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## Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty (A Critique of the OECD's Report: Harmful Tax Competition: An Emerging Global Issue)

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# TAXATION IN THE GLOBAL ARENA: PREVENTING THE EROSION OF NATIONAL TAX BASES OR IMPINGING ON TERRITORIAL SOVEREIGNTY?

## (A Critique of the OECD's Report: "Harmful Tax Competition: An Emerging Global Issue")

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## PREFACE

This article scrutinizes the latest recommendations published by the Organisation for Economic Co-operation and Development ("the OECD")<sup>1</sup> in its report "Harmful Tax Competition: An Emerging Global Issue ("The Report").<sup>2</sup> The significance of these recommendations is profound. This article seeks to expose the true meaning underlying this latest effort by the OECD toward creating a "level playing field"<sup>3</sup> in the international taxation forum. Moreover, this article tries to: (1) give meaning to terms that the OECD fails to define; (2) reveal the means by which the OECD intends to encourage other nations to adopt its utopian recommendations; and (3) bring to the surface the significance of The Report's odious tenets.

Special attention is given to the ramifications of The Report's recommendations upon sovereigns within the Caribbean basin<sup>4</sup>, whose economic survival relies heavily on the offshore financial investment industry. The article identifies those areas of The Report that appear overly ambiguous, subjective in nature, and potentially in violation of public international law. To clarify the basis of the critiques, the article traces who is being harmed and who has the most to gain from this untenable campaign against the economically inferior states.

Part I of this article provides a brief discussion of several topics helpful for comprehending the juxtaposition of forces that converge to create "frictions."<sup>5</sup> The first subject discussed is taxation and its nexus with the administration of an effective government; the article familiarizes the reader with basic taxation concepts and boilerplate terms. Part I also provides a gen-

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<sup>1</sup> The OECD was born in 1961 from the need to restructure its predecessor, the Organization for European Economic Co-operation. *See infra* Part I.B. *See also* THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 1 (1998) [hereinafter THE REPORT].

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* at 9.

<sup>4</sup> For example the Cayman Islands, a British dependent territory. *See The Mounting Assault on Financial Privacy*, OFFSHORE OUTLOOK, v.3 Issue 49 (1998).

<sup>5</sup> Frictions arise between sovereigns when, in a global marketplace, countries are forced to enter into administrative and political consultation to counter the effects of living in an increasingly interdependent world. *See* R.F.M. Lubbers, *The Globalization of Economy and Society* (visited Oct. 27, 1998) <<http://www.globalize.org/globview.html>>.

eral overview of the OECD's expanding role in the international fiscal taxation arena. Additionally, it studies how the OECD is continuously stymied by the economic and technological developments that drive globalization,<sup>6</sup> this century's greatest phenomena. Lastly, Part I briefly summarizes the OECD's most recent report.

Part II identifies the most odious portions of The Report, those that receive the most criticism from experts in the field of international taxation. It unmaskes the true intent of The Report's relevant sections. The final underlying meaning of The Report and its utopian proposals is then ascertained through a close examination of the language used. Part II also critiques the recommended factors for determining whether a state is a tax haven.<sup>7</sup> Lastly, this section explores the measures by which the OECD intends to urge compliance.

Part III of this article, the conclusion, attempts to answer the questions that the OECD's report has not addressed. Furthermore, this section pinpoints the options and decisions which offshore financial centers face in light of The Report's far reaching recommendations. Lastly, the conclusion provides an example of a situation involving a tax haven and a super-power state who face just such dilemmas in light of The Report, and observes their reactions.

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<sup>6</sup> Globalization entails a migration of independent national economies to a global marketplace; it is the becoming or making of 'worldwide.' *See id.* It is characterized by a "continuously reinforced interaction between politics, technology, and economies." *Id.*

<sup>7</sup> *See* David E. Spencer, *OECD Report Cracks Down on Harmful Tax Competition*, 9 J. INT'L TAX'N 26, 31 (1998). A tax haven is a tax-sheltered place. It is a tax paradise where a party is protected from taxation and allowed to reap the reward of a tax-free environment. More precisely, a tax haven is "a country or territory that grants to individuals and corporations the opportunity to allow them to escape from taxation in their country of origin, or to benefit from a tax system which is more advantageous . . . ."; MICHEL W.E. GLAUTIER, FREDERICK W. BASINGER, A REFERENCE GUIDE TO INTERNATIONAL TAXATION 54 (1987) [hereinafter THE GUIDE].

## I. HISTORY AND BACKGROUND

A. *Taxation: The Sovereign Right*

Taxation and the sovereign's absolute right to tax its subjects have their origins "in antiquity."<sup>8</sup> The right to tax forms one of the most intimate relationships between the sovereign and its subjects.<sup>9</sup> Kings and dictators may have given way to constitutional monarchs and democratic presidents, but taxation remains an essential part of government.<sup>10</sup> Governments have thus been forced to develop and adjust their formal taxing mechanisms to operate within the bounds of democratic societies.<sup>11</sup>

Taxation regimes, in their most primitive forms, evolved from two competing notions that "every man payeth equally for what he useth"<sup>12</sup> and that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."<sup>13</sup> These two divergent views have since become known, respectively, as the benefit and the ability-to-pay theories.<sup>14</sup>

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<sup>8</sup> THE GUIDE, *supra* note 7, at xi. The ability to raise revenue is directly linked to the ability to rule. The ability to successfully raise revenue has always been connected to and associated with the maintenance of a powerful and efficient army. Armies were in turn used by the king to secure the loyalty of servants and obtain the allegiance of other subjects. A weakened ruler would lose control over his domain when the bank was empty, and thus render the state unable to buy the allegiance of subjects. *See id.*

<sup>9</sup> *See id.*

<sup>10</sup> *See id.*

<sup>11</sup> *See id.* The limits imposed in taxation under a democratic scheme are grounded in the notion that the government's spending is under the watchful eye of the people, and that it is the people, not the king, who decide which taxes should be imposed after the government's fiscal budget is determined. Under democracy, governments are no longer free to arbitrarily impose taxes upon the people. *See THE GUIDE, supra* note 7, at xi.

<sup>12</sup> THOMAS HOBBES, THE LEVIATHAN 239 (Richard Tuck ed., Cambridge Univ. Press 1991) (1651).

<sup>13</sup> *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 310 (Edwin Cannan ed., Methuen & Co. 1925) (1776).

<sup>14</sup> *See* James Buchanan, *The Pure Theory of Government Finance: A Suggested Approach*, in FISCAL THEORY AND POLITICAL ECONOMY: SELECTED ESSAYS 12 & n.5 (University of North Carolina Press 1960) (1949). Under the benefit theory, a just tax distributes the tax burden in accordance with the distribution of governmental goods and services. *See id.* Meanwhile, under a pure ability-to-pay theory, those with greater capacity pay more tax. *See* SMITH, *supra* note 13, at 310.

In modern society, taxation remains an essential ingredient in the make-up of an effective government; because of this, nations ardently guard their right to tax all entities within their jurisdiction.<sup>15</sup> While type and method can vary depending on need, all independent states employ some formal system of taxation.<sup>16</sup> Governments' ability to tax the subjects within their national territory is based on one or all of the following rationales: (1) "citizenship"<sup>17</sup> based taxation; (2) "residence"<sup>18</sup> based taxation, and (3) "source"<sup>19</sup> based taxation. As a principle of customary international law, a country has prescriptive jurisdiction over its nationals, regardless of where they may be.<sup>20</sup>

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<sup>15</sup> See THE GUIDE, *supra* note 7, at xi. A nation's traditional jurisdiction extends to its physical boundaries, the boundary that under international law would define or mark its domestic (national) territory. Lawyers often refer to this in a legalistic sense as the point to where the "writ of sovereign law runs." *Id.* Practically, the state's right to tax is limited by its ability to exert its rights and authority. *See id.*

<sup>16</sup> *See id.*

<sup>17</sup> *See id.* at 37. In a citizenship-based taxing jurisdiction, so long as the subject is a citizen of that state he incurs tax liability. Citizenship is determined under the applicable laws of that state. An individual's citizenship is commonly established by the place of birth. Corporations, much like individuals, are deemed citizens of the jurisdiction in which they originate. For a corporation, their birth place equivalent is the place in which they are incorporated. *See THE GUIDE, supra* note 7, at 37-40.

