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# THE OECD AND THE EU: TWO APPROACHES TO HARMFUL TAX COMPETITION

Eric Osterweil[1]

Learned commentaries on the Organisation for Economic Co-operation and Development ("OECD") Report on Harmful Tax Competition: an Emerging Global Issue ("OECD Report")[2] and the European Union ("EU") Code of Conduct[3] have appeared in a variety of publications including this Journal.[4] Many of them have been critical of both the OECD Report and the EU Code of Conduct on grounds ranging from lack of clarity and precision to a failure on the part of their authors to understand elementary economics. Others have seen the EU Code of Conduct as a pernicious step to undesired harmonization of income taxes within the EU. Any initiative in the income tax field will have its supporters and detractors and efforts to end harmful tax practices are no exception to this rule. However, it is abundantly clear that there is a general movement to end national practices in the tax field which are harmful to other countries. The question becomes, therefore, to determine what are the key goals which both the EU and the OECD are attempting to achieve.

Both the OECD Report and the EU Code of Conduct deal with commercial activities although the OECD Report focuses on financial and service activities. Both indicate that low rates of taxation constitute a starting point for determining whether a

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1 Eric Osterweil, Partner, Oppenheimer Wolf & Donnelly LLP, Avenue Louise, 240, Box 5, 1050, Brussels, Belgium. Tel: (+32 2) 626 05 00. Fax: (+32 2) 626 05 10.

2 Approved by the OECD Council of Ministers on 9th April, 1998.

3 COM(97) final.

4 A useful comparison of the OECD Report and the EU Code of Conduct may be found in Easson, 'Harmful Tax Competition: The EU and OECD Responses Compared', 3 *ECTJ* 1 (1998). See also Pinto "EU and OECD to fight Harmful Tax Competition: Has the Right Path Been Undertaken?" 26 *International Tax Review* 386 (1998) at 386.

practice is harmful. Tax havens are an obvious target; but generally high-tax jurisdictions may also provide low rates of income taxation under specific circumstances.

Other factors which need to be examined for both tax havens and high-tax jurisdictions include lack of effective exchange of information with other jurisdictions and lack of transparency. Tax havens have the additional particularity that investors do not generally engage in substantial activities in those jurisdictions.

High-tax countries, as well as tax havens, sometimes engage in so-called "ring fencing" by which is meant that certain categories of taxpayers are granted privileges which are not generally available to all taxpayers.

While unusually low taxes on investments in conduit jurisdictions may raise alarm signals, the OECD Report emphasizes the absence of effective exchange of information and lack of transparency, both of which may be characterized as information inadequacies.[5] These shortcomings may be particularly harmful to the investor's home jurisdiction. The EU Code of Conduct, on the other hand, is silent on the issue of the exchange of information other than to stress the need for "full cooperation in the fight against tax evasion and avoidance, notably in the provision of information to other Member States in accordance with national legislation".[6]

Certain other practices such as ring-fencing may or may not be harmful to the investor's home jurisdiction but may put third countries at a disadvantage. Finally, certain tax practices may be designed to enhance a country's perceived weak economic position without necessarily being aimed at attracting investors from third countries.

The OECD Report serves as a series of recommendations and guidelines to both members and non-members of the OECD. It is not binding on OECD members. The EU Code of Conduct, on the other hand, constitutes a strong statement of policy which EU Member States have unanimously agreed to follow. It also includes a paragraph relating to the EC Treaty provisions on State Aid which, as will be seen below, refers principally to helping regions, industries or businesses which are in economic difficulty. The European Commission oversees and enforces EC policy on State Aid.

5 OECD Report, paras. 54 and 64.

6 Code of Conduct, para. M.

The differences in emphasis between the OECD Report and the EU Code of Conduct, combined with the fact that the OECD and the EU are organizations which have little in common with each other as regards structure and jurisdiction, are bound to lead to different approaches and, indeed, to different goals. Seven of the issues with which they have to deal are considered below.

**1. The Role of Low Taxation**

Neither the OECD Report nor the EU Code defines what is meant by low taxation. However, where a country or territory applies zero income taxation, there is a presumption that harmful practices are involved. It is, therefore, not surprising that the OECD has focused its initial efforts on jurisdictions which either have no income taxation or have very low rates of effective income taxation. Such jurisdictions are generally considered to be tax havens; but the OECD is not taking any chances on erroneously pinning a pejorative label on any jurisdiction. It has, therefore, sent out questionnaires to 47 jurisdictions which at first glance may fall into the tax haven category.[7] These questionnaires, we are told, are aimed at obtaining general information about the recipients' tax practices to enable the OECD to identify a list of tax havens.

