in the Caribbean Basin area (the termination was to be effective as of 1st January 1984). Several of these areas are tax havens which were exploiting third-country use of their treaties with the United States. With the Netherlands Antilles, negotiations have been going on for several years on a new treaty which would deal with most forms of third-country use. The present treaty has remained in force while the negotiations have proceeded.
30. These issues are discussed more fully in the report on conduit companies in this volume and the report on base companies is also of relevance.
31. The project is a three-phase operation. First, relevant information and documentation from the widest possible sources is gathered, then it will be processed to enable maximum use of computers. The material will be reviewed, analysed and matched so as to identify potential targets for examination and then cross-checked with other enforcement and information systems. Finally, packages of information containing substantive leads to potential tax violations, criminal and non-criminal, will be prepared.

Annex I

STATISTICAL DATA INDICATING THE LEVEL OF TAX HAVEN USE

Table 1. Ratio of Foreign Assets to Merchandise Exports 1978-1982
\$ billion

	1978	1980	1982
World	0.87	0.85	1.34
Industrial countries	0.90	0.99	1.45
Oil-producing developing countries	0.10	0.10	0.22
Non-oil producing developing countries	1.27	1.00	1.73
Selected Caribbean countries			
Bahamas	46.20	24.47	36.42*
Bermuda	32.75	57.00	108.33*
Panama	61.96	91.64	114.30
United States	0.74	0.79	1.72

* Estimate.

Source: *Tax Havens in the Caribbean Basin*, U.S. Department of the Treasury, 1984.

**Table 2. Estimated Stock¹ of Direct Investment by Member Countries
of the OECD Development Assistance Committee in Developing Countries
at end-1981 by Country Groups and Selected Host Countries**

With stock – book value – exceeding \$1 billion

Group/Country		\$ Billion	Percentage share
Low Income Countries (LICs)		10.2	7
<i>of which:</i>	India	2.7	
	Zaire	1.6	
Middle Income Countries (MICs)		49.1	36
<i>of which:</i>	Bermuda*	5.5	
	Panama*	4.9	
	Bahamas*	3.8	
	Netherlands Antilles*	3.7	
	Malaysia	3.5	
	Peru	3.0	
	Philippines	2.5	
	Colombia	2.0	
	Chile	2.0	
	Liberia*	1.7	
	Trinidad and Tobago	1.3	
	Israel	1.2	
New Industrialised Countries (NICs)		55.6	41
<i>of which:</i>	Brazil	17.2	
	Mexico	10.3	
	Spain	6.9	
	Argentina	5.6	
	Singapore	3.9	
	Hong Kong	3.8	
	Taiwan	2.3	
	Korea (South)	1.6	
	Greece	1.0	
OPEC		22.3	16
<i>of which:</i>	Indonesia	8.6	
	Venezuela	4.3	
	Nigeria	1.5	
	Libya	1.2	
Europe		11.5	9
Africa		15.5	11
Latin America		71.2	52
Asia		38.4	28
Total		137.2	100

* Offshore Banking Centre.

1. Including unallocated amounts and Japanese official support for private investment.

Source: *Investing in Developing Countries*, OCDE, 1983.

Table 3. Direct Investment Flows to Selected Tax Havens
\$US Million

	1980	1981	1982	1983
<i>Direct Investment</i>				
Bermuda	1 074.4	-589.5	968.0	46.2
Panama	707.3	1 318.1	1 599.6	593.4
Bahamas	69.6	238.1	244.6	826.7
Netherlands Antilles	88.7	953.0	130.1	434.1
Liberia	316.0	530.5	363.3	-275.8
Hong Kong	878.9	1 723.0	1 155.4	1 105.0
Total	3 134.9	4 173.2	4 461.0	2 729.6
All Direct Investment to less developed countries (LDCs)	39 372.2	55 639.4	43 010.5	32 518.8
%	7.96	7.50	10.37	8.39
Less Hong Kong (%)	5.72	4.40	7.68	4.99
<i>Gross National Product (GNP)</i>				
Bermuda	700	790	820	840
Panama	3 340	3 660	4 000	3 960
Bahamas	730	780	830	900
Netherlands Antilles	1 170	1 300	1 390	n.a.
Liberia	980	960	940	970
Hong Kong	23 270	25 050	26 310	6 670
Total	30 190	32 540	34 190	
Total GNP for all LDCs	2 401 310	2 471 320	2 428 480	n.d.
%	1.25	1.31	1.40	
Without Hong Kong (%)	0.28	0.30	0.32	

Source: *Geographical Distribution of Financial Flows to Developing Countries*, OCDE, 1984.

Table 4. Japanese Direct Investment in Some Tax Haven Jurisdictions
Amounts in millions of dollars

	1951/1970	1971/1977	1978	1979	1980	1981	1982	1983
Panama	26	155	140	142	222	614	722	1 223
Hong Kong	29	527	158	225	156	329	400	563
Liberia	6	361	182	130	110	466	434	323
Bahamas	1	23	1	6	24	0	3	1
Netherlands Antilles	1	13	36	30	1	0	31	69
Cayman Islands	0	96	37	35	16	26	6	1
Bermuda	0	342	22	2	6	32	5	14
	1973(260)							
a) Total of seven tax havens	63	1 517	576	570	535	1 467	1 601	2 194
b) Total foreign direct investment	3 577	18 633	4 598	4 995	4 693	8 931	7 703	8 145
a)/b) (per cent)	1,8	8,1	12,8	11,4	11,4	16,4	20,8	26,9

Source: *Annual Report of the International Finance Bureau*, Ministry of Finance, 1985.

Annex II

AN OUTLINE OF SUBPART F-TYPE COUNTERACTING LEGISLATION

United States		
1. Short title	Foreign Personal Holding Company Provisions (1937/84), Section 551ff IRC ¹	Controlled Foreign Corporation (CFC) Subpart F Provisions (1962/84), Section 951ff IRC ¹
2. Residents chargeable	U.S. shareholders – includes U.S. citizens, residents, domestic corporations, domestic trusts and estates, and domestic partnerships	
3. Minimum holding	More than 50 per cent in value of outstanding stock is, directly or indirectly, owned by five or less U.S. individuals or residents ²	More than 50 per cent of the total combined voting power is owned, directly or indirectly, by U.S. shareholders; a U.S. shareholder owns 10 per cent or more of stock
4. Low taxation	Applies regardless of tax rate of country of incorporation; however, exclusions and special rules for exceptions apply	
5. Income attributable to shareholders	– Dividends, interest, annuities, royalties – Stock and security transactions – Commodity transactions – Personal services contracts – Use of corporate property – Rents – Income from estates and trusts	– Foreign personal holding company income – Sales income – Services income – Shipping income – Oil related income – Income from insurance risks – International boycott income – Illegal bribes, kickbacks or other payments to government officials or agents – Increase in earnings invested in U.S. property
6. Situation when dividends are paid out of accumulated income already taxed under Subpart F-type legislation	If an actual dividend is paid, a foreign corporation may deduct the dividend in computing undistributed income	Excluded from the gross income of the shareholder i.e. not subjected to tax
1. If income is taxable under both provisions, taxation is governed by subpart F provisions for tax years of U.S. shareholders beginning after July 18, 1984. 2. In addition to the shareholders requirement, for a foreign corporation to be classified as a foreign personal holding company, at least 60 per cent of its gross income must be foreign personal holding company income as indicated under "Income attributable to shareholders". In general, for subsequent years, the gross income requirement becomes 50 per cent.		

Annex II (cont'd)

	Germany	Canada
1. Short title	Taxation of foreign "intermediate" companies Foreign Tax Law (1972) Sections 7-14 (AStG)	The "foreign accrual property income" or "FAPI" and "offshore mutual" rules
2. Residents chargeable	Individuals and corporate bodies	The FAPI and offshore mutual rules apply to individuals, trusts and corporations
3. Minimum holding	Over 50 per cent of shares or voting rights must be held by resident taxpayers (or emigrants in the sense of Section 2 AStG)	Control of foreign company results in accrual taxation of FAPI. Holdings between 10 and more than 50 per cent result in taxation of FAPI when it is repatriated. Holdings in foreign corporations of 10 per cent or more are subject to Canada's foreign affiliate rules for taxation of dividends received. Offshore mutual: no minimum
4. Low taxation	Tax levied by country of establishment less than 30 per cent of intermediate income tax	Canadian taxation applies regardless of the level of tax in the country of establishment
5. Income attributable to shareholders	List of active income categories which are not subject to this legislation. Passive income is primarily: - Dividends, interest or licensing fees, where no specific connections with genuine foreign activities exist - Low-activity trading (proof of activity required) - Low-activity provision of services (proof of activity necessary) - Other asset-holding and management	All types of income set out in a list and in particular: - Income from property - Non-active business income - One-half of capital gains from sales of non-active business assets - Offshore mutuals: specified rate of interest is applied to the cost of investment and the resulting amount is included income.
6. Situation when dividends are paid out of accumulated income already taxed under Subpart F-type legislation	Tax paid on dividends in previous four years is reimbursed	Dividends may be deducted from shareholder's taxable income. Source countries' taxation (corporate) reduces the amount of income taxed on an accrual basis before dividend received. Source country's taxation (withholding) reduces the amount of income taxed in the year the dividend is paid. Offshore mutuals: dividends received on those holdings in Canada reduce the amount described in Item 3.

Annex II (cont'd)

	Japan	France	United Kingdom
1. Short title	Taxation of the income retained by "Special foreign subsidiaries" - Special Taxation Measures Law of 31st March 1978 (revised in 1985)	Special regulation regarding base companies in Article 209B of CGI brought in with the Act of 18th January 1980	Imputation of chargeable profits and creditable tax of controlled foreign companies (CFCs): Finance Act 1984, Chapter VI
2. Residents chargeable	Individuals and corporations	Entities liable to corporation tax only	Companies only
3. Minimum holding	Over 50 per cent must be held by resident taxpayers. Shareholdings of under 10 per cent are in principle not liable to taxation	Over 25 per cent direct or indirect holdings of a French company in a company in a low-tax country	Only foreign companies controlled by United Kingdom residents (companies or individuals) can be CFCs. A charge may only be made, however, where 10 per cent or more of the CFC's chargeable profits can be apportioned to a company and its associates
4. Low taxation	Countries with "substantially lower taxation than Japan" (government publishes an exhaustive list of areas designated as tax havens)	General definition is 2/3 of French tax rate test in practice	If tax payable in the foreign territory of residence is less than 50 per cent of the corresponding United Kingdom tax (Government publishes non-exhaustive non-tax haven list)
5. Income attributable to shareholders	All types of retained income where no proof of activity is produced, such proof includes: - The running of a business with its own management; - In the case of wholesale, banking, trust, securities business, insurance shipping or air transport the principal part of their activities must be conducted with non-related persons; other businesses must conduct the principal part of their activities within the country in which the foreign subsidiary is located; - The foreign subsidiary must not have as its principal business activity: a) The holding of stocks and bonds, b) The provision of industrial, property rights, or copy-rights, etc., or c) The leasing of ships or aircraft	Applies in all cases where no proof is given that the activity of the company in the low-tax country is not aimed primarily at the transfer of profits. Sufficient evidence would be that the foreign company is effectively engaged in trade or business activities and carries on its business mainly in the local market or with third parties	The provisions apply by reference to the main business of a CFC, not by reference to particular types of income received. If there is sufficient physical presence in the territory of residence and the main business is not one of the following, no charge can arise: a) Holding securities, patents or copyrights; b) Dealing in securities; c) Leasing of any property or rights; d) Investment of funds which would otherwise be available for investment by associates; e) Dealing in goods involving the UK or associated persons; f) Dealing in any goods as wholesaler rather than retailer; g) Shipping or air transport; h) Banking or similar business; i) Administration of trusts; j) Dealing in commodity or financial futures; k) Insurance business
6. Situation when dividends are paid out of accumulated income already taxed under Subpart F-type legislation	Dividends are deductible up to the level of the amounts imputed over the previous five years	Dividends are deductible from the French company's results up to the level of the (reconstructed) income liable to corporation tax	The charge made in respect of the CFC's profits is treated as (added to) underlying tax and credit given accordingly against the tax on the dividend

DOUBLE TAXATION CONVENTIONS AND THE USE OF BASE COMPANIES

I. THE PROBLEM STATED

A. Base companies

1. For a number of years taxpayers have made increasing use of so-called “base companies”. Such companies, which are predominantly situated in low-tax countries, are used for the purposes of sheltering income there and thus reducing taxes in the home country of the taxpayer. This report examines how these tax advantages operate, the measures taken by various countries to combat such devices and safeguard the equity and neutrality of their tax systems and the international implications of these measures, especially with reference to double taxation conventions. It is clear that the problem of “base companies” should be seen against the background of the overall tax system in the country concerned. Thus, as discussed in paragraph 13 et seq. of the Introduction to this volume, the concept of neutrality may have a different meaning when applied to income in respect of which the country of residence operates a credit mechanism than when applied to income in respect of which an exemption mechanism is operated by the residence country.

2. Possibilities for international tax avoidance may be opened up by certain features of domestic tax laws. Double taxation conventions – the positive aspects of which are recognised – may, as a side effect, increase these possibilities. The same tax effects may, under certain circumstances, be the result of features in domestic laws, while, under other circumstances, they will result from tax treaties. Similarly, counteracting measures may be taken either under domestic law or under a tax treaty.

B. Relevant considerations

3. With regard to the frame of reference of this report three points should be kept in mind.

1. Relationship to other issues

4. The main issue dealt with in this report is the compatibility of domestic anti-abuse measures with, and their consequences for, the existing system of international tax relations. The OECD Model Convention which sets internationally-accepted standards in this field is used as a yard-stick. The report should also be considered in connection with the general framework of OECD activities on the improper use of tax treaties and in particular the work on “conduit” companies, which constitutes the next report in this volume. The “conduit company” concept is focused on tax advantages to be secured in the country of source of the sheltered income, whereas the “base company” is concerned with minimisation of tax in the country of residence of its controllers. Often the same corporate structure is designed to achieve both of these results and in those cases the problems can be regarded as different sides of the same coin.