<sup>18</sup> *See id.* at 37. In a residence-based taxing jurisdiction, regardless of whether the taxpayer is a citizen, simply being a resident of that jurisdiction is alone reason enough to incur a tax. Residence is determined under that particular jurisdiction's existing laws, a process that usually entails a determination of where the subject normally resides and where he conducts a substantial amount of his activities. In the case of an individual, residence is based on where he normally lives. Most countries employ a number of days present in the jurisdiction test. *See id.* at 37, 41-43. For example, residency may attach to an individual after 183 days, as is the case in the United States, or at a later time, such as 5 years, as is the case in France. *See id.* at 43 tbl. 3-2. Generally, the residence of a corporation, much like its citizenship, is presumed to be where the corporation was incorporated. *See id.* at 44. However, this is not always the case. For example, under the law of the United Kingdom [hereinafter the UK], even if a corporation is incorporated in State B and merely holds its board meetings in the UK, it has nonetheless incurred tax liability in the UK. *See MILTON GRUNDY, THE WORLD OF INTERNATIONAL TAX PLANNING* 24 (1984).

<sup>19</sup> *See THE GUIDE, supra* note 7, at 37. In a source-based taxing jurisdiction, where neither citizenship nor residency is relevant, if a subject derives income from a source within that jurisdiction he has incurred tax liability therein. Source, as applied to both individuals and corporations, most commonly describes the geographic location from where income is derived. *See id.* at 38, 47-48.

<sup>20</sup> *See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES* §§ 411-415 (1986). Customary international law "results from a general

These taxing mechanisms were substantially easier to implement in times when people and resources were highly immobile, as lack of movement made it easy to determine which taxing jurisdiction an entity was and should be subject to. However, as entities expanded their activities across national borders, they exposed themselves to the potential of taxation in an increasingly, even in a theoretically infinite, number of jurisdictions.<sup>21</sup> When the activity and/or the location of the entity crosses national borders, the entity becomes subject to "double taxation."<sup>22</sup> Double taxation surfaces because each jurisdiction, as it is rightfully empowered to do, taxes activities and entities within its borders as it deems fit; this creates conflicts of law as multiple nations' taxing authorities attempt to claim jurisdiction over the same activity or entity.<sup>23</sup> Ideally, an entity in such an undesirable position could turn to some other supreme body of law, perhaps international tax law, to resolve these conflicts; however, no such universal body of law exists.<sup>24</sup>

As capital resources become more mobile, entities seek to move their resources into low or "zero-tax"<sup>25</sup> jurisdictions, otherwise categorized as tax havens, in an attempt to maximize

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and consistent practice of states followed by them from a sense of obligation." *Id.* at § 102(2).

<sup>21</sup> See THE GUIDE, *supra* note 7, at xii.

<sup>22</sup> See *id.* at 10. In its simplest form, double taxation occurs whenever an entity is taxed more than once on the same activity. Double taxation can occur internally within one sovereign's national borders. For example, in the United States, Canada, Australia, Switzerland, and South Africa, taxes on corporations and individuals may be levied by both the local provincial government and the federal government. See *id.* at 38. The bigger problem lies in international double taxation, which results from conflicts between the autonomous taxing authorities of different countries. For example, company XYZ has its head office in country G and branches in countries I, R, and S. Assuming each branch is a resident under that country's residency requirements, then company XYZ must pay tax to G, I, R, and S. Double taxation on an individual level often occurs when a taxpayer, resident in one country, receives some income from another country. Illustrative of this would be when a citizen of country Z is lawfully residing in country D and receives stock dividends from a company in country H. The income received could be subject to tax in country Z based on citizenship, country D based on residence, and country H based on source. See *id.* at 155-7, 165.

<sup>23</sup> See *id.* at 165.

<sup>24</sup> See THE GUIDE, *supra* note 7, at xiii ("[t]he concept of a body of international tax law agreed to in terms of an international charter does not exist.").

<sup>25</sup> GRUNDY, *supra* note 18, at 57. Although a few zero-tax jurisdictions exist in the Pacific and the Persian Gulf, the majority of them are located within the Caribbean. For the most part, each are capable of offering the same services; however, a

their return by reducing costs. Along with the growing popularity of tax havens,<sup>26</sup> "high tax countries,"<sup>27</sup> realizing that their own unilateral actions will not suffice, have sought the assistance of international organizations and encouraged a coordinated approach to counter the resulting vacuum effect that tax havens are having on their respective national tax bases.<sup>28</sup>

Nations can no longer worry solely about the national effects of a chosen taxing scheme.<sup>29</sup> Because of the increased integration of national economies, nations must now also factor into their tax system design the potential interactions their system may have with the systems of their sovereign global neighbors, and take on the often-impracticable task of designing tax systems that interact well with those systems.<sup>30</sup> Each sovereign is thus faced with two competing policy determinations: (1) to try and protect the revenue yielded from its tax base, and (2) to maintain a tax climate that favors the inflow of investment and discourages the outflow of domestic capital resources.<sup>31</sup> A sure method of accomplishing this while remaining competitive in the global market place is yet to be found, however, various approaches and recommendations have been proffered.

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few of these jurisdictions have developed a niche. For example, the Cayman Islands feature flexible company laws and attractive trusts laws. *See id.* at 66.

<sup>26</sup> It is estimated that the Cayman Islands, the world's eighth largest financial center, has attracted nearly \$500 billion in deposits. *See* Michael Allen, *A Gathering Storm Threatens to Swamp Offshore Banking*, 98 WALL ST. J. EUR. 13 (1998); *see also* THE REPORT, *supra* note 1, at para. 35 ("the available data do suggest that the current use of tax havens is large, and that participation in such schemes is expanding at an exponential rate.") (emphasis added).

<sup>27</sup> *See* THE GUIDE, *supra* note 7, at 53. High tax countries consist, for the most part, of industrialized nations. These nations face very high levels of government spending, diminishing rates of productivity from the work force, onerous budget deficits and increased burdens of debt, which force them to continue at taxing at intolerable rates. *See id.* at 265. Corporate tax rates among these high tax countries range from 34% in the United Kingdom to 56.5% in Germany. The United States' overall corporate tax rate is not much better at 38.3%. *See* OECD, *TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES* 71 tbl. 3.14 (1991) [hereinafter *TAXING PROFITS*]. In regard to personal taxation on interest income, the above countries' tax rate average is 20%, 39.1% and 28%, with the distinction of the highest average tax rate going to Austria at 39.7%. *See id.* at 78 tbl. 3.19.

<sup>28</sup> *See* THE GUIDE, *supra* note 7, at 266; *see also* *TAXING PROFITS*, *supra* note 27, at 13.

<sup>29</sup> *See* *TAXING PROFITS*, *supra* note 27, at 13.

<sup>30</sup> *See id.* at 13.

<sup>31</sup> *See id.*



### B. *The Inception of the OECD*

The OECD was established in 1961 to continue the work of its predecessor, the Organisation for European Economic Co-operation ("OEEC").<sup>32</sup> The OEEC was instituted shortly after the Second World War to assist in rebuilding Europe, but it was unable to keep pace with the ever-changing global market place. Trade barriers within Europe were crumbling, the once immeasurable distance between industrialized nations separated by oceans was shrinking, and spill over effects from one nation's economic policies into neighboring countries were beginning to surface.<sup>33</sup> This increasing interdependence amongst industrialized nations caused the notion of international economic cooperation to become much more attractive for both European and North American countries.<sup>34</sup> The OEEC, recognizing that time to cooperate on a worldwide basis was ripe, prepared for a major organizational restructuring.

In December of 1959, the Presidents of the United States and France, along with the Chancellor of the Federal Republic of Germany and the Prime Minister of the United Kingdom, met in Paris<sup>35</sup> to take the first steps in establishing the OECD, and to announce their intentions to implement a plan for economic cooperation.<sup>36</sup> On the 12th and 13th of January 1960,<sup>37</sup>

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<sup>32</sup> See generally THE ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, THE OECD 9 (16th ed.) [hereinafter *The Book*]. The OEEC was established under the auspices of the Marshall Plan to administer aid and assist the European continent in recovering from the economic disaster of World War II. Those two tasks had all but been completed in 1961. Even before 1961, the OEEC had started to recognize its inability to better address the needs of a rapidly expanding Europe. See *id.*

<sup>33</sup> See *id.*

<sup>34</sup> The United States and Canada formed the North American contingency. See *id.* at 10.

