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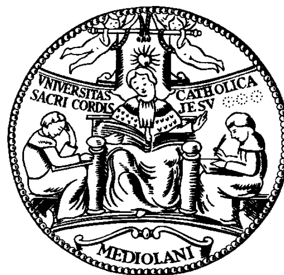

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# The Response of Tax Havens to Initiatives Against Harmful Tax Competition: Formal Statements and Concrete Policies

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## Abstract

We analyse the guidelines of OECD and EU projects against harmful tax competition and their effects on both anti tax-avoidance provisions of Member countries and fiscal systems of tax havens that made commitments to adhere to international standards. We consider the response of co-operative tax haven jurisdictions that actually goes in a twofold direction: the roll-back of privileged fiscal regimes for non-resident and commitments on exchange of information for tax matters. The paper shows how tax havens couple their adhesion to OECD and EU standards with tax reforms that try to maintain the characteristic of privileged tax system, even if in a different form. The aim to protect the tax base of high-tax jurisdictions seems to be partially disappointed, so that the success of the initiatives, from this point of view, is strictly bound to the concreteness of the results of tax havens formal commitments on the exchange of information.

JEL classification: H87, E62

Keywords: tax havens, harmful tax competition, tax harmonization

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## Introduction

The increase in capital mobility has created new opportunities for tax competition and new challenges for countries attempting to curb the harmful effects of fiscal policies that can influence both the policy decisions of other countries and the location of investments and financial activities. In this framework, particularly prominent is the role of tax havens and offshore financial centres: jurisdictions that engage in harmful tax competition linking the common features of their taxation systems - low or zero effective tax rate, "ring fencing" tax regimes, lack of transparency - to the introduction of special preferential tax regimes for particular activities and corporations (e.g." captive" insurance and offshore banking, trust, trading and holding companies, international financial services). In the last decade, the EU and the OECD member states have engaged in a far-reaching effort to counter the harmful effects of tax competition: the EU *Code of Conduct* and the OECD *project on Harmful Tax Competition* are the most important results of these common efforts. Members states agreed to undertake a political commitment to refrain from adopting new measures that constitute harmful tax practices, and to remove harmful features of preferential tax regimes within a five-year period; at the same time, a relevant number of tax haven jurisdictions has made commitments to adhere to the principles of the OECD initiative and to comply with them.
But how did these initiatives and formal statements put into effective policies? This paper tries to show it.

After a brief description of initiatives curbing harmful tax practices applied in tax havens jurisdictions, we analyse, in the second section, domestic anti tax-avoidance measures of major representative EU and OECD member countries, showing the compliance with OECD and Code of Conduct guide-lines. We put in evidence differences and similarities in the single countries' approach to the problem, highlighting the relativity of any criterion for the definition of *tax haven*, typical to anti-tax avoidance provisions and measures designed to target low tax jurisdictions.

In the third section of the paper, we try to explain the response of tax havens, setting it in the wide framework of advantages, not only fiscal benefits, that foreign investors search for through the establishment of their activities in a *low-tax* country. We consider some

jurisdictions that made commitments to adhere to the principles of the OECD project on harmful tax competition and we describe concrete policies followed to formal statements from a twofold profile - tax reforms prevalently based on the roll-back of privileged fiscal regimes for non-resident and the commitments on exchange of information for tax matters, according to standard model and procedures defined at the OECD level.

Finally, the fourth section considers the recent literature focusing on the effects - not necessarily positive - of the implementation of policies aiming to the inhibition of harmful tax practices. Initiatives to abolish offshore discriminating tax regimes and to exchange information could cause distortions in the countries that implement them, in terms of leading to an equilibrium outcome even worse than that which resulted from the adoption of harmful tax practices.

The aim of our work is to give a picture of the state of the art in the implementation of international initiatives against harmful tax competition involving *tax haven* jurisdictions. We rise some of the most prominent issues connected with these initiatives, their effects, their success and distortions, trying to describe what is really changing in the framework of harmful practices. According to our analysis, there are some improvements in the field of transparency and abolition of *ring-fencing* tax regimes, but tax havens seem to seek alternative measures in order to maintain the privileges of their tax systems.

## 1. The initiatives against "harmful" tax competition

Since the mid-1990's, the policies towards international tax competition aimed their action against any tax practices defined as "harmful" because of their ability to distort trade and investment flows, cause shifts in the tax burden, and impose constraints on government fiscal decisions by facilitating tax avoidance. Within this framework, international initiatives promoting fair competition highlighted the role of tax havens. These jurisdictions were considered more likely to be engaged in harmful tax competition, attracting foreign tax base by exploiting the possibilities offered by the removal of barriers to trade and capital. Thanks to their small size, tax havens suffer less, in revenue terms, from conceding special

preferential regimes, so that they can enjoy the positive impact from the location of investments and profits on economic growth and increased tax revenues (Ceriani, Giannini, 2004).
The correspondent revenue losses suffered by large countries, and the consequent desire to protect their domestic tax bases, were an evident spur to engage in projects aimed at directly or indirectly offering incentives to *tax haven* countries and territories to gradually eliminate their harmful tax practices.
The first step, following the scheme of this project, was to identify tax haven jurisdictions and to characterize the counterpart states by finding a definition for *tax haven* practices. The two main approaches to this problems are the OECD project on *harmful tax competition* and the EU *Code of Conduct.*

### *1.1 The OECD approach: international standards and definition of tax haven*

The Report adopted in 1998 by the OECD Council of Ministers (with Luxembourg and Switzerland abstaining) focusing on the taxation of geographically-mobile financial activities, such as financial and other services, provided an analytical framework for identifying harmful preferential tax regimes. The Report draws an important distinction between jurisdictions that tax income at a relatively lower rate, without engaging in harmful tax competition, and those where the existence of a low tax rate is coupled with other factors and special features, a combination of which constitutes harmful tax competition. The latter are regarded as both tax havens and "preferential regimes" provided in the context of a general income tax system.
The definition of tax havens was formulated on the basis of a set of criteria (OECD, 1998)

- no, or only nominal, effective tax rates;
- lack of effective exchange of information;
- lack of transparency; and
- absence of a requirement of substantial activities.

The first factor was considered a necessary condition, but not sufficient by itself, to identify a tax haven: at least one of the other three factors as well as the gateway criterion must exist. The lack of effective exchange of information means, in essence, an unwillingness to

exchange information on tax matters between tax authorities curbing tax evasion and avoidance, due to administrative policies and limited access to banking information. Lack of transparency is connected to special preferential treatment for individual taxpayers and the unavailability of the details of tax law and administrative practices. The fourth condition refers to facilities whereby a jurisdiction permits the establishment of foreign-owned enterprises without requiring local business activity or prohibiting commercial impact on the local economy[1].

A Forum on Harmful Tax Practices was established to carry out the work and present a progress report through which possible tax havens could be identified[2]. The evaluation of countries and territories was based on a review of such jurisdictions that appeared to have the potential for satisfying the predetermined conditions.

As a result, the Forum listed 35 jurisdictions (see table 1.1) found to meet the tax haven criteria and potentially eligible for common defensive measures and, at the same time, an effort was made to convince them to commit to eliminating their harmful practices[3].

But an agreement could not be immediately reached regarding the *harmful measures* on which to start the co-operation process. Multilateral international discussions on the project led to a gradual modification in the initial stance: following the widespread criticism on the part of OECD tax havens, it was conceded that every jurisdiction had a right to determine whether to impose direct taxes and to determine the appropriate tax rate.
"No or nominal taxation" alone was no longer considered a sufficient condition to bring the respective jurisdiction into the tax haven group[4]. The criterion of the lack of substantial activities was dropped because of difficulties in determining exactly what was meant by "substantial".

<table 1.1>

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[1] Additional factors that should be taken into consideration include failure to adhere to international transfer pricing principles, negotiable tax rates or tax bases, existence of secrecy provisions and regimes that are promoted as tax minimization vehicles.
[2] OECD, *Towards Global Tax Cooperation: Progress on Identifying and Eliminating Harmful Tax Practices,* 2000
[3] Bermuda, the Cayman Islands, Cyprus, Malta , Mauritius and San Marino issued an "advance commitment" letter prior to publication of the report, undertaking to eliminate the offending practices by 2005
[4] OECD, The *2000 Report*, p.10

The resulting modification to OECD policy limited the commitment only on the transparency and the effective-exchange of information criteria. Under the transparency criterion, jurisdictions commit to remove any features that depart from generally-accepted accounting standards, such as "secret" tax rulings and negotiation between the taxpayer and the tax administration over the applied tax rate.

*Exchange of information* would be based on legal mechanisms ensuring that information would be given to tax authorities of other countries in response to a specific request and that this information would be used only for the stated purpose.