5. The subject of this report is also related to the problem of international tax avoidance and evasion through the use of tax havens, a matter dealt with separately in the previous report in this volume. The emphasis of the present report, however, is on the implications for double taxation conventions.

2. *Economic aspects*

6. This report does not deal with the economic merits or demerits of base companies. Although there may be in some cases valid economic reasons or personal motives for making use of base companies, in practice, they are often used primarily for the purpose of reducing taxes chargeable to the person using the device. There are even instances where the wish to facilitate or to veil criminal activities is one of the motives behind the tax-saving arrangement. Whatever the main motive, where a tax advantage is obtained by using base companies the question arises whether, and to what extent, that advantage should be eliminated to ensure equity and neutrality of taxation in a country whose taxpayers make use of such companies.

3. *Territorial aspects ("tax havens")*

7. As noted above, the concept of base companies is often related to so-called "tax-haven countries". Even though a territorial clustering of base companies in such countries evidently occurs, base companies may also be found in so-called high-tax countries, either because the taxation there is acceptable for the taxpayers concerned due to the respective effective rates of tax in the country of the base company and in the country of their residence, or to advantages taken of special regimes or to the unintended consequences of domestic tax laws. This point is illustrated by the use of so-called "stepping-stone strategies", where income is sheltered in a low tax country and then channelled through a high-tax country to its final destination, the real origin of the income being concealed from the tax authorities of the latter.

C. Terminology

8. Terms such as "base company", "passive income" and "low taxation" are used throughout this report and typically encountered in discussions on this topic. However, no definitions of these terms are put forward in the report because they are flexible and relative notions depending upon the facts of particular cases and the policy attitudes in the taxing jurisdiction. The schematic presentation of typical situations given in Annex I and the description of legislation in six countries and the examples in the text should be sufficient to provide an understanding of the concepts involved. The following abbreviations are used in this report:

<i>Country of</i>	<i>Referred to as:</i>	<i>Abbreviation</i>
Residence of a base company's shareholder	Residence country	R
Residence of the base company itself	Base country	B
Source of the base company's income	Source country	S

II. ANALYSIS OF FUNCTIONS AND USES OF A "BASE COMPANY"

A. Sheltering of income

9. For tax purposes, the most important function of a base company is to collect income which otherwise would flow directly to the taxpayer. The taxpayer, therefore, does not normally become liable to tax on the income received by the base company, though economically he is entitled to such income and may well be able to direct its disposition. Thus, in the absence of counteracting measures, the base company would be able to shelter in a low tax jurisdiction such income from taxation in the taxpayer's residence country.

1. *Primary sheltering*

10. Initially, the income is sheltered from taxation in the taxpayer's country of residence by the mere fact that the base company is an entity of its own and is recognized as such in the residence country. By shifting the respective income from the taxpayer to the base company it is no longer covered by the normal taxation of world income to which the taxpayer is subject in most countries. This advantage is not offset by taxation in the country of the base company, since by carefully choosing the place of incorporation and arranging the affairs of the base company, the latter is subject to no tax or a very modest tax there. It is true that income may be taxed in the country of source (which may well be the same as the taxpayer's country of residence) under a "limited tax liability" criterion. But for a number of reasons this taxation is often non-existent or very low with respect to the type of income which is selected by taxpayers for sheltering in base companies as noted in the next report in this volume on "conduit" companies. Important net savings of taxes may accordingly result.

11. The tax advantage exists only as long as the sheltered income is not distributed. Taxpayers, therefore, often claim that this is merely a tax deferral. As the taxpayer may avoid such distributions by deferring them indefinitely and as strategies against their taxation can often be successfully deployed (cf. paragraph 12 below), the tax advantage may, in practice, be frequently equivalent to a permanent one.

2. *Secondary sheltering*

12. When income sheltered in a base company is distributed or otherwise transferred to the taxpayer it becomes taxable, usually as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided or reduced by "secondary sheltering". The main strategies are:

- Distribution as income of a type which is tax-exempt, the exemption being granted under tax treaties or specific domestic rules (director fees, salaries, dividends distributed by a subsidiary to its parent where an affiliation exemption applies in the latter's country);
- Reinvestment abroad of income sheltered in the base company or ploughing back as a loan to the shareholder company;
- Alienation of the capital holding in the base company, with the shareholder thereby realising a gain which is tax exempt or taxable at reduced tax rates.

Secondary sheltering is dealt with specifically in Part VI of this report.

B. Types of base companies

13. Base companies may be classified under different criteria. The following represents one possible classification.

1. Asset administration

14. This is the most common type of base company: the taxpayer transfers an income-generating assets to the company, thus sheltering from tax in the country of residence the income arising from those assets.

Example 1:

T, resident in country R, owns shares and debentures which he transfers to a base company in country B. The base company uses the sheltered income to buy other assets of the same kind.

Example 2:

T has developed a new product. It is patented in favour of a base company in country B which gives licences to third parties in countries S 1, S 2, S 3 and shelters the income arising from them (or lends it to T against the payment of interest which is deducted from T's taxable profits).

2. Financial pivots

15. Some base companies are used to form financial pivots for broad international activities. This usually concerns holding companies, e.g. the regional centres for multinational enterprises, and companies formed to issue loans or to centralise similar activities. Companies of this kind may also centralise banking or insurance activities and it may then be doubtful whether one can still regard them as "base companies" receiving passive income.

Example 3:

A multinational enterprise based in country R holds its participation in South America through a holding company set up in country B which is also the pivot for the whole intra-group financial relationships with respect to the area. A second base company in the Bahamas issues international loans and pays interest on them free of withholding tax.

Example 4:

A multinational enterprise centralises its insurance contracts in an "off-shore" captive corporation, which insures the risks within the group and covers them by reinsurance contracts.

3. Operational base companies

16. Base companies of this kind are used in connection with business or professional activities some of which are carried on outside the country where they have been set up. Thus, the base company "feeds" on the profits derived from these activities exercised elsewhere, so that the income derived can at least partly be sheltered in the base company.

Example 5:

T carries on an enterprise producing cars in country R and selling them in countries S 1, S 2, S 3. The cars are sold to wholesalers in these countries or in others via a base company set up in country B which acts as a sales company and shelters part of the income.

Example 6:

An artiste acts as an employee of a base company owned by himself ("rent-a-star"). The base company thus "feeds" on his professional income (the artiste receives only a relatively small salary) and shelters it.

Where operational base companies are used, the consequences of the avoidance devices are frequently aggravated by the manipulation of transfer prices.

4. Other types of base companies

17. Other types of base companies may be used for the purpose of channelling income only, for hiding activities or for other purposes (cf. for example the following report on the use of conduit companies).

III. COUNTERACTING MEASURES IN NATIONAL TAX LAWS

Preliminary remarks

18. There are two different approaches that national tax laws may take with respect to base companies. Adequate taxation may be sought:

- In the context of taxation of world-wide income in the State where the taxpayer is resident ("taxation from the top"), or;
- In the context of territorial taxation in the country of origin of the base company's income ("taxation from below").

Annex I gives a schematic presentation of the situation.

19. It has often been claimed that "taxation from below" is the appropriate response to the base company problem. Experience of the major States concerned has shown, however, that while adequate "taxation from below" is indispensable, legislative measures "from the top" are also necessary. This report deals only with the "measures from the top" of the taxpayer's country of residence. The problems of "taxation from below" are dealt with in the following report on conduit companies.

A. General surveillance measures

20. Under this heading two main groups of rules may be mentioned.

a) Transfer pricing

Transfer pricing is the subject of special provisions in most domestic tax laws. It is also covered by Article 9 of the OECD Model, and thoroughly treated in the 1979 and 1984 OECD reports on the topic. Transfer pricing rules are necessary to prevent income from being shifted artificially to base companies, especially in the case of operational companies. However, the arm's-length rules may not always be sufficient to prevent income shifting, as for instance, in the case of asset administration. Furthermore, problems which are difficult to solve may arise where the activities of the base company cannot clearly be ascertained or evaluated. This may be because there is a complex and intricate relationship

between that company and an enterprise of the taxpayer or because the company is allegedly carrying on a real economic activity which it cannot effectively sustain given the limited scope of its actual activities or resources (cf. paragraphs 47-49 and 92-98 of the preceding report on tax havens);

b) Special procedural rules

Tax laws may impose special information requirements on taxpayers operating in foreign countries. More far-reaching requirements may be applied to taxpayers relationships with companies having the characteristics of a base company. In some States the burden of proof is shifted to the taxpayer in such cases (see paragraphs 86-91 of the preceding report on tax havens).

B. "Substance-over-form" provisions

21. Substance-over-form provisions and courts' attitudes to them are discussed in paragraphs 52-54 and 81-85 of the preceding report on tax havens. In the context of this report it is noted that they are generally – but not exclusively – applied in the context of "taxation from the top" and reflect one of the following approaches:

- a) The legal personality of the base company may be disregarded;
- b) The base company may be regarded as a resident in the taxpayer's country, e.g. because its place of effective or central management is situated there;
- c) The base company may be deemed to have a permanent establishment in the taxpayer's country of residence, e.g. because it has a place of management there;
- d) The sheltering of the income may be disregarded, i.e. the activity of the base company or the income derived from it may be regarded as an activity or as income of the taxpayer himself.

22. These approaches presuppose that the economic reality of the base company and its economic motives can be fully evaluated. In the view of some countries this is very difficult, especially in the absence of any exchange of information with the country where the base company is situated. Other countries, however, (e.g. the Netherlands) which have quite general legal provisions and/or case law which permit the application of substance over form, are of the opinion that they are able to effectively combat tax avoidance through base companies. Even in cases where there is no exchange of information with the base country, it may be possible for the tax authorities of the residence country to determine the reality of the base company's operations when, under the residence country's rules, the taxpayer has the burden of proving that the base company carries on real economic activities. One advantage of this approach may be that overreaction can be better avoided by applying substance over form on a case by case basis than by introducing generally-applicable and complicated counteracting measures.

C. Subpart-F type counteracting legislation

1. General

23. As outlined in paragraphs 62-64 of the report on tax havens, several countries have adopted specific legislation against the sheltering of income in low-taxed base companies

situated abroad. Such legislation provides that, under certain conditions, a resident shareholder (e.g. a parent company) may be taxed on the profits of a foreign-controlled company which are not distributed to the shareholder (the term "subpart-F type" defence legislation, as used in this report, refers to provisions of that type). Such legislation is not normally applicable where base companies are made use of for non-tax reasons, i.e. where their use is fully justified on purely economic grounds.

2. Taxation of sheltered income in the hands of the resident taxpayer

24. Counteracting legislation provides for the taxation of the resident shareholder on the income sheltered in the base company which he controls. The base company itself seems in no case to be subjected to tax or obligations connected therewith. The shareholder's taxation rests on the assumption that the sheltered income is deemed:

- i) To be distributed ("fictive dividend" approach); or
- ii) To have arisen in the hands of the shareholder, i.e. that the company's activities are to be attributed to him ("piercing the veil" approach); or
- iii) To have improved the ability of the shareholder to pay taxes because economically it is at his disposal, thus constituting a capital yield of a special nature.

In practice counteracting legislation seems to have proceeded in a pragmatic way rather than by following rigidly any one of these theoretical approaches.

3. Relevant technical aspects

25. Only a few characteristics of the extremely technical provisions can be mentioned here:

- i) Generally counteracting legislation aims at a level of taxation which is no more burdensome than if the sheltered income had arisen directly to the taxable shareholder;
- ii) Specific problems arise with respect to dividends distributed by the base company to its shareholders; in these cases counteracting legislation prevents an internal double taxation (namely as income sheltered and as a dividend);
- iii) Taxes levied on the sheltered income, whether in the country of source or in the country of the base company, are usually credited;
- iv) All such legislation aims at covering base companies held indirectly (e.g. through a chain of base companies), though these often highly-technical provisions have to vary widely between countries;
- v) Further problems concern the treatment of pure holding companies, and of companies with both active and passive income.

4. International implications

26. States with a counteracting legislation evidently regard the effects of base companies as unbalancing the equity and neutrality of their tax systems. Tax advantages obtained through such companies seem improper to them, even if they are used for valid reasons or understandable motives. Opinions about what is improper or not may differ. Counteracting measures nevertheless have to respect the general principles underlying the OECD Model Convention, as discussed further in paragraphs 47 and 48.

IV. IMPLICATIONS OF A CONVENTION BETWEEN THE STATE OF THE TAXPAYER AND THE STATE OF THE BASE COMPANY

A. Treaty implications of general surveillance measures

1. *Transfer pricing*

27. Article 9 of the OECD Model Convention applies to relationships between the taxpayer and the base company. Therefore, transfer prices which differ from those which would be agreed upon between unrelated parties may be adjusted under that provision.

28. The considerations to be taken into account in this examination do not differ basically from those to be taken into account in other cases, so that the principles set out in the 1979 OECD report "Transfer Pricing and Multinational Enterprises" are valid in these cases. The actual economic function of the base company has to be carefully analysed (paragraph 17 of the 1979 report). The mere fact that the base company is able to shelter its profits under a low tax systems would, in any case, not lead independent parties to concede price advantages to it. Thus, its actual activities, risks and responsibilities have to be ascertained. Where the base company has no economic functions of its own but serves exclusively to channel assets to, or income through, a low tax area, it would normally not be able to realise profits in acting between independent parties and this would be the guideline in examining its transfer prices. No, or only a minimal, profit might thus be expected to arise to a base company in a low-tax country formally acting as a seller of merchandise produced by the taxpayer to customers outside that country, if the company actually does not carry out the delivery or other substantial commercial activities (paragraph 59 of the 1979 report). A base company with limited functions, responsibilities or risks corresponding to that of a broker, standby or subcontractor could, if acting between independent parties, obtain a profit only for its actual economic contribution and its transfer prices would normally be examined on a cost-oriented basis (e.g. based on a fee or on the cost-plus method). This basis would normally apply where mere marginal or auxiliary activities are exercised by the base company; where such arrangements do not correspond to normal business practice, no additional profit could be attributed to the base company by reference to what, under normal circumstances, would be the exercise of sound commercial judgement, or by reference to a specific allocation mechanism, e.g. the centering of cost-sharing arrangements in the base company.

