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International Financial Centres in the Global Economy

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International Financial Centres

Background

- Rise of Sector after the 1970s with significant expansion of global trade and investment, as well as communications and transportation technologies
- Service offerings include
 - Corporate related-party arrangements
 - Personal tax and non-tax planning
 - Some third-party arrangements (financing & insurance)
- Reaction by developing countries has been mixed
 - Strong reactions against personal tax and non-tax planning
 - Mixed reactions on corporate related-party arrangements
 - Mixed reactions on third-party arrangements
- Current situation: resurgence of debate, controversy & reaction

Perspectives on the role of IFCs

“tax havens and harmful preferential tax regimes ... affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems.”

OECD

Harmful Tax Competition: An Emerging Global Issue (1998)

Perspectives on the role of IFCs

“Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting.”

OECD

Addressing Base Erosion and Profit Shifting (2013)

Perspectives on the role of IFCs

“Globalisation has benefited our domestic economies. [...] The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. [...] Hence it supports growth, creates jobs, fosters innovation, and has lifted millions out of poverty.”

OECD

Action Plan on Base Erosion and Profit Shifting (2013)

Perspectives on the role of IFCs

“Preferential regimes continue to be a key pressure area. In 1998, the OECD issued a report (OECD, 1998) on harmful tax practices in part based on the recognition that a “race to the bottom” would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue. Agreeing to a set of common rules may in fact help countries to make their sovereign tax policy choices. The underlying policy concerns expressed in the 1998 Report as regards the “race to the bottom” on the mobile income tax base are as relevant today as they were 15 years ago.”

OECD

Action Plan on Base Erosion and Profit Shifting (2013)

Perspectives on the role of IFCs

“a necessary lubricant to the lumbering machines of the developed world”

Edward Troup

Tax Assurance Commissioner and second Permanent Secretary, UK HMRC
(formerly advisor to the Chancellor of the Exchequer and a Director General in HM Treasury)

Comments made in response to the OECD's 1998 Report on
Harmful Tax Competition: An Emerging Global Issue
at the

2001 meeting of the International Tax Planning Association (ITPA), in Berlin, June 17-19, 2001.

Harmful Tax Practices – 2014

“To counter harmful regimes more effectively, Action Item 5 of the BEPS Action Plan (OECD, 2013a) requires the FHTP to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes.”

OECD

Countering Harmful Tax Practices More Effectively,
Taking into Account Transparency and Substance (2014)

Harmful Tax Practices – 2014

Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful

The four key factors are:

1. The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
2. The regime is ring-fenced from the domestic economy.
3. The regime lacks transparency (for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
4. There is no effective exchange of information with respect to the regime.

Harmful Tax Practices – 2014

The eight other factors are:

1. An artificial definition of the tax base.
2. Failure to adhere to international transfer pricing principles.
3. Foreign source income exempt from residence country taxation.
4. Negotiable tax rate or tax base.
5. Existence of secrecy provisions.
6. Access to a wide network of tax treaties.
7. The regime is promoted as a tax minimisation vehicle.
8. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

Harmful Tax Practices – 2014

A regime that has been identified as being potentially harmful ... may be considered not to be actually harmful if it does not appear to have created harmful economic effects.

The following three questions can be helpful in making this assessment:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?

Substantial Activity Requirement

- Increasingly focus is shifting to location of “substantial activity”
- Substantial activity has been defined in relation to IP with reference to “nexus”:
 - R&D Activities
 - Measured by R&D expenditures (percentage not amount)
- Substantial activity has not been defined with reference to
 - Strategic and Control functions
 - Assets and Risks
 - Marketing & Client Facing Activity
- Formulaic approach (subject to upward income allocation on proof)*
 - * somewhat inconsistent with transfer pricing guidelines

Substantial Activity Requirement

- For Financial Services, similar input considerations arise with respect to location of “substantial activity”
 - R&D Activities
 - Strategic and Control functions
 - Assets and Risks
 - Marketing & Client Facing Activity
- Question is how much income (from capital) can be allocated
 - Third-party financing & proprietary trading by foreign FIs
 - Third-party insurance & reinsurance
 - Investment Advisory & Asset Management Services
 - Collective investment vehicles
 - Other legitimate tax-neutral arrangements

Substantial Activity Requirement

- What may need to change for IFCs? Strategy & Focus
- If you're going to subsidize an activity it has to be sensitive to the subsidy and not one where the subsidy will get taxed away (or otherwise compromised or counteracted) by another country
 - Less focus on related-party and personal arrangements
 - Less tax benefit likely to survive
 - More probability for reputational risk
 - More focus on third-party services & higher value inputs
 - The role of education & training (skills & languages)
 - Professional Ethics & Standards
 - More focus on financial stability and oversight and other regulatory and non-tax standards, as well as transparency, conducive to attracting substantial activity in third-party services
 - Whole of government, regional approach (not fragmented)