Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms

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PRÉCIS
Cet article examine les réponses des diverses administrations aux initiatives de l’Organisation pour la coopération et le développement économiques (OCDE) et de l’Union européenne (UE) pour contrer les pratiques fiscales dommageables. Plus particulièrement, l’article décrit des mesures dites de protection ou de défense mises de l’avant par les principaux pays membres de l’OCDE de l’UE et qui visent à la fois à décourager les contribuables de transférer des revenus imposables vers des paradis fiscaux et à encourager ces administrations à mettre fin aux privilèges fiscaux pour les non-résidents. Il y est aussi question des mesures de réforme fiscale prises par les paradis fiscaux qui se sont formellement engagés à respecter les normes internationales de pratique fiscale. Une analyse des 36 paradis fiscaux dit « coopérants » montre que seulement huit ont annoncé ou ont véritablement entrepris des programmes de réforme et même dans ces administrations, les nouvelles mesures continuent d’offrir un avantage fiscal, quoique sous une forme différente. A cet égard, les initiatives de l’OCDE et de l’UE semblent en partie inexécutables. En conclusion, les auteurs estiment que la méthode la plus efficace pour combattre les effets dommageables liés à la concurrence fiscale réside dans la coopération internationale, plus particulièrement la conclusion d’accords d’échange de renseignements entre les administrations à régime d’imposition élevée et à régime d’imposition faible.

ABSTRACT
This article examines the response of various jurisdictions to initiatives against harmful tax competition undertaken by the Organisation for Economic Co-operation and Development (OECD) and the European Union. Specifically, it describes defensive measures adopted in major OECD countries in the European Union, both to discourage...
taxpayers from diverting taxable income to tax havens and to encourage such jurisdictions to remove tax privileges for non-residents, and steps toward reform taken by tax havens that have made a formal commitment to comply with international standards of tax practice. A review of 36 “cooperative” tax havens shows that only 8 have announced or actually acted on programs of reform; and even in those jurisdictions, the new measures still preserve a tax advantage, albeit in a different form. In this respect, the aim of the OECD-EU initiatives seems to be partially frustrated. The authors conclude that the most effective way of combating the harmful effects of tax competition is to focus on international cooperation, particularly through exchange-of-information agreements between high-tax and low-tax jurisdictions.

**KEYWORDS:** TAX HAVENS ■ HARMFUL TAX PRACTICES ■ TAX COMPETITIVENESS ■ HARMONIZATION

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**INTRODUCTION**

Increased capital mobility has created new opportunities for tax competition and new challenges for countries attempting to curb its harmful effects. Preferential tax policies adopted by competing jurisdictions result in distortion of both the policy decisions of other jurisdictions and taxpayers’ decisions on the location of investments and financial activities. In this context, tax havens and offshore financial centres (OFCs) are of particular concern. Tax havens are jurisdictions that engage in harmful tax competition by linking the distinctive features of their tax systems—a low or zero effective tax rate, financial and commercial secrecy, and lack of transparency—to special preferential tax regimes, along with “ring fencing” of those regimes, for particular activities and corporations (such as “captive” insurance, offshore banking, trust, trading, and holding companies, and international financial services).

Over the last decade, the European Union and the Organisation for Economic Co-operation and Development (OECD) have engaged in a far-reaching effort to counter the harmful effects of tax competition, through the EU Code of Conduct for
business taxation and the ongoing OECD project on harmful tax practices. As a result of these initiatives, assenting member states have agreed to refrain from adopting new measures that constitute harmful tax practices and to remove the harmful features of existing tax regimes within a five-year period. In addition, the large majority of jurisdictions identified as tax havens have made a formal commitment to adhere to and comply with the principles of the OECD initiative. This article considers whether and to what extent these “cooperative” tax havens have translated their formal statements of commitment into concrete reforms in tax policy and practice.

The first section below briefly describes the OECD and EU initiatives designed to curb harmful tax practices in tax haven jurisdictions. In the second section, we review defensive measures adopted by major OECD countries in the European Union, in compliance with the OECD and Code of Conduct guidelines, with particular emphasis on domestic anti-avoidance legislation. We highlight the differences and similarities in the various countries’ approaches to competition from low-tax jurisdictions, pointing out that any criterion used in defining a tax haven (whether in anti-avoidance provisions or in other measures designed to target low-tax jurisdictions) is necessarily relative. In the third section, we try to explain the response of tax havens, viewing it in the context of the advantages—including but not confined to tax benefits—that foreign investors look for when they consider establishing their activities in a low-tax jurisdiction. Out of a total of 36 cooperative tax havens, we identify 8 that have announced or implemented concrete reforms in accordance with their formal commitment to OECD principles. These reforms fall into two main groups: statutory amendments predominantly aimed at rolling back preferential tax regimes for non-residents; and agreements to exchange information on tax matters, reflecting the standard adopted for purposes of the OECD initiative.

The aim of our study is to describe the progress made to date in implementing international initiatives against harmful tax practices in tax havens. We discuss some prominent issues associated with these initiatives, and we try to determine what real changes have taken place within the framework of harmful tax practices. We conclude that while there has been some improvement regarding transparency and the abolition of ring-fenced tax regimes, tax havens seem to be seeking alternative ways of preserving a competitive advantage through their tax system.

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INITIATIVES AGAINST “HARMFUL” TAX PRACTICES

Since the mid-1990s, policies addressing international tax competition have been aimed at discouraging tax practices defined as “harmful” because of their ability to distort trade and investment flows, cause shifts in the distribution of the tax burden, and impose constraints on other governments’ fiscal decisions by facilitating tax avoidance. At the international level, initiatives promoting fair competition have highlighted the problem of tax havens. These jurisdictions are considered to be engaged in harmful tax competition in that they attract foreign tax base by exploiting the possibilities offered by the removal of barriers to trade and capital. Being relatively small, tax havens generally suffer less than other countries, in revenue terms, from providing tax concessions for certain taxpayers and activities; on the contrary, they enjoy increased economic growth and increased tax revenues derived from the location of foreign investment and profits in their territory.2

The corresponding revenue losses suffered by other countries, and the desire to protect their domestic tax base, were an evident stimulus to these jurisdictions to cooperate in projects aimed at offering tax havens direct or indirect incentives to eliminate their harmful tax practices. The first step was to identify tax haven jurisdictions and to specify those practices that constitute harmful tax competition. This task was undertaken by the OECD through its harmful tax competition project and by the EU Council of Economics and Finance Ministers (“the ECOFIN Council”) in the development of a code of conduct governing tax competition within the European Union.

The OECD Approach: A Definition of “Tax Haven” and International Cooperation in Applying Standards

The report on harmful tax competition approved in 1998 by the OECD Council of Ministers (with Luxembourg and Switzerland abstaining) focused on the taxation of geographically mobile financial and other service activities, and provided an analytical framework for identifying jurisdictions engaged in harmful tax practices.3 The report draws an important distinction between jurisdictions that tax income at a relatively low rate without engaging in harmful tax competition, and jurisdictions with tax regimes that combine a low tax rate with other factors and/or special features, which together constitute harmful tax competition. The report draws a further distinction between jurisdictions in the latter category (referred to as “tax havens”) and other, higher-tax jurisdictions that engage in harmful tax competition through “preferential tax regimes”—tax preferences granted to certain taxpayers or activities in the context of the general income tax system.

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The definition of a tax haven was based on the following criteria:

- no tax, or only nominal tax, on the relevant income;
- no effective exchange of information;
- lack of transparency; and
- absence of a requirement that substantial activities be carried on in the jurisdiction.

The first factor was initially considered a necessary and sufficient condition to identify a tax haven (though this position was subsequently modified, as discussed below). The second factor, “no effective exchange of information,” means, in essence, an unwillingness to exchange information on tax matters with tax authorities aiming to curb tax evasion and avoidance, as reflected, for example, in administrative policies denying access to banking and other financial information. Lack of transparency refers to the unavailability of details of tax law and administrative practice relating to special preferential treatment of certain taxpayers. The “lack of substantial activities” criterion was later clarified as referring to tax privileges granted to foreign-owned enterprises that do not have a significant presence in the jurisdiction or contribute to the local economy (ring fencing).