2. *Special procedural rules*

29. The question arises whether special procedural rules are consistent with Article 9 (Associated enterprises) and Article 24 (Non-discrimination) of the OECD Model Convention:

a) Procedural rules and transfer pricing

30. As noted in paragraph 25 of the 1979 OECD report, transactions between related parties should be supported by relevant documentation. It is clear from the report that this applies in a specific way to arrangements aiming at minimizing taxes in low tax areas. In this context it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes to be found in the context of national laws on base companies are

contrary to the arm's-length principle. These questions are not confined to base company situations, and have to be considered in a wider context. It should be noted, however, that a number of countries interpret Article 9 in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of that Article and that it has the function of raising the arm's-length principle at treaty level, thus enabling the Contracting States to deal with it under mutual agreement procedures and to give rise to corresponding adjustments. This is a topic dealt with in the 1984 OECD report on transfer pricing (see bibliography to this volume) and which might be reconsidered again by the Committee on Fiscal Affairs at some later date.

b) Procedural rules and non-discrimination

31. Even if the country of residence of the taxpayer imposes information requirements on him in respect of his relationship with the base company which are more stringent than the normal requirements, or even if the burden of proof is reversed in this respect, Member countries, subject to one dissenting view, consider that there is no discrimination within the meaning of Article 24 of the OECD Model. First of all, the different treatment is not based on nationality (cf. paragraphs 1 and 3 of Article 24). Secondly, the different treatment does not depend on whether or not the taxpayer is controlled by a non-resident (cf. paragraphs 4 to 6 of Article 24). In addition the circumstances under which the information requirements are imposed are not "the same" within the meaning of Article 24, because it follows from the very nature of foreign relationships which cannot be explored effectively by the national tax authorities that information requirements have to be more burdensome than for the purely domestic context. However, if applied indiscriminately to all situations (including non-tax havens), these requirements could constitute an obstacle to international investment.

3. Conclusions

32. It appears then that general surveillance measures are not curtailed by a tax treaty between the country of residence of the taxpayer and the country of the base company. The internationally agreed principles of the 1979 OECD report on "Transfer Pricing and Multinational Enterprises" provide valid guidelines for an effective application of the arm's-length principle in the case of base companies. In any future revision of the OECD Model Convention this aspect might however be stressed in the Commentaries on Article 9.

33. On the other hand, general surveillance measures may lead to differences in applying the Convention. Any such difficulties should be solved in accordance with the mutual agreement procedure as set out in Article 25 of the Model Convention.

B. Treaty implications of "substance-over-form" provisions

1. The concept of person

34. Normally the base company will be regarded as a person (cf. Article 3 of the OECD Model) if it has been set up according to the laws of a given country. There may be specific situations in which a base company has to be treated as non-existent, e.g. because:

- The treaty exceptionally does not treat it as a company; or

- It has to be denied legal personality under the rules of international private law; or
- The act of setting-up the base company is invalidated in itself under the laws of the country where it is established.

Leaving aside these very special situations, the base company cannot be treated as non-existent under the Convention. The question however arises of whether or not the company is a resident of the low-tax country where it has been set up.

2. *Definition of residence*

35. For treaty purposes a company is a resident of the Contracting State in which its place of effective management is found, and this is so irrespective of where its place of incorporation is situated (cf. paragraphs 1 and 3 of Article 4 of the OECD Model). The country of residence of the taxpayer could therefore tax the income of the base company if the place of effective management were situated there. This will sometimes be the case in practice. On the other hand, deeming under national law that the place of effective management is situated in the taxpayer's country would not overrule the provisions of the Convention.

36. Article 4, paragraph 1, second sentence of the OECD Model, excludes from the term "resident of a Contracting State" any person who is "liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein". This exclusion relates clearly to specific privileges granted by reason of the international relations of a person and gives such a person in effect the status of a non-resident rather than that of a resident. The Commentaries on the OECD Model give as an example the case of certain diplomatic personnel. The exclusion would, nevertheless, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income by privileges tailored to attract base companies. There are, however, difficulties inherent in this approach which are discussed in paragraph 14 of the following report on conduit companies.

3. *Permanent establishment of the base company*

37. While the place of effective management is normally situated in the country where the base company has been set up, it could be questioned whether or not a permanent establishment of the base company is situated in the taxpayer's country of residence, thus enabling that country to tax the income attributable to the permanent establishment, for example, because it has a place of management there [cf. Article 5, paragraph 2 (a) of the OECD Model]. This is a question of fact but it also involves difficult problems of interpreting these provisions. Here again, the use of a deeming provision under the national law of that country would not suffice if there is no factual basis for recognising a permanent establishment. Even if a permanent establishment in the form of a place of management were present, it has to be kept in mind that the tax regime of a permanent establishment differs to a large extent from that of a company having its place of effective management in the country. Only profits attributable to the permanent establishment are taxed. Sometimes, there are different tax rates, taxation of distribution is differently effected, etc.

4. *Attribution of activities and/or income*

38. While recognising that the base company as a legal entity has its place of effective management in the country where it has been set up and does not have a permanent

establishment in the country of residence of the taxpayer, the latter country could at least, under its national tax law, attribute to the taxpayers the activities and/or the income of the base company. This approach would clearly not be contrary to the OECD Model if the base company acted as a mere intermediary, an agent, a fiduciary or nominee of the taxpayer (cf. for example, the notion of beneficial owner in Articles 10 to 12 of the OECD Model). However the question arises as to whether, quite generally, domestic rules as to who is regarded as the recipient of specific income for tax purposes are compatible with treaties. This question especially arises in the case of "anti-abuse" or "substance-over-form" rules according to which it is not the base company itself but its shareholder, who is regarded as the true recipient of the income shifted to the base company.

39. The large majority of OECD Member countries consider that rules of this kind are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity and/or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (cf. Article 9, paragraph 2). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.

40. It is not easy to reconcile these divergent opinions in theory, nor in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. On the dissenting view, to give domestic rules precedence over treaty rules as to whom, for tax purposes, is regarded as the recipient would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable. The problems arising here are very similar to those arising in the case of specific counteracting measures (see paragraph 47 below).

5. *Conclusions*

41. Tax treaties set limitations to technical rules though these limits are not very well defined. Furthermore, there are certain doubts as to their implications for the "substance-over-form" provisions. This adds to the well known practical difficulties of implementing national provisions of this type. Further clarification therefore seems to be necessary. In any case, where States feel that difficulties might arise in this area, they would try to settle them by inserting specific safeguards in their bilateral treaties.

42. A certain danger remains that technical and "substance-over-form" provisions could lead to double taxation even where a convention exists. Therefore, States applying provisions of this type should endeavour to alleviate any such double taxation in accordance with the letter and if possible with the spirit of their double taxation treaties.

C. Treaty implications of counteracting measures

1. General outline of the problem

43. Under existing counteracting measures, the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base company usually protects, however, income flows only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty.

44. This attitude has sometimes been challenged as being contrary to the general structure and the spirit of tax treaties, except where a specific saving clause acknowledges the counteracting measures. It is said that counteracting measures implicitly disregard the company as a person, which is contrary to the treaty (cf. paragraph 34 above).

45. There seems to be several answers to that contention:

- a) On the technical level, counteracting measures can attribute activities – and thus income – to a shareholder, which is not contrary to tax treaties (cf. paragraph 40 above). If the counteracting measures have the effect of taxing a deemed dividend of the base company, this is well within the taxing rights conferred on the taxpayer's country of residence under the rules of tax treaties regarding taxation of dividends (cf. Articles 10, 23A and 23B of the OECD Model);
- b) On the tax policy level, counteracting measures pierce only the “umbrella effect” of the taxpayers' arrangements. This effect and the consequent possibilities for an indefinite deferral are not guaranteed by tax treaties which were never intended to prohibit national safeguards for the equity and neutrality of a country's tax law;
- c) On the international level, as long as some countries regard it as a sovereign right to shape their fiscal system in a way which might negatively affect other countries, tax authorities in these other countries must safeguard their sovereign right to preserve the equity and neutrality of their tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems.

46. It is evident that these are the views of States adopting counteracting measures and a very large majority of OECD Member countries have supported them. However, while counteracting measures as described above are not inconsistent with the spirit of tax treaties, there is agreement that Member countries should carefully observe the specific obligations clearly evidenced in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be adequate to grant him the protection which the treaty network would have provided if the taxpayer had not used the base company.

47. Whilst the majority of OECD Member countries thus accepts counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, it firmly adds that

such measures should be used only for this purpose. It would be contrary to the general principles underlying the OECD Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer. It is also of relevance that a country's willingness to co-operate effectively with other tax administrations will normally be a strong deterrent to use base companies in that country.

48. However, there is no easy way of drawing clear-cut rules from these guidelines. An international consensus should be established, to which States newly introducing counter-acting measures might refer. In this respect, the OECD Committee on Fiscal Affairs has played and could continue to play a role which would be helpful, vis-à-vis both Member countries which already apply counteracting measures or are considering adopting measures of this kind, and those Member countries which view such measures taken in other countries as infringing their own tax sovereignty, or going against their tax policy or being contrary to international commitments. The Committee would accordingly appear to constitute the appropriate forum for discussion of such policy issues.

2. Paragraph 5 of Article 10 of the OECD Model

49. It might be argued that where the taxpayer's country of residence, pursuant to its counteracting measures, seeks to tax profits which have not been distributed it is acting contrary to the provisions of paragraph 5 of Article 10. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under a counteracting legislation. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

3. Treatment of the taxable amount

50. The appropriate treatment of the taxable amount under a tax convention between the country of the base company and the country of the taxpayer depends on how the relevant counteracting legislation is regarded. If it attributes the activities or the income of the base company to the taxpayer, one has to look to the composition of the income; it may be composed of different items of income (business profits, interest and royalties) derived from the country of the base company or from any other country and the provisions that are relevant for these items have then to be applied. If the taxable amount is, however, a deemed dividend or a particular capital yield, it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 of the OECD Model or as other income within the meaning of Article 21 of the OECD Model. At least under some counteracting measures the taxable amount is treated as a dividend with the result that an exemption, provided for by a tax convention, e.g. an affiliation exemption, is also extended to it (for instance, in Germany). It is doubtful whether the treaty requires this to be done. If the country of residence considers that this is not the case – and consequently refuses the affiliation exemption for “deemed dividends” – it may face the allegation that it is obstructing the normal operation of the affiliation exemption, by taxing the dividend (in the form of “deemed dividend”) in advance.

4. Treatment of dividend distributions of the base company

51. Where dividends are actually distributed by the base company the provisions of a bilateral Convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the Convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (i.e. tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under counteracting legislation. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the counteracting legislation and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under a counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the counteracting measures and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (e.g. time lapsed since the taxation of the "deemed dividend").

V. IMPLICATIONS OF CONVENTIONS WITH THIRD STATES

52. Base companies often shelter third country income. There exists no apparent tax-relevant relationship between the country of source (S) and the home country (R) of the taxpayer as long as the latter does not take protective measures. Only when that country recoups its taxation in ways described in Chapter III, does its system have an effect on taxation in country S. By doing so, country R may in specific situations even produce effects of tax significance for other countries (cf. subchapter C below). The present chapter deals with the relevance and implications of such relationships for taxation.

A. Third country income: basic approaches

53. In the case of third country income, the following problems may arise.

- a) In the absence of a treaty between country R and country S, should country R allow a credit for the taxes which are imposed by country S?
- b) Where a tax treaty exists between these two countries:
 - i) Should country S limit its taxation under the treaty provision?
 - ii) Should country R credit the taxes of country S and, if so, should it credit the full amount or only the amount due under treaty limitations?
 - iii) Should country R exempt income if the treaty provides for such an exemption in case of direct flows of income from country S?

54. It seems clear that the answer in each case should normally be negative as, from a legal point of view, it is assumed that two separate relationships exist between countries S

and B on the one hand, and between countries B and R on the other hand, and the base company's own separate entity prevents any direct tax relationship between country S and country R. The answer would be positive only if a tax-relevant direct relationship existed between those two countries.

55. Whether a tax-relevant relationship exists between country S and country R depends on how the legislative measures in country R are legally construed. Basic situations may be illustrated by three examples.

Example A:

Country R regards the base company as a resident because, under its domestic law, that company has a place of central management there. Country R thus treats the base company as any other resident. Consistently, the companies' dealings with country S should be treated as any other direct relationship, so that double taxation reliefs available in R domestically or under the treaty between S and R have to be granted. Treaty protection should also be given by country S since it depends (under Article 4 of the OECD Model) only on the law of country R whether the base company is a resident thereof for the purposes of the treaty and falls, consequently, under its personal scope (Article 1 of the OECD Model).

Example B:

Country R regards the base company as a foreign resident. However, it considers, under its national tax law, income sheltered in the base company to be income arising directly to its resident shareholder (e.g. by a substance-over-form approach). Again, viewed from country R, there is a direct relationship because one of its residents receives income from country S. Country R will, therefore, grant relief against double taxation which is available domestically or under its treaty with country S. The situation may, however, be viewed quite differently by country S which may maintain that, according to its law, the income was received by the base company and that seizure of that income by country R cannot change this. In fact, if country R allocates, under its domestic law, income to the resident shareholder, it does not, under the OECD Model, automatically follow that the income is covered by the treaty as country S may allocate the income, independently, on the basis of its own domestic law (with the exception mentioned in paragraph 58 below).