After this "downgrading" of the initiative, the problem of the artificial limitation of the concept of tax haven became more evident. The search for a definition of tax haven was a controversial process whose difficulties were evident in subsequent OECD Reports. In 1987, the OECD Committee on Fiscal Affairs, in its report *International Tax Avoidance and Evasion*, stressed the difficulty of giving an objective definition of tax haven and the unavoidable failure of attempts in that direction. The more radical approach to the issue of tax havens, marked in the 1998 Report, however, required the narrowing of the term, leading to some inevitable distortions. First of all, the definition of tax haven is given only in respect to the taxation of mobile activities and financial and other services. Secondly, strictly from the standpoint of tax regime features, the adoption of a *tax rate* approach overlooked the complexity of the tax haven reality. Then, due to the auxiliary nature of the "no or nominal taxation" criterion, according to principal critics, the prosecution of OECD initiatives of co-operation remains founded on the vagueness of the other criteria, with particular reference to the concept of substantial activities.

### *1.2 The EU Code of Conduct: the indirect involvement of European tax havens*

In 1997, the European Union finance ministers agreed to a package of measures to curb harmful tax competition based on a political agreement referred to as a Code of Conduct for business taxation, and on commitments to remove harmful tax regimes following a review process.

The Code of Conduct, like the OECD initiative, considers legislative provisions, regulation and administrative practices. And, like the OECD project, it identifies key factors to evaluate the potential harmfulness of these measures. The basic condition refers to an effective level of taxation significantly lower than that generally applied in the member states.

These *harmful* regimes are then *ring-fenced*: applied only to non-residents and to transactions with non-residents or isolated from the domestic market. The fiscal privileges are not granted with regard to real economic activity, departing from OECD principles and without following transparency criteria.

The assent of member states to the Code of Conduct meant a commitment to refrain from introducing new harmful measures (stand-still) and to roll back existing ones; to exchange information on potentially harmful measures applied or to be issued; and to promote the rollback of harmful measures in third countries: in particular, in the dependencies and affiliated territories of EU member states.

According to these formal commitments, a special group was to be set up to identify potentially harmful measures. In November 1999, the Code of Conduct group presented a Report (the *Primarolo Report*) containing the assessment of 66 harmful tax measures that cover financial services and group financing, intragroup services, holding companies, insurance, exempt and offshore companies. Considering the effect of this initiative on tax havens, we can note that, unlike the OECD list of member and non-member jurisdictions meeting the definition of tax haven, the *Primarolo Report* lists single harmful tax measures applied in jurisdictions affiliated with EU member states and targeted as *tax havens* according to the OECD criteria (see table 1.2.)

While the OECD call these countries or territories to make commitments and to co-operate on the basis of international standards, the Code of Conduct Group involved them indirectly, making the success of the EU initiative dependent on the concrete actions of the member states to promote proceedings against harmful measures in their dependencies.

<table 1.2>

## 2. What are the available defensive measures?

The second stage of the project, following the identification of factors characterizing tax havens, was to define the means to counteract harmful tax competition. The 2000 OECD Report provides some *Recommendations* referring to three areas: (i) domestic policies; (ii) bilateral agreements; (iii) international co-operation.

In the area of fiscal policies, the OECD Report recommended unilateral and bilateral efforts to strengthen the co-ordinated action against harmful practices.

The *Recommendations* for Member countries suggest the adoption of some defensive measures against uncooperative jurisdictions, such as disallowance of deductions, exemption or credits related to payments made to subjects located in countries engaged in harmful tax practices (with an exception if these payments derive from substantial activities and do not exceed an arm's length amount); *thin capitalization* rules; *Controlled Foreign Companies* (CFC from now on) legislation; restriction on participation exemptions and foreign tax credit; transfer pricing rules; requirement of information reporting rules for transactions involving Uncooperative Tax Havens or taking advantage of their harmful tax practices.

The objective of these defensive measures is essentially to increase the cost of turning to foreign structures and companies in low-tax countries primarily to benefit from preferential tax conditions and to minimize tax costs.

We can consider some EU member states (also OECD members) and examine the state of the art in the adoption of most common anti-tax avoidance provisions (see table 2.1).

Since the start of the OECD project, in 1998, the evolution and most recent introductions of these "defensive measures" refer to the CFC legislation and thin capitalization rules. In recent years, five of the EU countries (Belgium, Ireland, Italy, Netherlands and Norway) have introduced this type of provision by adopting CFC legislation. Referring to *thin capitalization* rules, the latest countries to adopt theme were Italy and Netherlands (2004); but also less recently legislation has been amended in a restrictive way.

<table 2.1>

The recent evolution of these anti-tax avoidance provisions is linked to the controversial question of their compatibility with non-discrimination principles and the aim to achieve an EU market without tax obstacles**.**

Traditionally, industrialised countries have used thin capitalization rules to prevent erosion of their tax bases. This practice brings great advantages when the foreign companies are located in a low-tax jurisdiction, so that the interest derived from granting loans 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 could recharacterize interest as dividends for purposes of domestic law and deny interest deductions to the domestic subsidiary. Evidently, such a recharacterization could trigger a double taxation. The alternative solution considers interest on excessive debt financing as disallowed expenses.

About half of the EU member states currently have some kind of thin capitalization rules. The table below provides a brief description of these rules in several EU countries. Other member states have administrative practices that presume a tax avoidance practice in the intra-group financing process, even though they do not have specific thin capitalization legislation.

Recent changes in anti-tax avoidance legislation were driven from a 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 Art. 43 of the EC Treaty[5]. After the ECJ decision, it became clear that several EU Member States' thin capitalization regimes would not be considered legitimate: the rules typically treated companies owned by non-resident shareholders differently from companies owned by resident shareholders with respect to the deductibility

[5] The case of *Lankhorst-Hohorst GmbH vs Steinfurt Finance Authority* (case C-324/00 of 12 December 2002) concerned the tax treatment of interest that a German company was paying on a loan from its Dutch parent company. The borrower was clearly thinly capitalized. According to the German statutory provisions, interest paid by a German subsidiary on a loan provided by a foreign parent company was taxed as a deemed dividend at a rate of 30%, whereas, in the case of a German subsidiary with a German parent company, interest paid would have been treated as expenditure. The EJC judged the incompatibility of the German thin capitalization rules in s. 8 of the Corporate Income Tax Act with the freedom of establishment principle in Art.43 of the EC Founding Treaty. Difference in treatment may not be justified by the risk of tax evasion since the foreign parent company will in any event be subject to tax in the state in which it is established (*Lankhorst-Hohorst,* C-324/00, 2002, ECJ, at. par. 37)

of interest paid on loans. This is, according to the Court, a restriction that may make cross-border economic activities within the EU less desirable than purely domestic activities.

<table 2.2>

The ECJ decision started a movement towards amendment of thin capitalization rules, based in most cases on the extension also to resident companies. From 1 April 2004, UK's thin capitalization provisions apply to debt between two UK companies as well as in cross-border situation, and to each individual company on a stand-alone basis, rather than to a UK grouping[6]. Of course, Germany has amended its rules to bring transactions between resident companies within their scope. Spain amended its rules as 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 a Spanish black list of tax havens). Denmark has presented a tax bill which, when enacted, will apply to loans between Danish companies. The French Courts ruled the incompatibility of thin capitalization rules with tax treaties as well with freedom of establishment. Anyway, some problems of compatibility with the principle of non-discrimination still remain and it is not clear if these efforts will be sufficient to save their respective regimes (Thoemmes et al. 2004)

First of all, the decision to remove thin capitalization rules only in relation to shareholders resident in the EU (e.g. Spanish reform) leaves the new legislation conformed to the principle of freedom of establishment, but there could be a problem of compatibility with the principle of the free movement of capital, enshrined in Art.56 of the EC Treaty [7]. In relation to third countries, the *freedom of establishment* principle is not applicable because its scope is limited to individuals and companies of EU Member States; on the contrary, Art. 56 prohibits all restrictions on the movement of capital and on payments between 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, the applicable

[6] UK abolished its separate legislation relating to thin capitalization and extended the provisions of its transfer pricing law to generally cover the same area.

[7] Although the EC treaty does not include a definition of *movement of capital*, it may be safely assumed that direct investment in subsidiaries should fall 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 analysed carefully: the crucial element could be the standard the ECJ would use to determine what constitute an arbitrary restriction.

Another question is related to non–discrimination provision included in the OECD model tax treaty. Art. 24 prohibits discrimination against companies on the basis of whether they are owned by residents or non-residents[8].

Third, there is a problem referred to the nature of this anti-tax avoidance provision. In fact, unilateral measures such as thin capitalization rules raise concerns from double taxation perspective, since Member States determine unilaterally when interest should be reclassified as dividend, for domestic as well cross-border cases. Recharacterization conflicts may be solved only through a mutual agreement procedure under an applicable double tax treaty. This could generate problems of incompatibility with EC Treaty, if the unilateral restriction would apply regardless of tax treatment in the other Member State.