Following endorsement of the 1998 report, the OECD established a forum on harmful tax practices to carry out further work and present a progress report identifying tax havens, as well as other jurisdictions with preferential tax regimes. The evaluation of countries and territories was based on a review of jurisdictions that appeared to have the potential for satisfying the specified criteria. This review resulted in a list of over 40 jurisdictions that were found to meet the tax haven criteria and therefore could qualify for targeting through coordinated defensive measures. Before publication of the OECD’s list, identified tax havens were encouraged to make a formal “advance commitment” to eliminate their harmful practices and comply with the principles of the 1998 report. Six jurisdictions did so, reducing the list to 35 tax havens, identified in table 1.

However, agreement could not immediately be reached regarding the tax haven practices that could properly be considered “harmful” and subject to elimination.
under the commitment to cooperate in the project. Multilateral discussions led to gradual modification of the initial stance. Following widespread criticism by the listed tax havens, the OECD conceded that every jurisdiction has the right to decide whether to impose direct taxes and to determine an appropriate tax rate. Consequently, “no or nominal tax” was no longer considered a sufficient condition to identify a jurisdiction as a tax haven, though it remained a necessary condition in combination with at least one of the other three factors. In addition, the OECD agreed not to apply the “substantial activities” criterion in drawing up its tax haven list because of difficulties in determining exactly what was meant by “substantial.”

These adjustments highlighted the artificiality of the tax haven definition. It is clear from successive OECD reports that the search for an acceptable definition is a difficult and controversial process. In 1987, the report of the OECD Committee on Fiscal Affairs on international tax avoidance and evasion stressed the difficulty of formulating an objective definition of tax haven and the inevitable failure of attempts to do so. The more radical approach to the issue of tax havens embraced by the 1998 report required a narrower definition of the term, unavoidably resulting in some distortion. First, the definition applies only with reference to the taxation of “geographically mobile financial and other service activities.” Second, the emphasis on tax rates overlooked the importance of other features of preferential tax

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8 Ibid., at paragraph 7.

regimes offered by tax havens. Also, according to leading critics, owing to the supplementary role of the tax rate criterion, the furtherance of the OECD initiative through the cooperation of tax havens was impeded by the vagueness of other criteria, notably the concept of “substantial” activities.

The modification of OECD policy limited the commitment of cooperative tax havens to two conditions, transparency and the effective exchange of information. Under the transparency requirement, jurisdictions are committed to removing any features that depart from generally accepted accounting standards and other established laws and practices, such as “secret” tax rulings and negotiations between the taxpayer and the tax administration with respect to the applicable tax rate. The exchange-of-information requirement is based on legal mechanisms ensuring that information is given to tax authorities of other countries in response to a specific request and that this information is used only for the stated purpose.

**The EU Code of Conduct: Indirect Application to Tax Havens**

In 1997, the ECOFIN Council agreed on a package of measures to curb harmful tax competition, referred to as “the Code of Conduct for business taxation.” The code, which has political force but is not legally binding, commits assenting EU members to the elimination of harmful tax practices following completion of a prescribed review process.

The Code of Conduct, like the OECD initiative, applies to a range of potentially harmful tax measures, including legislative provisions, regulations, and administrative practices. Tax measures are subject to assessment under the review process if they affect, or may affect, the location of business activity in the European Community by providing for an effective level of taxation significantly lower than that generally applied in the member state. Also like the OECD project, the code sets out key factors to be considered in evaluating the potential harmfulness of such measures. Specifically, tax measures may be considered harmful if

- they apply only to non-residents or to transactions with non-residents;
- the effect of the tax advantages granted is isolated from the domestic economy and from the national tax base (ring fencing);
- they confer tax advantages in the absence of real economic activity and substantial economic presence;
- they depart from OECD transfer-pricing principles; or
- they lack transparency.

In assenting to the code, member states agreed to refrain from introducing new harmful measures (standstill) and to eliminate existing ones (rollback); to exchange information on existing and proposed tax measures that may be potentially harmful; and to promote the abolition of harmful tax measures in third countries, particularly in their own dependencies or associated territories.

To facilitate implementation of these formal commitments, the code provided for the creation of a special group to identify potentially harmful measures. In November
1999, the Code of Conduct Group presented a report ("the Primarolo report")\(^\text{10}\) in which it assessed 66 potentially harmful tax measures relating to a range of activities and entities, including financial services and group financing, intragroup services, holding companies, insurance, and exempt and offshore companies. With respect to tax havens, the Primarolo report identified harmful tax measures in several dependencies or associated territories of EU member states that would have been targeted as tax havens under the OECD criteria (see table 2); however, in contrast to the OECD project, which covers both member and non-member jurisdictions, the Code of Conduct Group did not assess jurisdictions outside the reach of the European Union. Moreover, while the OECD calls on tax havens to cooperate in complying with international standards, the Code of Conduct Group involves them indirectly, relying on EU members to promote the elimination of harmful measures in their dependencies and territories.

**DEFENSIVE MEASURES RECOMMENDED BY THE OECD**

The second stage of the OECD project, following the identification of factors characterizing tax havens, was to define the means to counteract harmful tax practices in those jurisdictions. The 2000 OECD report provided recommendations in three areas: domestic legislation, bilateral agreements (tax treaties), and international cooperation.\(^\text{11}\) To increase the effectiveness of defensive measures, the report recommended coordinated action by member countries as well as unilateral efforts to combat harmful practices.

The recommendations suggest a range of defensive measures that member countries may adopt against uncooperative tax havens, including

- disallowance of deductions, exemptions, or credits related to payments made to residents of countries engaged in harmful tax practices (with an exemption if these payments derive from substantial activities and do not exceed an arm's-length amount);
- thin capitalization rules;
- controlled foreign corporation (CFC) rules;
- restrictions on the availability of participation exemptions or a foreign tax credit;
- transfer-pricing rules; and
- information-reporting rules for transactions involving uncooperative tax havens or taking advantage of their harmful tax practices.

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\(^{11}\) Towards Global Tax Co-operation, supra note 1, at paragraphs 32 to 38.
TABLE 2 Harmful Tax Practices in EU Dependencies or Associated Territories Meeting the OECD Tax Haven Criteria, 1999

<table>
<thead>
<tr>
<th>Dependency or territory</th>
<th>Harmful tax practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aruba (Kingdom of the Netherlands)</td>
<td>Exempt companies; offshore companies; captive insurance; free zones</td>
</tr>
<tr>
<td>British Virgin Islands (Oversea Territory of the United Kingdom)</td>
<td>International business companies</td>
</tr>
<tr>
<td>Gibraltar (Oversea Territory of the United Kingdom)</td>
<td>Exempt (offshore) companies; captive insurance; qualifying (offshore) companies</td>
</tr>
<tr>
<td>Guernsey/Sark/Alderney (Dependency of the British Crown)</td>
<td>International loan business; offshore insurance companies, insurance companies; exempt companies; international bodies</td>
</tr>
<tr>
<td>Isle of Man (Dependency of the British Crown)</td>
<td>International loan business; exempt insurance companies; exemption for non-resident companies; offshore banking business; international business companies</td>
</tr>
<tr>
<td>Jersey (Dependency of the British Crown)</td>
<td>International treasury operations; captive insurance companies; tax-exempt companies; international business companies</td>
</tr>
<tr>
<td>Netherlands Antilles (Kingdom of the Netherlands)</td>
<td>Captive insurance; offshore companies; free zones</td>
</tr>
</tbody>
</table>


Essentially, the objective of these defensive measures is to increase the cost of establishing foreign-owned structures and companies in low-tax jurisdictions primarily with the aim of benefiting from tax preferences and minimizing tax costs.

We will now consider some defensive measures adopted by major OECD countries in the European Union—in particular, domestic anti-avoidance legislation, the listing of targeted jurisdictions, and tax treaty measures.

**Domestic Anti-Avoidance Legislation**

The most common anti-avoidance provisions are listed in table 3. Our discussion will focus on recent developments in the use of CFC legislation and statutory thin capitalization rules.

Two of the 10 countries with CFC legislation, Italy and Norway, have introduced these provisions in recent years. The latest countries to adopt statutory thin capitalization rules are Italy and the Netherlands (2004). A number of other countries
have amended their thin capitalization legislation in response to concerns about its scope and effect. These changes are linked to the controversial question of the compatibility of the legislation with non-discrimination principles and the aim of establishing an EU market without tax obstacles.

