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di GARUFI SEBASTIANO
discussa presso Università Commerciale Luigi Bocconi-Milano nell'anno 2011
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INTRODUCTION

It is commonplace thinking about tax havens as enchanting islands in the sun and with palm trees, located in remote corners of the earth, where rich individuals and multinational enterprises place their money and benefit from tax savings. However, such a traditional image is misleading and is far from the truth. Although the term "tax haven" is broadly used, there is not unanimous consent upon what can be really labelled as such.

Until recently tax havens and tax havens activities have attracted only intermittent attention from academics and governments. Since 2000 the attention to the subject has rapidly grown, subsequently to the terrorist attacks on the United States on 11 September 2001 and the so-called "Enron scandal". The collapse of the US energy company Enron, in particular, has been linked to the extensive use of offshore companies registered in the Cayman Islands, Barbados, Bermuda, the Turks and Caicos and Aruba, which were used for various purposes, including tax avoidance and the hiding of off-balance sheet liabilities.[1]

The more recent 2008 Liechtenstein episode, regarding the disclosure of a list of taxpayers with offshore accounts, drew a lot of attention on the rapid growth of the volume of transactions routed through the offshore circuits, the stock of wealth held offshore and the rising number of jurisdictions engaged in tax havens and offshore finance activities. Financial institutions, investors, and commercial enterprises seek out the particular attractions offered by these jurisdictions, resulting in significant capital flows into and out of entities established in the so called "offshore financial centres". Given the amount of illegal activities that consequently took place through these jurisdictions, tax havens and offshore financial centres have quickly become a very hot topic both in the academic literature and in political agendas, and have drawn the attention of financial market participants, scholars, regulators, domestic governments and international organisations.[2]

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[1] See C. James, *The Enron collapse: Caribbean tax havens offers assistance*, Financial Times, 13 February 2002; J.D. Reardon, *The Enron bankruptcy: what went wrong?*, Derivatives and financial instruments, 5/2002, 158-162.

[2] As it will be broadly discussed in the present work, considerable work on tax havens has been undertaken by different international organisations, such as the Organisation for Economic Co-operation and Development, the European Union, the Financial Stability Forum, the International Monetary Fund, the Financial Action Task Force on Money Laundering. Tax havens also drew the attention of G-7, G-8, G-20 Finance Ministers, the Basel Committee on Banking Supervision (see *The Supervision of Cross-Border Banking*, Report by a Working Group comprised of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors. October 1996, available at http://www.bis.org/publ/bcbs27.htm), the International Association of Insurance Supervisions (see *Insurance Supervisory Information Sharing,* February 1999, available at http://www.iais.org), the International Organisation of Securities Commissions (see *Hedge Funds and Other Highly Leveraged Institutions*, IOSCO Hedge Fund Task Force, November 1999; and *The Objectives and Principles of Securities Regulation*, September 1998, both available at http://www.iosco.org), and the United Nations (see *Financial Havens, Banking Secrecy and Money Laundering*, UN Office for Drug Control

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The increasing globalisation and the lack of international coordination in international fiscal affairs induced the major developed countries, and especially those grouping within the G-20 and the G-8, to focus their attention on the problems of domestic tax base erosion resulting from international tax avoidance and tax evasion through the use of those jurisdictions called “tax havens”. Concerns about so called “tax havens” and “offshore financial centres” have intensified in the context of initiatives undertaken by the international community to strengthen financial system, in response to the recent financial crisis.[3] The recent initiatives at the international level are concentrating their efforts to tackle what they call “harmful tax competition”.

Considering the great attention that these jurisdictions have been recently drawing in the political agendas, the present work intends to investigate the legal and theoretical foundations (if any) of the initiatives undertaken at the international level to fight against international tax evasion and tax avoidance that take place through the use of tax havens. This work specifically focuses on the taxation issues related to such jurisdictions, and therefore scant attention is paid to investigation on the international criminal activities generally taking places through the use of tax havens, such as money laundering, terrorism financing, fraud, corruption, and so on.

In order to clarify the focus of the analysis conducted in this research, Chapter 1 deals with the issue of providing a correct definition of these jurisdictions, by scrutinising the meaning and the different uses of the terms “tax havens” and “offshore financial centres” in both the academic and the political literature, with particular attention to the definitions developed by the Organisation for Economic Cooperation and Development, the International Monetary Fund, the Financial Stability Forum, the Financial Action Task Force on Money Laundering, as well as the Tax Justice Network. This latter, more specifically, focuses its attention on the existing level of secrecy of a given jurisdiction and thus proposes the new definition of “secrecy jurisdiction” as opposed to “tax haven”. The purpose of Chapter 1 is to develop a phenomenological analysis of tax havens and to describe their main characters, their typologies and the likelihood of a country to become a tax haven. The analysis distinguishes between the expressions “tax havens” and “offshore financial centres” and acknowledges the different usages of these terms. Finally, a discussion about the most common instrument to define tax havens, i.e. blacklisting, is developed. The analysis leads to the result that both the academic and the political literature have developed so many definitions of tax havens that there is no clear and

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and Crime Prevention, May 1998). Concern about the tax haven development came also from several high-tax countries, which appointed special Committees in charge of observing its effects. See, for example, A. Edwards, *Review of Financial Regulation in the Crown Dependencies: A Report (The Edwards Report)*, London, 1998. United Kingdom *Review of Financial Regulation in the Crown Dependencies*, United Kingdom, November 1998, available at http://www.archive.official-documents.co.uk/document/cm41/4109/4109-i.htm.