A review of jurisdictions which are commonly known as tax havens reveals that there are substantial variations which can be discerned.[8] Some, like the Bahamas and Cayman Islands, have no income taxes whatsoever; they survive on indirect taxes including fees charged upon the formation of companies. Others, such as Guernsey and Jersey, apply income taxes to local resident companies at a low rate, but provide for either a total exemption for non-resident companies; or, in the alternative, they apply a low, negotiable tax under the provisions of International Business Company legislation. Other jurisdictions, such as the Netherlands Antilles or Cyprus, actually have a relatively high rate of corporate income taxation, but they afford substantial facilities for non-resident persons to invest in companies taxed at rates which do not generally exceed five percent. All of these jurisdictions attract foreign investors who are interested in the low or no-tax features of local tax law. Most of them do not apply a withholding tax on the payment of interest or dividends to foreign investors.

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7 17 Tax Notes International 24 (1998) at 1855.

8 See Zagaris, 'OECD Report on Harmful Tax Competition: Strategic Implications for Caribbean Offshore Jurisdictions', 17 Tax Notes International (1998) at 1507.

Tax havens whose legal systems are based on English common law offer trusts which enable investors to protect, or as some would say, hide their investments from the claims of creditors and tax administrations. Indeed, the trust mechanism has become so popular that certain civil law low-tax countries such as Panama and Liechtenstein have grafted trusts upon their local legal system. As should be evident, tax havens may not be popular with high-tax jurisdictions because of the low taxes offered by those havens; but the major problem from a high-tax jurisdiction point of view is not so much the low tax, but rather the opportunities offered to hide income derived by companies located in those jurisdictions.

Many high-tax jurisdictions also offer low-tax or perhaps even no-tax facilities. These benefits are generally granted to investors complying with specific tailor-made legislation. Various techniques may be used to achieve low- tax or no-tax facilities including tax holidays or provisions designed to reduce the investor's taxable base. The special group established by the Code of Conduct and headed by Dawn Primarolo, the UK Treasury Minister, (the "Code of Conduct Group") has drawn up a list of approximately 85 tax measures within EU Member States, including their offshore territories or dependencies, which may at first blush be seen to be harmful.[9]

Since the Code of Conduct Group has not published the list of tax measures which will be under scrutiny, one can only conjecture upon the provisions of national tax law which are involved.[10] The Irish experience is, however, instructive in at least one respect. It will be recalled that three separate tax regimes in Ireland featured income tax rates not exceeding ten percent benefiting companies in the International Financial Services Center ("IFSC"), the Shannon Zone, and qualifying manufacturing companies. The European Commission negotiated an agreement with Ireland whereby these special facilities would be phased out over a period stretching to 31st December 2005. In their stead, Ireland will introduce a 12.5 percent income tax on trading profits by 1st January 2003.[11]

It would be difficult to argue that the proposed Irish income tax of 12.5 percent is not a low rate when compared with rates applied in other EU Member States. What is instructive about the Irish experience is that, in the Commission's view, low taxes in and of themselves are not necessarily indicative of harmful tax competition. Indeed, quite the contrary may be asserted. Countries may compete with each other

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9 An Agence Europe dispatch dated 30th November 1998 refers to measures in all EU Member States except Austria.

10 Lists have appeared in various publications purporting to identify the tax measures which are under scrutiny.

11 Press Briefing of the Irish Department of Finance, 22nd July 1998.

by offering low income taxes provided that local and foreign investors benefit from a level playing field.

## 2. Ring-Fencing

A difficulty arises when countries offer special low-tax benefits which are not generally available to all taxpayers who are in the same general category of taxpayer. For example, a country may grant accelerated depreciation allowances to its taxpayers. If all taxpayers who are similarly placed benefit from accelerated depreciation, there should be no problem. But what is not acceptable is the granting by Country A of special depreciation allowances only to foreign investors or foreign-owned companies. That type of measure may be seen to enrich Country A and to erode Country B's tax base. As an example of this type of practice, in order to attract investment, several EU Member States grant special tax benefits to foreign executives who are hired for the purpose of implementing national investment programs.[12] If those same benefits are not available to local nationals, then the practice may be seen to be a typical example of ring-fencing which may be viewed as harmful.