Traditionally, industrialized countries have used thin capitalization rules to prevent erosion of their tax base. Taxpayers can obtain a significant tax advantage by locating a foreign company in a low-tax jurisdiction, so that the interest derived from granting loans to a domestic subsidiary is taxed at a lower rate. Most thin capitalization rules prescribe debt-to-equity ratios for funding shareholdings. If the fixed ratios are exceeded, the rules may recharacterize interest as dividends for purposes of domestic law and deny interest deductions to the domestic subsidiary, resulting in double taxation. Alternatively, the rules may treat interest on excessive debt financing as a disallowed expense.

About half of the EU member states currently have some kind of thin capitalization rules. Table 4 provides a brief description of the statutory provisions in nine EU countries. Other member states do not have specific thin capitalization legislation but apply administrative practices targeting tax avoidance through the intragroup financing process.

### TABLE 3  Anti-Avoidance Legislation Adopted in Selected EU Countries

<table>
<thead>
<tr>
<th></th>
<th>Thin capitalization legislation</th>
<th>CFC legislation</th>
<th>Disallowance of interest, royalties, and fees</th>
<th>Transfer-pricing rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Belgium</td>
<td>+</td>
<td>+</td>
<td>+</td>
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<tr>
<td>Denmark</td>
<td>+</td>
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<td>+</td>
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<tr>
<td>Finland</td>
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<tr>
<td>France</td>
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<tr>
<td>Germany</td>
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<tr>
<td>Greece</td>
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<td>Ireland</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>Norway</td>
<td></td>
<td>+</td>
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<tr>
<td>Portugal</td>
<td>+</td>
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<tr>
<td>Spain</td>
<td>+</td>
<td>+</td>
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<tr>
<td>Sweden</td>
<td></td>
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<td>+</td>
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<tr>
<td>United Kingdom</td>
<td>+</td>
<td>+</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>TABLE 4 Statutory Thin Capitalization Rules in Selected EU Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-to-equity ratio</td>
</tr>
<tr>
<td>Belgium</td>
</tr>
<tr>
<td></td>
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<tr>
<td>Denmark</td>
</tr>
<tr>
<td>France</td>
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<tr>
<td>Germany</td>
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<tr>
<td>Italy</td>
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<tr>
<td></td>
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<tr>
<td>Portugal</td>
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<tr>
<td>Spain</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

(Table 4 is concluded on the next page.)
Recent changes in thin capitalization legislation have followed from the decision of the European Court of Justice (ECJ) in the *Lankhorst-Hohorst* case. The court held that German thin capitalization rules, which applied only to non-resident companies, violated the freedom-of-establishment provision in article 43 of the European Community’s founding treaty. After the ECJ decision, it became clear that the thin capitalization regimes of several member states would not be considered legitimate: the rules typically treated companies owned by non-resident

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**TABLE 4 Concluded**

<table>
<thead>
<tr>
<th>Note</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>A 3:1 safe haven for holding companies has recently been abolished; however, holding companies are subject to special rules regarding the determination of the relevant equity in order to take their holding activities into account.</td>
</tr>
<tr>
<td>b</td>
<td>A substantial interest exists if a person owns directly or indirectly more than 25 percent of the nominal capital of the resident company.</td>
</tr>
<tr>
<td>c</td>
<td>For 2004 only.</td>
</tr>
<tr>
<td>d</td>
<td>The thin capitalization rules do not apply to small and medium-sized enterprises (defined on the basis of revenues). An exemption is provided for banks and firms engaged in banking and/or investment activities, and for SIM (corporations providing financial intermediation services). Holding companies are instead subject to the thin capitalization rules irrespective of their revenues. The borrowing company will not be subject to the restriction if it is able to prove that the credit facilities were obtained under its own credit capacity, rather than that of the shareholder.</td>
</tr>
<tr>
<td>e</td>
<td>Debt in excess must be greater than €500,000. As an alternative to the 3:1 ratio, the taxpayer has the option to apply a debt-to-equity ratio based on the commercial consolidated accounts of the group to which the taxpayer belongs.</td>
</tr>
<tr>
<td>f</td>
<td>This rule may not apply if the company proves that, taking into account its type of activity, the sector in which it operates, its size, and other relevant criteria, it could obtain the same loan on similar terms from an independent entity.</td>
</tr>
<tr>
<td>g</td>
<td>There is no redefinition of interest as a dividend if the recipient company is within the charge to UK corporation tax. Even though there is no thin capitalization of the interest-paying company, the deduction of excessive interest can be disallowed.</td>
</tr>
</tbody>
</table>

shareholders differently from companies owned by resident shareholders, by restricting the deductibility of interest paid on loans. According to the court, this restriction may make cross-border economic activities within the European Union less desirable than purely domestic activities.

The ECJ decision started a movement toward amendment of thin capitalization rules, based in most cases on their extension to resident companies.

- Effective April 1, 2004, the United Kingdom’s thin capitalization provisions apply to debt between two UK companies as well as in a cross-border situation, and to each individual company on a stand-alone basis rather than to a UK grouping.\(^{14}\)
- Germany, of course, has amended its rules to bring transactions between resident companies within their scope.
- Spain amended its rules, effective from the beginning of 2004, to make the regime inapplicable in the case of loans from EU-resident corporations that are related parties (unless the entity is resident in a territory included in the Spanish blacklist of tax havens, described below).
- Denmark has presented a tax bill that, when enacted, will extend the rules to loans between Danish companies.

However, it is not clear whether these efforts will be sufficient to save the respective regimes.\(^ {15}\) The French courts have ruled that thin capitalization rules are incompatible with tax treaties as well as with freedom of establishment, and there is still the possibility of conflict with the principle of non-discrimination.

First, while the decision to exclude EU-resident shareholders from the rules (as in the Spanish reform) brings the amended legislation into accord with the principle of freedom of establishment, there could be a problem of compatibility with the principle of free movement of capital enshrined in article 56 of the EC treaty.\(^ {16}\) In relation to third countries, the freedom-of-establishment principle is not applicable because its scope is limited to individuals and companies resident in the European Union; in contrast, article 56 prohibits all restrictions on the movement of capital and on payments between EU member states and between member states and third countries. To determine whether a parent company resident in a third country could claim protection under the free-movement-of-capital principle, the applicable

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14 The United Kingdom abolished its separate thin capitalization provisions and extended its transfer-pricing legislation to generally cover the same area.


16 Although the EC treaty does not define “movement of capital,” it is safe to assume that direct investment in subsidiaries falls within the meaning of the rule. The scope of the free movement of capital is wider than the scope of the other freedoms in the EC treaty because it is not limited to the EU cases.
restrictions need to be analyzed carefully; the crucial element could be the standard
the ECJ would use to determine what constitutes an arbitrary restriction.

Second, there is the question of compatibility with the non-discrimination provi-
sions in article 24 of the OECD model tax treaty.\textsuperscript{17} Article 24 prohibits discrimination
against companies on the basis of their ownership by residents or non-residents.\textsuperscript{18}

Third, there is a problem relating to the nature of this anti-avoidance measure. In fact, unilateral measures such as thin capitalization rules raise concerns from the
perspective of double taxation, since member states independently determine when
interest should be reclassified as a dividend, for cross-border as well as domestic
transactions. Redefinition conflicts can be solved only through a procedure of
mutual agreement under an applicable double tax treaty. Incompatibility with the
EC treaty could arise if the unilateral restriction applied regardless of tax treatment
in the other member state.

The distinction between domestic and foreign investments also constitutes the
basis of CFC legislation. All CFC rules operate in a similar way: income earned by a
foreign subsidiary is deemed to be distributed to the domestic parent company if
certain conditions are met. Usually, these conditions require the domestic parent
to have a majority or at least a qualified ownership interest in the foreign company,
and the foreign company must be subject to low taxation. In reference to thin
capitalization rules, the EC treaty has been interpreted as prohibiting a member state
from imposing restrictions on its own taxpayers with respect to their investments
in other EU countries. CFC regimes involve a similar type of differential treatment:
profits earned by a domestic subsidiary are sheltered against taxation at the level of
the domestic parent; on the other hand, income earned by a foreign subsidiary, under
certain conditions, is deemed to be distributed to the parent and taxed at the level
of the parent. This can constitute a restriction on the freedom of the domestic parent
to make an investment in a subsidiary in another EU member state.