The distinction between domestic and foreign investments constitutes the basis of CFC legislation too. 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 this one must be subject to a low taxation. Referring to thin capitalization rules, the EC Treaty has been interpreted as prohibiting a Member State from imposing restrictions on its own taxpayer, regarding their investments in foreign (i.e. other European) 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 of the freedom of the domestic parent to make an investment in a subsidiary in another EU Member State.

Besides the potential problem of constraints in the investment decisions, another element of interest as regards CFC legislation refers to the question of the definition of tax

[8] Art. 24(4) provides that interest, royalties and other payments made to non-residents will be deductible for purpose of determining the taxable profits of a company under the same conditions as if they had been paid to a resident of the respective state

haven. This kind of anti-tax avoidance provision and, in general, all measures designed to target low tax jurisdictions, make evident the problem of the relativity of any criterion for definition. Different countries approached the problem from different perspectives (see table 2.3).

Both types of CFC rules, following a *transactional* approach or a *jurisdictional* approach, adopt the comparison between domestic tax rate and corporate tax rate applied to the controlled foreign company as one of the primary criteria for the imposition of special tax measures. At first, the *transactional* approach attempts to target the tax benefits enjoyed by the entities owned or controlled by resident taxpayers in respect of income from certain type of transactions (passive income), independently from the pure localization; the *jurisdictional* approach proceeds from the principle that the income from a controlled company established in a low tax jurisdiction or enjoying a preferential tax regime is deemed as distributed, independently from the source of income. An analysis of the criteria defined by the EU member countries for the definition of *low-tax* jurisdiction shows partial differences in the attitudes of these countries towards tax haven jurisdictions and a different political sensitivity towards the issue.

<table 2.3>

Most of the EU countries fix a threshold to the corporate tax rate applied to the foreign company under which the source country is considered a *low-tax* jurisdiction and the CFC rules are applied (in conjunction with the other criteria). Only Italy and Portugal do not define a ratio and make reference to a black list of tax havens. The lowest threshold is the Swedish limit of 15,4%. Particularly restrictive is the level fixed by Spain: 26,25% of the effective corporate income, under which to proceed with a direct taxation. Germany uses a nominal tax rate for the cross-jurisdictional comparison of income tax rate, with evident problems of distortion and overlooking of the complexity in the criteria for the tax base definition. On the contrary, an *effective tax rate* approach ( for instance, in the case of Finland, France, Spain) is less simplistic but very difficult to apply for both revenue authorities and tax payers.

*Black lists* are often associated to CFC provisions; such lists include a general reference to tax haven countries and territories, and, in several cases, a specification of harmful tax practices (also applied in *high-tax* jurisdictions).

The best-constructed list is the Italian *Black list*, that makes a distinction among: (i) privileged tax regimes under any circumstance; (ii) countries regarded as having a privileged tax regime, with the exception of certain specific activities; (iii) countries and territories without privileged tax regime but deemed to be tax havens with regard to specified low-tax activities (offshore legislation or other tax incentives).

Both Portugal and Spain list tax havens by region: the Portuguese *black list* (Ordinance 150/2004) is particularly restrictive with 84 jurisdictions identified as low-tax jurisdictions for CFC purpose (the only harmful tax measure mentioned is the one practised by Luxembourgian exempt holding companies); the Spanish one (Royal Decree 1080/1991) lists 47 tax havens and 1 preferential regime (Luxembourgian special holding company).

A very important element to point out is that the Spanish CFC legislation is the only anti-tax avoidance provision in EU, to time, that makes a specific recall to the OECD initiatives against harmful tax competition, deeming not to be a tax haven for any tax purposes countries signed an OECD-like exchange of information agreement.

The Finnish CFC rules make a specific reference to tax treaty countries that would not fulfil the 75% test: Barbados, Malaysia, Malta, Pakistan, Singapore, Switzerland and the United Arab Emirates; then they consider as controlled foreign corporation any company enjoying special tax benefits in its country of residence (even if it is resident in a tax treaty country other than the ones listed above)[9]

UK and Sweden adopt a *negative* approach in listing countries that meet the conditions necessary for exclusion from the charge imposed by the CFC legislation. Both countries draft a sort of *white list*; the UK list in particular, is divided into two sections: one for excluded countries and the other for countries excluded unless the foreign controlled company benefits from any of the listed privileged tax measures.

As noted above, a comparison of the black lists produced by the EU countries stress the relevant differences in their attitude to the *tax haven* jurisdictions. A reason could be found in political and economic relationships with these territories and countries. The political

[9] A special tax benefit would be, for instance, the coordination centre tax rules in Belgium or benefits provided on a regional or discretionary basis, such as those in Madeira or the Canary Islands. Benefits available under the

sensitivity of the issue is pointed out by the small number of lists that targeted as tax haven practices the privileged fiscal regimes applied by developed *high-tax* countries.

In the area of bilateral agreement, OECD *Recommendations* explicitly refer to tax treaties signed with low-tax jurisdiction, suggesting to member countries the requirement of comprehensive information reporting rules for transactions involving Uncooperative tax havens or taking advantage of their harmful tax practices; the application of a withholding tax to payments of dividends, interest and royalties made to subjects benefiting from harmful tax practices; the limitation of treaties with countries or jurisdictions involved in harmful tax practices. The table 2.4 shows bilateral treaties to avoid double taxation signed between EU member countries and tax havens. As we can see, all counteracting jurisdictions, with tax treaties still in force, are co-operative jurisdictions.

Some of the treaties signed between Member countries and low-tax jurisdictions exempt from withholding tax interest and royalties payments made to subject resident in tax privileged countries[10]. In most cases, there is an explicit exclusion for companies subject to advantageous tax regimes.

<table 2.4>

Considering the number of tax treaties in force (see figure 2.1), for single member countries, we can notice the particular attitude of the United Kingdom, which signed a relevant number of tax treaties with countries having a privileged tax regime. On the other hand, Spain has no treaties with tax haven jurisdictions.

<figure 2.1>

## 3. Tax havens' behaviour between formal statements and need to survive: reforms and results

Through the determination of the criteria for identifying harmful preferential tax

general tax rules, such as the participation exemption in the Netherlands, are not considered special tax benefits and therefore fall outside the scope of the controlled foreign company law.

[10] See, for instance, Italy-Cyprus, Germany-Cyprus, France-Mauritius, Belgium-Cyprus tax treaties.

regimes and tax havens, the OECD set out the limits established by the international tax standards on the sovereignty for tax legislation. At the same time, a positive approach states the need for a co-operation with interested parties on the international principle of transparency, fairness and disclosure.

The response of tax havens to such a policy could be explained by setting it in the framework of advantages - not only fiscal benefits - foreign investors search for as they set their activities in a low-tax jurisdiction.

Tax havens are generally considered as jurisdictions enjoying a hedge based on fiscal and regulatory advantages: a low or zero tax burden; special tax regimes for particular categories of income or groups of companies; a stable political and economic framework; confidential laws that ensure privacy on investments and transactions inside the jurisdiction; a financial and commercial legislation granting asset protection and facilitations for investors who can act without regulatory burdens and bureaucracy, supported by a developed and reliable banking and financial network. Tax havens differ, however, according to tax benefits, advantages to specific subjects, incentives to particular economic and financial activities, so that when we speak about *tax haven*, we are referring to a very heterogeneous and complex reality.

As for the tax regime, we can adopt the usual distinction in: (i) *Non- tax havens*, offering complete shelter of taxation on income, capital, real estate[11]. Their fiscal revenue consists essentially of indirect taxes like annual fees for the registration of companies; licence fees[12]; excise duties. (ii) *Low-tax havens*, with low income tax rates and, generally, the absence of withholding taxes on dividend, interest and royalties[13]. (iii) *Foreign tax havens*: tax havens with no taxation on income from foreign sources[14]. (iv) *Special tax havens:* tax

[11] Examples of tax haven with no direct taxation are: Bahamas, Bermuda, Cayman Islands, Antigua & Barbuda, Anguilla, Turks & Caicos.

[12] Licence fees for banks and financial institutes vary in general in reference to the target of the activity; licence can be: *unrestricted; restricted* (for activities inside a group of companies only); *for non-active entities* (for the pure administration of the real estate)

[13] Examples of *low tax havens* are Cyprus, the Isle of Man, the British Virgin Islands and Barbados. One of the advantages connected to this type of tax havens are tax treaties with high tax jurisdictions that can low the level of withholding taxes applied by those countries on flows of dividend, interest and royalties addressed to the low tax jurisdictions.

[14] Examples are Panama and Hong Kong.

havens with special privileged tax regimes. Generally speaking, these tax regimes are accorded to special entities defined as *offshore companies*, which are completely owned by non-residents[15]. The initiatives adopted to eliminate "harmful tax practices" are principally addressed to this preferential regimes.
The proposed classification results, of course, from a simplification; it should be noted that one jurisdiction, in its tax haven practices, may be classified in different way, targeting several kinds of fiscal privileges, so that thresholds in the categories identified above are very fleeting.