<sup>35</sup> See *id.*

<sup>36</sup> The intentions were incorporated into the communiqué, issued at the close of the December 21st meeting, which read as follows:

[r]ecognising the great economic progress of Western Europe . . . [and] that virtually all of the industrialized part of the free world is now in a position to devote its energies in increased measure to new and important tasks of co-operative endeavor with object of: (a) furthering the development of less developed countries, and (b) pursuing trade policies directed to the sound use of economic resources and the maintenance of harmonious international relations, thus contributing to growth and stability in the world economy and to a general improvement in the standard of living.

representatives from thirteen countries<sup>38</sup> and the European Economic Commission met and adopted resolutions, which were unanimously approved, enumerating certain preliminary actions that needed to be taken.<sup>39</sup> As a result of this meeting, a group of four persons, later known as the "Four Wise Men,"<sup>40</sup> were selected and began holding meetings in Paris to work toward setting up this new and improved organization.

On April 7, 1960 the long anticipated report of the Four Wise Men, entitled "A Remodeled Economic Organisation,"<sup>41</sup> was released. The preamble of the report stressed the great economic strides of Western Europe and its two new associates, the United States and Canada; it noted new types of problems that demanded a unified front, and it described the spill over effect of economic policies into neighboring countries.<sup>42</sup> The report proposed that the remodeled OEEC should be called the OECD, a name that would not only emphasize the organization's concern for the growth of its own members, but also fortify the organization's interest in the economic health of lesser-developed countries.<sup>43</sup> The report defined the aims of the organization,<sup>44</sup>

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See The Book, *supra* note 32, at 10-11.

<sup>37</sup> See *id.* at 11.

<sup>38</sup> Belgium, Canada, France, Denmark, the Federal Republic of Germany, Greece, Italy, the Netherlands, Portugal, Sweden, Switzerland, the United Kingdom and the United States. See *id.* n.1.

<sup>39</sup> The representatives from the thirteen governments and the European Economic Commission proposed that: (1) A meeting of senior officials from the twenty governments be held in Paris on April 19, 1960 to consider the best means to attain its objectives; (2) a group of four persons be appointed to prepare a report examining the most effective methods for attaining their objectives and that appropriate recommendations also be made; (3) prepare and submit for approval the necessary articles of the agreement, and (4) identify any current functions of the OEEC which would continue to be governed under the proposed improved organization; and (3) the above appointed group consult with all twenty governments and any relevant international organizations in preparing their report. See *id.* at 11-12.

<sup>40</sup> The group was composed of Ambassador W. Randolph Burgess, M. Bernard Clappier of France, Sir Paul Gore-Booth of the United Kingdom, and Mr. Xenophon Zolotas of Greece. See *id.* at 13 & n.2.

<sup>41</sup> See The Book, *supra* note 32, at 11.

<sup>42</sup> See *id.* at 14.

<sup>43</sup> See *id.*

<sup>44</sup> The aims, as finally agreed to under Article 1, were to:

(a) achieve the highest sustainable economic growth and the employment and rising standard of living in Member countries, while maintaining financial stability, and thus contribute to the development of the world

suggested that the founding membership initially be limited to members and associates of the OEEC, including the United States and Canada,<sup>45</sup> provided provisions for accepting new members,<sup>46</sup> enumerated the obligations of its members,<sup>47</sup> and made recommended a smooth transitional period.<sup>48</sup>

In order to assure a "smooth transitional period," the report called for the establishment of a Preparatory Committee ("Committee") whose composition included representatives from the twenty governments and which was chaired by the Secretary General Designate.<sup>49</sup> The Committee began working on the 14th of September and continued without interruption until November 23rd, 1960.<sup>50</sup> On December 13th, in a meeting held in Paris, the Ministers of each member country approved the Committee's report and on the next day the Convention establishing the OECD was signed.<sup>51</sup> During the first nine months of 1961, the primary focus was on the continued restructuring of the nascent organization into what is now the OECD.<sup>52</sup> By September 30th the OECD was in full operation and had passed the transitional phase with extraordinary smoothness.<sup>53</sup>

The OECD has continued to meet and address the problems that confront its members in the ever-changing, fast-paced global environment. The OECD has thus far withstood the test of time and remained true to its philosophy of a unified multi-lateral approach to seeking solutions for matters that pose a danger to its members. With the globalization of economies, the emergence of third world countries in the international market place, and the increasing free flow of investments, the OECD is

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economy; (b) to contribute to sound economic expansion of Member as well as non-member countries in the process of economic development; and (c) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

*Id.* at 19.

<sup>45</sup> *See id.* at 14.

<sup>46</sup> *See* The Book, *supra* note 32, at 14.

<sup>47</sup> *See id.*

<sup>48</sup> *See id.* at 14-15.

<sup>49</sup> *See id.* at 14.

<sup>50</sup> *See id.* at 15.

<sup>51</sup> *See* The Book, *supra* note 32, at 15-16.

<sup>52</sup> *See id.* at 16.

<sup>53</sup> *See id.*

now faced with a new breed of problems that it may well be ill equipped to handle.<sup>54</sup>

C. *The Interim: Globalization—The Economic Phenomena of the 20th Century*

Globalization,<sup>55</sup> arguably the Twentieth Century's greatest economic event, is believed to be a direct by-product of liberalizing national economies.<sup>56</sup> The crumbling of international trade and investment barriers, when considered in conjunction with the recent technological boom, has forced both governments and multinational enterprises ("MNEs")<sup>57</sup> to implement global strategies if they desire to remain competitive. Along with the advent of technology and a globalized market place has come the ease with which entities may move capital across borders and the expansion of international financial markets.<sup>58</sup> Governments, MNEs and individuals have all felt globalization's positive effects in some form or other.<sup>59</sup>

Advancements in technology, together with the increased mobility of capital and the highly competitive financial environment, have posed new challenges for governments. Governments are under fire to: (1) determine which revenue and expenditure structures are best suited to their political and so-

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<sup>54</sup> For example, some of the new problems with which the OECD is faced are dealing with limited capacity of local taxing authorities to control the outflow of capital resources as these resources become highly mobile. See THE REPORT, *supra* note 1, at para. 4, 11, 13.

<sup>55</sup> See Lubbers, *supra* note 5.

<sup>56</sup> See THE REPORT, *supra* note 1, at 8.

<sup>57</sup> MNE's are entities that conduct their affairs in numerous countries. In essence, an MNE is considered completely operational in each country that it is in. In comparison, an international enterprise extends its net of activities across national borders. An example of such activities would be import and export operations. Also in existence are global enterprises that look at the world economy as one market. See generally Lubbers, *supra* note 5.

<sup>58</sup> See The Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (visited Sep. 11, 1998) <[http://www.oecd.org/daf/fa/TAX\\_COMP/taxcomp.htm](http://www.oecd.org/daf/fa/TAX_COMP/taxcomp.htm)> [hereinafter The Site].

<sup>59</sup> Some of the more positive affects according to the OECD have been: (1) modernization of taxing systems via tax reforms; (2) erosion of the links between a MNE and any one nation; (3) reduced costs of capital to MNEs; (4) encouraged governments to fine tune their taxing and spending systems to make their investment markets more attractive, and (5) enhanced prosperity for the individual investor. See THE REPORT, *supra* note 1, at 13-14.

cial conditions (based primarily on their ideological beliefs);<sup>60</sup> (2) develop policies to continue taxing activities that are increasingly more mobile in nature, while not having those same policy determinations spill over into neighboring states; and (3) close the gaping holes which corporations and individuals may use to "escape" taxation.<sup>61</sup>

Countries whose borders have been blurred because of the globalizing phenomena have been forced to sacrifice too much of their sovereignty in order to reap the benefits of partaking in the global marketplace.<sup>62</sup> Globalization has also resulted in the odious tenet, embraced by a few industrialized nations<sup>63</sup> and other non-governmental world organizations,<sup>64</sup> that hold that because an entity is a world leader it may impose its own laws and value systems extraterritorially. Professor Lubbers, a leading scholar of the globalization process, who stated "we may have one world, but we will have to make due with states,"<sup>65</sup> has summarily critiqued this tenet. Clearly, the inference to be drawn from this statement is that, although the world may be shrinking, governments nonetheless continue to do their work on the basis of territoriality within the borders of their own state.<sup>66</sup> This places great emphasis on the preservation of a state's territorial sovereignty as mandated under the Charter of

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<sup>60</sup> See MASON GAFFNEY, INTERNATIONAL TAX COMPETITION: HARMFUL OR BENEFICIAL? 6-7 (August 1998); THE GUIDE, *supra* note 7, at 155-156.