In addition to the potential problem of constraints in investment decisions,
another element of interest as regards CFC legislation concerns the question of the
definition of tax haven. This kind of anti-avoidance provision—and, in general, all
measures designed to target low-tax jurisdictions—highlights the problem of the
relativity of any defining criterion. Different countries have approached the prob-
lem from different perspectives, adopting either a transactional or a jurisdictional
approach (see table 5).

Both approaches rely on comparison of the domestic tax rate and the corporate
tax rate applied to a controlled foreign company (as defined) in determining the

\textsuperscript{17} Organisation for Economic Co-operation and Development, \textit{Model Tax Convention on Income
and on Capital: Condensed Version} (Paris: OECD, January 2003) (herein referred to as “the OECD
model treaty”).

\textsuperscript{18} More particularly, article 24(4) provides that interest, royalties, and other payments made to a
non-resident of a contracting state will be deductible for the purpose of determining the taxable
profits of a company under the same conditions as if they had been paid to a resident of that state.
<table>
<thead>
<tr>
<th>Country</th>
<th>Approach</th>
<th>Targeted income</th>
<th>Control of the foreign company</th>
<th>Tax incentive to source income in a low-tax jurisdiction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>Transactional</td>
<td>Financial activities income of the subsidiary&lt;sup&gt;a&lt;/sup&gt;</td>
<td>Direct or indirect ownership of at least 25% of the capital or more than 50% of the voting rights in the subsidiary</td>
<td>Corporate taxation on the subsidiary lower than 22.5% (75% of the Danish corporate income tax rate of 30%)</td>
</tr>
<tr>
<td>Finland</td>
<td>Jurisdictional</td>
<td>All types of income</td>
<td>Direct or indirect ownership of at least 50% of the capital or at least 50% of the voting rights in the foreign entity&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Effective tax rate on the subsidiary lower than 17.4% (3/5 of the Finnish corporate income tax rate of 29%)&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: Industrial activities, similar production activities, ship-owning, sales or marketing activities; company resident in a country with which Finland has a tax treaty&lt;sup&gt;d&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>Jurisdictional</td>
<td>All types of income</td>
<td>Direct or indirect ownership of 10% or more of the capital (or a participation of at least €22.8 million) in a non-resident enterprise&lt;sup&gt;e&lt;/sup&gt;</td>
<td>Tax borne by the foreign entity is at least 1/3 lower than the tax that would have been borne in France</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: Commercial or industrial activities predominantly carried out in local market</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>Transactional</td>
<td>Passive income</td>
<td>Direct or indirect ownership of more than 50% of the voting rights in the subsidiary</td>
<td>Corporate tax rate on the subsidiary lower than 25%&lt;sup&gt;f&lt;/sup&gt;</td>
</tr>
<tr>
<td>Italy</td>
<td>Jurisdictional</td>
<td>All types of income</td>
<td>Direct or indirect holding of the majority of voting rights or sufficient to exert a decisive influence; dominant influence due to special contractual relationship</td>
<td>Level of corporate taxation significantly lower than that in Italy and lack of effective exchange of information (reference to a blacklist)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: Substantial industrial or commercial activity, such that participation in the foreign entity does not achieve sourcing of income in a tax haven</td>
<td></td>
</tr>
</tbody>
</table>

(Table 5 is continued on the next page.)
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Approach</th>
<th>Targeted income</th>
<th>Conditions for application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>Jurisdiction</td>
<td>All types of income</td>
<td>Direct or indirect ownership of at least 50% of the capital</td>
</tr>
<tr>
<td>Portugal</td>
<td>Jurisdiction</td>
<td>All types of income</td>
<td>Direct or indirect ownership of at least 25% of the capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: At least 75% of the CFC profits arise from local farming activities, or from commercial transactions mainly with the local market or not involving residentsg</td>
</tr>
<tr>
<td>Spain</td>
<td>Transactional</td>
<td>Passive income</td>
<td>Holding percentage of at least 50% with reference to capital, equity, profits, or voting rights</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: Active holding; aggregate amount of passive income less than 15% of total income of the CFC or less than 4% of the total if the CFC is part of a group of companies</td>
</tr>
<tr>
<td>Sweden</td>
<td>Jurisdiction</td>
<td>All types of income</td>
<td>Direct or indirect ownership of at least 25% of the capital or voting rights in the foreign entity</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: International shipping activities, provided that the shareholder is also engaged in shipping activities</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Jurisdiction</td>
<td>All types of income</td>
<td>Interest of at least 25% in the undistributed profits of the non-resident company; ownership of more than 50% of the share capital or voting poweri</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Exemption: Companies carrying on business in countries included in a “white list”</td>
</tr>
</tbody>
</table>

(Table 5 is concluded on the next page.)
TABLE 5 Concluded

a A foreign subsidiary is considered to primarily deal in financial activities if at least \( \frac{1}{3} \) of its income derives from financial activities or insurance business (for example, interest, dividends, capital gains on shares and other securities).

b The taxable income of the foreign entity can be allocated only to a Finnish shareholder that owns directly or indirectly more than 10% of the share capital of the foreign entity or whose share of the total return from the foreign entity is at least 10%.

c Reduced to 26% after reform.

d The company resident in the contracting state must be subject to tax that does not differ significantly from the tax payable in Finland and the company resident in that state is not entitled to targeted benefits in its country of residence.

e The CFC rules for structures created before September 30, 1992 apply if an entity subject to French corporate tax has at least a 25% holding in a non-resident subsidiary benefiting from a low-tax regime.

f 30% before 2001.

g The main activity of the CFC must be other than one of the listed activities (for example, banking, certain types of insurance, holding, or transfer of corporate rights or securities).

h When the CFC is resident in a tax haven (with reference to a blacklist), a stricter scheme applies since it is presumed (although with a right of rebuttal) that (1) the corporate tax actually paid on any kind of income by the CFC is less than 26.25%; (2) all income accruing to the CFC is “passive”; (3) the annual minimum income derived by the CFC is equal to 15% of the acquisition cost of the underlying participating interest. These presumptions do not apply if the CFC consolidates its accounts with a Spanish-resident entity.

i The CFC holds an interest of at least 5% in another resident or non-resident company; it is directly involved in the management of the affiliate; and at least 85% of the affiliate’s total income arises from “active” business activities.

j In addition, where a company would not otherwise be considered to be controlled by UK-resident persons, it shall nevertheless be treated as so controlled if (1) there are two persons who, taken together, control the company; (2) one of those persons is resident in the United Kingdom and controls at least 40% of the company; (3) the other person controls at least 40% but not more than 55% of the company.

application of special tax measures. The transactional approach targets the tax benefits derived by resident taxpayers from a CFC in respect of income from a certain type of transaction (passive income), regardless of the location of the company. The jurisdictional approach proceeds from the principle that the income of a CFC established in a low-tax jurisdiction or benefiting from a preferential tax regime is deemed to be distributed to the parent company, regardless of the activity giving rise to that income.

A survey of the criteria adopted by EU countries for the definition of a low-tax jurisdiction reveals differences in their attitude to tax haven jurisdictions, and different political sensitivities in addressing the issue. As table 5 shows, most countries set a threshold for the corporate tax rate applied to the foreign company below which the source country is considered a low-tax jurisdiction and the CFC rules are applied (subject to other specified conditions). Only Italy and Portugal do not define a threshold rate but instead refer to a blacklist of tax havens. The lowest threshold is the Swedish limit of 15.4 percent. Particularly restrictive is the threshold set by Spain: an effective rate of 26.25 percent on corporate income, below which direct Spanish taxation applies. Germany uses a nominal tax rate in comparing domestic and foreign income tax rates, with evident problems of distortion and disregard of the complexity in the criteria for the tax base definition. By comparison, an effective tax rate approach (applied, for example, by Finland, France, and Spain) is less simplistic but very difficult to apply for both revenue authorities and taxpayers.

**Listed Jurisdictions**

Tax haven blacklists are often associated with CFC provisions. These lists include a general reference to tax haven countries and territories, and some also identify harmful tax practices, which may be applied in high-tax as well as low-tax jurisdictions.

The best-constructed list is the Italian blacklist, which distinguishes between (1) preferential tax regimes in any circumstance; (2) countries considered to have a preferential tax regime with the exception of certain specified activities; and (3) countries and territories without a preferential tax regime but deemed to be tax havens with regard to specified tax practices (offshore legislation or other tax incentives).