Tax havens may also promote the localisation of foreign direct investments aiming at the development of the industrial and economic background of the country, through exemption from the payments of custom duties on building materials, equipment, plant; exemptions from business licence and real property taxes, tariff protection and concessions[16]. Tax exemption, tax credits or low taxation of income generally characterize *free trade zones* in which fiscal incentives are combined with infrastructures supporting manufacturing and commercial activities and to non-fiscal incentives[17].

Although fiscal privileges are considered as the most characterizing element of tax havens, one should not undervalue extra-fiscal advantages granted to companies or individuals: (i) the low standard for the regulation system, with reference, in particular, to the company law and exchange controls that means a substantial liberalization of investments in the country. The characteristic flexibility of the company legislation means simplified rules of

[15] The term "offshore companies" includes different features like *Exempt companies, Qualifying companies* or *International Business Companies (IBC)*, which are generally subject only to annual fee, with no direct income taxation. Privileges can consist in exemptions from income tax but also in a de-taxation of foreign source incomes, for example through a subsequent refund to shareholders, complete or partial, of the paid company tax. Preferential tax regime can be accorded to offshore companies in spite of their business or with reference to a specific activity (international trading, international financial services, offshore banking and insurance operations, offshore management of funds, offshore holding consultancy services, headquarters operations, international technology services, shipping, aircraft and management operations).

[16] For instance*: Mauritius Industrial Expansion Act*, *Malta Industrial Development Act*, *Aruban Land Development Ordinance, Bahamian Industries Encouragement Act, Netherlands Antilles Profit Tax Ordinance, Barbados Small Business Development Act.*

[17] E.g., sunk contributions, financial assistance, flexibility and simplifying procedures for the personal engagement.

redaction of the Company Act; the non-request of a minimum stock capital; the absence of constraints in the transfer of shares and few duties in the keeping of books[18].

(ii) High standard of financial, banking and commercial secrecy. Nominee companies, provisions that enforce sanctions in the case of the break of secrecy, the absence of the request for the shareholders book - typical tax havens features - are one of the OECD initiatives target and the objective of the formal statement of compliance to the international co-operation principles on the exchange of information between tax authorities.

(iii) The development of offshore financial centres (OFC). We can distinguish different kinds of OFC in relation to their stage of evolution, and to their support to concrete business. We can classified OFC in: *notional offshore centres*, booking centres (jurisdictions through which transactions, whose value added are created offshore, are booked) characterized by tax regimes and company laws advantaging the localisation of offshore companies but also house banking and financial structures whose aim is essentially to address *paper-profits* from international transactions to non-resident companies; *compound offshore centres,* where notional activities are jointed however to financial and functional services. This kind of OFC is housed, for example, in Bahamas, Bahrain, Barbados, British Virgin Island, Cayman Islands, Gibraltar and Netherlands Antilles. And the highest stage of this process is the evolution in *functional offshore centres* where we find extremely developed network of financial services and international banks. Examples of *functional OFC* are Bermuda, Isle of Man and Channel Islands. More specifically, subjects that operate inside OFC are: (a) offshore banks, who provide services to individuals and companies in the form of treasury structures created by transactional corporations with the aim of managing international income and capital flows, and branches of international banks; (b) companies which provide financial and insurance services: mutual funds[19], offshore trust, multi-currency loans, offshore stock broking and captive insurance[20]; (c) companies providing other services: managing, consulting and technology services.

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[18] For example, according to the Cayman Companies Law, the only required document is a formal statement through which the director certifies that the company activity takes place outside the jurisdiction.

[19] Most important specialized centres for Offshore Funds are Bermuda, Hong Kong, Cayman Islands and Channel Islands.

[20] The principal Captive offshore companies are established in Bermuda, Cayman Islands and Guernsey.

Such background shows how tax havens can specialize their offer, choosing the structures of fiscal advantages and incentives that allow the development of specific industrial, financial sector.

In such framework it becomes clear that the elimination of discriminatory tax regimes and the negotiation of tax information exchange agreements do not exhaust the tax havens' privileges supply and allow them to substantially keep their role unchanged. There are, however some distortions connected with such reforms of tax regimes, which will be discussed later on.

Through the 2000 Progress Report, the OECD started a process whereby tax havens could commit to eliminate harmful tax practices. The first step of this process was a formal advance commitment to co-operate in order to improve transparency, exchange of information and to eliminate regimes aiming to attract business without real economic activity.

A total of 36 jurisdictions (see table 3.1) have committed to adhere to the principles of the project on harmful tax competition with a standard "Commitment letter" through which single tax havens state the manner in which they would implement their commitment and the measures they would prepare to take on a phased basis by 31 December 2005.
The reference is the Memorandum of Understanding on eliminating harmful tax practices and the terms inside (see table A.1 in Appendix). Year 2003 was the deadline for the implementation of provisions ensuring the effective exchange of information with tax authorities for criminal tax matters and the transparency of the tax system (denying secret rulings and the negotiation of the tax rate with single investors). Year 2005 would be the fixed term to reach effective exchange of information for civil tax matter and the abolition of "ring-fencing" tax regimes, as well.

<table 3.1>

The formal response of tax havens to initiatives to curb unfair competition consists substantially in commitments to negotiate tax information exchange agreements defining the tax matter that should be covered. Referring to transparency, the single tax havens ensure that information on beneficial ownership of companies, partnership, other legal entities and on trustees and beneficiaries of trusts will be available to tax or regulatory authorities. This agreement, according to the content of the standard letter, would also mean the requirement of

financial accounts to be kept by companies, partnership and other legal entities established or having a place of business in the tax haven.

Commitments are offered by tax havens on the basis of: (i) the exclusion from the list of Uncooperative tax havens and from any framework of coordinated defensive measures; (ii) the guarantee of application of defensives measures to Uncooperative jurisdictions, including OECD member countries and other countries that fail to satisfy the standard of the 1998 Harmful Tax Competition Report, (iii) the participation in the Global Forum for the definition of standard for the implementation of such commitments valid at the international level. Finally, tax havens ensure with this formal statement that no new regime would be introduced, and no existing regime would be modified failing the principle of transparency and effective exchange of information.

Only five jurisdictions (Andorra, Liberia, Liechtenstein, Marshall Islands, Monaco) decided not to comply with international standards; these countries were included in a *List of Uncooperative tax havens* and stated to be eligible for co-ordinated defensive measures.

But what has changed so far? How do formal statements turn into real tax reforms? What would be the consequent evolution? We show it through the analysis of the tax reforms and draft of several specific low-tax jurisdictions, targeted as co-operative tax havens, in accordance to their commitments.

We focus on the response of the co-operative jurisdictions from a twofold profile: (i) proposed and concrete tax reforms, based prevalently on the roll-back of privileged fiscal regimes for non-residents; (ii) commitments on the exchange of information for tax matters according to the standard model and procedures defined at the OECD level.

### *3.1 Tax reforms in co-operative jurisdictions*

Commitments specifically referred to the changes in the tax regimes characteristics required the achievement, by 31 December 2003, of transparency of the tax system and the removal of restrictions to do business in the domestic market for entities qualifying for preferential tax treatment. By December 2005, co-operative tax-haven are asked to abolish “ring-fencing” regimes.

Apart from formal statements, the concrete response to the initiative against harmful tax competition can be evaluated through the analysis of actual tax provisions and rules, and official announcement of tax reforms. The exam of the co-operative jurisdiction tax systems shows that most of them have not yet put their formal commitments into practice.

<table 3.2>

It's interesting to note that, with the exception of Mauritius, the only jurisdictions that implemented concrete response are dependencies of EU Member countries (Aruba, Gibraltar, Netherlands Antilles, Isle of Man and Jersey) and one of the EU new entry , Cyprus – countries and territories subject to the bounds of the Code of Conduct commitments.

As noted in the first section, one of the goals of the EU Code of Conduct is the promotion of the rollback of harmful measures in third countries - in particular, in dependencies and affiliated territories of EU member states[21]. All the reforms analysed go exactly towards the abolition of offshore regimes and tax exempt companies owned by non-resident. At the same time, with the aim to maintain tax privileges, some of the cooperative jurisdictions lowered or have a project of lowering tax rate for all types of companies (following the example of Ireland).

<table 3.3>

Cyprus announced its tax reform plan as part of the preparation for membership of the EU. The Government decided to set a standard corporate tax rate of 10% for both offshore and onshore companies (the main beneficiaries were onshore companies, which paid corporation tax at 25% of net profits).