<sup>61</sup> See THE REPORT, *supra* note 1, at para. 42. It should be noted that, in past reports, the OECD has attempted to distinguish between "tax avoidance" and "tax evasion," the former being lawful while the latter is unlawful. See OECD, INTERNATIONAL TAX AVOIDANCE AND EVASION 10-11 (1987). However, it seems that the OECD no longer wishes to make this distinction and thus has created a new term in the field of tax mitigation-to "escape" taxes. See GAFFNEY, *supra* note 60, at 15.

<sup>62</sup> See generally Lubbers, *supra* note 5. Sovereign administrative powers of states have been weakened by: (1) erosion of borders making it easier for cross-border flows of capital; (2) need for international collaboration to tackle problems, and (3) short-term thinking syndrome within governmental organs and electoral cycle. See *id.*

<sup>63</sup> Such as the United States of America, the United Kingdom, France, and Germany. See THE GUIDE, *supra* note 7, at 54.

<sup>64</sup> For example, the OECD and the World Trade Organization. See generally Lubbers, *supra* note 5.

<sup>65</sup> *Id.*

<sup>66</sup> See *id.*

the United Nations<sup>67</sup> and as recognized under public international law.<sup>68</sup>

The OECD recognized the dangers presented by a global marketplace competing for highly mobile activities, and through various instruments<sup>69</sup> sought out the support of both its members and non-members to aid it in resolving the difficulties it could not cure on its own.<sup>70</sup> In its latest efforts against the incongruity of national taxation systems, the OECD has once again called upon this coordinated global approach.

D. *Advent of The Report: "Harmful Tax Competition: An Emerging Global Issue"*<sup>71</sup>

In May 1996, the expanded OECD<sup>72</sup> was summoned to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998."<sup>73</sup> The mandate received vast support from the world's seven largest players, the "G7,"<sup>74</sup> who stood to suffer the most if the man-

<sup>67</sup> See U.N. CHARTER art. 2, para. 4 & 8. Article 2 of the United Nations Charter maintains that "[a]ll members shall refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any state . . ." and further provides that "[n]othing contained in the present charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state . . ." *Id.*

<sup>68</sup> See *supra*, Part I.A.

<sup>69</sup> Some of the OECD's earlier reports are: ISSUES IN INTERNATIONAL TAXATION: INTERNATIONAL TAX AVOIDANCE AND EVASION (1987), TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES (1991) and TAX INFORMATION EXCHANGE BETWEEN OECD MEMBER COUNTRIES: A SURVEY OF CURRENT PRACTICES (1994).

<sup>70</sup> See THE REPORT, *supra* note 1, at para. 4-14.

<sup>71</sup> *Id.* at 1.

<sup>72</sup> The OECD now consists of 29 members. The original members, namely Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States, were joined by nine accessionists: Japan (April 28th, 1964), Finland (January 28th, 1969), Australia (June 7th, 1971), New Zealand (May 29th, 1973), Mexico (May 18th, 1994), the Czech Republic (December 21st, 1995), Hungary (May 7th, 1996), Poland (November 26th, 1996) and Korea (December 12th, 1996). See *id.* at 2.

<sup>73</sup> *Id.* at 3.

<sup>74</sup> See Les Sommest des Sept Pays Industrielles, *Lyon - Sommet du G7* (visited Oct. 28, 1998) <<http://www.ccn.cs.dal.ca/Current/HalifaxSummitG7/g7-glos.html#g7>>. The G7 or "Group of Seven," is composed of the world's seven largest economies: the United States of America, the Federal Republic of Germany, Japan,

date failed and the status quo continued. The OECD reacted by assigning its Committee on Fiscal Affairs to begin working on this issue.<sup>75</sup>

After two years of work, the Special Sessions on Tax Competition, the self-created arm of the OECD's Committee on Fiscal Affairs that was jointly chaired by France and Japan, presented the results and formally issued The Report.<sup>76</sup> The Report summarizes itself as follows:

Globalisation has had positive effects on the development of tax systems and has encouraged countries to engage in base broadening and rate reducing tax reforms. However, it has also created an environment in which *tax havens* thrive and in which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities. Tax competition in the form of harmful tax practices can distort trade and investment patterns, *erode national tax bases* and shift part of the tax burden onto less mobile tax bases, such as labor and consumption, thus adversely affecting employment and undermining the fairness of tax structures.

The Report emphasizes that governments must *intensify their cooperative actions* to curb harmful tax practices. To achieve this, OECD Member governments have developed 'Guidelines on Harmful Preferential Tax Regimes.' These Guidelines will discourage the spread of harmful preferential tax regimes and encourage countries with such regimes to eliminate them. To counteract both *tax havens* and harmful preferential regimes, Member governments have also agreed to pursue vigorously the

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France, the United Kingdom, Italy, and Canada. *See id.* The G7's endorsement was noted in their communiqué from their summit meeting in Lyon, France which read as follows:

Finally, globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to the erosion of national tax bases. WE STRONGLY URGE THE OECD TO VIGOROUSLY PURSUE ITS WORK IN THE FIELD, AIMED AT ESTABLISHING A MULTILATERAL APPROACH UNDER WHICH COUNTRIES COULD OPERATE INDIVIDUALLY AND COLLECTIVELY TO LIMIT THE EXTENT OF THESE PRACTICES. We will follow closely the progress on the work by the OECD . . . .

*See THE REPORT, supra note 1, at 7. (emphasis added).*

<sup>75</sup> *See id.* at 3 (emphasis added).

<sup>76</sup> *See id.* at para. 3; *see generally* The Site, *supra* note 58.

implementation of *other Recommendations* in The Report, including entering into a dialogue with non-member countries.<sup>77</sup>

The analysis and proposals of The Report are rooted in the proposition that as we move toward a global free market, key resources such as labor and capital become more mobile and are drawn into more attractive low tax states,<sup>78</sup> thus eroding the national tax bases of high tax states.

## II. THE REPORT: FULLY EXPOSED

### A. *Defining Harmful*<sup>79</sup>

At the outset, The Report makes its intent to focus on counteracting “harmful tax practices”<sup>80</sup> readily apparent. However, The Report never clearly states what the OECD considers harmful. For instance, paragraph 30 of The Report states that jurisdictions “that drive the *effective rate tax rate* levied on income [generated] from the mobile activities *significantly below* rates in other countries have the potential to cause harm . . .” (emphasis added).<sup>81</sup> At no time does The Report propose or even suggest a minimum effective tax rate that could be used as a type of demarcation point to determine when a jurisdiction should be considered to have engaged in this harmful act.<sup>82</sup> Moreover, the Report, in its see-sawing format, concedes that some effects of tax competition are acceptable and actually substantially beneficial.<sup>83</sup>

The Report’s concession is most obvious when it states that “intensified competition . . . in the global market place has had

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<sup>77</sup> See THE REPORT, *supra* note 1, at back cover.

<sup>78</sup> See GAFFNEY, *supra* note 60, at 2.

<sup>79</sup> Black’s Law Dictionary defines harm as “[t]he existence of loss or detriment in fact of any kind . . . resulting from any cause.” BLACK’S LAW DICTIONARY (6th ed. 1990).

<sup>80</sup> See THE REPORT, *supra* note 1, at para. 4. Paragraph 4 explicitly reads: “[t]he Report is intended to develop a better understanding of how tax havens and preferential tax regimes, collectively referred to as *harmful tax practices* affect the location of financial . . . activities, erode [national] tax bases . . ., distort trade and investment patterns . . .” See *id.* (emphasis added).

<sup>81</sup> *Id.* at para. 30.

<sup>82</sup> See, e.g., Spencer, *supra* note 7, at 32.