Both Portugal and Spain list tax havens by region. The Portuguese blacklist (Ordinance 150/2004) is particularly restrictive, with 84 jurisdictions identified as low-tax jurisdictions for CFC purposes; the only harmful tax practice mentioned is Luxembourg’s exempt holding company regime. Spain’s blacklist (Royal Decree 1080/1991) identifies 47 tax havens and 1 preferential tax regime (again, Luxembourg’s holding company regime). It is noteworthy that Spain’s CFC legislation is the only domestic anti-avoidance legislation in the European Union, to date, that refers specifically to the OECD initiative against harmful tax competition, deeming countries that have signed an exchange-of-information agreement similar to that recommended by the OECD not to be tax havens for any tax purposes.

Finland’s CFC rules list tax treaty partners that do not meet a specified tax rate threshold (75 percent of the applicable Finnish rate); currently, seven countries do
not meet this test (Barbados, Malaysia, Malta, Pakistan, Singapore, Switzerland, and the United Arab Emirates). However, the treaty country exemption will also be denied to any company that enjoys special tax benefits19 in its country of residence, whether or not that country is a listed country.

The United Kingdom and Sweden adopt the opposite approach, drafting a “white list” of countries that meet the conditions necessary for exclusion from the charge imposed by the CFC legislation. The UK list is subdivided into two categories: excluded countries and countries that are excluded unless a CFC benefits from a preferential tax measure in that country.

A comparison of the lists produced by the EU countries emphasizes the differences in their attitude to tax haven jurisdictions, noted above. These differences could be due to their respective political and economic relationships with these territories and countries. The political sensitivity of the issue is indicated by the small number of lists targeting the preferential tax regimes applied by developed high-tax countries.

**Tax Treaties**

The 2000 OECD report refers explicitly to the implementation of defensive measures through tax treaties. Recommended measures include comprehensive information-reporting rules for transactions involving uncooperative tax havens or taking advantage of their harmful tax practices; the application of withholding tax to payments of dividends, interest, and royalties made to persons benefiting from harmful tax practices; and the limitation of treaties with jurisdictions involved in harmful tax practices.

Table 6 and figure 1 show EU countries with tax treaties currently in force with tax havens. All signatories are cooperative jurisdictions under the OECD initiative (see table 7 in the next section for the updated list of cooperative tax havens). The attitude of the United Kingdom is noteworthy in that it has signed by far the largest number of treaties with tax havens. Of the EU countries with domestic anti-avoidance legislation discussed above, only Spain has no treaties with such jurisdictions.

While some treaties between member countries and low-tax jurisdictions exempt from withholding tax interest and royalty payments made to residents of countries with preferential tax regimes,20 in most cases companies subject to such regimes are explicitly excluded from treaty benefits.

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19 Examples of special tax benefits are benefits provided under the coordination centre rules in Belgium and benefits provided on a regional or discretionary basis, such as those available in Madeira and the Canary Islands. Benefits available under general tax rules, such as the participation exemption in the Netherlands, are not considered special tax benefits and therefore are not within the scope of Finland’s CFC legislation.

20 See, for instance, the Italy-Cyprus, Germany-Cyprus, France-Mauritius, and Belgium-Cyprus tax treaties.
TABLE 6  Tax Treaties in Force Between Selected EU Countries and Tax Havens

<table>
<thead>
<tr>
<th>EU country</th>
<th>Tax haven</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Cyprus, Malta</td>
</tr>
<tr>
<td>Belgium</td>
<td>Cyprus, Malta, Mauritius</td>
</tr>
<tr>
<td>Denmark</td>
<td>Cyprus, Malta</td>
</tr>
<tr>
<td>Finland</td>
<td>Barbados, Malta</td>
</tr>
<tr>
<td>France</td>
<td>Bahrain, Cyprus, Malta, Mauritius</td>
</tr>
<tr>
<td>Germany</td>
<td>Cyprus, Malta, Mauritius</td>
</tr>
<tr>
<td>Greece</td>
<td>Cyprus</td>
</tr>
<tr>
<td>Ireland</td>
<td>Cyprus</td>
</tr>
<tr>
<td>Italy</td>
<td>Cyprus, Malta, Mauritius</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Aruba, Malta, Netherlands Antilles</td>
</tr>
<tr>
<td>Norway</td>
<td>Barbados, Cyprus, Malta</td>
</tr>
<tr>
<td>Portugal</td>
<td>Malta</td>
</tr>
<tr>
<td>Sweden</td>
<td>Barbados, Cyprus, Malta, Mauritius</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Antigua and Barbuda, Barbados, Belize, Cyprus, Guernsey, Isle of Man, Jersey, Malta, Mauritius, St. Kitts and Nevis</td>
</tr>
</tbody>
</table>


RESPONSE OF TAX HAVENS: COOPERATION VERSUS ECONOMIC SURVIVAL

Through the determination of criteria for identifying harmful preferential tax regimes and tax havens, the OECD limits the sovereignty of jurisdictions as regards tax legislation by means of international standards. At the same time, a positive approach recognizes the need for cooperation between jurisdictions based on international principles of fairness, transparency, and exchange of information. The response of tax havens to such a policy may be explained by viewing it in the context of the advantages, including but not restricted to tax benefits, that foreign investors seek in locating their activities in a low-tax jurisdiction.

Generally, tax havens are considered to be those jurisdictions that offer the following advantages: low or zero tax rates; special tax regimes for particular categories of income or business entities; a stable political and economic environment; laws that ensure privacy regarding investments and transactions within the jurisdiction; financial and commercial legislation granting asset protection and tax relief for investors, but without the burden of a regulatory bureaucracy; and a developed and reliable banking and financial network. Tax havens differ, however, with respect to their preferential tax regimes and the advantages they offer to particular taxpayers or for particular economic and financial activities. Accordingly, when we speak of “tax havens,” we are referring to a heterogeneous and complex reality.
As regards preferential tax regimes, we adopt the usual distinctions:

1. **No-tax havens**, providing complete shelter from tax on income, capital, and real estate.\(^{21}\) These jurisdictions essentially derive their revenues from indirect taxes such as fees for the registration of companies, licence fees,\(^{22}\) and excise duties.

2. **Low-tax havens**, with low income tax rates and, generally, no withholding taxes on payments of dividends, interest, and royalties.\(^{23}\)

3. **Foreign-tax havens**, with no tax on income from foreign sources.\(^{24}\)

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\(^{21}\) Examples of tax havens with no direct taxation are Anguilla, Antigua and Barbuda, the Bahamas, Bermuda, the Cayman Islands, and Turks and Caicos.

\(^{22}\) Generally, licence fees for banks and other financial institutions vary by reference to the target of the activity. A licence can be unrestricted; restricted to activities within a group of companies; or restricted to non-active entities (purely for the administration of real estate).

\(^{23}\) Examples of low-tax havens are Barbados, the British Virgin Islands, Cyprus, and the Isle of Man. One of the advantages associated with this type of tax haven is access to tax treaties with high-tax jurisdictions that can lower the level of withholding taxes applied by those countries on flows of dividends, interest, and royalties to the low-tax jurisdiction.

\(^{24}\) Examples are Hong Kong and Panama.
4. **Special-tax havens**, offering preferential treatment through a special tax regime. Generally, a special tax regime applies to special entities, referred to as “offshore companies,” which are wholly owned by non-residents.\(^{25}\)

The initiatives to eliminate harmful tax practices are principally addressed to tax havens in the last group.

The above classification oversimplifies in that a jurisdiction’s tax practices may place it in more than one category, depending on the kinds of tax privileges offered. Tax havens may also attract foreign direct investment aimed at developing the industrial and economic infrastructure of the country, by providing exemptions from customs duties on building materials, equipment, and plant, or from business licence fees and real property taxes, or by offering tariff protection and other concessions.\(^{26}\) Tax exemptions, tax credits, or low taxation of income generally characterize “free trade zones,” in which tax incentives are combined with infrastructure supporting manufacturing and commercial activities, as well as non-tax incentives.\(^{27}\)

Although tax privileges are the principal defining feature of tax havens, one should not underestimate the importance of non-tax advantages granted to companies or individuals, particularly the following:

1. **A low level of regulation.** A liberal approach to company law and exchange controls, in particular, implies substantial freedom of investment in the country. Typical examples of flexibility in company legislation are a simplified companies act, no minimum share capital requirement, the absence of constraints on transfers of shares, and few mandated bookkeeping requirements.\(^{28}\)

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25 The term “offshore companies” includes, for example, exempt companies, qualifying companies, and international business companies (IBCs), which are generally subject only to an annual fee, with no direct income taxation. Tax preferences can consist in not only exemption from income tax but also detaxation of foreign-source income—for example, through a subsequent refund, complete or partial, to shareholders of any company tax paid. Preferential tax treatment can be accorded to offshore companies regardless of their business or with reference to a specific activity (such as international trading, international financial services, offshore banking and insurance operations, offshore management of funds, offshore holding consultancy services, headquarters operations, international technology services, shipping, aviation, or management operations).