Example C:

Country R has a counteracting legislation under which the income of the base company is deemed to be distributed to the shareholder resident in country R at the time when it accrues to that company. From a legal point of view, there then exists no tax-relevant relationship between country S and country R. The base company is recognised by both countries as a resident of country B and as recipient of the income, and this bars any direct relationship between countries S and R. Neither country would, therefore, grant domestic or treaty protection against double taxation.

56. Even though the situation may be very similar in all three cases from an economic point of view, i.e. income sheltered in a tax haven has been recouped by country R, the relationship between country R and country S depends on the specific kind of counteracting measures in country R and varies, therefore, from one example to another. It may seem adequate to take into account in some way the taxation in country S and treaty relationships

with that country. This is suggested, *inter alia*, by the fact that the tax administration of country R will frequently be dependent, for the implementation of its counteracting measures, on co-operation with the tax administration of country S on the basis of the treaty between these countries. This may be a reason why even countries with legislation of the kind referred to in Example C above often on their own account grant their taxpayers the benefits of treaties with source countries, though they would not formally be obliged to do so.

B. Third country income: conclusions and recommendations

1. Credit in the country of residence for foreign taxes paid at source

57. Tax authorities – and especially, subject to one dissenting view, those of countries which apply “subpart F” type defensive provisions – concur with the view that country R should credit in all cases the taxes of country S where this is provided for generally by its domestic law or by its treaties in case of direct flows of income from country S. This is evidently based less on technical or legal considerations than on the acceptance of a general principle. As set out in paragraphs 46-48 of this report, counteracting measures should comply with the spirit of international tax law by seeking to avoid double taxation. To follow this in the relationship between country R and country S should be generally encouraged.

2. Limitation of source taxation under double taxation treaties

58. As a general principle, it cannot be accepted that the source country is obliged to waive or reduce its tax under a treaty with the country of residence. Such an obligation would result clearly from the OECD Model only where the base company is resident in country R by the criteria of Article 4. Whether this is the case will often be difficult to ascertain, and Contracting States will normally need a mutual agreement procedure to make the necessary findings. It would not be acceptable, for instance, that the base company itself asks for some reduction of S’s tax under the convention between S and R without showing that it is treated as a resident of country R.

59. In all other cases, the country of source will normally treat the income in question as income of the base company itself. There is, then, no basis in the treaty between country R and country S for the base company to claim a limitation of source taxation. It may, of course, happen that pursuant to country S’s domestic law it is possible to allocate income under a “substance-over-form” approach to a person other than the one formally receiving it. Country S, however, may well argue that such approaches are designed to combat the avoidance of taxes of its own country. In the present context, however, treaty application would not serve to counteract tax avoidance in the country of source but to protect country R’s revenue or the interests of its taxpayers.

3. Amount of credit to be granted in the country of residence

60. It has been argued above that country R should, according to its domestic law, credit the taxes of country S in the same way as it would credit taxes levied at source on direct flows of income (cf. paragraph 57); there are even more reasons for doing so where a treaty exists between country S and country R. It may, however, occur that taxation at source levied by country S is relieved or reduced under such convention in the case of income arising directly to a resident of country R. Would country R then be entitled to deny its credit or limit its

amount of tax to treaty levels? The answer, in principle, should be in the negative as the source country is normally not obliged to relieve or reduce its tax (cf. paragraph 58 above). Where, in specific cases, country R and country S agree that source taxation on the base company income should be limited under the treaty between them, this would of course affect the credit granted in country R. The tax authorities of country R may also reasonably expect the taxpayer to take advantage of any tax treaty which might exist between country B and country S. In order to find a general guideline and to simplify an already complex situation, it is suggested that residence countries, as a general rule, should give full credit for taxes effectively levied at source.

4. Application of the exemption method by the country of residence

61. Country R may, in its treaty with country S, have adopted the exemption method for relieving double taxation. This will not affect passive income like dividends, interest and royalties which normally give rise only to credit for tax at source. However, exemption may be applicable to income arising to the base company from immovable property or permanent establishments in State S, where the treaty between R and S would provide for exemption in the case of similar income derived directly from S by residents of R.

62. It seems clear from the text of the convention that the exemption method has to be applied in the Examples A and B (see paragraph 55 above). In Example C, no such obligation exists but some States seem to be inclined to grant the application of the exemption method for special reasons under their domestic law (e.g. because it simplifies matters and prevents more tax being levied in cases of tax avoidance than in other cases). The application of treaties in such cases requires international co-operation in order to prevent the income being exempted twice, but otherwise no general recommendation can be given.

5. Holding companies

63. A characteristic situation is the one where a base company receives income from an active subsidiary. This is often the case when base companies are used by internationally-operating enterprises as a regional centre or as a financial pivot.

64. In a situation where a participation in a company of S were held directly by a resident of R, the dividends would mostly be relieved from recurrent corporate taxation by an indirect tax credit, or by an exemption (affiliation exemption) in country R, either under domestic law or under the treaty with country S. The question whether these reliefs should be granted where a counteracting measure applies has to be answered in principle in the same way as the question whether an exemption under a treaty between countries R and S should be applied for direct income flows originating in S (cf. paragraph 62).

C. Relationships with non-source countries

1. Implications of tax conventions on second-tier base companies

65. Since counteracting measures also include second-tier base companies, situations may arise where two different measures of this kind are imposed simultaneously on the same income. Thus a German parent holding a Bahamas base company (sub-subsidiary) via a Canadian base company (subsidiary) may be taxed on the undistributed income of the

Bahamas base company while the same amount may be taxable under the Canadian defence legislation in the Canadian company. Though the second-tier base company (sub-subsidiary) is outside the personal scope of the convention between the country of the parent and the country of the first-tier base company (subsidiary), Member countries having adopted subpart F type legislations agree that both the country of the parent and the country of the first-tier subsidiary may apply their counteracting measures in this situation, unless there is a saving clause on this in the convention between the country of the parent and that of the subsidiary.

66. From a legal point of view, situations may, once more, vary according to what kinds of measures are used by both States applying counteracting measures. It may well be that there is a direct tax relationship between them, e.g. if both consider the base company as resident. In this case, treaties or domestic laws generally would avoid double taxation. Where no such direct relationship exists (e.g. when both countries use the mechanism of Example C), fully-fledged double taxation might result, thus creating an overreaction by measures designed to counter international tax avoidance. While this may not be in conflict with the Model Convention, States in which this problem arises should endeavour, in appropriate circumstances, to solve it either by domestic law or in their treaties. Germany and Canada have resolved it in the Protocol to their tax treaty by inserting the following provision:

“..., in cases where the same income is subject to the special tax referred to in ... and the special tax referred to in ..., the Contracting State of which the controlling shareholder is a resident shall give credit for the special tax of the other Contracting State.”

2. Shareholders (of base companies) with double residence

67. Where the taxpayer who is subject to counteracting measures in country R, (of which he is a resident under that country's domestic laws), is at the same time a resident of X (under the latter's domestic laws), and his personal and economic relations are closer to country X (cf. paragraph 2 of Article 4 of the OECD Model), the application of the counteracting legislation may be barred on the grounds that income derived from a third country is taxable only in the country of residence within the meaning of the Convention (i.e. country X), unless there is a permanent establishment in the other country (R) with which the participation in the base company is effectively connected. This seems to be justified because the taxable amount, though possibly not considered as income in country X, constitutes income within the meaning of the Convention (cf. Article 21 and Article 3, paragraph 2, of the OECD Model) and thus has to be treated accordingly. This becomes even more evident if both country R and country X impose counteracting legislation of a “subpart-F” type.

3. Participation in a base company held in a permanent establishment

68. Where the participation in the base company is effectively connected with a permanent establishment situated in a third country, a similar question arises if the Convention with that country provides for exemption of the permanent establishment's income (cf. Article 23 A of the OECD Model). There can hardly be any doubt that the country of residence has in this case to exempt the income. However, it will be rather exceptional in practice that the participation is in fact effectively connected with the permanent establishment, i.e. that the base company has relations exclusively with the permanent establishment and not with the enterprise as a whole.

VI. QUESTIONS OF SECONDARY SHELTERING

69. As indicated in paragraph 12 of this report, when income sheltered in a base company is distributed or otherwise transferred to the taxpayer, it becomes subject to tax, normally as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided by "secondary sheltering", the main strategies of which have already been described. In the following paragraphs, the main issues arising in an international context are briefly discussed, with respect to countries who do not have counteracting measures as described in the foregoing chapters.

70. The cases of secondary sheltering may be summarised by saying that income is disposed of by the taxpayer in such a way that it is either:

- a) Not taxable under the domestic law of his country of residence, which will be the case, for instance, when it is accumulated and reinvested in the base country or in a third country; or
- b) Ploughed back in the taxpayers' enterprise in country R, as a loan giving rise to interest payments which are normally deductible from taxable profits of that enterprise; or
- c) Exempted from normal taxation in country R under special rules of domestic law or of a double taxation treaty, the most frequent cases being the following:
 - i) Base company income is distributed to the parent company resident in country R, where an affiliation exemption applies to relieve recurrent corporate taxation either under domestic rules or under a treaty;
 - ii) The taxpayer (an individual) receives income from the base company as salaries or directors' fees, which are exempt in R under a treaty; or
- d) Enjoying a special tax treatment in country R, e.g. where, at the liquidation of the base company, income accumulated there is distributed to the parent-company in country R as profits from liquidation and subject there to a lower rate of tax applicable to capital gains.

1. Reinvestment in a country other than the country of residence

71. In this case, it will be difficult for the country of residence to combat secondary sheltering. Countries wanting to counteract this type of strategy should rather have recourse to counteracting measures described in the foregoing chapters.

2. Reploughing by loans to the shareholder company

72. Though a naive and rather straightforward form of tax avoidance, reploughing by loans is not easy to counter once a tax administration has accepted the use of base companies as a bona fide arrangement. The authorities in the country of residence may endeavour to show that the loan operation is an artificial one. They may want to argue that, on the facts, no interest deduction is to be allowed to the taxpayer's enterprise (if any "interest" is paid) because the funds are in reality not those of the base company but belong to the taxpayer. Demonstration of this will be easier if the domestic laws of country R contains "substance-over-form" provisions.

73. However, proving that the loan is effectively a distribution under a substance-over-form standard will often be difficult if the argument is restricted to the "loan arrangement" itself (because the background arrangement has been accepted). Even in the case of a highly artificial arrangement, it will often be difficult to ascertain facts and intentions (such as, when it is part of the arrangement, the lack of intent to repay the "loan"). It may be easier if the "loan arrangement" is regarded as part of a series of interdependent stages in a scheme which, looked at as a whole, can be regarded as a single composite transaction. The loan might be disregarded if the transaction as a whole, or a single part of it, does not meet "substance-over-form" criteria. It is, however, clear that such arguments might imply that not only the "loan" and the secondary sheltering but the use of the base company and the primary sheltering are abusive.

74. United States law contains a provision which includes as income of United States shareholders of base companies certain loans by the base company to United States persons. However, when the income of the base company has already been included in the United States shareholder's income under subpart F, these rules would not operate to impute additional income to the shareholders. No other specific domestic measures are known against reploughing through loans. They would probably have to take into account the whole series of transactions rather than only the "loan". Once more efforts against secondary sheltering would require similar legislation and administrative machinery to those against primary sheltering.

3. *"Repatriation" as dividends or other tax-exempt income*

a) Repatriation as tax exempt dividends

75. Where the income sheltered in the base company is "repatriated" as dividends paid to the parent company, such income will frequently be exempted under an affiliation exemption. The country of residence (of the parent company) should examine closely whether the dividends received would unconditionally qualify for the affiliation exemption, if there is no, or very low, corporate taxation in the country of the base company. Clearly, the exemption creates a void in tax terms and, as it were, transfers the low tax level of the tax haven country into the tax system of the country of residence. Countries which wanted to avoid such secondary sheltering have limited their exemptions in their domestic law, or in their treaties, to cases where recurrent corporate taxation really occurs. This may be done, among other things, by:

- Providing for an "activity clause" which prevents dividends from "non-active" companies from being exempted;
- Excluding from the exemption, dividends distributed by companies subject to low taxation;
- Switching from the exemption system to a system of indirect tax credit.

A further solution may be to adopt a more severe "substance-over-form" approach.

76. The measures described above may be difficult to apply and add to the complexity of a country's tax system, as it might be necessary to draw a dividing line between active and passive income and/or to define low taxation. In order to remain flexible, a special regime countering secondary sheltering may have to combine both elements in some way. Similar technical difficulties to those which exist under more comprehensive counteracting measures (especially those of the subpart-F type) would then have to be solved. It may, therefore, be better to adopt counteracting measures described in the foregoing chapters (i.e. one already

designed to counter primary sheltering) rather than to set up a complicated system for the sole purpose of countering secondary sheltering.

b) Other tax-exempt payments

77. Where there is a convention between the base country and the country of residence and the latter applies the exemption method to avoid double taxation, "repatriation" of sheltered income sometimes takes forms such as wages or directors' fees. In these cases, the authorities of country R may endeavour to show, as the case may be, that such income does not have the character of wages, or of directors' fees, within the meaning of the relevant articles of the convention between country B and country R, (corresponding to Articles 15 and 16 of the OECD Model) but rather constitutes "dividends" or "other income" (under Article 21) thus being fully taxable in the taxpayer's country of residence.

78. For example, if dependent services were not carried out on behalf of the base company but on behalf of the taxpayer himself or of his enterprise, exemption might be denied. Likewise, amounts paid as directors' fees would be treated as dividends insofar as they exceed the amount which would have been paid in the absence of the taxpayer's own interest in the base company. No tax exemption would be due where, according to Article 4 of the 1977 OECD Model, the base company is to be regarded as a resident in country R. The exemption should also be denied if the taxpayer has claimed tax exemption or reduction in the country of the base company by pretending that the payment had not the character of a salary or of director's fees. For doing so, the tax authorities of country R may obtain information from the tax authorities of country B (cf. Article 26 of the Convention) in order to show that the taxpayer did not exercise in country B, an activity sufficient to justify the payment of the income; country R may also wish to enter a mutual agreement procedure with country B.