<sup>83</sup> Beneficial effects include simplification of tax systems, improving the investment and financial markets, expansion of international financial markets and improved standards of living world-wide. See THE REPORT, *supra* note 1, at para. 21-23.



and continues to have many positive effects.”<sup>84</sup> What The Report does object to are the effects that result from what it labels harmful tax competition. Similar to the flaw discussed above, here too The Report also fails to delimit the point at which acceptable tax competition ceases and harmful tax competition begins.<sup>85</sup>

The Report does not (nor could it ever) admit to being subjective but it comes dangerously close at various points. Not only is the substantially lowered effective tax rate test subjective to the individual country,<sup>86</sup> but The Report itself says that “[t]ax competition and the interaction of tax systems can have effects that some countries may view as negative or harmful but others may not.”<sup>87</sup> Thus, countries have no choice but to remain cautious because no clear guiding standard is formulated. Essentially, by not espousing any standard, The Report seems to allow for any country that deems itself as being harmed to make a claim.<sup>88</sup>

Although any country may theoretically bring a claim on the grounds that it is being harmed by another’s practices, after considering the make-up of the OECD and the history of the campaign against tax havens, it becomes evident that The Report’s harmful test is relative to those countries with the most to lose.<sup>89</sup> Surely, The Report would not allow for two jurisdictions that meet the criterion<sup>90</sup> of a tax haven to claim they are being harmed by another low tax state. Thus, The Report, albeit implicitly, seeks to shelter high tax states exclusively.

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<sup>84</sup> *Id.* at para. 37.

<sup>85</sup> *See, e.g.,* GAFFNEY, *supra* note 60, at 2.

<sup>86</sup> For instance if country X’s corporate tax rate is 55% and its neighbor, country B enacts a corporate tax of 40%, which is still relatively high, country X can claim that by doing so country B is harming it because no minimum effective tax rate below which a country can not go is ever mentioned in the Report. *See generally* Spencer, *supra* note 7, at 32.

<sup>87</sup> THE REPORT, *supra* note 1, at para. 27.

<sup>88</sup> *See generally* GAFFNEY, *supra* note 60, at 2.

<sup>89</sup> The U.S. has traditionally spearheaded the campaign against tax havens. As tax havens have lured in more and more business, tax administrations of developed countries have become more and more concerned. These developed countries face increased spending requirements and have seen their deficits grow, thus for them more is at stake. *See* THE GUIDE, *supra* note 7, at 265-266. High tax countries, led by the U.S., have decided that “the real culprits in the flight of investment capital [are] tax havens and their users.” *Id.* at 55.

<sup>90</sup> *See infra* Part II.B.

### B. *Identifying a Tax Haven*

Prior to considering the OECD's identifying factors, it should first be noted that even those nations who have the most to lose, the high tax states who have taken it upon themselves to develop a list of tax havens, have never been able to agree on an identical list of tax havens.<sup>91</sup> Essentially, this is because the area of international taxation is one where no consensus has ever existed. Which states are considered tax havens and which are not has always depended upon who you asked, a determination that the OECD now seeks to harmonize in its report.<sup>92</sup>

The Report's starting point for identifying a tax haven requires asking "whether a jurisdiction imposes no or only nominal taxes"<sup>93</sup> and whether it "offers itself, or is *perceived* to offer itself, as a place to be used by non-residents to escape tax in their country of residence."<sup>94</sup> The Report's other "key factors"<sup>95</sup> include "lack of effective exchange of information,"<sup>96</sup> "lack of transparency,"<sup>97</sup> and "no substantial activities."<sup>98</sup> These fac-

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<sup>91</sup> See THE GUIDE, *supra* note 7, at 231. The U.S. Internal Revenue Service [hereinafter IRS] considers some 30 jurisdictions as tax havens; Milton Grundy, an English tax expert, lists 13 to 19, and Andre Beauchamp, an expert from France, compiled a list of 47. Although all three agree on a few jurisdictions, such as the Bahamas, Luxembourg, and the Cayman Islands, they are in dispute regarding others, such as Singapore, Switzerland, Barbados and Panama. See *id.* at 232 & tbl. 15.1 at 233. Beauchamp's list is the only one of the three to consider the UK a tax haven. Beauchamp's definition of a tax haven, the most helpful of the three, may be summarized as follows: "[a] Tax Haven is country or territory that grants to individuals and corporations the opportunity to allow them to escape from taxation in their country of origin, or to benefit from a tax system which is more advantageous to them . . .," *Id.* at 232. Partly because of the leadership role of the U.S., most nations use the IRS' list as a guideline. See *id.* at 232.

<sup>92</sup> See THE REPORT, *supra* note 1, at 22.

<sup>93</sup> *Id.* at 22. Even if a jurisdiction has a taxing system in place, it may, nonetheless, be included as a tax haven. For example, although a jurisdiction may impose some tax, and thus fail the first requirement, that jurisdiction may still be considered as not having any taxes in place if its domestic source income tax is narrowly applied. See *id.* at para. 52.

<sup>94</sup> *Id.* at para. 52 (emphasis added).

<sup>95</sup> *Id.* at 23. The Report stresses the importance of each of these factors within a particular context. See THE REPORT, *supra* note 1, at para. 52.

<sup>96</sup> *Id.* at 23. Determination of lack of effective exchange of information is based on the existence of secrecy laws and other nondisclosure rules from which entities may benefit because it protects them against scrutiny from tax authorities. See *id.*; see generally, SPENCER, *supra* note 7, at 31.

<sup>97</sup> THE REPORT, *supra* note 1, at 23. Lack of transparency refers specifically to a jurisdiction's administrative practices, be they legal, legislative, or simply administrative. An example would be a law that bars bank officials, at the risk of

tors, not surprisingly, resemble those traditional indicia of a tax haven<sup>99</sup> as composed by the United State's Internal Revenue Service.

### 1. *No or Nominal Taxes and Perception*

The decision to tax or not to tax and the manner in which to tax within domestic borders is one that has always been within the absolute discretion of each sovereign.<sup>100</sup> International law proscribes that the "enforcement jurisdiction of a country is limited to its own borders . . . ."<sup>101</sup> Implicit in the principle of sovereignty is the fundamental belief that no sovereign is subordinate to another; all sovereigns are seen as equal in the eye of international law.<sup>102</sup> By using a state's method of taxation as a determinative factor, The Report impinges upon terri-

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criminal punishment, from divulging information about a depositor. This, the Report says, facilitates tax evasion and avoidance. *See id.* at para. 53.

<sup>98</sup> *Id.* at 23. No substantial activities, according to the Report, provides an inference that these jurisdictions are not attempting in good faith to attract businesses, but rather are solely focused on attracting investments for tax evading purposes because they are not requiring substantial business to occur within their own territory. *See id.* at para. 55.

<sup>99</sup> The IRS which states that there is no definition of a tax haven, developed the following criteria in identifying a tax haven: (1) imposition of no or low tax (as compared with the US); (2) high levels of bank secrecy; (3) importance of banking and financial sectors to the jurisdiction; (4) availability of modern communications; (5) lack of foreign currency controls, and (6) self promotion as a tax haven. *See THE GUIDE, supra* note 7, at 232-234.

<sup>100</sup> *See supra* Part I.A. *See also* GAFFNEY, *supra* note 60, at 4-5 (The authority to tax is "[p]urely sovereign power. Under public international law, the sovereignty of a state is recognised as territorial in scope."); Arthur J. Cockfield, *Tax Integration Under NAFTA: The Conflict Between Economic and Sovereignty Issues* 34 STAN. J. INT'L L. 39 ("[n]ation-states . . . find the prospect of ceding the power to shape tax policies — policies traditionally used to pursue domestic political, social, and economic goals-unnerving.") (emphasis added); Nancy H. Kaufman, *Fairness and The Taxation of International Income* 29 LAW & POL'Y INT'L BUS. 145, 166 ("[u]nder the principal of territoriality, in customary international law, a sovereign has prescriptive competence with respect to the activities occurring and the wealth existing within its territorial borders.") *quoting from* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 411-415 (1986); *THE GUIDE, supra* note 7, at 157 (there are "no restrictions that limit the sovereignty of countries with regard to taxation.")

<sup>101</sup> *THE GUIDE, supra* note 7, at 157 *quoting from* F.A. MANN, *STUDIES IN INTERNATIONAL LAW* 95 (1973).