26 See, for example, the Mauritius Industrial Expansion Act, Act no. 11 of 1993; the Malta Industrial Development Act, 1998; the Aruban Land Development Ordinance; the Bahamian Industries Encouragement Act, 1970, c. 301; the Netherlands Antilles Profit Tax Ordinance, 1940; and the Barbados Small Business Development Act, 1999-23.

27 For example, sunk contributions, financial assistance, flexibility, and simplifying procedures for hiring staff.

28 For example, under the Cayman Companies Law, 1990, the only required document is a formal statement in which a director of the company certifies that its activity takes place outside the jurisdiction.
2. **A high level of financial, banking, and commercial secrecy.** Nominee companies, provisions to enforce sanctions if secrecy is not maintained, the absence of the requirement of a shareholder register—all typical tax haven features—are targeted by the OECD by requiring a formal commitment to international cooperation through compliance with the principle of effective exchange of information between tax authorities.

3. **The existence of offshore financial centres.** OFCs can be classified in three categories based on their activities and the level of support provided by the tax haven jurisdiction, not only through tax regimes and company laws favouring the creation of OFCs but also through the local banking and financial infrastructure.

   a. **Notional offshore centres**, essentially consisting of a business address through which offshore transactions are registered for tax purposes. The aim of this kind of OFC is to distribute paper profits from international transactions to non-resident companies.

   b. **Compound offshore centres**, in which notional activities are linked to financial and functional services. This kind of OFC is found, for example, in the Bahamas, Bahrain, Barbados, the British Virgin Islands, the Cayman Islands, Gibraltar, and the Netherlands Antilles.

   c. **Functional offshore centres**, with a highly developed network of financial and international banking services. Examples of jurisdictions with functional OFCs are Bermuda, the Channel Islands, and the Isle of Man.

More specifically, entities that operate within OFCs include

- offshore banks, which provide loans and cash management services to individuals and companies funded through an internal financing affiliate (or “international holding company”), with the aim of managing international income and capital flows;
- branches of international banks;
- companies that provide financial and insurance services, such as mutual funds, offshore trusts, multi-currency loans, offshore stockbroking, and captive insurance;
- companies that provide management, consulting, technology, and other services.

The above summary shows how tax havens can specialize, choosing to offer advantages and incentives that will foster the development of specific commercial and/or financial sectors. Given such a framework, it is clear that, even if tax havens

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29 The most important specialized centres for offshore funds are Bermuda, Hong Kong, the Cayman Islands, and the Channel Islands.

30 The principal captive offshore companies are established in Bermuda, the Cayman Islands, and Guernsey.
eliminate their discriminatory tax practices and negotiate information exchange agreements, they will still have opportunities to offer a range of benefits specifically designed to attract non-resident investors, in effect substantially maintaining their present role.\footnote{There are, as well, some distortions associated with the reform of preferential tax regimes. The abolition of preferential regimes may lead countries to compete through the general tax system, with negative effects on tax revenues and causing the allocation of capital to simply take different forms: see Eckhard Janeba and Michael Smart, \textit{Is Targeted Tax Competition Less Harmful Than Its Remedies?} CESifo Working Paper no. 590 (Munich: Center for Economic Studies and Ifo Institute for Economic Research, October 2001); and Michael Keen, \textit{“Preferential Tax Regimes Can Make Tax Competition Less Harmful”} (2001) vol. 54, no. 4 \textit{National Tax Journal} 757-62. Just as the rollback of preferential regimes could lead to even more harmful forms of tax competition, the sharing of information for tax purposes will likely result in inefficiencies for small jurisdictions and, particularly, for low-tax jurisdictions: see Vito Tanzi and Howell H. Zee, \textit{“Can Information Exchange Be Effective in Taxing Cross-Border Income Flows?”} in Krister Andersson, Peter Melz, and Christer Silfverberg, eds., \textit{Modern Issues in the Law of International Taxation} (The Hague: Kluwer Law International, 2001), 259-68; and M. Keen and J.E. Ligthart, \textit{“Information Sharing and International Taxation: A Primer”} (unpublished, 2003).}

In the course of consultations preceding the 2000 report, the OECD introduced a process to facilitate the elimination of harmful tax practices in cooperating tax havens. The first step in this process was a formal written commitment (an “advance” or “scheduled” commitment) in which a tax haven agreed to improve transparency and exchange of information, and to eliminate preferential offshore regimes and ring fencing of such regimes. Implementation deadlines for fulfilling the various terms of the commitment were set out in a memorandum of understanding (summarized in the appendix to this article). December 31, 2003 was the deadline for the implementation of measures ensuring the effective exchange of information with tax authorities for criminal tax matters and the achievement of transparency in the tax system (for example, by eliminating secret tax rulings and the negotiation of the applicable tax rate). December 31, 2005 was the deadline for achieving effective exchange of information for civil tax matters and the abolition of ring fencing.

By 2001, the terms of formal commitments had been narrowed, as discussed earlier. Countries explicitly agreed to implement transparency and exchange-of-information measures, but they were no longer required to eliminate preferential tax regimes and ring fencing. However, jurisdictions were strongly encouraged to review and reform such harmful practices.

To date, a total of 36 jurisdictions identified as tax havens under the OECD criteria have signed a standard commitment letter, agreeing to undertake reforms (see table 7). The implementation deadlines are based on the 2000 memorandum of understanding. Only 5 jurisdictions (Andorra, Liberia, Liechtenstein, the Marshall Islands, and Monaco) have decided not to comply with international standards. These countries are listed as “uncooperative tax havens” and declared to be possible targets for coordinated defensive measures.

The formal response of tax havens to initiatives to curb unfair competition consists substantially in commitments to negotiate information exchange agreements
defining the tax matters that should be covered. With reference to transparency, tax havens agree to ensure that information on beneficial ownership of companies, partnerships, and other legal entities and on trustees and beneficiaries of trusts will be available to tax or regulatory authorities. For this purpose, according to the content of the standard letter, tax havens must require that financial accounts be kept by companies, partnerships, and other legal entities established or having a place of business in the jurisdiction.

Commitments are offered by tax havens on the basis of

- their exclusion from the list of uncooperative tax havens and from any framework of coordinated defensive measures;
- the guarantee of application of defensive measures against uncooperative jurisdictions, including OECD member countries and other jurisdictions that fail to satisfy the standard of the 1998 harmful tax competition report; and
- participation in the OECD’s Global Forum for the definition of standards for the implementation of such commitments valid at an international level.

Finally, under this formal statement, tax havens agree that they will not introduce new regimes or modify existing ones in contravention of the principles of transparency and effective exchange of information.
But what has changed so far? How do formal statements become real tax reforms? What further developments can be anticipated? We will answer these questions through a review of evidence of action taken to date by the jurisdictions listed as cooperative tax havens, in fulfillment of their commitments.

We focus on the response of cooperative jurisdictions on two fronts:

1. proposed and concrete tax reforms, directed mainly to the rollback of preferential tax regimes for non-residents; and
2. agreements to exchange information on tax matters, in accordance with the standard and model developed for purposes of the OECD initiative.

**Reform of Preferential Tax Regimes**

Commitments specifically referring to changes in tax regimes required the achievement of a transparent tax system and the removal of preferential tax treatment for entities not carrying on local business activities by December 31, 2003. Effective exchange of information and the abolition of ring fencing were to be accomplished by December 31, 2005. (As noted earlier, the preferential regime and ring fencing objectives became optional, though strongly encouraged.)

Apart from formal statements, the response to the initiative against harmful tax practices can be evaluated by examining announced programs of reform and measures actually implemented by cooperative tax havens. As table 8 shows, most of these jurisdictions have not yet put their formal commitments into practice.