## 3. Level of Activity

Investments channelled through tax havens are generally carried out in essentially letterbox operations. Local trust companies serve to administer companies constituted by foreign investors. The assets of those companies are reinvested outside the tax haven. Thus, the level of activity carried out in those jurisdictions is minimal particularly when compared with the level of funding which passes through the books of the companies concerned.

However, tax havens are not alone in providing opportunities for letterbox or minimal operations. The tax legislation of many EU Member States permits the formation of intermediary holding companies which suffer little or no tax on dividends received. Indeed, the EU Parent-Subsidiary Directive is designed to do just that.[13] In some jurisdictions, such as Belgium, Luxembourg, and the Netherlands, capital gains derived from the disposal of shares in subsidiary companies will escape income taxation. Moreover, the combination of domestic

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12 Surprisingly, it would appear that expatriate tax regimes are not on the Code of Conduct Group "hit list".

13 Council Directive 90/435/EEC, 23rd July 1990; OJ No.L225 of 20th August 1990 at 6.

legislation and effective tax treaties may allow intermediary finance companies to channel interest from borrowers to ultimate lenders with a minimum of income taxation at the level of the finance company.

It can be concluded that a low level of commercial or financial activity is unlikely in and of itself to be viewed as a harmful tax practice. Indeed, arguably, if taxation is to be measured by the level of activity, then no taxation or a low level of taxation may not be inappropriate.

## 4. Transparency

A level tax playing field in any jurisdiction requires that a reasonable degree of information be publicly readily obtainable regarding the treatment of taxpayers by local tax administrations. Special deals benefiting specific taxpayers, which are not available and which are not known to other taxpayers similarly placed, may be indicative of harmful tax competition. This would be particularly true if a country affords special benefits to foreign investors which are not accessible to all investors similarly placed, or, for that matter, if there is discrimination against foreign investors.

Some countries are prepared to issue tax rulings for the benefit of specific taxpayers. In some countries ruling criteria are vague or not generally known. Moreover, there may be administrative practices which are, in fact, contrary to statutory law or regulations. In such cases, the lack of transparency in the operation of a tax regime will make it harder for other countries to judge the impact of such rulings or practices on their own taxpayers.

The lack of transparency is not strictly speaking an exchange-of-information issue. If a country's tax system achieves a general level of transparency, there may be no need to supply information to other countries. For example, if it is publicized and generally known that interest spreads on back-to-back loans channelled through a particular country will be enforced as indicated in a published ruling, then the tax administrations having jurisdiction over both the creditor and debtor persons will be in possession of information needed to determine the tax position of their respective taxpayers.

The ruling practices in several EU Member States, including the Netherlands, will probably be subject to scrutiny by the Code of Conduct Group. However, defenders of the Netherlands ruling practice will no doubt argue that rulings are issued in

accordance with well-known and published criteria.[14] The question may then turn on whether Dutch ruling practices particularly in the field of financing companies meet internationally accepted transfer pricing principles or whether the Netherlands tax system is being used to obtain an unfair advantage over other countries.

## 5. Exchange of Information

The OECD Report argues that:

> The ability of a country to provide information to third countries is a key factor in deciding upon whether the effect of a regime operated by that country has the potential to cause harmful effects.[15]

There is a vast network of bilateral income tax treaties which do provide for an exchange of information in accordance with specific treaty provisions. Moreover, there is a multilateral arrangement regarding the exchange of information amongst EU Member States.[16] Nonetheless, those provisions are not necessarily sufficiently responsive to the requirements of proper tax administration because of national secrecy laws and practices. In particular, national bank secrecy rules may serve as a restraint on the ability of tax administrations to obtain and transmit information to other tax administrations.

Twenty-seven out of the twenty-nine OECD member countries approved the OECD Report. Switzerland rejected the Report in part because of its failure to protect bank secrecy. Luxembourg indicated that it "does not share the Report's implicit belief that bank secrecy is necessarily a source of harmful tax competition".[17]

Tax havens by and large refuse to divulge banking or other information to foreign tax authorities. Unless there is an applicable tax convention, there is no obligation

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14 See Bax, "La Politique conventionnelle neérlandaise: un modèle de transparence", 177 Fiscologue International, (1998).