<table 3.4>

Isle of Man and Jersey are basing their proposals of tax reform on a zero rate for corporations and Gibraltar would abolish taxation of company profits, replacing it with a payroll tax (a fixed tax for employment) and a business property occupation tax[22]. The revenue losses

[21] The assent of Member States to the Code of Conduct was connected also to formal commitments to ensure that no new harmful measure would be introduced, information on tax measures applied or to be issued, potentially harmful, would be exchanged, to set up a special group aiming at identify potentially harmful measures.

[22] In addition, and subject to EU clearance, two sectors of the economy will only pay a new tax on profit. The sectors are financial services providers and utility companies. The intended rate of profit taxes for financial services providers is 8%, and will be subject - aggregated to the other taxes - to a maximum cap of 15% of profit.

would be offset through a higher tax imposition on less mobile factors and through indirect taxation.

Netherlands Antilles abolished the distinction between onshore and offshore companies but maintained their character of privileged fiscal system with the introduction of a tax exempt company (Nederlands Antilliaanse Besloten Vennootschap), which is exempt from both the corporate income tax and the new dividend withholding tax.

Finally, Mauritius modified its offshore regime in 1999, through the introduction of two types of company: (i) *Global Business Company Categorie 1*(old Offshore Company), regarded as being resident and therefore able to take advantage of Mauritian double tax treaties and subject to corporate income tax at 15%; (ii) *GBC2* (old International Company), with the same tax benefits as a GBC1 Company, but considered as non-resident . Initiatives are also taken with effect to transparency: in fact, until 2003 offshore companies could opt to pay tax at any rate they chose in between 15% and 35%, and normally made such choice according to the rules governing *controlled foreign corporations* in the country where its major shareholder was based. The legislation enacted in 2000 removed the facility to choose tax rates from 2003.

### *3.2 The co-operation in tax matters through the exchange of information*

The opportunity given by the OECD to make a commitment to end harmful tax practices meant a concrete elaboration of the term "exchange of information" with the involvement of "committed jurisdictions" as well: Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino [23]. To reach this object, the OECD decided to work on the development of a model

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Since the taxes are capped at 15%, local companies which currently pay 20% or 35% profit taxes will be better off. In March, 2003, the EU's Council of Finance Ministers confirmed that the reforms do not constitute harmful tax measures. Nevertheless, there is still one hurdle to overcome in the form of the European Commission who must make a ruling on the tax reforms according to the State Aid criteria. However, the government's European legal advisers, and the UK government are of the firm view that the scheme complies with State Aid rules.

[23] The Agreement was developed by the OECD Global Forum Working Group on Effective Exchange of Information. This *Working Group* consisted of representatives from OECD Member countries as well as delegates from the *committed* jurisdiction.

vehicle to set the standard of what constitutes an effective exchange of information helping the initiative against harmful tax competition[24]. The result of these efforts was an *Agreement on Exchange of Information on Tax Matters* containing two models, a bilateral version and a multilateral agreement which provides the basis for an integrated bundle of bilateral treaties.

The Model Agreement relates to all direct taxes but is limited to exchange information upon request, not including spontaneous or automatic exchange of information[25]; it only covers tax matters: "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"[26]. The Agreement lists then a number of grounds on which a request for information may be declined. 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 and administrative practices": the purpose is to prevent the applicant Party from circumventing its domestic law limitations by requesting information from the other Contracting Party.

Each Contracting Party shall ensure that its competent authorities can 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;

b) information regarding the ownership of companies, partnerships, trusts, foundations, ownership information on all individuals in an ownership chain[27].

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[24] Although exchange of information is also central to the debate in the European Union on the taxation on savings, it is not exactly the same issue. The taxation of savings is a narrower problem than harmful tax practices. On the other hand, the discussion in the European Union is more ambitious, as it aims to an automatic exchange of information. Luxembourg, Belgium and Austria, all of which still have bank secrecy, do not want to accept the automatic exchange of information in the EU concerning taxes on savings before 2011, and then only if a group of countries larger than European Union does likewise.

[25] "The multilateral Agreement applies to taxes on income or profits, taxes on capital, taxes on net wealth, and estate, inheritance or gift taxes". "Taxes on income or profits" include taxes on gains from the alienation of movable or immovable property.

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" (OECD, *Agreement on Exchange of Information on Tax Matters,* Commentary on art.3)

[26] 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. Notwithstanding the foregoing, information of the type referred to in Article 5, paragraph 4 shall not be treated as such a secret or trade process merely because it meets the criteria in that paragraph. OECD, *Agreement on Exchange of Information on Tax Matters,* art.7

[27] The Agreement "does not create an obligation on the Contracting Parties to obtain or provide ownership information with respect to publicly traded companies or public collective investment funds or schemes unless

The Agreement, subject to ratification, acceptance or approval, would have been entered into force on 1 January 2004 for "criminal tax matter" and, after two years (2006), for all tax matters (determination, assessment and collection of taxes; recovery and enforcement of tax claims; investigation or prosecution of tax matters).
Examples of such agreements concluded by jurisdictions targeted as tax haven are the United States-Cayman Islands tax information exchange agreement and the USA agreements with Guernsey, Jersey and the Isle of Man; with Antigua and Netherlands Antilles.

As noted above, the Model Agreement is intended to define the standard of what constitutes effective exchange of information; however, the OECD purpose is not to prescribe the format for how this standard should be achieved: numerous ways are available to implement it. Among them, we can consider provisions by which some of the co-operative tax havens established procedures designed to enable governments to comply with requests made under any tax information exchange agreement concluded with other countries.
In this direction, tax havens that actually carried out their commitments on exchange of information are Antigua and Barbuda (Antigua and Barbuda Tax Information Exchange Act of 2002); British Virgin Islands with their *Financial Service(International Co-operation) Act,* which provides a framework for rendering legal assistance between domestic and foreign regulatory authorities as for obtaining information; Dominica, whose Financial Secretary is permitted by the *Exchange of Information Act of 2001* to provide information -including those pertaining to companies and financial services- to a foreign regulatory authority when requested; and St.Vincent with the *Exchange of Information Act* (2002).

## 4. Inhibition of preferential tax regimes and exchange of information: are the remedies worse than the diseases?

The solution of distortions deriving from harmful tax competition practices takes its place in the wide discussion about the economics of tax competition. A broad literature has

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such information can be obtained without giving rise to disproportionate difficulties", OECD *Agreement on*

investigated dynamics, reasons and effects of tax competition, stressing its potential harmful features and the negative externality for the countries not engaging in such a practice. A more recent literature focuses on the potential effects of the implementation of policies aiming to the inhibition of harmful tax practices: effects that are not necessarily positive.

As the third section of this paper shows, preferential regimes are the first target of a policy aimed at countering the harmful effect of tax competition. Their abolition would remove a source of distortion in the allocation of assets and activities: we can think of the analysed experience of tax havens and their initiatives to roll-back privileged regimes for *offshore* corporations. This view, supported by considerations of political nature, can be brought out by economic evaluations.

The abolition of preferential regimes may lead countries to compete on the general tax system with negative effects on tax revenues, and with distortions on the allocation of capital just taking different forms. Starting from this assumption, some authors tried to evaluate the relative effects on tax revenues: the results are nonetheless ambiguous. Janeba and Smart (2001) conclude that restrictions on preferential regimes are likely to increase or reduce tax revenues depending on the elasticity of the aggregate tax base and on the relative elasticity of the more mobile tax base (to which preferential regimes are applied) with respect to less mobile activities (which are taxed according to the general rules). Keen (2001) - through extremely simplified assumptions - reaches the conclusion that preferential regimes may even serve a purpose in protecting tax revenues, limiting the scope of tax competition and preventing it to become more pervasive and consequently more harmful; treating alike both more and less mobile tax base, the incentive to compete for the most mobile bases would intensify the tendency to compete for the less mobile bases: the outcoming equilibrium could be even worse. Moreover, if the impact of tax competition comes through a lowering of the general level of business taxation, there would also be a significant reallocation of productive factors and negative externalities would be higher. Keen brings up the example of Ireland as a tax system which became more aggressively competitive, and we can add Cyprus, Gibraltar,

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*Exchange of Information on Tax Matters,* art.7

Isle of Man and Jersey, in the near future, as instances of response to pressure for the elimination of harmful tax practices in the same direction.

Like the roll-back of discriminating regimes that could lead to results even worse than the harmful effects of tax competition, the decision to exchange information and its effect on competitive equilibrium are a theoretical challenge.

By considering the few contributions of literature, we start with a question asked by Keen and Ligthart (2003): what are the reasons why any country should provide information to another and which is the appropriate amount of information to provide? Conclusions are, even in this case, ambiguous.

Bacchetta and Espinoza (1995), on the basis of a highly stylized model, consider optimal strategies in the transmission of information for governments behaving either co-operatively or non-cooperatively. If the countries cannot co-operate, a country may voluntary provide - at least - some information to its partners[28]. In the hypothesis of co-operation, the optimal level of information exchange depends on the institutional features of the system[29]. Extending the model to the case of asymmetric countries and considering the two effects of information exchange (a *strategic* effect, referred to changes in the foreign tax rate due to the level of information transmitted, and a *direct* effect on the tax revenue), BE state that a large country would have a bigger incentive to share information, as the strategic effect would be larger and the direct effect smaller, than a small country.