It is worth emphasizing that, excluding only Mauritius, of the eight jurisdictions that have announced or implemented reforms, six are dependencies of EU countries (Aruba, the British Virgin Islands, Gibraltar, the Isle of Man, Jersey, and the Netherlands Antilles) and one (Cyprus) is an EU newcomer—all countries and territories directly or indirectly subject to the principles of tax practice in the EU Code of Conduct. Mauritius was one of the six jurisdictions that made an advance commitment to cooperate, before publication of the 2000 OECD report.32

Details of the reforms proposed or adopted in these jurisdictions are set out in tables 9 and 10.

As discussed earlier, one of the goals of the EU Code of Conduct is to promote the rollback of harmful measures in third countries—in particular, in dependencies and associated territories of EU member states.33 All of the jurisdictions with programs of reform have moved toward the abolition of offshore regimes and tax-exempt status for companies owned by non-residents. At the same time, with the aim of preserving their tax advantage for foreign investment, most of these jurisdictions have lowered or plan to lower corporate tax rates for all types of companies (following the example of Ireland).

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32 See supra note 7 and the accompanying text.
33 Assenting member states also agreed to promote the other principles of the code (including standstill on the introduction of potentially harmful measures and exchange of information) and to report to the Code of Conduct Group on practices in their dependencies and territories.
Cyprus (which announced its tax reform plan as part of its preparation for membership in the European Union) has decided to set a standard corporate tax rate of 10 percent for both offshore and onshore companies. This represents a significant reduction for onshore companies, which previously paid corporation tax at 25 percent of net profits.

The Isle of Man and Jersey have issued proposals for a zero rate of corporate tax applicable to most or all types of corporations. Gibraltar has also announced plans to eliminate the taxation of company profits (with two exceptions), but intends to substitute a payroll tax (a fixed tax on employment) and a business property occupation tax.34 These new measures would allow Gibraltar to offset revenue losses through indirect taxation and an increased tax burden on less mobile factors of production. Jersey also expects to recover lost revenue through the introduction of a goods and services tax, a 10 percent tax on profits of certain financial services companies, and reform of the personal income tax.

The Netherlands Antilles has abolished the distinction between onshore and offshore companies but has maintained preferential taxation for a new form of company (Nederlands Antilliaanse Besloten Vennootschap), which is exempt from both corporate income tax and the new dividend withholding tax. The British Virgin Islands’ new BVI Business Companies Act, 2004 abolishes ring fencing entirely: all companies, whether offshore or carrying on business in the BVI, will be subject to a zero tax regime.

34 Subject to EU approval, Gibraltar has announced a new 8 percent tax on profits applicable to financial service providers and utility companies. A cap is proposed on the aggregate of the new tax with other taxes at a maximum of 15 percent of profits. As a result, local companies that currently pay taxes on profits at 20 percent or 35 percent will be better off. In March 2003, the ECOFIN Council confirmed that the reforms do not constitute harmful tax measures. Although the European Commission has yet to rule on the tax reforms according to the state aid criteria, it is the opinion of Gibraltar’s European legal advisers, and the UK government, that the scheme complies with state aid rules.
<table>
<thead>
<tr>
<th>Offshore tax regimes</th>
<th>Corporate taxation</th>
<th>Other provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aruba:</strong> New Fiscal Regime (NFR), July 1, 2003</td>
<td>Abolition of preferential offshore regime; for companies formed prior to the introduction of the NFR, the existing privilege continues until the end of 2007 (effective tax rate of 2.4% or 3%)</td>
<td>The NFR contains a specific exemption for an Aruba exempt corporation (AEC) (with an exclusion for an AEC that generates profits from illegal activities, as defined under Aruba criminal law)</td>
</tr>
<tr>
<td></td>
<td>From January 1, 2007, all companies, offshore and local, will be subject to a zero tax regime</td>
<td>Introduction of a dividend withholding tax and an imputation payment system</td>
</tr>
<tr>
<td></td>
<td>The registration fee (equal to the annual one) depends on the company’s authority to issue shares and is set in the range of US$350 to US$1,100</td>
<td></td>
</tr>
<tr>
<td><strong>British Virgin Islands:</strong> The BVI Business Companies Act, 2004, effective January 1, 2005</td>
<td>Abolition, after a two-year transition period, of the distinction between “offshore” and local companies</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10% corporate income tax rate applied to both onshore and offshore companies, plus a 2% levy on wage bills, and a “special contribution” related to defence, which applies the 10% corporate tax rate to intercompany dividend and interest payments</td>
<td>Introduction of a residence-based system of taxation</td>
</tr>
<tr>
<td><strong>Cyprus:</strong> Income Tax Act No. 118(I), July 2002</td>
<td>Abolition of offshore regime (4.25% tax rate)</td>
<td>Provision for exchange of financial and tax information</td>
</tr>
</tbody>
</table>

(Table 9 is concluded on the next page.)
| Mauritius: Financial Services Development Act 2001 | Supervision of almost all types of offshore entity other than banks, including entities operating in the Free Port and the Export Processing Zone | Reduction of the profit tax rate to 30% (plus 15% municipal surcharge) | Introduction of a new company form (Nederlands Antilliaanse Besloten Vennootschap), which can be tax-exempt but does not benefit from tax treaties
Introduction of a 10% withholding tax on dividends
Introduction of a 100% participation exemption for profits from shareholdings in resident companies and qualifying Dutch-resident companies, reduced to 95% for shareholdings in other non-resident companies |
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<tbody>
<tr>
<td>Netherlands Antilles: The New Fiscal Framework, 1999</td>
<td>Abolition of the distinction between offshore and onshore companies, at least for newly formed entities</td>
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</tr>
</tbody>
</table>
TABLE 10  Tax Reforms Announced by Cooperative Tax Havens

<table>
<thead>
<tr>
<th>Offshore tax regimes</th>
<th>Corporate taxation</th>
<th>Other provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Isle of Man</td>
<td>Abolition of preferential offshore regime (currently, Manx-resident companies (1) owned by non-residents, (2) that do not trade in the Isle of Man, and (3) that do not have any source of income in the island, apart from interest from the Isle of Man government or bank interest, are tax-exempt)</td>
<td>Introduction of a zero standard tax rate for all companies (actually taxed at 18%), except for certain regulated financial sector businesses, which could be taxed at a rate of 10%</td>
</tr>
<tr>
<td>Gibraltar</td>
<td>Abolition of existing zero-rate privilege for exempt and qualifying companies</td>
<td>New taxes effective January 1, 2003: (1) a “company payroll tax” (introduced in respect of employees in Gibraltar); (2) a new business property occupation tax introduced in respect of property in Gibraltar occupied by companies for business purposes</td>
</tr>
<tr>
<td>Jersey</td>
<td>Abolition of tax-exempt companies (international business company)</td>
<td>Proposed 8% tax on profits applicable to financial service providers and utility companies</td>
</tr>
<tr>
<td></td>
<td>Reduction of the standard corporate tax rate to zero</td>
<td>Introduction of a 10% profits tax on all businesses regulated by the Jersey Financial Services Commission (primarily banks, trust companies, and investment managers)</td>
</tr>
<tr>
<td></td>
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<td>Phase-out of personal income tax allowance on a sliding scale on household income</td>
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<td>General goods and services tax of 5% in 2007 with some exemptions</td>
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<td>Savings in state expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Introduction, in 2006, of a form of pay-as-you-earn system for paying tax</td>
</tr>
</tbody>
</table>
Finally, Mauritius modified its offshore regime in 1999, through the introduction of two types of “global business company” (GBC): a GBC1 (formerly an “offshore company”), regarded as resident and therefore able to take advantage of Mauritian double taxation treaties, and subject to corporate income tax at 15 percent; and a GBC2 (formerly an “international company”), with the same domestic tax benefits as a GBC1 but considered non-resident. Mauritius has also taken steps to improve transparency. Until 2003, offshore companies could opt to pay tax at any rate between 15 percent and 35 percent. Normally, they made this choice according to the rules governing CFCs in the country where the company’s major shareholder was based. Legislation enacted in 2000 removed this opportunity effective January 1, 2003.