15 OECD Report, para. 64.

16 Directive concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation, Council Directive 77/799/EEC of 19th December1977, OJ No. L 336, 27th December 1977 at 15.

17 OECD Report, Annex II at 74.

on those jurisdictions to communicate to foreign tax administrations banking or other confidential information regarding persons doing business in those jurisdictions.[18]

It is difficult to dispute the contention that if any jurisdiction refuses to communicate information about persons doing business in its territory, it is difficult for the tax authorities in any other jurisdiction to know whether there has been any harmful advantage granted to its taxpayers.

## 6. Unilateral Measures to Combat Harmful Tax Practices

OECD and other developed or developing countries have a considerable range of weapons in their tax legislation arsenal to combat what they perceive to be unfair tax competition. These weapons may include, inter alia:

- exchange-of-information clauses in bilateral income tax treaties;
- Controlled Foreign Corporation ("CFC") legislation;
- taxation of foreign investment funds regardless of distributions;
- transfer pricing rules;
- stringent reporting requirements;
- co-ordinated enforcement programs.

Some countries, such as Belgium and the Netherlands, which have a participation exemption system with respect to dividends paid to companies resident in those countries, are likely to refuse the exemption for dividends which have not suffered any tax at the level of the paying company.

Unilateral measures, and bilateral and multilateral arrangements cannot succeed in the absence of adequate access to information. Thus, in the absence of transparency and proper exchange-of-information measures, harmful competition will be difficult for tax administrations to detect and to combat.

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18 Many tax havens located in the Caribbean have signed tax information exchange agreements ("TIEAs") with the US Internal Revenue Service pursuant to the Caribbean Basin Economic Recovery Act of 1983.

## 7. International Jurisdiction over Harmful Tax Measures

Two international bodies have jurisdiction over potentially harmful tax practices: the EU and the World Trade Organization.

(a) Fiscal State Aid in the EU

Pursuant to the EU Code of Conduct, EU Member States have committed themselves not to introduce new tax measures which are harmful.[19] Moreover, they have agreed to roll back harmful tax measures over a period of two years ending on 31st December 1999.[20]

Some but not all of the tax measures covered by the EU Code of Conduct fall within the scope of the State Aid provisions of EC Treaty Articles 92 to 94. The Commission has over the years established procedures and conditions regarding State Aid granted by Member States including tax measures intended to assist business enterprises. State Aid issues are handled by the Commission's Competition Directorate together with competition cases under EC Treaty Articles 85 and 86.

State Aid is not defined in the EC Treaty; but it is generally understood to include assistance granted by government bodies to selected regions, industries or even individual companies. EC Treaty Article 92(1) states that:

> any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

The Code of Conduct requires the Commission to draw up guidelines relating to the application of EC Treaty Articles 92 and 93 relating to direct business taxation. The Commission has done so in a notice dated 11th November 1998.[21] The guidelines set forth in the notice are designed to clarify the application of State Aid rules to cases relating to direct business taxation.

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19 Code of Conduct, Paragraph E. 19

20 Ibid. Paragraph F.

To meet the test of State Aid in a business context, a tax measure must meet four conditions:[22]

1. It must confer a specific advantage to recipients which relieves them of charges that are normally borne by them. Tax measures may include, *inter alia*, tax holidays, special deductions which serve to reduce the taxable base, tax reductions or deferment of taxation.

2. The advantage must be granted through State resources.

3. The measure must affect competition and trade between Member States.

4. The measure must be specific or selective in that it favours certain undertakings or the production of goods.

If a tax measure constitutes State Aid under EC Treaty Article 92(1), it may, nevertheless, be exempted from the principle of incompatibility under one of the exemptions provided for in Articles 92(2) and (3). Three types of State Aid will automatically benefit from an exemption: (a) aid having a social character granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned; (b) aid to make good the damage caused by natural disasters or exceptional occurrences; and (c) aid granted to the economy of certain areas formerly known as East Germany.

The Commission may grant an exemption in certain other areas relating to economic development and the promotion of culture and heritage conservation. The Council of Ministers, on proposal of the Commission, may act on the basis of a qualified majority to grant other measures of State Aid.