On the contrary, Tanzi and Zee (2001) move from the observation that the national interest is in not sharing information, avoiding a loss of attractiveness to foreign investors. This lead to the presumption that information would be under-supplied and the enforcement of a multilateral co-operation would require some form of punishment in the case of defection (*defensive measures* of the OECD initiative against uncooperative tax havens can be considered an example of this kind of penalty).

[28] In a first phase, a country may provide some information to its partner since this will induce the partner to set a higher tax rate in the second phase: the knowledge of the exchange of information between authorities makes it less attractive for its residents to invest abroad.

[29] When tax credit is not full, investment abroad is discouraged as it is partially taxed twice. By exchanging information only partially among themselves, governments reduce the distortion provoked by imperfect credit.

According to Keen and Lighthart (2003), the attraction of defection, and consequently the difficulties of co-operation, would be greater, the more imbalanced capital flows are, and the more sensitive such flows are to the effective tax treatment. The evident implication is that small countries have the most to gain from remaining outside information sharing agreements. The little knowledge about the circumstances in which countries, and specifically small countries, can gain from entering a mutual exchange of information, leaves some doubts on the reasons why tax havens should agree to provide information through the subscription of formal agreements; KL proposed that very small countries are, owing to their size, more vulnerable to the suasion of greater powers. We can also presume that the desire of tax havens to co-operate is essentially a question of reputation. These jurisdictions showed real interest in moving away from an image of weakness and distress for their country's financial system that would grant opportunities to international crimes.

## Conclusions

Removing the source of distortion in the allocation of assets and activities can be considered the primary object of initiatives aimed to promote fair competition. Investment location decisions should be driven by economic considerations and not primarily by tax factors. Pursuing this aim is however connected with a crucial side-effect: the protection of the tax base for large and *high-tax* countries.

The development of this project inevitably brings over issues and problems that should be a challenge for the improvement in international efforts to counter harmful tax competition. Some critics – mainly from the business side – consider the OECD a cartel of *high-tax* jurisdictions guilty of unfair tax competition much more harmful then that of which the OECD is complaining about. But the aim to eliminate the risk of distortions of trade and investment trough the achievement of international standards is debated also from the economics point of view. Recent literature rises some doubts on remedies proposed by international institutions, because they could result in distortions even worse than the effect of harmful tax practices. First, the abolition of preferential tax regimes may encourage

countries to compete on the general tax system, and the negative effects on tax revenues and the allocation of resources would not disappear, but just take different forms. These results can be extended to the roll-back of *offshore* tax regimes by tax haven countries and to the *harmful* spill-over effects stemmed from reductions of the general level of capital taxation. Second, the literature focusing on the economics of the information exchange shows a likely inefficiency in the sharing of information for tax matters for small jurisdictions and, specifically, for low-tax jurisdictions.

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 fiscal system in compliance with OECD and EU Guidelines. According to our analysis, only in few cases concrete tax reforms have followed, so far, formal commitments. Most of *co-operative* jurisdictions that implemented changes in their tax structure are dependencies or affiliate territories of the EU Member countries, subject to the bounds of EU Code of Conduct commitment. This shows the mutual reinforcement of initiatives . All of them are *low-tax* jurisdictions; this means that they have the opportunity to abolish discriminations between resident and non-resident, preserving anyway fiscal privileges, even though in a different form (for instance, through a relevant general reduction of the income tax rate and the definition of special tax regimes for certain type of business and companies rather than a distinction between offshore and onshore activities).

Considering that tax havens will unlikely give up the benefits on economic growth and tax revenues from foreign investments and capital, the solution adopted by now by some of the co-operative jurisdictions seems to be the possible response for many tax haven countries. Final evaluations will be possible only by the end of 2005, but first considerations, on the basis of tax havens' attempts of *replacement*, show that *high-tax* jurisdictions' goal of protecting their tax base seems to be partially disappointed, letting international tax competition take place on general statutory rates and regimes.

The real challenge in the rollback of harmful practices will be on the exchange of information and the effectiveness of the results of tax havens formal commitments. The effective sharing of information alone should be most helpful in curbing fiscal abuses connected, for example, with lack of substantial activity, making them easy targets for

domestic anti-tax avoidance measures. Tax havens' compliance to set, with OECD Member countries, the standard of what constitutes an effective exchange of information shows the importance of the dialogue among countries to ensure the application of the project guidelines. The improvement of international co-operation, agreements and inter-state assistance in tax matters could lead to much more results than initiatives aimed to target tax havens and curb particular features of their fiscal framework with means that cast doubts on the legitimacy of their tax policies and limit their sovereignty in fiscal matters.

The solution of the tax-avoidance problem connected to tax haven practices is essentially granted to domestic legislation and anti-tax avoidance provisions that discourage the shifting of income to locations due primarily to tax minimization purposes. The results of such unilateral counter-measures will be strengthened if they are adopted by a wide range of countries; moreover, the OECD project will be arguably more effective if it promotes a better coordination between national and international initiatives against harmful tax practices (so far, the Spanish CFC legislation is the only example in this sense).

Finally, the application of *defensive measures* really only to uncooperative jurisdictions constitutes a strong incentive for tax havens to go on towards a choice of co-operation.

**Table 1.1: The OECD list of tax havens**

| | |
|---|---|
| Andorra | Liechtenstein |
| Anguilla | Maldives |
| Antigua and Barbuda | Marshall Islands |
| Aruba | Monaco |
| Bahamas | Montserrat |
| Barbados | Nauru |
| Belize | Netherlands Antilles |
| Bermuda | Niue |
| British Virgin Islands | Panama |
| Cook Islands | Samoa |
| Cyprus | St. Christopher (S. Kitts) &Nevis |
| Dominica | St. Lucia |
| Gibraltar | St. Vincent and the Grenadines |
| Grenada | Tonga |
| Guernsey/Sark/ Alderney | Turks & Caicos Islands |
| Isle of Man | US Virgin Islands |
| Jersey | Vanuatu |
| Liberia | |

Source: OECD, *Towards Global Tax Cooperation: Progress on Identifying and Eliminating Harmful Tax Practices,* 2000

**Table 1.2: Harmful tax practices in EU dependencies or affiliate territories meeting the OECD tax haven criteria**

| EU Member states dependencies or affiliate territories | Harmful Tax Practices |
|---|---|
| **Aruba –** Kingdom of the Netherlands | Exempt companies; Offshore companies; Captive Insurance; Free Zones |
| **British Virgin Island –** Overseas Territory of the United Kingdom | International Business Companies |
| **Gibraltar** – Overseas Territory of the United Kingdom | Exempt (offshore) companies; Captive insurance; Qualifying (offshore) companies |
| **Guernsey/Sark/Alderney –** Dependency of the British Crown | International loan Business; Offshore insurance companies, Insurance companies; Exempt companies; International Bodies |
| **Isle if Man -** Dependency of the British Crown | International Loan Business; Exempt insurance companies; Exemption for Non resident companies; Offshore banking business; International Business Companies |
| **Jersey -** Dependency of the British Crown | International treasury operations; Captive insurance companies; Tax Exempt companies; International Business Companies |
| **Netherlands Antilles –** Kingdom of the Netherlands | Captive insurance; Offshore companies; Free Zones |

Source: Council of the European Union, *Report of the Code of Conduct Group on Business Taxation,* Brussels, 1999

**Table 2.1:** ***Defensive measures*** **actually adopted by some of the EU Member States**

| **EU Member States** | **Anti-tax avoidance provisions** | | | |
|---|---|---|---|---|
| | **CFC legislation** | **Thin capitalization rules** | **Disallowance of interest, royalties and fees** | **Transfer pricing rules** |
| Austria | | | | |
| Belgium | | ● | ● | |
| Denmark | ● | ● | | ● |
| Finland | ● | | | ● |
| France | ● | ● | | ● |
| Germany | ● | ● | | ● |
| Greece | | | | ● |
| Ireland | | | | ● |
| Italy | ● | ● | ● | ● |
| Netherlands | | ● | | ● |
| Norway | ● | | | ● |
| Portugal | ● | ● | ● | ● |
| Spain | ● | ● | ● | ● |
| Sweden | | ● | | |
| UK | ● | ● | | ● |

Source: Our elaboration on IBFD, *Taxation of Companies in Europe* (2004)