Cooperation Through the Exchange of Information

The commitment of jurisdictions to cooperate in ending harmful tax practices required elaboration of the exchange-of-information principle, not by OECD countries alone but in collaboration with cooperative tax havens. With this objective, a special working group was formed within the OECD’s Global Forum, consisting of representatives of OECD countries and delegates from 11 tax havens—Aruba, Bahrain, Bermuda, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, San Marino, and the Seychelles. This group was charged with the development of a model agreement establishing the standard of effective exchange of information for purposes of the OECD project. The result of their efforts was the 2002 Agreement on Exchange of Information on Tax Matters. The agreement sets out two versions of the model, a bilateral version and a multilateral version that “provides the basis for an integrated bundle of bilateral treaties.”

In broad terms, the model agreement covers information relating to the administration and enforcement of direct taxes, including the determination, assessment,
and collection of taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters. 40 However, the agreement is limited to the exchange of information on request; it does not set out terms and conditions for spontaneous or automatic information exchange. 41 The agreement also restricts requests to information that is “foreseeably relevant” to a specific matter of tax administration or enforcement: “Contracting Parties are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.” 42

Under article 5(4) of the model agreement, each contracting party agrees to authorize its competent authorities to obtain and provide upon request “a) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees; [and] b) information regarding the ownership of companies, partnerships, trusts, foundations, . . . and other persons, including . . . ownership information on all such persons in an ownership chain.” 43 However, a contracting party may decline a request for information on grounds set out in article 7. For example, a requested party “shall not be required to obtain or provide information that the applicant Party would not be able to obtain under its own laws for the purposes of the administration or enforcement of its own tax laws.” 44 The purpose of this rule is to prevent a party from circumventing restrictions on its powers to collect information under its own domestic laws. 45

Article 15 suggests different effective dates for the application of the agreement’s provisions, depending on the purpose for which the information is to be used: for example, January 1, 2004 for “criminal tax matters” and January 1, 2006 for all other matters covered by the agreement. However, these dates may vary as agreed by the contracting parties.

“Bilateral agreements will cover, at a minimum, the same four categories of direct taxes . . . unless both parties agree to waive one or more of them.”

40 Article 1 of the model agreement.

41 However, the commentary on article 5(1) of the model agreement, at paragraph 39, suggests that “Contracting Parties may wish to consider expanding their co-operation” by negotiating an agreement that covers automatic and spontaneous exchanges and simultaneous tax examinations.

42 Commentary on article 1 of the model agreement, at paragraph 3.

43 However, in the case of publicly traded companies or public collective investment funds or schemes, contracting parties are not required to provide ownership information “unless such information can be obtained without giving rise to disproportionate difficulties” (article 5(4)(b)).

44 See also article 7(2): “The provisions of this Agreement shall not impose on a Contracting Party the obligation to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process.” However, article 7(2) also provides an exclusion for information referred to in article 5(4); see supra note 43.

45 See the commentary on article 7(1), at paragraph 73.
The United States has adopted the OECD model as the basis for agreements with several jurisdictions targeted as tax havens, including the Cayman Islands, Guernsey, Jersey, the Isle of Man, Antigua, and the Netherlands Antilles. However, while the model is intended to establish the standard of effective exchange of information, the OECD recognizes that countries may choose to use other instruments (such as double taxation agreements) to implement that standard. Some of the cooperative tax havens have established procedures designed to enable their government authorities to comply with requests made under tax information exchange agreements concluded with other countries.

In this respect, tax havens that have actually acted upon their commitment to the effective exchange of information are Antigua and Barbuda, through the Antigua and Barbuda Tax Information Exchange Act of 2002; the British Virgin Islands, whose Financial Services (International Co-operation) Act, 2000 provides a framework for rendering legal assistance between domestic and foreign regulatory authorities in obtaining information; Dominica, whose Financial Secretary is permitted by the Exchange of Information Act of 2001 to provide information, including information pertaining to companies and financial services, to a foreign regulatory authority on request; and St. Vincent, with the Exchange of Information Act (2002).

**CONCLUSIONS**

Removing sources of distortion in the allocation of assets and activities can be considered the primary objective of initiatives aimed at promoting fair competition. Investment location decisions should be driven by economic considerations and not primarily by tax factors. The pursuit of this aim, however, is also motivated by a crucial side-effect: the protection of the tax base of large and high-tax countries.

The development of this project inevitably raises issues and problems that represent a challenge to increased international efforts to counter harmful tax competition. Some critics—mainly from the business side—regard the OECD as a cartel of high-tax jurisdictions guilty of tax competition much more harmful than that to which they are objecting. But the aim of eliminating the risk of distortions of trade and investment through the application of international standards is also a matter for debate from the economic point of view.

As far as the erosion of national tax bases is concerned, the real protection of tax revenue is strictly connected to the response of tax havens involved in the project and to their choices in reforming their tax systems in compliance with OECD and EU guidelines. Our study reveals that, so far, only in a few cases have concrete tax reforms followed formal commitments. Most of the cooperative jurisdictions that have implemented changes to their tax structures are dependencies or associated territories of EU countries, and thus are indirectly subject to the restrictions of the EU Code of Conduct. This shows the mutual reinforcement of initiatives. All of them are low-tax jurisdictions and thus have the opportunity to abolish discrimination between residents and non-residents while preserving tax privileges, possibly in a different form (for instance, through a general reduction of the income tax rate.
and the definition of special tax regimes for certain types of business and companies, rather than a distinction between offshore and onshore activities).

It is unlikely that tax havens will give up the benefits of economic growth and tax revenues deriving from foreign investments and capital; therefore, the solution adopted by some of the cooperative jurisdictions seems to be the only possible response for many tax haven countries. Final evaluation will be possible only at the end of 2005, but initial consideration, on the basis of tax havens’ attempts to maintain tax privileges, shows that the high-tax jurisdictions’ goal of protecting their tax base seems to be partially frustrated, in that harmful international tax competition can still take place through general statutory rates and special regimes.

The real challenge to the rollback of harmful practices involves the exchange of information and the effectiveness of the practical results of tax havens’ formal commitments. The effective sharing of information alone would be most helpful in curbing tax abuses connected, for example, with lack of substantial activity, making them easy targets for domestic anti-avoidance measures. The cooperation of tax havens with OECD countries in setting the standard of effective exchange of information shows the importance of dialogue between countries to ensure the application of the project guidelines. The improvement of international cooperation, agreements, and assistance in tax matters could lead to much better results than initiatives aimed at targeting tax havens and curbing particular features of their tax systems through measures that cast doubt on the legitimacy of their tax policies and attempt to limit their sovereignty in tax matters.

The resolution of the tax-avoidance problem presented by tax havens is essentially assigned to domestic legislation, through anti-avoidance provisions that discourage the shifting of income to foreign locations primarily for tax purposes. The results of such countermeasures will be strengthened if they are adopted by a wide range of countries. Moreover, the OECD project will arguably be more effective if it promotes better coordination between national and international initiatives against harmful tax practices. (To date, the Spanish CFC legislation is the only domestic legislation to incorporate specific reference to the OECD initiative.)

Finally, the application of defensive measures only to uncooperative jurisdictions constitutes a strong incentive for tax havens to institute reforms and to cooperate with other countries in eliminating harmful tax practices.

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<th>Deadline&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Action</th>
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<td>By December 31, 2001</td>
<td>Adoption of a plan indicating how each jurisdiction that agrees to the terms of the memorandum will, by December 31, 2005, achieve transparency and effective exchange of information for all tax matters, and eliminate any regimes that attract business without substantial business activity.</td>
</tr>
<tr>
<td>By December 31, 2002</td>
<td>Access for the jurisdiction’s regulatory and tax authorities to information regarding the beneficial owners of companies, partnerships, and other entities organized within the jurisdiction, and information on the identity of the principal beneficiaries of trusts and foundations.</td>
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</table>
| By December 31, 2003 | Effective exchange of information with persons or authorities concerned with the enforcement of criminal tax matters.  
Achievement of transparency in the tax system by eliminating rules that depart from accepted laws and practices, such as secret rulings and the ability of investors to negotiate the applicable tax rate.  
Elimination of the practice of attracting business without substantial domestic activity, by removing preferential tax treatment for entities not carrying on local business activities. |
| By December 31, 2005 | Effective exchange of information with persons or authorities concerned with the enforcement of civil tax matters, as well as criminal tax matters.  
Abolition of ring fencing. |

<sup>a</sup> Some deadlines may vary for jurisdictions that negotiate an exchange-of-information agreement in accordance with the OECD model agreement adopted in 2002: Agreement on Exchange of Information on Tax Matters (Paris: OECD, April 2002).