79. There may remain artificial arrangements which cannot be solved in this way. The problem then arises as to whether the exemption can be denied in another way, e.g. by showing that the payment is a part of a series of interdependent transactions in a prearranged scheme which, as a whole, has no other purpose than securing a tax advantage.

80. Where it seems necessary, tax treaties should take into account situations of the kind discussed in paragraphs 75 to 79 above. This may best be done by excluding certain companies from their scope or by adopting the credit method for eliminating double taxation, either generally or for certain items of income.

4. Extraction of income as capital gain

81. In a number of countries capital gains are subject to lower taxation than ordinary income. There are therefore substantial tax benefits to be obtained by arranging to convert income into a capital gain through a base company. This can be done by accumulating the income, and then extracting it by either disposing of part or all of the holding in the base company or liquidating the company altogether.

82. This is a common tax avoidance route. One area in which it has been exploited is that of collective investment institutions such as offshore mutual funds (referred to in paragraph 108 of the foregoing report on tax havens). A number of countries have specific counteracting measures to ensure that a proper tax charge is levied on the investor's share of the base company's income.

83. In such cases, the country of residence will have to make use of any safeguards, provided under domestic law, for not granting the special tax regime applicable to capital

gains where the circumstances in which the company has been liquidated suggest that artificial arrangements have been made for the purpose of enjoying the benefit of the special regime. If no such safeguards exist in its law, country R could introduce provisions under which capital gains from the disposal of a participation in a base company would be taxable as ordinary income.

5. Final remarks

84. Amending domestic laws with adequate provisions for dealing with secondary sheltering may be difficult in practice, and the efficacy of such counteracting measures cannot be guaranteed. These considerations may therefore lead the country of residence to consider introducing counteracting measures as described in the foregoing sections which may be directed both at primary and secondary sheltering.

VII. COMBATING TAX AVOIDANCE AND TAXPAYER PROTECTION

85. When a taxpayer tries to avoid taxation by sheltering income in a base company, he enters a "tax triangle" formed by his home country, the base country (the tax haven) and the country of source. While this may give rise to considerable tax advantages, the taxpayer risks running unexpectedly into tax charges he would not otherwise have borne. Thus, the taxes in the country of source may be unexpectedly high, especially if a treaty between the base country and the country of source cannot be invoked because one or both Contracting States regard its use as improper by reason of the artificiality of the arrangement. It is possible that unexpected changes in taxation procedures and domestic laws of the base country may cause difficulties for the taxpayer. Counteracting measures deployed by the home country may definitely aggravate the situation. It is clear that the taxpayer using a base company has to bear the risks inherent in the situation which he has created.

86. Another danger is that of double taxation (especially economic double taxation). A number of such situations have been described in the foregoing chapters and still others may occur. This results from three risks inherent in the "tax triangle":

- Counteracting measures are by their nature unilateral measures of a State which finds that its tax has been avoided; those countries in the "triangle" whose tax has not been avoided (or avoided in a specific way) and which deploy no such measures, have no reason to recognise them, because to do so might even have undesirable tax effects for them;
- International tax relations are based on the assumption of bona fide situations and not adapted to specific measures such as counteracting measures, especially in a triangular situation;
- The tax authorities concerned may be reluctant to rectify a situation created by the taxpayer for his own advantage.

Taxpayers should therefore always be aware of such risks and realise that tax authorities cannot be expected to be as anxious to avoid the consequences of the situation as they might be in normal cases.

87. There is even doubt whether, in the base company situation, double taxation should be avoided in a systematic way. Two lines of thinking have been expressed:

- It is argued, on the one hand, that the taxpayer has to bear the full risks of an arrangement which he has voluntarily entered into with a view to obtaining a tax advantage. Tax authorities could not safeguard him in any way from the unexpected consequences that such arrangements may have. In addition, such protection may not be desirable, as the residual risk of double taxation could act as a certain deterrent against artificial arrangements;
- On the other hand, it is argued that the taxpayer may ask for fair treatment, once tax administrations have successfully deployed their counteracting measures. Letting him incur double taxation in cases where this could be avoided would clearly lead to an additional tax burden which has the character of a penalty. However, this cannot be justified, as penalties would normally be imposed by the domestic laws of the countries concerned and should be under the safeguard of their normal courts.

These diverging views cannot readily be reconciled. They are not based on well-defined legal principles but rather reflect different general attitudes towards tax avoidance. These divergences and the fact that they will often be difficult to reconcile are matters that taxpayers should be aware of.

88. The nearest one can come to a conclusion is that, while tax administrations cannot offer any guarantee against the risks inherent in base company arrangements, they should certainly try to avoid over-reacting. For this, it is advisable that:

- Residence countries should observe the general principles set out in paragraphs 46-48 when shaping and deploying their counteracting measures;
- Countries which have co-operated through an exchange of information in order to combat tax avoidance should be willing to co-operate in appropriate circumstances for the avoidance of double taxation in the same case.

89. There are, however, limits to this. Co-operation will presuppose that the taxpayer has given full information and that tax authorities are sufficiently convinced that they have under view the full scope of the taxpayer's tax avoidance strategies, so that no other income of considerable amount has been sheltered from their taxation. In practice such a presupposition may often be ill-founded. Furthermore, the taxpayer cannot justifiably expect to have the taxation imposed in the base country reduced, when he voluntarily used this country as a means of sheltering his income from taxation in his country of residence.

90. Finally, in the context of taxpayers' protection, mention should be made of the mutual agreement procedure provided for by Article 25 of the OECD Model. As a principle, OECD States generally agree that Article 25 applies to double taxation resulting from the application of defensive measures described above. This was made explicit when the OECD Model was completed, in 1977, to cover cases of economic double taxation, with the scope of the mutual agreement procedure being extended accordingly (see paragraph 8 of the Commentary on Article 9 and paragraphs 8 and 9 of the Commentary on Article 25). In practice, and except in one State where the courts have taken an opposite view, tax authorities do consider that taxation under counteracting measures is within the scope of the mutual agreement procedure.

91. However, the mutual agreement procedure does not guarantee to the taxpayer that double taxation will be fully avoided. A taxpayer whose attempts to avoid tax have been

successfully frustrated by counteracting measures cannot expect his tax authorities to be anxious to enter into a mutual agreement procedure. More generally, Article 25 lays on tax administrations a mere duty to negotiate but in no way an obligation to reach agreement, as no procedure, for arbitration or otherwise, is available to the taxpayer in cases where tax administrations still disagree on the way double taxation should be remedied.

VIII. FINAL REMARKS

92. After consideration of the problems arising from tax avoidance and evasion through the use of base companies, it does not seem possible to formulate recommendations which would be applicable in all cases and acceptable to all Member countries. However, a number of tentative conclusions have emerged:

- a) Counteracting measures against the use of tax havens are a relatively novel feature in both domestic laws and in international tax relations, which are sensitive to the extent that such counteracting measures deal with situations where conflicts arise between the legal form and economic realities;
- b) In the view of the States which have introduced them, counteracting measures constitute an essential instrument against tax avoidance practices, which in their absence would probably have become more widespread. Subject to one dissenting view, these measures are regarded as generally consistent with the principles underlying the OECD Model Convention and the spirit of international tax treaties. Solutions to possible difficulties should be found either in the text or by observing the spirit of the Model. However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot be fully safeguarded by tax authorities;
- c) The use of base companies exploits national legal systems for the diversion of income out of the reach of national taxation. It is therefore inevitable that counteracting measures go against the general structure of legal systems in Member countries, such as territoriality of taxation and the recognition of juridical persons. By doing so, counteracting measures may create uncertainties as far as legal positions and business environments are concerned. States should avoid as far as possible bringing inconveniences to "bona fide" economic activities and should not infringe upon the tax sovereignty of other States;
- d) Counteracting measures should therefore focus on clearly-identified fields of abuse. They should not be extended to activities such as production, or normal rendering of services or trading, of companies engaged in real industrial or commercial activity when they are clearly related to the economic environment of the country where they are resident and these activities are carried out in such a way that no tax avoidance can be suspected. Technical aspects of such legislation also should be consistent with the spirit of tax treaties. It is desirable that States which have introduced, or will introduce, measures of that type be ready to discuss any problems created in a bilateral or, where appropriate, a multilateral context;

- e) Matters dealt with in this report tend to evolve over time. The Committee on Fiscal Affairs, which is the appropriate body for discussions on such measures, will therefore be closely following developments in this area, and will be prepared to take the matter up again as required, with the possibility that amendments to the 1977 Model Convention may result.

93. In conclusion, the Committee has expressed the wish that:

- a) Member countries which introduce measures to counteract the use of base companies, should design such measures in accordance with both the principles of international taxation generally agreed upon among OECD Member countries and the spirit of double taxation conventions and take account of the undesirable consequences that such measures might have for other countries;
- b) Member countries, when applying any such measures, should, to the maximum extent possible keep this application consistent with their obligations arising from their double taxation conventions;
- c) Those Member countries which consider that counteracting measures taken in other countries infringe their tax sovereignty, or are contrary to international commitments and their tax policy, or create other problems, should take up the matter in the Committee with a view to finding appropriate solutions.

94. The Committee also intends:

- i) To continue to explore problems so raised and recommend solutions to them;
- ii) To discuss new developments in this field; and
- iii) To take up the topic again when next considering possible amendments to the 1977 Model Convention.

Observations by Switzerland:

95. The counteracting measures described in this report, notably in paragraphs 29 to 31 and 38 to 40, are contrary to the spirit of bilateral double taxation conventions signed between OECD Member countries as they result, in effect, in an extra-territorial application of domestic tax legislation.

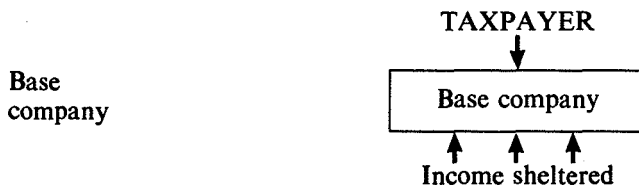
96. These measures hamper international economic relations and result in an additional administrative burden for both taxpayers and tax authorities. As divergences of view exist as to what extent some provisions (cf paragraphs 30, 38 and 39 above) are contrary to the 1977 OECD Model Convention (article 7, paragraph 1 and article 24 especially), legal provisions of that kind should not be implemented without prior consultation of partner countries; the latter's interests should then be taken into consideration.

97. Finally, Switzerland considers that the interpretation given in paragraph 36 of the report, concerning paragraph 1 of article 4 is not in conformity with the meaning and purpose of that provision.

Annex I

**INTERNATIONAL COUNTERACTING MEASURES:
AN OVERVIEW**

<i>Country of: Residence of share- holder</i>	General surveillance measures – Arm’s-length rules – Procedural rules	Substance-over- form provisions	Defence legislation	Measures “from the top”
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<i>Source of income</i>	General measures – Arm’s-length rules – Procedural rules	Specific approaches: – Look-through approach – Exclusion approach – Subject-to-tax approach – Channel approach – <i>Bona fide</i> provisions	Taxation at source (e.g. withholding tax)	Measures “from below”
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DOUBLE TAXATION CONVENTIONS AND THE USE OF CONDUIT COMPANIES

I. THE PROBLEM STATED

A. General

1. In its Commentary on Article 1 of the 1977 OECD Model Convention, the Committee on Fiscal Affairs expressed its concern about improper use of tax conventions (see paragraph 9) by a person (whether or not a resident of a Contracting State), acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person.

2. This report deals with the most important situation of this kind, where a company situated in a treaty country is acting as a conduit for channeling income economically accruing to a person in another State who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty. This situation is often referred to as "treaty shopping". The "conduit company" which is characteristic of such schemes is usually a corporation, but may also be a partnership, a trust or a similar entity. The tax advantages with which this report is primarily concerned occur to the detriment of the country of source of income. Whilst there is some brief consideration of taxation in the country of residence of the person to whom the income economically accrues, this is dealt with mainly in the foregoing report on "base companies".

3. Though not dealt with in this report, it is noted that a legal entity is sometimes created in an intermediary country for other than tax purposes (such as access to capital markets, currency regulations, political situations or the need to be present in the country of investment under the "flag" of the intermediary country), and that does, of course, have tax consequences.

B. Conduit companies

4. The treaty benefits referred to above may be obtained in two principle ways, either by the use of direct conduit companies or through a "stepping-stone" strategy. The essence of these manoeuvres is described below and represented diagrammatically in Annex I.

1. Direct conduits

A company resident of State A receives dividends, interest or royalties from State B. Under the tax treaty between States A and B, the company claims that it is fully or partially exempted from the withholding taxes of State B. The company is wholly owned by a resident of a third State not entitled to the benefit of the treaty between States A and B. It has been created with a view to taking advantage of this treaty's benefits and for this purpose the assets and rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax-exempt in State A, e.g. in the case of dividends, by virtue of a parent-subsidiary regime

provided for under the domestic laws of State A, or in the convention between States A and B.

2. "Stepping stone" conduits

The situation is the same as in example 1. However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related "conduit company" set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime.

In either case the use of the "conduit company" does not give rise to substantial taxation in the conduit States. This is normally essential for the scheme, as otherwise the advantage of using the tax treaty would mostly be compensated for by taxation in that State.