**Table 2.2. - Thin capitalization rules in EU Member countries**

| EU MEMBER STATES | DEBT-TO-EQUITY RATIO | FIELD OF APPLICATION | FISCAL TREATMENT OF INTEREST PAID ON EXCESSIVE DEBT FINANCING |
|---|---|---|---|
| Belgium | 7:1 | Belgian companies which beneficial owner is not subject to tax or is subject to a tax regime significantly more advantageous than the Belgian income tax system | Disallowed expense |
| | 1:1 | Belgian companies whose loans are granted by shareholders (natural persons) directors, managers, liquidators, if the interest rate exceeds the market rate | Recharacterization as deemed dividend |
| Denmark | 4:1 | Danish companies with debt to controlling non-resident natural or legal persons Non-resident companies that are included under Danish law in group consolidation with a Danish parent company | Disallowed expense |
| France | 1.5:1 | French companies controlled from foreign parent companies | Disallowed expense |
| Germany | 1.5:1(1) | German companies which beneficial owner is resident and non-resident shareholders with a substantial interest in the related party(2) | Recharacterization as dividend for corporate income purpose |
| Italy | 5:1 (3)<br>4:1 | Italian borrowing companies with debt granted by shareholders that control (directly or indirectly) the Italian borrowing companies(4) | Recharacterization as dividend distribution |
| Netherlands | 3:1 (5) | Dutch companies for interest on loans provided to group companies or related companies | Disallowed expense |
| Portugal | 2:1 | Portuguese companies with debt from non-resident related parties(6) | Disallowed expense |
| Spain | 3:1 | Spanish companies with debt from a extra-UE related party | Recharacterization as dividend for corporate income purpose |
| United Kingdom | No fixed ratio, leaving the matter open to negotiation; 1:1 is usually acceptable | Debt between UK companies and in cross-border transactions | Recharacterization as dividend for corporate income purpose(7) |

(1) The 3:1 safe haven for holding companies has been recently abolished; holding companies are, however, subject to special rules regarding the determination of the relevant equity in order to take their holding activities into account.
(2) A substantial interest exists if a person owns directly or indirectly more than 25% of the nominal capital of the resident company.
(3) For 2004 only.
(4) The thin capitalization rules do not apply to small and medium-sized enterprises (the definition of the size depends on their revenues amounts). An exemption from the law is introduced for banks and firms that perform banking activities, financial holdings and SIM. Holding companies are instead subject to the thin-capitalization rules irrespective of their revenues amount. 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.

(5) Debt in excess must be greater than 500,00 €. As an alternative to the 3:1 ratio, the taxpayer has the option to apply the debt-to-equity ratio based on the commercial consolidated accounts of the group to which the taxpayer belongs

(6) This rule may not applied if the company proves that taking into accounts its type of activity, the sector in which it operates, its dimensions and other relevant criteria, it would be possible to obtain the same loan on similar terms from an independent entity.

(7) There is no recharacterization 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

Source: IBFD (2004), *Company taxation in EU*, 2004; PriceWaterhouseCoopers (2003), *Corporate taxation* - Worldwide Summaries (2002-2003)

**Table 2.3.– CFC Legislation in EU Member countries**

<table>
<tr><th rowspan="2">EU Member States</th><th rowspan="2">APPROACH</th><th rowspan="2">OBJECTIVE FIELD OF APPLICATION</th><th colspan="2">CONDITION FOR APPLICATION</th></tr>
<tr><th>Control of the foreign company</th><th>Localization in a low-tax jurisdiction</th></tr>
<tr><td>Denmark</td><td>Transactional</td><td>Financial activities income of the subsidiary (1)</td><td>Direct or indirect ownership of, at least, 25% of the capital or of 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 CIT rate of 30%)</td></tr>
<tr><td rowspan="2">Finland</td><td rowspan="2">Jurisdictional</td><td>All type 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 (2)</td><td>Effective rate of corporate taxation on the subsidiary lower than 17,4% (3/5 than the Finnish CIT of 29%(3))</td></tr>
<tr><td colspan="3">Exemption: Industrial activities, similar production activities, ship-owning, selling or marketing activities; company resident in a country with which Finland has a tax treaty (4)</td></tr>
<tr><td rowspan="2">France</td><td rowspan="2">Jurisdictional</td><td>All type of income</td><td>Direct or indirect holding of 10% or more of the capital (or a participation of at least €22.8ml) in a non-resident enterprise (5)</td><td>Tax borne by the foreign entity is 1/3 or more lower than the tax which would have been borne in France</td></tr>
<tr><td colspan="3">Exemption: Commercial and industrial activities predominantly carried out in local market</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>A corporate tax rate on the subsidiary lower than the 25% (6)</td></tr>
<tr><td rowspan="2">Italy</td><td rowspan="2">Jurisdictional</td><td>All type of income</td><td>Direct or indirect holding of the majority of the votes at the shareholders' meeting or sufficient to exert a decisive influence; dominant influence due to special contractual relationship</td><td>Level of corporate taxation significantly lower than the Italian one and lack of effective exchange of information<br>(reference to a black list)</td></tr>
<tr><td colspan="3">Exemption: Industrial and commercial substantial activity; proving that the participation in the foreign entity does not achieve the localisation of income tax haven</td></tr>
<tr><td>Norway</td><td>Jurisdictional</td><td>All type of income</td><td>Direct or indirect ownership of, at least, 50% of the capital</td><td>General income tax rate on profits is 2/3 or less of the Norwegian rate which would apply if the company were resident in Norway</td></tr>
<tr><td rowspan="2">Portugal</td><td rowspan="2">Jurisdictional</td><td>All type of income</td><td>Direct or indirect ownership of, at least, 25% of the capital</td><td>Reference to a black list</td></tr>
<tr><td colspan="3">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 residents. (7)</td></tr>
<tr><td rowspan="2">Spain</td><td rowspan="2">Transactional</td><td>Passive income</td><td>Holding percentage of at least 50% referred to capital, equity, results or voting rights</td><td>Effective corporate tax rate lower than 26,25%(75% of the Spanish corporate income tax rate of 35%) (8)</td></tr>
<tr><td colspan="3">Exemption: Active holding(9); the aggregate amount of passive income is less than 15% of total income of the CFC or less than 4% of the total if the CFC forms part of a group of companies</td></tr>
<tr><td rowspan="2">Sweden</td><td rowspan="2">Jurisdictional</td><td>All type of income</td><td>Direct or indirect ownership of, at least, 25% of the capital or voting rights in the foreign entity</td><td>The income of foreign entity is subject to a 15,4%tax rate (55% of the Swedish corporate income tax rate of 28%)</td></tr>
<tr><td colspan="3">Exemption: International shipping activities, provided that also the shareholder is engaged in shipping activities</td></tr>
</table>

| United Kingdom | Jurisdictional | All type of income | 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 power(10) | Level of taxation lower than 75% of what it would have paid had it been a UK resident |
|---|---|---|---|---|
| | | **Exemption:** Companies carrying on business in countries included in a "white list" | | |

(1) A foreign subsidiary is considered to primarily deal in financial activities if at least 1/3 of its income derives from financial activities or insurance business (e.g., interest, dividends, capital gains on share and other securities)
(2) 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 proportion of the total return of the foreign entity is at least 10%
(3) 26% after the reform
(4) The company resident in the contracting State must be subject to tax that does not significantly differ from the tax payable in Finland and the company resident in that State is not entitled to specific tax benefits in its country of residence.
(5) The CFC rules for structures created before 30 September 1992 apply if a French corporate tax entity has a 25% or more holding in a non-resident *subsidiary* benefiting from a low-tax regime
(6) 30% before 2001
(7) The CFC main activity must be other than one of the listed activities (e.g. banking, certain types of insurance, holding or transfer of corporate rights or other securities).
(8) When the CFC is resident in a tax haven (reference to a black list), a stricter scheme applies since it is presumed (although with a right of rebuttal) that: (i) the corporate tax actually paid on any kind of income by the CFC is less than 26.25%; (ii) all income accruing to the CFC is "passive"; (iii) the annual minimum income derived by the CFC is equal to 15% of the acquisition cost of the underlying participating interest.
These presumptions, however, do not apply when the CFC consolidates its accounts with a Spanish resident entity.
(9) 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.
(10) In addition, where a company would not otherwise be considered as controlled by UK resident persons, it shall nevertheless be treated as so controlled if: (i) there are two persons who, taken together, control the company; (ii) one of those persons is resident in the United Kingdom and controls at least 40% of the company;(iii)the other person controls at least 40% but not more than 55% of the company.