[3] On this topic, see G. Loomer, G. Maffini, *Tax Havens and the Financial Crisis*, Oxford University Centre for Business Taxation, available at http://www.sbs.ox.ac.uk/centres/tax/Documents/policy_articles/TaxHavensandtheFinancialCrisis.pdf.

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common understanding of the nature of the phenomenon. Such a situation raises the difficulty to adequately address and combat through legal instruments something which is not even sufficiently defined and understood.[4]

In order to address this latter issue and better understand the tax haven phenomenon, Chapter 2 investigates the origins of tax havens, the evolution and impact of tax havens on non-haven countries. The purpose of this analysis is to understand whether the identification of the source of the phenomenon might be helpful to take action against them. Therefore, it is demonstrated that tax havens have always existed in the form of "tax-minimisation strategies" by sovereign jurisdictions and that they have originated from the worldwide taxation principle, on which tax systems of modern high-tax countries are normally based. The most common tax planning techniques used by multinational companies and wealthy individuals through tax haven jurisdictions (which are briefly described in Chapter 2) are in fact based on the existing tax laws in their home countries. This thus demonstrates that the tax haven phenomenon has deep root in the experience of worldwide taxation by capital exporting countries, and quantitative data clearly show the great impacts of tax havens on high-tax countries' and developing countries' economies.

From a political and policy standpoint, both at the international and the national level, the problem of tax havens has commonly been dealt with in terms of tax competition. The more favourable tax regime provided by these jurisdictions to non-resident investors is commonly claimed to erode high-tax countries' tax bases. In this respect Chapter 3 provides an overview at the current literature of tax competition. To that purpose, a definition of tax competition is first provided, in order to demonstrate that at the international level the existing differences between tax systems do indeed affect taxpayers' choice of investments. Thus, States do compete among each other in order to attract foreign tax bases. The analysis of Chapter 3 then focuses on the existing literature of tax competition, providing an overview at the classical theory elaborated by Tiebout as opposed to modern theories which are based on Oates' model. Whereas the classical theory predicates for the so called "beneficial effects" of tax competition, the modern thought achieves opposite results. According to modern literature tax competition lowers governments' expenditures below their efficient levels and results in an inefficient provision of public goods. Subsequent elaborations of the Oates' model on tax competition also conclude for the so called "wasteful effects" of tax competition, considering a number of different variables, such as capital taxation in small open economies; the presence of externalities; the presence of two factors of production, i.e. capital and labour; asymmetrical tax competition, i.e. between a large and a small region; and the response to tax competition by multinational firms. The exam is finally focused on the effects that tax competition brought forward by tax havens has on high-tax countries. In this respect, it is highlighted that the current literature does not share a common view: while some

[4] In this sense M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 95.

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authors find no activity diversion from high-tax countries, some others conclude for the erosive effects of tax havens on high-tax countries. A minority theory which proposes to observe competition from the perspective of taxpayers, rather than of governments, is also briefly discussed.

On the basis of the overview at the current literature on tax competition provided in Chapter 3, Chapter 4 discusses the political and legislative initiatives undertaken at the EU, OECD and domestic level aimed at curbing the harmful effects of tax competition by tax havens. In line with the modern economic literature, the received view by the international community is that tax competition does indeed provoke a "race to the bottom" effect. Accordingly, Chapter 4 describes the concept of tax competition in the EU, the Monti Package and the Code of Conduct; it discusses the Reports issued by the OECD from 1998 to 2006 and the effects that blacklisting has on targeted jurisdictions' reputation; finally it offers an overview at the most common anti-tax havens measures enacted by single States' legislation, as well as some remarks on the differences of the approaches of the EU and the OECD.

The analysis developed in Chapter 5 deals with the most recent initiatives at the OECD level against those jurisdictions labelled no longer as "tax havens", but as "uncooperative jurisdictions". Starting from the 2001 Report, the attention of the OECD has shifted to the "uncooperative jurisdictions" paradigm, therefore putting emphasis on the cooperative attitude of a targeted jurisdiction in exchanging information for tax purposes. Since the recent G-20 and G-8 summits, lack of transparency and exchange of information have started being perceived as the main obstacles to the proper enforcement of domestic tax legislations of high-tax countries, based on the worldwide taxation principle. In this respect, an analysis of the OECD's instruments through which exchange of information can take place is first provided, i.e. Art. 26 of the OECD Model Convention and the Model of Tax Information Exchange Agreement. Then the exam focuses on the OECD's standard on exchange of information and provides an analysis of the two criteria under which a given jurisdiction is included in or removed from the most recent OECD black list, i.e. "transparency" and "exchange of information". Subsequently, after providing a description of the joint OECD/Council of Europe Convention on mutual administrative assistance, the exam is focused on the EU instruments allowing exchange of information in tax matters, i.e. the mutual assistance directive, the EU Savings Directive and the recent proposals of amendments, as well as the Commission's Communication on "good governance in tax matters". Finally, the attention is shifted to one of the most remarkable examples of individual initiative undertaken by States to collect information for tax purposes from foreign entities, i.e. the US 1999 "Qualified Intermediary" regulation and the US 2010 "Foreign Account Tax Compliance Act".