C. Examples

5. The following are some illustrative examples:

a) Example 1

A person X, resident of a State which has not concluded any tax treaties, derives interest from bonds of a number of States, which under the laws of these States is subject to withholding taxes therein. X sets up a company in State A, which has an extended network of tax treaties; he transfers the bonds to the company. The interest flowing now to that company is subject to no, or very low, taxation in State A due to specific tax exemptions provided for companies of that kind. On the basis of State A's treaty network, the company claims exemption from or reduction of withholding taxes in the States where the interest arises. The interest received by the company which is a resident of State A is then transferred to X as a loan.

b) Example 2

A company Y resident of State O has developed a patent and intends to enter into license agreements with licensees in a number of countries. Y transfers the patent to a company set up in State A. As in example 1. the royalties are subject in State A to no, or very low, taxation; and exemption from, or reduction of, withholding taxes is claimed in the States of source. The royalties may then be transferred to Y as a dividend and may often be exempted by a participation exemption in the State of residence of Y.

c) Example 3

A company Z is a parent company with wholly-owned subsidiaries in States C₁, C₂, C₃. The State of residence of Z has no treaties with C₁, C₂ or C₃. Z transfers its participations to a company in State A. The dividends received are not subject to a tax because of a participation exemption or a system of indirect credit existing in that State. Exemption from withholding taxes in the States of residence of C₁, C₂, C₃ is claimed on the basis of the treaty network of State A. The dividends are reinvested by Z in new subsidiaries.

d) Example 4 (stepping-stone)

A tax haven company plans to invest funds as a loan in a high tax State A. The funds are channelled through a company set up for this purpose in a high tax State B. This company receives interest from State A at a rate of, say, 12 per cent and pays interest to the tax haven company at a rate of 11.5 per cent. State A levies a

withholding tax on interest which is reduced to nil under the convention between States A and B. State B does not levy withholding tax on interest under domestic law. In such a case the tax haven company benefits from a treaty between the high tax States A and B though it is subject to tax in the latter State only to an insignificant degree (i.e. paying a normal tax only on the marginal ½ per cent of the interest).

D. Main characteristics of “conduit configurations”

6. Through the configurations described above, the conduit company takes advantage of the treaty provisions under its own name in the State of source; economically, however, the benefit goes to persons not entitled to use that treaty. A net tax advantage results because little or no taxation occurs in the State(s) of conduit. The advantage arises in the source country. As its tax laws deal adequately with the situation (it generally taxes all non-residents including the conduit company) the problem is created exclusively by the treaty itself and therefore can only be dealt with under the treaty.

7. This situation is unsatisfactory in several ways:

- a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;
- b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the Contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal tax regime of that State;
- c) The State of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

These considerations endorse the Committee on Fiscal Affairs' general view that the use of treaties is improper where a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State primarily to obtain treaty benefits which would not be available directly to such person (cf. paragraph 1 above). They will be of relevance in deciding in which actual situations treaty benefits should be denied under existing treaties in order to cope with cases of “treaty shopping” and which new provisions should be included in bilateral treaties or in amendments to the OECD Model.

E. Other aspects of the problem

8. This report focuses on taxation in the State of source. There are also tax advantages in the State of residence of the taxpayer who economically benefits from the treaty benefits. In fact, in the examples set out in paragraph 5 above, that State cannot, or does not, tax the income, though in all cases the taxpayer has its full economic benefits (by receiving it as a loan

or as a dividend or by using it for investment in other subsidiaries). However, these tax advantages raise quite different issues: they have their source in national law, and treaty aspects usually arise only as secondary problems. These issues are considered in the separate reports contained in this volume which deal with "tax havens" and "base companies". Similar considerations apply to problems arising from the issue of bonds through conduit companies set up in countries which have no withholding tax on interest.

F. Bona Fide transactions

9. The configurations described above occur in many normal transactions of enterprises operating internationally. Thus a group's parent company in State X may have an operation subsidiary in State A which develops a patent in connection with its production activities and which licenses the patent to an enterprise in State B from which it receives royalties. It is clear that tax exemptions provided for such royalties in the treaty between State A and State B should not be denied because there is no such treaty between the State of source of the royalties (B) and the State of the parent company (X). Such bona fide transactions do not fall within the scope of this report, for they clearly involve no improper use of tax treaties. This is, generally speaking, true in all cases in which the assets or rights giving rise to income for which treaty benefits are claimed are effectively connected to activities like producing, rendering of services or trading in the market of State A.

G. Similar cases

10. The foregoing discussion is based on the assumption that improper use was made by a person resident in a State which had no treaty with the State of source. Similar problems may arise where there is a treaty between the State of residence and the State of source, but:

- a) This treaty offers less protection than the treaty between the State of source and the State of conduit;
- b) The use of a conduit company can avoid the disclosure of information to the State of residence;
- c) Both treaties offer equal protection but use is made of the conduit company in order to avoid taxation in the State of residence [e.g. because, by using the conduit company, income such as royalties is transformed into dividends to be exempted by a participation exemption (see example 2 of paragraph 5)].

The principles set forth in this report are applicable to such cases.

H. Search for solutions

11. The existence of "conduit companies" has long been perceived to be a problem in treaty negotiations. It may also become a problem in the application of existing treaties if the treaty partners were not aware of the existence of "conduit companies" when negotiating the treaty or if it only becomes a problem subsequently (e.g. by reason of changes in domestic laws or by the emergence of new tax avoidance schemes, as in the case of "stepping-stone strategies").

12. In seeking a response to this problem this report considers:
- a) Certain provisions of existing OECD Model Convention and their implications for conduit companies (Part II);
 - b) Specific provisions currently found in bilateral treaties (Part III), and;
 - c) The problems of applying existing tax treaties (Part IV).

On the basis of these studies the report sets out suggestions for future action (Part V).

II. THE 1977 OECD MODEL CONVENTION: GENERAL APPROACH AND SPECIFIC PROVISIONS

A. The general situation

13. Normally under the OECD Model the conduit company is regarded as a person [Article 3, paragraph 1 a) and b)] resident in the State of conduit (Article 4). It is therefore entitled to claim the benefits of the treaty in its own name. There are of course situations where specific circumstances exclude the company from treaty benefits, but it is rarely possible to verify that such circumstances are present. This is the case, for example, where:

- The entity used as a conduit is not recognised as a juridical person (being, for example, a partnership, or a trust which may not be a “person” under the treaty provisions);
- The company is not liable to tax in the State of conduit on the basis of its domicile, place of management or other criterion of a similar nature (e.g. because its Board of Directors does not meet in that State);
- The assets and rights giving rise to the dividends, interest and royalties have not effectively been transferred to the company so that it acts as a mere nominee when receiving payments of such income.

In cases of doubt the conduit company should, at the request of the tax administration of the State of source, give the necessary information. It is, however, often found that these approaches are generally not sufficient to counteract the improper use of treaties in the conduit situation.

B. Anti-avoidance provisions

14. The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a “conduit company”.

- a) Article 4, paragraph 1, second sentence excludes from the term “resident of a Contracting State” any person who is “liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein”. This provision relates clearly to specific privileges granted by reason of the international relations of a person and giving such a person, in effect, the status of a non-resident rather than that of a resident. The commentaries on

the 1977 OECD Model give as an example the case of certain diplomatic personnel. The provision would, however, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income (as viewed from their State of residence) by privileges tailored to attract conduit companies. It has, however, inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, so that there is an element of uncertainty concerning its application against conduit companies. Furthermore, to be effective, such provisions should also apply where the conduit company is fully exempt from tax under specific privileges, even though they cannot cover the stepping stone situation (see paragraph 4 (b) above and paragraph 36 of the previous report on base companies) or cases where the special status is not based on an exemption of income.

- b) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its "beneficial owner". Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraphs 12, 8 and 4 of the Commentary to Articles 10, 11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary. This examination will in any case be highly burdensome for the country of source and not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company, the company's relationships to the shareholders or other interested parties or the decision-making process of the conduit company. So even an exchange of information between the country of source and the country of the conduit company may not solve the problem. It is apparently in view of these difficulties that the Commentaries on the 1977 OECD Model mentioned the possibility of defining more specifically during bilateral negotiations the treatment that should be applicable to such companies (cf. paragraph 22 of the Commentary on Article 10).

15. The new provisions of the 1977 OECD Model thus deal with the conduit situation in a rudimentary way, expressing only a general concern that improper use of treaties should be avoided. Although it is clear that all necessary information should be exchanged between the two Contracting States for the application of these clauses, this is not sufficient to preclude a person from acting through a legal entity created in a State in order to obtain treaty benefits which would not be available directly to them, and from obtaining unjustifiable tax advantages (paragraphs 8 and 9 of the Commentary on Article 1).

16. Opinions may differ as to whether the absence of an overall solution to the conduit problem was at the time a serious flaw in the 1977 OECD Model. It was understood, as pointed out in the OECD Commentaries, that Member countries were free to insert adequate solutions in their bilateral treaties. However, the problem has become more acute over recent years and calls for further study. Improvements seem advisable in several respects:

- a) OECD should set out policies regarding conduit companies in more detail in order to prevent improper use of tax treaties. Consequently the Commentaries should in some way (e.g. in a summarised form or by citing this report) take into account the conclusions reached by the Committee on Fiscal Affairs in Part III below;
- b) Recently new strategies seem to have been developed for the use of conduit companies based in many countries. The OECD Model or its Commentaries should accordingly offer solutions to this problem taking into account the considerations under Part IV;
- c) The provisions mentioned in paragraph 14 above and/or the Commentaries should be revised in order to solve any existing difficulties and doubts.

These problems will be considered in any revision of the OECD Model.

III. BILATERAL TREATIES: PROBLEMS FOR NEGOTIATIONS

A. General policy approaches

1. Treaty policy vis-à-vis low-tax countries

17. The conduit problem is normally generated by the fact that treaty benefits are not balanced by corresponding tax in the country where the conduit company has its residence, because under that country's system no tax (or no significant tax) arises. In such a situation, a radical solution would be not to conclude treaties with countries which are especially prone to becoming a base for conduit companies (e.g. because they have no income tax or offer specific tax exemptions for such companies). Basically this policy in many cases is sound as the slight double taxation which may occur may be dealt with satisfactorily under provisions of domestic law.

2. Specific provisions relating to low-tax countries

18. Refraining from treaties with such countries is, however, not always feasible for other countries, for example, because important normal business relationships exist between the two countries concerned which should be protected against double taxation, or because of other overriding treaty objectives (e.g. improving the climate for private investment in developing countries). Furthermore, the conduit situation may even occur between countries whose taxation has no special features, especially in the case of stepping-stone strategies [see paragraph 4² above].

19. In such situations it would correspond to sound treaty policy to take special care that bilateral treaties form an instrument for avoiding international double taxation while

counteracting improper use of its provisions. A treaty partner may, if it wishes to be protected against international tax avoidance schemes:

- Ask that the other State be prepared to co-operate by exchange of information and in any other way in order to prevent international tax avoidance;
- Take the necessary measures to be able in practice to give information [cf. Recommendation 833 (1978) of the Parliamentary Assembly of the Council of Europe, paragraph 11 (i)].

Reference may also be made to that part [paragraph 11 (ii)] of the Recommendation cited above according to which States should refrain from creating special tax laws which tend in practice to give undue tax favours to certain companies in respect to foreign-earned income.

20. Difficulties with conduit companies may occur between all OECD Member countries, as specific tax avoidance schemes may use even a so-called “high tax country” as a basis for an improper use of tax treaties [e.g. by “stepping-stone companies” – cf. paragraph 4² above]. Most OECD Member countries are ready to co-operate in such situations in the way described in the foregoing paragraph. As bilateral treaties of an OECD country with other countries may be made use of by residents of other OECD countries there is a common interest among many OECD Member countries that adequate policies are developed.

B. Specific provisions relating to conduit companies

21. An important method for finding adequate solutions to problems caused by conduit companies is the insertion of specific clauses dealing with this special situation. In this section, several specific approaches are discussed under the headings “general description”, “scope and limitations” and “evaluation”. These are:

1. The “look-through” approach (paragraphs 23-25);
2. The exclusion approach (paragraphs 26-28);
3. The subject-to-tax approach (paragraphs 29-36);
4. The channel approach (paragraphs 37-41);
5. Bona fide provisions (paragraph 42).

Examples of such provisions used in certain tax treaties between OECD Members are set out in Annex II.

22. The Committee on Fiscal Affairs has refrained from drafting definitive texts, from making strict recommendations as to the circumstances in which they should be applied and from giving an exhaustive list of such possible counter-measures. The texts quoted below are merely intended as suggested benchmarks which treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

- The degree to which there may be actual tax advantages obtained by conduit companies;
- The legal context in both Contracting States, and;
- The scope of bona fide economic activities that might unintentionally be covered by such provisions.

1. The "look-through" approach

a) General description

23. The most radical solution to the problem of conduit companies would be to allow treaty benefits to a company only insofar as the company is owned by residents of the State of which the company is a resident. For example, such a provision might have the following wording:

"A company which is a resident of a Contracting State shall be entitled under this Convention to relief from taxation in the other Contracting State with respect to any item of income, gains or profits, only to the extent that it is not owned directly or through one or more companies, wherever resident, by persons who are not residents of the first-mentioned State."

b) Scope and limitations

24. The "look-through approach" ("piercing the veil of the company") is the most direct way of attacking the conduit problem. While it is relatively simple and straightforward, there are, however, evident disadvantages:

- i) Such provisions are incompatible with the principle of the legal status of corporate bodies, as recognised in the legal systems of all OECD Member countries, and except in cases of abuse, in the OECD Model;
- ii) Such provisions would require extensive bona fide amplifications (cf. paragraph 42 below). This may lead to rules which are complicated and burdensome to administer;
- iii) The provisions do not prevent "stepping-stone" strategies [cf. paragraphs 4² and 5 (d) above];
- iv) There would have to be machinery to apply the clause in a simple and secure way. This may require the shift of the burden of proof;
- v) Implementation of the provision would be very difficult in countries where companies' stock is mainly made up of bearer shares.

c) Evaluation

25. The "look-through approach" seems an adequate basis for treaties with countries which have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it would be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities. What is said in paragraph 19 above would be relevant to such modifications.