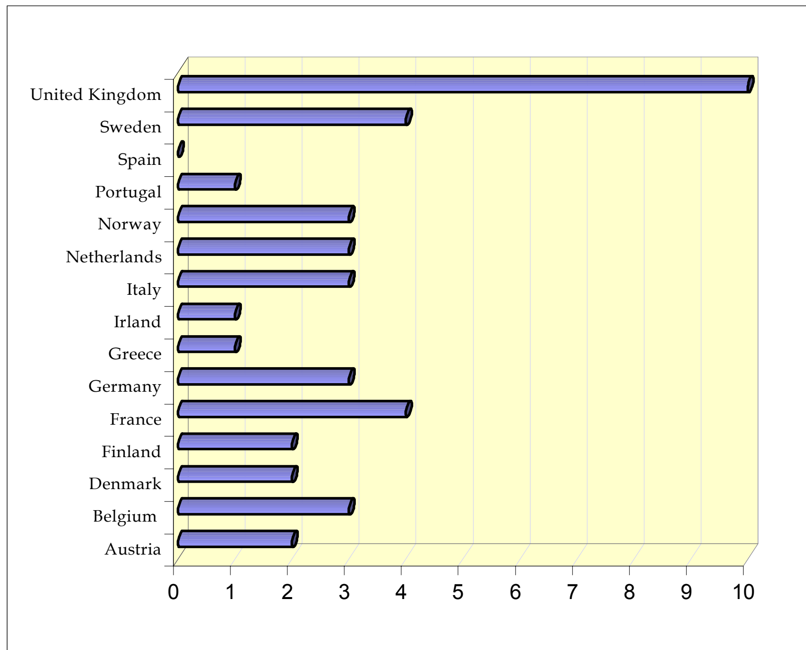
Source: IBFD (2004), *Company taxation in EU*, 2004; PriceWaterhouseCoopers (2003), *Corporate taxation* - Worldwide Summaries (2002-2003)

**Table 2.4: Tax treaties in force with tax havens**

| EU | COUNTERACTING TAX HAVENS |
|---|---|
| Austria | Cyprus, Malta |
| Belgium | Cyprus, Malta, Mauritius |
| Denmark | Cyprus, Malta |
| Finland | Barbados, Malta |
| France | Cyprus, Malta, Mauritius, Bahrain |
| Germany | Cyprus, Malta, Mauritius |
| Greece | Cyprus |
| Ireland | Cyprus |
| Italy | Cyprus, Malta, Mauritius |
| Netherlands | Malta, Netherlands Antilles, Aruba |
| Norway | Barbados, Cyprus, Malta |
| Portugal | Malta |
| Sweden | Barbados, Cyprus, Malta, Mauritius |
| UK | Antigua e Barbuda, Barbados, Belize, Guernsey, Jersey, Isle of Man, Cyprus, Malta, Mauritius, St Kitts&Nevis |

Source: IBFD, *Taxation of Companies in Europe* (2004)

**Figure 2.1: Number of tax treaties with Tax havens**




Source: IBFD, *Taxation of Companies in Europe* (2004)

**Tab 3.1: The List of Co-operative tax havens**

| | |
|---|---|
| Anguilla | Maldive |
| Antigua and Barbuda | Malta |
| Aruba | Mauritius |
| Bahamas | Montserrat |
| Bahrain | Nauru |
| Barbados | Netherlands Antilles |
| Belize | Niue |
| Bermuda | Panama |
| British Virgin Islands | Samoa |
| Cayman Islands | St. Christopher (S. Kitts) &Nevis |
| Cook Islands | St. Lucia |
| Cyprus | San Marino |
| Domenica | Seychelles |
| Gibraltar | St. Vincent and the Grenadines |
| Grenada | Tonga |
| Guernsey | Turks & Caicos Islands |
| Isle of Man | US Virgin Islands |
| Jersey | Vanuatu |

Source: OECD

**Table 3.2: Status of the initiatives of tax havens to eliminate "harmful tax regimes"**

| Tax havens without a project of reform | Tax havens engaged in project of tax reforms | Tax havens that have reformed their fiscal privileged measures |
|---|---|---|
| Anguilla, Antigua, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Dominica, Guernsey, Malta, Maldive, Niue, Samoa, Turks&Caicos, US Virgin Islands, Vanuatu, Bahrain Montserrat, Nauru, St Kitts and Nevis, St. Lucia, San Marino, Seychelles, St. Vincent, Tonga | Isle of Man, Gibraltar, Jersey (see table 3.4) | Aruba, Cyprus, Mauritius, Netherlands Antilles (see table 3.3) |

**Table 3.3: Tax Reforms in co-operative tax havens**

| | *Offshore t*ax regimes | Corporate taxation | Other provisions |
|---|---|---|---|
| **Aruba** (New Fiscal Regime NFR, 1 July 2003) | Abolition of privileged offshore regime. For companies formed prior the introduction of the NFR the existing privileged continues until the end of 2007 (ETR 2.4 or 3%) | | - The NFR contains a specific exemption for the Aruba Exempt Corporation (AEC), although the exemption is misapplied in the event that the AEC generates profits from illegal activities, as defined under Aruba criminal law;<br>- Introduction of a dividend withholding tax and an imputation payment system |
| **Cyprus** (Income Tax Act N. 118(I), 2002, July) | Abolition of offshore regime (4.25% tax rate) | 10% CIT applied to both onshore and offshore companies, plus a 2% levy on wage bills, and a *Special Contribution* related to defense which applies the 10% corporate tax rate to inter-company dividend and interest payments. | - Introduction of a residence-based system of taxation;<br>- Provision of exchange of tax and finance information |
| **Mauritius** (Financial Services Development Act 2001) | Supervision of almost all types of offshore entity other than banks, including the Free Port, and the Export Processing Zone | | |
| **Netherlands Antilles** (The New Fiscal Framework, 1999) | Abolition of the distinction between offshore and onshore companies, at least for new formations | Reduction of the profit tax rate to 30% (plus 15% municipal surcharge) | - Introduction of a new company form named NABV (Nederlands Antilliaanse Besloten Vennootschap) which can be tax-exempt, but does not benefit from tax treaties;<br>- Introduction of a 10% withholding tax on dividends;<br>- A 100% participation exemption has been introduced for profits coming from shareholdings in resident companies and qualifying Dutch-resident companies. The exemption is 95% for shareholdings in other non-resident companies. |

**Table 3.4: The announced tax reforms**

| | *Offshore* tax regimes | Corporate taxation | Other provisions |
|---|---|---|---|
| **Isle of Man** | Abolition of privileged offshore regime. Currently, Manx resident companies (i) owned by non-residents (ii) that do not trade in the Isle of Man (iii) and do not have any source of income in the island (apart from interest from the IoM Government or bank interest) are exempt | Introduction of a zero standard rate for all companies (actually taxed at 18% tax rate), except for certain regulated financial sector businesses, which could be taxed at a rate of 10% | |
| **Gibraltar** | The existing corporate forms which allowed zero taxation, the Exempt and Qualifying companies, was abolished | - Introduction of a zero rate of corporation tax for all companies;<br>- introduction of new taxes on company personnel and property occupation which will be capped at 15% of profits;<br>- annual companies registration fee of £300 (if the company has income) or £150 (if the company has no income) | - New taxes came into force from 1st January 2003: (i) a "Company Payroll Tax" (introduced in respect of employees in Gibraltar.); (ii) a new Business Property Occupation introduced in respect of property occupied in Gibraltar by companies for business purposes.<br>- The sectors of financial services providers and utility companies are taxed at a 8% tax rate |
| **Jersey** | Abolition of tax-exempt companies (International Business Company) | Reduction of the standard corporate tax rate to zero. | - Introduction of a 10% profits tax on all businesses that are regulated by the Jersey Financial Services Commission (primarily banks, trust companies and investment managers);<br>- Phasing out Personal Income Tax Allowances on a sliding scale on household incomes;<br>- General goods and services tax of 5% in 2007 with some exemptions;<br>- Savings in State expenditure;<br>- The introduction, in 2006, of a form of pay-as-you-earn system for paying tax. |

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## Appendix

**Table A.1: Memorandum Of Understanding (MOU) on eliminating harmful tax practices**

| **Duration:** 31 July 2001 to 31 December 2005 | |
|---|---|
| **By 31 December 2001** | **Adoption of a plan** indicating how, by 31 December 2005, each jurisdiction that agrees to the terms of MOU will achieve transparency, effective exchange of information for all tax matters and eliminate any regimes that attract business without substantial business activity. |
| **By 31 December 2002** | **Access for the regulatory and tax authorities to information regarding the beneficial owners** of companies, partnership and other entities organised inside the jurisdiction, and the information on the identity of the principal benefiting from trusts and foundations. |
| **By 31 December 2003** | **Effective exchange of information** to persons or authorities concerned with the enforcement of **criminal tax matters.** **Transparency of tax system** based on rules that depart from accepted laws and practices, secret rulings and the ability of investors to *negotiate* the rate of tax to be applied; **Not attracting business without substantial domestic activity**, with a removal of restriction on the ability to do business in the domestic market for entities qualifying for preferential tax treatment. |
| **By 31 December 2005** | **Effective exchange of information** to persons or authorities concerned with the enforcement of **all tax matters** (referred also to "civil tax matters"). **Abolition of "ring-fencing" tax regimes** |

Source: OECD, Framework for collective Memorandum Of Understanding (MOU) on eliminating harmful tax practices, 2000

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