Several cases decided by the Commission and confirmed by the European Court of Justice have dealt with issues of State Aid in the tax field. Some State Aid measures have been approved,[23] others have not.[24]

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21 Commission notice on the application of the State Aid rules to measures relating to direct business taxation. OJ No. C 384 of 10th December 1998 at 3.

23 E.g Irish International Finance Companies(2IFSCs") were initially approved by the Commission

24 E.g Case102/87, *France v Commission* (1988) ECR 4082, a scheme involving tax-free interest payments was held to be incompatible with the common market.

Clearly, the State Aid provisions of the EC Treaty constitute a powerful instrument in the hands of the Commission and the Council of Ministers. Many, but not all, tax measures which may be viewed as harmful will fall under the rubric of State Aid. On the other hand, general measures which are not regional in character or specific to industries or businesses may not be caught under the State Aid provisions but may fall within the ambit of the Code of Conduct.

The State Aid provisions of the EC Treaty perform an essential function in preserving a level playing field within the EU.

(b) World Trade Organization ("WTO")

The WTO has jurisdiction over international trade issues. On occasion, a tax dispute will rise to the level of a trade issue within the jurisdiction of the WTO. The most high-profile issue has been the claim lodged by the European Commission against the United States in the case of US Foreign Sales Corporations ("FSCs").[25] FSC legislation is designed to promote exports of US made products by reducing the overall income tax burden on profits derived from the sale of those products. The Commission believes that the FSC is contrary to WTO rules in effect and constitutes harmful tax competition. The United States has counter-attacked with criticism of certain tax practices of six European countries: Belgium, France, Greece, Ireland, the Netherlands, and Spain.

**Summary and Conclusion**

The OECD is a significant international institution by reason of its moral authority. However, it has no power to compel any nation to act or to refrain from acting on any issue. Nonetheless, due to its prestige and the intellectual resources which it can bring to bear on important legal, political, economic and social issues, OECD members and non-members alike can be influenced by decisions taken by the OECD Council of Ministers and by the work of OECD Committees such the Committee on Fiscal Affairs.

It is fair to say, therefore, that the OECD Report will influence decision-makers in OECD member countries. The OECD Report is a useful compendium of principles relating to harmful tax competition and steps which can be used to combat harmful tax practices. The OECD's current approach emphasizes what the Fiscal Affairs Committee appears to consider the most dangerous harmful tax practice, to wit the

25 Request filed on 18th November1997.

pervasive lack of exchange of information and perceived lack of transparency in tax havens and other jurisdictions.

By contrast with the OECD, the EU is an organization with considerable political and economic power. It is less concerned by issues relating to the exchange of information because Member States have a dense network of income tax treaties which provide for the exchange of information in defined circumstances. Perhaps, for that reason, the Code of Conduct has not explicitly pinpointed the exchange of information as a significant issue. Nonetheless, issues relating to the exchange of information are not absent within the EU. For example, the issue of bank secrecy has been of particular concern to Luxembourg. Moreover, exchange of information is clearly a bone of contention with respect to Member State territories and dependencies such as the Channel Islands, Isle of Man, Gibraltar, and the Netherlands Antilles.

The Code of Conduct Group will identify other tax practices which are harmful and EU Member States are politically bound to eliminate those practices which are ultimately condemned by the EU Council of Ministers. Lack of transparency, violation of transfer pricing rules and ring-fencing would appear to be specific targets of EU attack.

The State Aid provisions of the EC Treaty constitute a potent weapon enabling the European Commission and the Council of Ministers in appropriate circumstances to force Member States to refrain from adopting harmful tax measures or preventing such measures from taking effect. Not all tax measures which may be viewed as harmful fall within the framework of the State Aid provisions. However, the scope for action under the State Aid provisions is considerable.

Additionally, the Commission of the EU as a body can act for Member States in proceedings under the rubric of unfair trade practices under the WTO Agreement. It is in that context that the EU has launched its complaint against US FSCs. Of course, by the same token, the EU may itself be the target of complaints by third countries for tax measures which may be in violation of the WTO Agreement.

In short, the EU is likely to be a far more significant player than the OECD in the battle against harmful tax competition. The OECD will, however, remain a useful intellectual resource for analysing harmful tax competition issues and for nudging OECD members and other countries to modify their legislation and practices.