2. The exclusion approach

a) General description

26. Often conduit situations can be created only by the use of tax-exempt (or nearly tax-exempt) companies which may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies. The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies

from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:

“No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section ... of the ... Act, or under any similar provision enacted by ... after signature of the Convention.”

The scope of this provision, as far as income paid by the company is concerned, could be limited by referring only to specific types of income, such as dividends, interest, capital gains, directors' fees, etc.

Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

b) Scope and limitations

27. An exclusion provision would cover companies which, under the tax law of the State of residence, have in practice the status of a non-resident, rather than that of a resident. Such a provision should, however, apply not only in cases of full exemption, but also in the case of a reduction of tax to levels lower than the expected overall treaty benefits. On the other hand, an exclusion provision would not exclude from treaty benefits charitable institutions enjoying tax exemption as a consequence of the specific purpose for which they are organised and operated. Such an exclusion provision, however, is of a very limited scope and cannot deal with more advanced techniques of improper use of tax treaties.

c) Evaluation

28. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State which has created special privileges in its tax law may prevent these privileges from being used in connection with the improper use of tax treaties concluded by that State.

3. The subject-to-tax approach

a) General description

29. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the respective income is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the OECD Model does not recommend such a general provision. While this seems adequate with respect to normal international relationships a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

“Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:

- i) Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and

- ii) Exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income which is subject to tax in the last-mentioned State under the ordinary rules of its tax law.”

The concept of “substantial interest” may be further specified when drafting the Convention. Contracting States may express it, for instance, in terms of a certain percentage of the capital or of the voting rights of the company.

b) Scope and limitations

30. The subject-to-tax approach, although somewhat similar to the exclusion clauses, covers cases in which it is not possible to give a strict definition of the excluded situation. Thus, the “taxation under ordinary rules” test would exclude from treaty benefits companies enjoying:

- Specific privileges granted to “base companies”, “domiciliated companies”, etc.;
- Waivers of tax under specific arrangements between the conduit company and the tax administration;
- Substantial reduction of tax as well as complete exemption.

31. On the other hand there are advanced techniques of improper use of tax treaties which could not be covered by the subject-to-tax approach. This is especially so with the “stepping-stone strategies”, where the company incurs expenses it can offset against income in accordance with normal rules of tax laws.

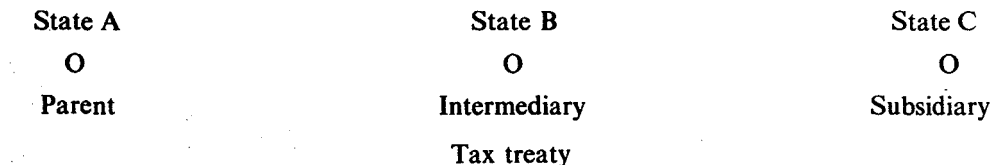
32. Moreover, the subject-to-tax approach would exclude from the benefit of tax treaties companies enjoying:

- Tax privileges granted to charitable organisations, pension funds or similar institutions;
- Tax privileges granted with a view to fostering the economic development of the country of the conduit company (“tax holidays”).

In circumstances such as those derogations from such provisions may be envisaged.

c) Substantial participation

33. Special attention should be given in this context to the holding of a substantial participation in a company through an intermediary as illustrated by the following diagram:



In this case State B will grant dividends received by the intermediary from the subsidiary an exemption or an underlying tax credit tantamount to an exemption or near exemption.

34. As this exemption or credit is granted with a view to the tax borne by the subsidiary in its State of residence on the distributed profits (State C), many States will regard it as part

of their normal rules for avoiding double taxation rather than a specific tax privilege. This approach would recommend that it be regarded as a tax under ordinary rules for the purposes of the foregoing paragraphs. Situations of this kind may, however, involve elements which would make it improper for the intermediary company to invoke the benefits of a tax treaty. This may, *inter alia*, be true if the intermediary company:

- Is not the beneficial owner of the dividends;
- Has to be regarded as a mere channeling company as referred to under paragraphs 37 to 41, or;
- Where such companies are used to shield off a low-taxed company against taxation in the country of the parent.

35. On the other hand, there is certainly no reason to regard the use of the treaty as improper, if the participation is effectively connected to a bona fide commercial activity carried on by the intermediary. Contracting States should consider cases of that kind with a view to their specific situation.

d) Evaluation

36. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (cf. paragraph 42 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies".

4. The channel approach

a) General description

37. The approaches dealt with in the foregoing sections are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision which would single out cases of improper use with reference to the conduit arrangements themselves. Such a provision might have the following wording:

"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:

- i) Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
- ii) Exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes, etc.)."

b) Scope and limitations

38. This approach would be satisfactory in covering a broad spectrum of cases typically involving improper use of tax treaties like:

- Cases of mere administration of assets;
- The so-called “stepping-stone strategies”;
- Other cases where income is merely transmitted through conduit companies with a view to minimising taxes.

39. On the other hand it could cover normal business activities or cases where the assets from which the income in question arises is effectively connected with a genuine activity like the carrying on of a trade or business or the exercise of independent personal services. Therefore, it would seem necessary to supplement such a provision by a bona fide clause (cf. paragraph 42 below).

40. Also this solution is of a very general nature, which might lead to administrative difficulties and doubts in its application – such as the types of expenses to be covered and the linkage, both in amount and in time, to be made between the income received and the expenses paid. This is evident in the case of substantial holding (cf. paragraph 33 above), as well as in cases where assets are held by a bank or an insurance business. The interpretation would certainly depend largely on standards the Contracting States have developed internally to counter unjustifiable tax advantages (like the principle of “substance-over-form”, general anti-abuse clauses, etc.).

c) Evaluation

41. The solution proposed in paragraph 37 above appears the only one to be effective against “stepping-stone” devices. It is not found as such in bilateral treaties but its principle seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. Contracting States which consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause. Moreover, because of the administrative difficulties referred to above, it seems advisable to include it only in specific cases, where the use of “stepping-stone devices” frequently occurs or is likely to occur.

5. Bona fide provisions

42. The solutions described above are of a general nature. In connection with them, it will be necessary to provide specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

i) General bona fide provision

“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and thus do not have as primary purpose the obtaining of any such benefits.”

ii) Activity provision

“The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a

resident and the relief from taxation claimed from the other Contracting State is with respect to income which is connected with such operations.”

iii) *Amount of tax provision*

“The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident.”

iv) *Stock exchange provision*

“The foregoing provisions shall not apply to a company resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or through one or more companies each of which is a resident of the first-mentioned State – by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered.”

v) *Alternative relief provision*

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that such expression “shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention.”

The determination of those provisions which are regarded as necessary in a specific treaty depends on the general approach taken in that treaty.

IV. APPLICATION OF EXISTING TREATIES

A. General considerations

43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of “pacta sunt servanda” even if considered to be improper. The Contracting States should, however, be prepared to grant all possible help by exchange of information (cf. paragraph 19 above) and to remedy the situation by adequately revising the treaty (cf. Part III above).

B. Handling of artificial tax avoidance

44. It may be asked, however, whether artificial tax avoidance schemes could not be countered by applying certain domestic measures available to Contracting States to fight domestic tax avoidance. Two types of situations may be identified:

- a) A State may wish to protect itself against “abuse of law” by applying the general provisions in its domestic laws: it will then deny the benefits of the convention to income paid by a resident of that State to a company situated in the other State when it has reasons to suspect an improper use of the convention. The question arises as to whether the denial of treaty benefits in such cases is compatible with treaty obligations. This relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States, some taking the view that where the beneficiary of the income fulfills the conditions set in the convention (beneficial ownership, residence), the provisions of the convention should apply, notwithstanding the domestic provisions of the State of source (see also paragraphs 43 to 48 in the foregoing report on “base companies”) others taking the contrary view.
- b) A State may be led to take steps to protect its partners from the result of the interaction of special characteristics of its domestic laws with the use of conduit companies situated in its territory. Switzerland is a case in point. The question of the impact of these unilateral measures in the State of source may arise in such situations. For instance, if Switzerland, as State of residence of the conduit company, finds that the company, while fulfilling the conditions set in the convention, does not meet the requirements of its domestic laws and, accordingly, refuses to certify and transmit to the tax authorities of the State of source a request for relieving tax withheld at source, it may be questioned whether the State of source has the right to refuse relief.

45. A special difficulty increasingly encountered by tax authorities under existing conventions is the use of highly artificial arrangements called “stepping-stone” devices [cf. paragraphs 4² and 5 (d)]. Such arrangements make use of the fact that two high taxing countries:

- Have differing tax laws (one levies a withholding tax on interest, the other does not);
- Respect the taxation rights of the tax haven country, and;
- Regard anti-abuse clauses in their treaties as unnecessary.

Improper use of tax conventions in such cases may be counteracted by changing one of these basic conditions. It is, however, evident that this may require a change of policies which could affect bona fide economic activities. This might also lead to complicated rules, highly burdensome to tax administrations. It may therefore be preferable to counteract such highly complex arrangements by recourse to the principle of “substance over form”.

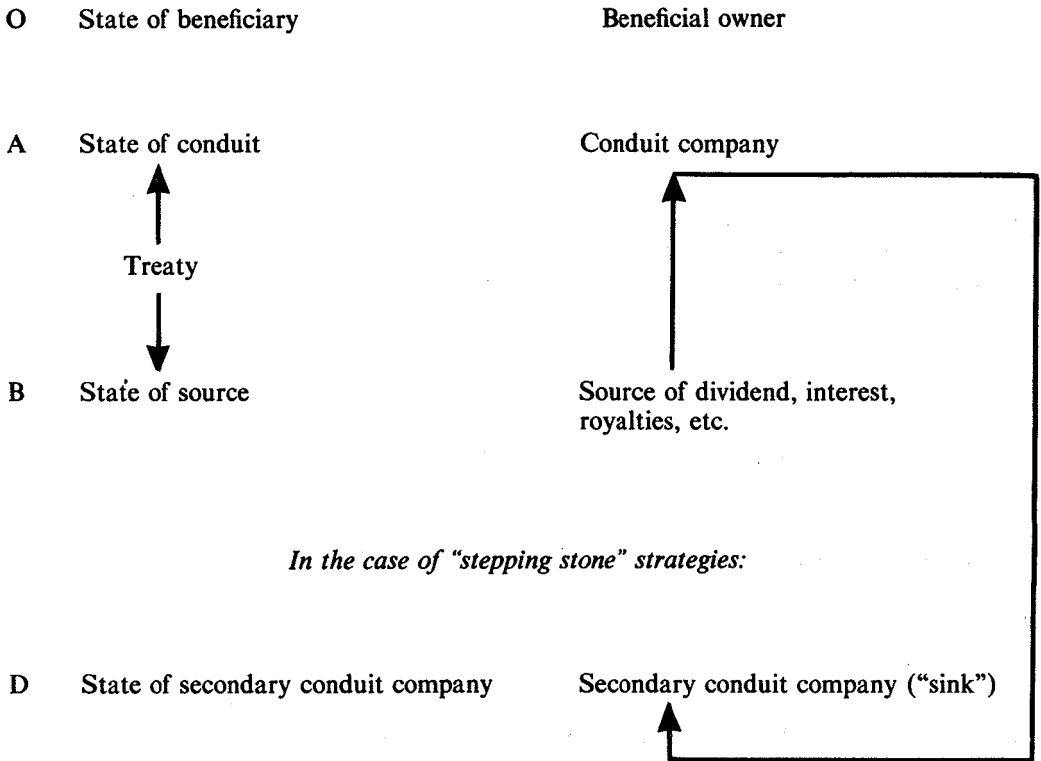
V. FINAL REMARKS

46. The Committee considers that competent authorities in charge of negotiating or revising conventions and of implementing existing ones:

- i) Should pursue their efforts and foster co-operation against improper use of tax conventions through “conduit companies” and, for this purpose
- ii) Take account of the considerations set out in Parts II to IV of this report.

Annex I

DESCRIPTION OF "CONDUIT" SITUATIONS



Annex II

EXAMPLES OF BILATERAL CLAUSES

A. THE "EXCLUSION" APPROACH

1. Type related exclusion (German-Luxembourg Agreement)

Article 1

1. The Agreement shall not apply to holding companies within the meaning of the special Luxembourg laws (currently the Acts of 31st July 1929 and 27th December 1937). Neither shall it apply to income derived from such holding companies by a person domiciled in the Federal Republic of Germany or to shares in such companies belonging to such person.

2. The Agreement shall not apply to non-recurrent taxes on fortune or on capital gains.

3. If any doubts arise with respect to the future taxes to which the Agreement shall apply, the competent authorities of the Contracting States shall come to an understanding with a view to interpreting or amending the Agreement as may be considered necessary.

2. Tax status related exclusion (German-Canadian Agreement)

Article 29

Miscellaneous rules

1. With respect to income taxable in a Contracting State, the provisions of this Agreement shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded:

- a) By the laws of a Contracting State in the determination of the tax imposed by that State, or;
- b) By any other agreement entered into by a Contracting State.

2. It is understood that nothing in the Agreement shall be construed as preventing:

- a) Canada from imposing its tax on amounts included in the income of a resident of Canada according to Section 91 of the Canadian Income Tax Act;
- b) The Federal Republic of Germany from imposing its taxes on amounts included in the income of a resident of the Federal Republic of Germany according to Part 4 of the German "Aussensteuergesetz".

Where such imposition of tax gives rise to a double taxation, the competent authorities shall consult for the elimination of such double taxation according to paragraph 3 of Article 25.

3. Articles 6 to 23 of this Agreement shall not apply to non-resident-owned investment corporations as defined under Section 133 of the Canadian Income Tax Act, or under any similar provision enacted by Canada after the signature of this Agreement, or to any income derived from such companies by any shareholders thereof.