<sup>102</sup> *See* ROBERT H. JACKSON, *QUASI-STATES: SOVEREIGNTY, INTERNATIONAL RELATIONS AND THE THIRD WORLD* 32 (1990).

torial sovereignty,<sup>103</sup> an act otherwise violative of international law and long-standing international doctrines.<sup>104</sup>

The Report concludes that no two taxing systems will ever be identical, because of each country's differing budgetary needs, varying levels of natural resource wealth, and deeply rooted and often contradicting ideological views.<sup>105</sup> Nonetheless, The Report insists on seeking a universal "level playing field."<sup>106</sup> It calls for a uniform tax across the globe, a goal to be achieved by imposing the standards of its most powerful members, The Report's "internationally accepted standards."<sup>107</sup>

Paragraph fifty-two explicitly states that when a jurisdiction "offers itself, or is *perceived* to offer itself, as a place to be used by non-residents to escape taxes . . ." <sup>108</sup> it may, when combined with the fact that it levies no or nominal taxes, be consid-

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<sup>103</sup> Sovereignty in the internal arena denotes the "constitutional independence of other states." See *id.* at 32. Sovereignty "is a legal, absolute, and unitary condition." *Id.* at 32 quoting from ALAN JAMES, SOVEREIGN STATEHOOD 25 (1986). Sovereignty as between states connotes independence and is essentially the right to exercise within its borders, to the exclusion of all others, the traditional functions of a state. See INGRID DETTER DELUPIS, INTERNATIONAL LAW AND THE SOVEREIGN STATE 3-4 (1987). Sovereignty refers to "the totality of powers which States may, under international law, have." JAMES CRAWFORD, THE CREATION OF STATES IN INTERNATIONAL LAW 27 (1979).

<sup>104</sup> Not only is it a violation of territorial sovereignty, but also a manner by which governments may circumvent the Act of State Doctrine. Essentially, the Act of State Doctrine binds every sovereign to respect the independence of every other sovereign, and it mandates that the judiciary of one country may not sit in judgment on the acts of another nation when those acts occur within that state's territorial boundaries. See *Underhill v. Hernandez*, 168 U.S. 250 (1897). Thus, the Report is sanctioning other branches of government—the executive or legislative—to do what the judiciary was barred from doing because of the sanctity of a state's sovereignty. It is punishing states for acts, namely deciding how to tax within its borders, that are deemed unfavorable from the viewpoint of high tax states.

<sup>105</sup> Paragraph 26 of the Report reads: "[t]he Committee recognises that there is no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have [negative effects] for other countries, these are essentially *political decisions for national governments*. THE REPORT, *supra* note 1, at para. 26 (emphasis added).

<sup>106</sup> *Id.* at para. 8. The Report considers a "level playing field" a necessity for the continued global economic growth. See *id.* But if tax competition was in part responsible for globalization, as the Report concedes, and the Report is now urging for identical tax systems with identical rates, no room for competition would exist. See generally GAFFNEY, *supra* note 60, at 6.

<sup>107</sup> THE REPORT, *supra* note 1, at para. 26. The report once again fails to define what the internationally accepted standard is. See generally GAFFNEY, *supra* note 60, at 6.

<sup>108</sup> THE REPORT, *supra* note 1, at para. 52.

ered a tax haven.<sup>109</sup> The word perception implies subjectivity, as it leaves the determination of which jurisdiction is a tax haven to the eye of the beholder.<sup>110</sup> The inadequacy of using perception as a consideration is demonstrated by the fact that no two experts have been able to agree upon a single list of tax havens.<sup>111</sup> Under a perception standard even high tax states may in theory be considered tax havens for some limited purposes.<sup>112</sup> Thus, by using perception as a criterion, the question inevitably becomes: *a tax haven according to whom?*

## 2. *Lack of Effective Exchange of Information and Lack of Transparency*

The Report is once again keying in on a decision that is ultimately one of the national government. Lack of effective exchange of information and lack of transparency are so interwoven that it might be helpful to consider them together. Both factors stem from the decision of a government to enact legislation within its borders to bar officials from divulging information to foreign tax authorities.<sup>113</sup> Whether a government permits its industries to divulge client information is a decision, as The Report recognizes, traditionally reserved to the sovereign.<sup>114</sup>

Although the high degree of privacy afforded by tax haven states is common thread, this is not to say that tax havens have been fully uncooperative in exchanging information with foreign authorities.<sup>115</sup> In areas where a consensus exists, such as in drug trafficking and money laundering, virtually all tax haven states have recognized the need to cooperate.<sup>116</sup> In the area

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<sup>109</sup> See *id.* at para. 46.

<sup>110</sup> See THE GUIDE, *supra* note 7, at 232.

<sup>111</sup> See *supra* Part I.A.

<sup>112</sup> For instance, in the UK non-residents are generally not subject to capital gains tax on interest income paid by UK banks, thus making it attractive for foreigners. See GRUNDY, *supra* note 18, at 23.

<sup>113</sup> For example, the Cayman Islands law subjects a banker to fines and imprisonment if he divulges information of a client to foreign authorities. See Allen, *supra* note 26, at 13.

<sup>114</sup> See THE REPORT, *supra* note 1, at para. 53-54.

<sup>115</sup> The Report acknowledges that "[s]ome progress has been made in the area of access to information . . . that permit[s] exchange of information on criminal tax matters related to certain other crimes . . ." *Id.* at para. 54.

<sup>116</sup> Mutual Legal Assistance Treaties in Criminal Matters Treaties [hereinafter MLATS] between the US and 19 other countries (for example: Switzerland in

of fiscal taxation, no such consensus exists. Nevertheless, a state's failure to enter into a treaty that may be of no benefit to them<sup>117</sup> is factored into the formula of identifying a tax haven. The Report seeks to criminalize an area where no international body of law exists by punishing those states who do not follow the new so called internationally accepted standards because they do not regard fiscal crimes as seriously.<sup>118</sup>

### 3. *No Substantial Activities*

The Report states that "the absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven."<sup>119</sup> The "no substantial activities" requirement calls for individual governments to make an assessment of what they consider substantial, and thus an entity's economic activity must conform to what the relevant government unilaterally deems appropriate.<sup>120</sup> The word substantial is often referred to as a "term of art" within American jurisprudence because it connotes a government's ability to impose its own views on its citizens.

### C. *OECD Recommendations: The Call for Compliance via International Coercion*

The Report's third chapter, "Counteracting Harmful Tax Competition," enumerates nineteen total recommendations that may be adopted to curb harmful tax practices.<sup>121</sup> The recommendations are proposed under the belief that "[g]overnments cannot stand back while their tax bases are eroded through the

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1977, the UK concerning the Cayman Islands, the British Virgin Islands, Anguilla, Monsterrat and the Turks and Caicos Islands in 1990, and the Bahamas in 1989) have been entered into force and 15 more MLATS have already been signed. See *Mutual Legal Assistance in Criminal Matters Treaties and Other Agreements* (visited Oct. 30, 1998) <<http://travel.state.gov/mlat.html>>.

<sup>117</sup> For example, the Cayman Islands, because they don't impose any taxes and don't need to be concerned with tax evaders, have no incentive to expend its valuable resources to assist other nations locate tax evaders. See, e.g., Allen, *supra* note 26.

<sup>118</sup> See generally THE GUIDE, *supra* note 7, at xiii; Allen, *supra* note 26, at 13; GAFFNEY, *supra* note 60, at 15-16.

<sup>119</sup> THE REPORT, *supra* note 1, at 23.

<sup>120</sup> See generally GAFFNEY, *supra* note 60, at 15-16.

<sup>121</sup> See THE REPORT, *supra* note 1, at 37.

actions of countries that offer tax payers ways to exploit tax havens . . . ."<sup>122</sup> In sum, The Report attempts to prevent a "race to the bottom"<sup>123</sup> effect. Implementation of these recommendations requires "co-ordinated action at the international level . . . ."<sup>124</sup> because the suggested measures would be more effective if they "conform to practices adopted at the international level."<sup>125</sup>

The Report, in order to maintain its integrity, has resorted to adopting the politically correct language of the times.<sup>126</sup> The greatest evidence of this is paragraph 29, which acknowledges that it is acceptable for a nation to devise its own tax system, so long as they do not

redirect capital and financial flows and the corresponding revenue from the other jurisdictions by bidding aggressively for the tax base of other countries. Some have described this effect as 'poaching' as the tax base 'rightly' belongs to the other country. Practices of this sort can *appropriately be labeled harmful tax competition as they do not reflect different judgments about the appropriate level of taxes and the public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country's sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes.*<sup>127</sup>

From this passage one might infer that The Report will consider the subjective motives behind a country's chosen tax system, an action that violates the state's territorial sovereignty.<sup>128</sup> The door is left open for those nations who have a long standing, ideologically based policy to not tax their subjects to adopt such

<sup>122</sup> *Id.* at para. 85.