B. THE "SUBJECT TO TAX" APPROACH

B1 (Germany-United Kingdom treaty)

Article VI

1. Dividends paid by a company resident in one of the territories to a resident of the other territory may also be taxed in the former territory. Tax shall not, however, be charged in that former territory at a rate in excess of 15 per cent on the gross amount of such dividends provided that those dividends either are subject to tax in the other territory or, being dividends paid by a company which is resident in the United Kingdom, are exempt from Federal Republic tax under the provisions of subparagraph (a) of paragraph 2 of Article XVIII.

2. Notwithstanding the provisions of paragraph 1 of this Article Federal Republic tax on dividends paid to a company resident in the United Kingdom by a company resident in the Federal Republic at least 25 per cent of the voting shares of which are owned directly or indirectly by the former company may be charged at a rate exceeding 15 per cent but not exceeding 25 per cent if the rate of Federal Republic corporation tax on distributed profits is lower than that on undistributed profits, and the difference between those two rates is 28 per cent or more; where the difference between the two rates is 20 per cent or more but less than 28 per cent Federal Republic tax on such dividends may be charged at a rate exceeding 15 per cent but not exceeding 20 per cent.

3. Where a company which is a resident of one of the territories derives profits or income from sources within the other territory, there shall not be imposed in that other territory any form of taxation on dividends paid by the company to persons not resident in that other territory, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, whether or not those profits represent, in whole or in part, profits or income so derived.

B2 (Germany-Switzerland treaty)

Article 23

2. Even though a company meets the conditions provided in paragraph 1, a company resident in Switzerland in which persons who are not residents of Switzerland have, directly or indirectly, a substantial interest in the form of a participation, may only claim the benefit of the reduction of taxes imposed by the Federal Republic of Germany on German source interest [Article 11, paragraph¹], royalties [Article 12, paragraph¹], and on capital gains [Article 13, paragraph³], if these interests, royalties, or capital gains are subject, in the canton in which this company has its seat, to the cantonal tax on income under the same or similar provisions as are envisaged in regarding the federal defence tax.

3. A family foundation resident in Switzerland may not claim the benefit of the reductions of tax imposed by the Federal Republic of Germany on German source dividends [Article 10, paragraph², through⁴], interest [Article 11, paragraph¹], and royalties [Article 12, paragraph¹], and capital gains [Article 13, paragraph³], if the founder, or the majority of the beneficiaries are non-residents of Switzerland and more than one-third of the relevant income is not, or will not benefit persons which are residents of Switzerland.

4. If the competent authority of the Contracting State, from which the items of income originate, has reasonable grounds to cast doubt on the declarations made by the recipient of the items of income in his effort to obtain a tax reduction, which are confirmed by the competent authorities of the other State, then the competent authority of the first-mentioned State shall communicate these grounds to the competent authority of the other State; this authority shall then undertake a new investigation and inform the competent authority of the first-mentioned State of the conclusions reached. In case of disagreement between the competent authorities of the two States, Article 25 shall apply.

C. THE "CHANNEL" APPROACH

German-Swiss tax treaty

Article 23

1. A company which is a resident of a Contracting State, and in which persons who are not residents of that State have, directly or indirectly, a substantial interest in the form of a participation, or otherwise, may only claim the tax reductions provided for in Articles 10 through 12 with respect to dividends, interest, and royalties, derived from sources in the other State, as provided for in Articles 10 through 12, where:

- a) The interest-bearing debts to persons who are not residents of the first-mentioned State are not higher than six times its equity capital and reserves; this restriction does not apply to banks and similar institutions;
- b) The interest paid on loans agreed upon with non-resident lenders is not paid at a higher rate than the normal interest rate; the normal interest rate means:
 - i) With respect to the Federal Republic of Germany: the rate of the current yield of interest-bearing securities from inland issuers plus two percentage points,
 - ii) With respect to Switzerland: the average interest rate on debt obligations issued by the Swiss Confederation plus two percentage points;
- c) Not more than 50 per cent of the relevant income derived from sources in the other Contracting State is used to satisfy claims (interest, royalties, development-, advertising-, initial- and travel expenses, depreciation on any kind of business asset including on immaterial goods, processes, etc.) by non-residents of the first-mentioned State;
- d) Expenses connected with the relevant income derived from sources in the other Contracting State are met exclusively from that income;
- e) The corporation distributes at least 25 per cent of the relevant income derived from sources in the other Contracting State.

Additional measures already taken, or to be taken by one of the Contracting States, against abuse of the use of tax relief relating to withholding tax levied at source in the other Contracting State, are not prejudiced hereby.

TAXATION AND THE ABUSE OF BANK SECRECY¹

1. This report was derestricted by the OECD Council on 3rd July 1985.

I. INTRODUCTION

1. When the Council adopted, on the 21st September, 1977 a Recommendation on Tax Avoidance and Evasion, it established certain aims and instructed the Committee on Fiscal Affairs to pursue its work with a view to facilitating the achievement of these aims and to submit, as appropriate, specific proposals for increased co-operation between Member countries. It is in accordance with this mandate that this report has been prepared. Thus, though this note takes account of the legitimate reasons for safeguarding bank secrecy against ordinary third parties and refers to some of the non-fiscal reasons why there is support for bank secrecy, its focus is on the consequences that bank secrecy may have from the point of view of equity and the efficiency of tax collection.

2. Bank secrecy matters to tax authorities because it can be abused to escape payment of tax due. It may also provide an obstacle to international exchanges of information, the furtherance of which is one of the main aims of the Committee¹. In view of the importance of the subject, the Committee therefore considered that it should put on record its views as tax experts.

3. It may be added that the Committee on Fiscal Affairs is not alone in this opinion and that the Parliamentary Assembly of the Council of Europe adopted in 1978 the following resolution [Recommendation 833(1978) of the Parliamentary Assembly].

“4. Noting that unreasonably restrictive rules of bank secrecy encourage the commitment of international tax offences;

II. Recommends that the Committee of Ministers:

- i) urge governments of the Council of Europe member states to abolish unduly strict rules on bank secrecy, wherever necessary, with a view to facilitating investigations in cases of tax evasion or concealing income arising from other criminal activities, while paying due regard to the protection of individual privacy.”

4. This report considers successively the major aspects of bank secrecy and the scope for improving international co-operation in related tax matters.

II. TAX AND NON-TAX ASPECTS OF BANK SECRECY

A. Tax aspects

5. There exist in all countries provisions which oblige or enable a bank to refuse disclosing information about its clients' affairs to ordinary third parties. Bank secrecy derives

from the concept that the relations between a banker and his customer obliges the banker to treat all of his customer's affairs as confidential. However, this confidentiality can be abused to escape tax.

6. Unduly restrictive bank secrecy has undesirable consequences from the point of view of tax administrations and taxpayers:

- Governments are deprived of receipts because tax administrations remain in ignorance of a number of transactions;
- There is a lack of equity between those taxpayers who can and do exploit this particular loophole, and those who cannot² or do not, which distorts the distribution of the tax burden and which may lead to disillusionment with the fairness of the tax system;
- International co-operation between tax administrations may be hampered.

7. Accordingly, the governments of a number of OECD Member countries have taken the view that tax authorities should not be treated as ordinary third parties with respect to bank secrecy where the possibility of tax evasion arises, and bank secrecy may be lifted in the case of the tax authorities in these circumstances. The Committee welcomes these developments, noting that the tax authorities themselves are bound to secrecy towards ordinary third parties and, in a number of cases, even towards other administrative departments.

8. The Committee notes also the fact that the tax authorities of some countries have greater possibilities of obtaining information from banks than those of others alerts the former to situations where their taxpayers escape taxation by going beyond their reach and arranging their affairs in or through places offering them better protection. Such undesirable effects could be remedied through international co-operation if there was a generally accepted approach to bank secrecy where tax avoidance and evasion may reasonably be inferred. The need for such international co-operation is strengthened by the fact that it is impossible, and undesirable, for the authorities of one country to extend unduly the application of their laws beyond their own jurisdiction. A number of countries have passed legislation which prohibits the disclosure or production of documents in compliance with legal instructions of foreign authorities by the residents. Information necessary for judicial or administrative proceedings may then be obtained only with the co-operation of the other country.

B. Non-tax aspects

9. Apart from the need to protect the bank client's privacy, the main argument for bank secrecy has been that a country's banks should not be put at a competitive disadvantage vis-à-vis those of other countries. There are many factors, as well as bank secrecy, which may influence the location of bank deposits, such as the efficiency of the banking system, prevailing rates of interest and the general economic climate. However, it is noteworthy that the major financial centres, especially those in non-OECD countries, do have strict bank secrecy rules.

10. Bank secrecy towards the tax authorities could influence the location of bank deposits only insofar as practices differed among countries. In practice most countries do not feel the need for bank secrecy to apply to tax authorities, though in a few countries such secrecy does apply generally, or only in respect of deposits by non-residents. If it is considered

that any competitive disadvantage due to this disparity should be remedied by harmonization, this could be achieved, for the reasons set out in Part I A above, through relaxation of bank secrecy vis-à-vis tax administration in the relevant countries.

11. Bank secrecy might indirectly have some undesirable effects on those countries which have balance-of-payments difficulties and are in need of foreign capital inflow. Due to technical limitations in tax offices and exchange control units, some of the proceeds which legally ought to be repatriated (e.g. earnings from exports of goods and services) are sometimes left abroad and deposited in foreign banks which deprives the country of some foreign exchange resources.

12. As is known, bank secrecy is also used to hide funds derived from illegal activities (e.g. traffic in drugs and stolen goods) or to frustrate exchange control measures. The relation between "crime" and "secrecy" is therefore attracting increasing attention³. It is noteworthy that, even in countries where there is a strict bank secrecy, the latter may be lifted as part of penal proceedings.

III. SCOPE FOR IMPROVED INTERNATIONAL CO-OPERATION

A. Exchange of information

13. Whether or not bank information concerning taxpayers may be obtained and transmitted to another State normally depends both on domestic powers and on the existence of either a double taxation convention with provision for exchange of information or a more general mutual assistance treaty. The basic issue here is whether special considerations apply, or should apply, to bank information as compared to information from other sources.

14. There is nothing in the provisions of Article 26 of the OECD Model Double Taxation Convention to suggest that special considerations would justify special restrictions in the exchange of bank information. Where the information obtained from banks is already at the disposal of the competent authorities of the requested State (e.g., because of reporting requirements there), there should therefore be no objections to the transmission of such information abroad.

15. Even when the information requested is not available in the documentation of the requested State, there is nothing under the Model Convention to suggest more restrictive treatment of bank information than of other kinds of information. The assistance provided by the requested State will depend on general considerations such as: is the request acceptable? To what extent should the limitations provided under paragraph 2 of Article 26 be used?

16. Though tax authorities' possibilities of having access to bank information differ widely between countries, it is considered that tax authorities should, wherever possible, show restraint in making use of the rights of refusal offered by paragraph 2 of Article 26 (for reasons of "reciprocity" or "business secrecy"). There seems no reason, from a legal point of view, to single out bank information for special attention. Much would probably depend on the particulars of the case and on the extent to which tax authorities feel able to exercise, in that particular case, powers that are recognised by the Courts.

17. Because differences in the "level" of bank secrecy might lead to a very minimal exchange of information taking place between some countries, it is stressed that the authorities of the requested State should show restraint before turning down a request for information and should, to every possible extent, take account of the arguments developed by the applicant State, which would normally be in a better position to evaluate whether or not tax evasion is likely to be occurring. In other words, as previously stated, the principle of reciprocity should be interpreted as widely and flexibly as possible.

18. Subject to the special problems referred to in the last two paragraphs, competent authorities should be ready to furnish to their treaty partners any information obtained from banks that they would be able to use domestically.

19. Some countries have also indicated that they are prepared, on the basis of their domestic legislation, to take unilateral action to furnish information available from banks.

B. Other instruments

20. Where tax evasion is a criminal offence and/or tax authorities may initiate criminal proceedings, bilateral or multilateral agreements for assistance in criminal matters might be used in specific cases to solve difficulties arising from bank secrecy. Though domestic legislations vary, this is likely to depend on whether there is enough suspicion or evidence of evasion.

21. Since 1982, the United States authorities have taken initiatives to secure co-operation in information exchanges from countries of the Caribbean Basin. Under this approach, countries in that area must relax bank and commercial secrecy through the negotiation of agreements with the United States before certain United States' benefits would become available. These agreements would be similar to mutual assistance treaties insofar as tax matters were concerned, and both civil and criminal tax information would be covered.

IV. SUMMARY OF SUGGESTIONS

22. The Committee sees two means of making practical progress in this field:
- Increasing where necessary the information available domestically through relaxation of bank secrecy towards tax authorities;
 - Making further use through exchange of information procedures of data obtainable from banks.
23. On the first approach, the Committee urges the tax authorities of those countries whose laws do not permit them to obtain sufficient information from banks to stress the importance of amending these laws: to this end reference could be made to the growing relaxation of bank secrecy in relation to tax authorities in other OECD Member countries and to recommendations of international organisations such as the Council of Europe (see paragraph 3 above).

24. On the second approach, the following possibilities are foreseen for making practical progress. Competent tax authorities should:

- a) Endorse the view that there is no special problem about exchanging bank information (paragraphs 13-15);
- b) Be prepared to exchange information to the maximum extent possible under the provision of Article 26 of the OECD Model Convention (paragraphs 16-18);
- c) Where appropriate, provide information on a unilateral basis.

V. FINAL REMARKS

25. *Austria, Luxembourg, Portugal and Switzerland* could not adhere to the text of this report, nor to the suggestions made in paragraphs 22 to 24.

NOTES AND REFERENCES

- 1. Cf. the multilateral Convention on mutual administrative assistance in tax matters which has been drafted in conjunction with the Council of Europe.
- 2. In particular those whose income is derived entirely from wages and salaries.
- 3. E.g. see: *Crime and Secrecy: the use of offshore banks and companies*, U.S. Senate, Committee on Governmental Affairs, United States G.P.O., Washington 1983.