<sup>123</sup> *Id.* at para. 43. Race to the bottom refers to the practice of nations continuously lowering their taxes in order to remain competitive, thus resulting in a race to the lowest tax rate - the bottom. The Report refers to nations who do so as "places that offer themselves as places to be used by non-residents to escape tax in their own country . . . ." *Id.* at para. 41-44.

<sup>124</sup> *Id.* at para. 89.

<sup>125</sup> THE REPORT, *supra* note 1, at para. 91.

<sup>126</sup> Paragraph 90 is illustrative of this, where the report concludes that "there is a strong case for intensifying international co-operation when formulating a response to the problem of harmful tax competition, *although the counteracting measures themselves will continue to be primarily taken at the national . . . level.*" *Id.* at 90 (emphasis added).

<sup>127</sup> THE REPORT, *supra* note 1, at para. 29 (emphasis added).

<sup>128</sup> See *supra*, Part I.A.

a policy, while the door is closed on nations who may choose to do the same in order to attract investors.<sup>129</sup> The distinction, between those nations who wish to reduce their taxes but are unable to do so, and those who are high tax states as a matter of principle, would prove difficult to draw, as no state would ever adopt a tax system which fails to support its budgetary needs.<sup>130</sup>

The Report calls for "severe" counter-measures to be instituted against those who do not accept and adopt its recommendations.<sup>131</sup> The Report again dodges the burden of clearly specifying what it is calling for and does not describe what severe measures are; one may infer that they would involve some form of international pressure or coercion. Such a conclusion is supported by paragraph 171, which states that it would be worthwhile for the OECD to further "explor[e] the possibility of addressing harmful tax competition using a wide range of non-tax measures."<sup>132</sup> This statement, more than any other, clearly suggests that political or economic force, namely international coercion, may be used by the OECD if tax havens are slow to voluntarily adopt their recommendations.<sup>133</sup>

This type of international coercion is perfectly logical in light of the inequality of power that exists between the OECD members, the most powerful nations in the world, and the tax havens, which are economically weaker and geographically smaller jurisdictions.<sup>134</sup> Directly forcing compliance would run contrary to the OECD member's professed democratic ideals. By allowing for voluntary conformance to their self-made standards,<sup>135</sup> the OECD leaves space for debate on the status of

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<sup>129</sup> See generally GAFFNEY, *supra* note 60, at 13-14.

<sup>130</sup> See *id.* (supporting that many countries that may want to reduce their taxes are unable to do so).

<sup>131</sup> THE REPORT, *supra* note 1, at para. 95. The Report reads: "[s]evere counter-measures are appropriate and indeed necessary to deal effectively with this extreme type of harmful tax competition." *Id.*

<sup>132</sup> *Id.* at para. 171.

<sup>133</sup> See SPENCER, *supra* note 7, at 35 ("the Committee implicitly suggests that political or economic pressures, or both, be exerted against those tax havens . . . that . . . do not voluntarily adopt the Committee's recommendations."); GAFFNEY, *supra* note 60, at 7 ("the OECD countries are seeking to counteract these effects by essentially coercive action. In practice, this means applying political pressure and seeking to intervene in the internal affairs of other jurisdictions . . .").

<sup>134</sup> See *id.* at 7.

<sup>135</sup> See *supra* Part II.B.(1).



public international law.<sup>136</sup> It is a perversely clever maneuver. By elevating their subjective internationally accepted standard test to the level of customary international law vis-à-vis state acquiescence, the OECD creates a situation where any state in violation of the newly created standard may, with time, be considered in breach of international law, and more importantly, as a consequence, be ultimately subject to increased coercion by high tax states.<sup>137</sup>

#### D. *Noteworthy Abstentions*

Switzerland and Luxembourg, both OECD members,<sup>138</sup> abstained on relatively similar grounds from being bound by The Report. Luxembourg's abstention is grounded in the belief that bank secrecy, one of The Report's "key factors,"<sup>139</sup> is not a source of harmful tax competition. Luxembourg further objected to the use of lack of exchange of information as a factor in identifying a tax haven.<sup>140</sup> These two objections stem from the concern that The Report "lends credence to the so-called criterion of reputation - a criterion without any objective basis."<sup>141</sup> This further supports this article's primary concern: the tenuous subjectivity of The Report. Luxembourg is also troubled by the fact that *any* country when compared to another could have the appearance of a tax haven.

Switzerland's objection consists of the following concerns: (1) The Report's failure to take into account non-tax factors which lead to harmful tax competition; (2) the intrusion on the territorial sovereignty<sup>142</sup> of a state (by considering the fact that tax rates of one state may be lower than another as a criterion); (3) The Report's failure to take into account the structural differences between states; and (4) the lack of incentive for off-shore centers to assist foreign states in tracking down tax

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<sup>136</sup> See GAFFNEY, *supra* note 60, at 8.

<sup>137</sup> See *id.*

<sup>138</sup> See THE REPORT, *supra* note 1, at 2.

<sup>139</sup> See *supra* Part II.B.(2).

<sup>140</sup> Luxembourg states "[i]t cannot accept that an exchange of information that is circumscribed by the respect of international laws and respective national laws be considered a criterion to identify a harmful preferential tax regime or tax haven." THE REPORT, *supra* note 1, at 74.

<sup>141</sup> *Id.* at 74.

<sup>142</sup> See *supra* Part II.B.(2).

evaders.<sup>143</sup> Switzerland concedes that some forms of tax competition may be harmful; however, Switzerland stresses that it also is not immune from these consequences.<sup>144</sup> Thus, although Switzerland agrees with a coordinated approach, its statements implicitly suggests a *laissez-faire* approach, in which nations are left to unilaterally determine the most effective means to curb harmful tax practices.<sup>145</sup>

The resolution of these issues will entail a lengthy process that is just beginning to evolve. The lack of consensus within the OECD itself provides non-members, at least for the time being, with assurances that this area will continue to be greatly debated. Nonetheless, these recommendations, as Switzerland and Luxembourg recognize, could have a profound impact on those low tax jurisdictions whose survival is based on attracting legitimate business.<sup>146</sup>

### III. CONCLUSION

The OECD's Report, quite ironically, has labeled as harmful tax competition something that was created, encouraged, and accepted when occurring within the national borders of the high tax states themselves.<sup>147</sup> In reviewing the relevant his-

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<sup>143</sup> See THE REPORT, *supra* note 1, at 76-78.

<sup>144</sup> See *id.* at 76.

<sup>145</sup> See *id.* at 76-77.

<sup>146</sup> A case in point is the Cayman Islands, a dependent territory of the UK, who in order to save its industry may be forced to vote for independence from the British crown. The Cayman Islands, who as a dependent of the UK must comply with the recommendations of the Report vis-à-vis the UK's acceptance, is at risk of having its investors flee to the Bahamas which is no longer under the British crown. See GRUNDY, *supra* note 18, at 61-64; See also OFFSHORE OUTLOOK, *supra* note 4, at 6-7. The Cayman Islands, one of the first Caribbean countries to accept the money laundering laws, have gone a long way to discourage criminals from doing business in their jurisdiction. See generally Allen, *supra* note 26.

<sup>147</sup> Best illustrative of this is the state of Florida in the US that has always been considered a "tax haven" state because of its favorable taxation systems with respect to retirees. For example, in 1982 the Federal tax was 50 percent, but if retirees were to move to Florida then their tax liability would be no more than the local tax rate. See GRUNDY, *supra* note 18, at 11. Surely, neighboring states felt that this was eroding their tax base by attracting its citizens to seek shelter in Florida. Yet, if a state were to make this argument in the US it would not receive any support. For another illustration, consider the state of Delaware whose laws of incorporation have traditionally been considered among the most flexible. Delaware's favorable laws made incorporation of a company cheap and quick. Delaware was never accused of engaging in harmful tax competition, although for

tory, it is perhaps unsurprising that this is not the first time that the U.S. Internal Revenue Services' criteria have been used internationally to identify tax havens.<sup>148</sup> It should also be of no surprise that The Report is saturated with the type of highly subjective words of legal art to which American jurists have grown accustomed.<sup>149</sup> It is completely contradictory for states such as the U.S., who preach competition in their own private sectors, to now denounce that same type of competition merely because it is occurring between governments in the international public forum.<sup>150</sup>

The Report seeks to end harmful tax competition by calling for a global tax rate, but due to its overbroad language and failure to define any concrete standards, it also sweeps into its net other forms of tax competition that may be beneficial.<sup>151</sup> By never adequately defining harmful tax competition and ignoring the inherent benefits of differing competing tax rates, The Report fully discounts any legitimate business reasons that en-

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decades most entities in neighboring states would go and incorporate a company in Delaware, not their own home states. Nonetheless, Panama, whose Companies Law were modeled on the state of Delaware's, is considered to be engaging in harmful tax competition. *See id.* at 39-40. (Both examples are hard to reconcile unless what the US is saying is that what is good for the goose is not good for the gander.)

<sup>148</sup> When the North Atlantic Free Trade Agreement was finalized, it was once again the US and its governmental organs who devised the tax policies. Mexico and Canada were essentially forced, due to their lack of power, to accept what the US recommended. *See* Cockfield, *supra* note 100, at 44. This is a clear illustration of the odious tenet by stronger nations that they may impose their will upon the weaker. *See also supra* Part I.C.

<sup>149</sup> For example: substantial. In the Report, one of the determining factors, no "substantial activities" within the jurisdiction is a mirror image of a component of the US test for determining personal jurisdiction over a person—namely a "substantial connection." *Asahi Metal Industry Co. v. Superior Court*, 480 U.S. 102, 106 (1987).

<sup>150</sup> *See* Mason Gaffney, *Taxation of Mobile Capital in a Global Free Market: Opportunities and Threats for Low Tax Countries, and the Worldwide Benefits of International Tax Competition* (Sept. 2, 1998).

<sup>151</sup> *See* Cockfield, *supra* note 100, at 48, stating that "[t]he economic benefits derived from tax differentials can sometimes outweigh the benefits of efficiency gains provided by tax integration . . ." *Id.* Furthermore, "[c]ompetition for capital investment can be viewed as desirable insofar as it creates an incentive for governments to fashion an 'optimal regulatory burden.'" *Id.* quoting from Charles E. McLure, *Tax Competition: Is What's Good for the Private Goose also Good for the Public Gander?*, 39 NAT'L TAX J. 341-48 (1986).

tities may have for moving their resources to low tax states.<sup>152</sup> Tax havens perceive themselves and offer themselves not as jurisdictions for evading taxes, but rather as business centers that simply offer a superior services-to-costs ratio, something that every profit maximizing entity seeks.<sup>153</sup>

Due to the barrage of regulations and due diligence standards that have been imposed upon the offshore industry, it has become significantly easier to open an international bank account in Miami, Florida than in the same bank's branch located in Panama.<sup>154</sup> The impact of this report on states, which due to their lack of natural resources must rely on their financial industry, could produce even deeper concerns. Tax haven jurisdictions associated with major powers, such as the Cayman Islands who are still under the British Crown, may soon be forced to choose between the lesser of the two evils: remain associated and be forced to comply with The Report's recommendations or declare independence and give up the benefits that such associations can bring.<sup>155</sup>

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<sup>152</sup> The legitimate reasons for doing business via an offshore are numerous. Take for example a few reasons for establishing a trust offshore as opposed to onshore: (1) asset planning so that a wealthy individual may have more involvement in deciding how to dispose of his assets; (2) tax mitigation (carrying out the trust in the least expensive way); (3) asset protection from potential creditors; and (4) clearer rules or no rules of perpetuity, forced heirship and other areas which complicate matters in their own jurisdictions. A situation where an offshore trust would be most effective is as follows. Assume a UK national, working in Hong Kong, marries a local Chinese national where they establish their permanent home. The UK national over time accumulates certain assets and together with his wife they own all the shares of stock of several companies, some of which are incorporated in foreign jurisdictions (i.e. Panama, Cayman Islands, Mexico, etc.) and they also act as directors. Were any one of the directors (either Husband or Wife) to die, the estates in a normal situation would be slow to settle and thus would cause major disruption to the companies. By using a discretionary trust offshore, the trust can own the shares in the companies and thus, when any one of the directors dies, the company can continue under the direction of a surviving family member and only the interests of the discretionary beneficiaries cease. See Peter Willoughby, *Offshore Trusts and Companies – Not Just For Int'l Tax Practitioners*, 24 STEP 15 at 20 (August 1998).

<sup>153</sup> See Gaffney, *supra* note 150.

<sup>154</sup> See OFFSHORE OUTLOOK, *supra* note 4, at 2; see also Willoughby, *supra* note 152 (suggesting that high tax states, before pointing the finger, should look at their own national regulations which may create a tax haven like environment).

<sup>155</sup> See *Offshore Outlook*, *supra* note 4, at 5-7.

In the Cayman's, this question has caused many to fundamentally question the path of the small nation's future.<sup>156</sup> By remaining under British rule the Cayman Islands would be sacrificing much of their territorial sovereignty, something the Caymanians are in opposition to.<sup>157</sup> However, by declaring independence the Caymanians would lose the benefit of being watched for under the British Crown.<sup>158</sup> Forcing the issue is the latest British Crown report focusing on the existing financial regulations within the Channel Islands.<sup>159</sup> Apparently in response to the OECD's latest proposals, The Crown made its intent to crack down on these low tax jurisdictions perfectly clear.<sup>160</sup> Like many in their position, the ultimate question that the Caymanians face is to what degree is it folly to further sacrifice their sovereignty in order to satisfy a few powerful nations who arguably should first look within their own borders before beginning to point the finger.

The Report does not cure the uncertainty that has long been the hallmark of international taxation. What is clear is

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<sup>156</sup> See *id.*

<sup>157</sup> See *id.*

<sup>158</sup> See *id.*

<sup>159</sup> See Andrew Edwards, *Review of Financial regulations in The Crown Dependencies* (visited Nov. 20 1998) <<http://www.nds.coi.gov.uk/coi/coip> [hereinafter The Edwards Report]. The Edwards Report seeks to increase the level of transparency in all financial dealings and recommends the establishing of Financial Crime Units on each of the Channel Islands. See *id.* These crime units are intended to carry out on-site inspections. See *id.* The Edwards Report also recommends appointing financial services ombudsmen to assist in the regulating of the financial services industry. See *id.* The Edwards Report also stresses cooperation and states that "the Islands are firmly committed to combat crimes of all kinds . . . and to the fullest co-operation with other jurisdictions." *Id.* Another area that The Edwards Report pays particular attention to are the regulations with respect to nominee directors. See generally The Edwards Report. It states that the Islands should consider requiring "disclosure of true (beneficial) ownership where this differs from nominal ownership" and in addition, the islands should also consider "including a requirement to report changes in beneficial ownership." *Id.* Aside from these specific objectives, The Edwards Report goes on to include ambiguous provisions such as "mak[ing] it as difficult as possible for practitioners to engage in, facilitate or acquiesce in *disreputable conduct* of any kind. . . ." *Id.* (emphasis added). Another perfect example is where The Edwards Report recommends that the Islands enact measures to "restrain assets in cases of *unexplained life-styles* . . . ." *Id.* (emphasis added). What should this a huge concern for the Cayman Islands is that the British Crown appears to be very serious as they expect to have these measures implemented by the Spring of the year 2000, at which point the Cayman Islands might well be next on the Crown's agenda. See *id.*

<sup>160</sup> See The Edwards Report, *supra* note 159.

that people by their nature are concerned with maximizing profits and reducing costs, and as such, the competition for capital will never cease. These latest efforts are unlikely to gain support from low tax jurisdictions. Such jurisdictions are very aware of the potential result of The Report's initiative: not an end to the situation, but simply a relocation, as well as a recasting of the players – with them left in the street. Thus, the only remaining question, which The Report subtly answers, is who will decide where and how this competition will take place in the future.

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