Chapter 6 draws the conclusions of the analysis developed in the present work. It first critically discusses about the reputational use of the term "tax havens" in the OECD's campaign and highlights the existence of some very favourable tax regimes in some high-tax countries which are never been included in any black list. Then, the

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attention is focused on the concept of tax competition proposed by the OECD and it is pointed out that there are some theoretical contradictions in the OECD stance: whereas modern economic theories favour free competition as opposed to monopoly, high-tax countries intend to limit tax competition for reducing their tax base erosion. Probably due to this implicit asymmetry, the international community and the OECD have shifted their attention from “tax havens” to “uncooperative jurisdictions”. A subsequent discussion leads to the conclusions that non-governmental organisation, such as the OECD, may not be the proper institutions, endowed with the proper legal binding instruments, to develop an international regime for dealing with harmful tax practices.

The attention in this final Chapter is also focused on whether the uncooperative attitude of targeted jurisdictions and their refusal to exchange information can be regarded as a form of internationally wrongful act. Such an issue is addressed in the light of the Project of Articles on the Responsibility of States for internationally wrongful act and the analysis draws the conclusion that there is no international obligation imposing a cooperative attitude upon sovereign States. Finally, an exam of the role of exchange of information in the harmful tax competition project is developed. It is noted in this respect that exchange of information is in fact currently regarded as the most effective instrument to curb international tax evasion and international tax avoidance, but automatic exchange of information is more effective and should be therefore preferred to exchange upon request.

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CHAPTER 1

TAX HAVENS OR OFFSHORE FINANCIAL CENTRES: A DEFINITIONAL DILEMMA

Approaching the tax havens phenomenon entails the main problem of providing a correct definition of which jurisdictions can be labelled as such. Both the political and the academic literature have developed so many definitions of tax havens that there is no clear and common understanding of the nature of the phenomenon. To that purpose, Chapter 1 intends to scrutinise the meaning and the different uses of the terms “tax havens” and “offshore financial centres” in the current literature in order to develop a phenomenological analysis of tax havens and thus to describe their main characters, their typologies and the likelihood of a country to become a tax haven (paragraphs 1-2). The analysis draws a distinction between the expressions “tax havens” and “offshore financial centres” and acknowledges the different usages of these terms (paragraphs 3-5). The exam is focused on the most influential definitions proposed by some international organisations (i.e. Organisation for Economic Cooperation and Development, the International Monetary Fund, the Financial Stability Forum, the Financial Action Task Force on Money Laundering) (paragraphs 6-7), and the new definition of “secrecy jurisdictions” proposed by the Tax Justice Network (paragraph 8). Finally, a discussion about the most common instrument to define tax havens, i.e. blacklisting, is developed (paragraph 9). The analysis leads to the result that both the academic and the political literature have developed so many definitions of tax havens that there is no clear and common understanding of the nature of the phenomenon. Such a situation raises the difficulty to adequately address and combat through legal instruments something which is not even sufficiently defined and understood.

1. The main characters of tax havens: introductory survey and typologies

As tax havens can be regarded as a difficult phenomenon to identify through a clear and concise definition, it is quite common to provide a phenomenological definition of “tax haven” by looking at their different features.[5] Different criteria have been

[5] In the academic literature the subject of tax havens did not attract much attention till the 1990s, when first studies started appearing. For example, R.A. Johns, C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979*, London, 1993 and J.R. Hines, E.M. Rice, *Fiscal paradise:*

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identified in the literature,[6] so that a country having the most of these indicators is likely to be identified as a tax haven. These features can be grouped in tax characters and non-tax characters and interestingly also high-tax countries, which are not commonly labelled as tax havens, quite often exhibit some of these characters.

Among the above mentioned tax characters, no or very low taxation is probably the most important attractive feature of a tax haven, as it represents the most typical international strategy adopted by local governments to attract foreign investment. This in fact allows non-resident investors to benefit from a shelter from their home State's taxation. Tax havens commonly provide for a two-tier tax system, i.e. one tier for residents and another for non-residents. Whereas resident taxpayers are normally

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Foreign tax havens and American business, The Quarterly Journal of Economics, 2/1994, 149-182 examined the role of offshore finance in the global economy. S. Roberts, *Fictitious Capital, Fictitious Spaces: the Geography of Offshore Financial Flows*, in S. Corbridge, R. Martin, N. Thrift (Eds.), *Money, power and space*, Oxford, 1994, 91-115; M.P. Hampton, *Treasure islands or fool's gold? Can and should small island economies copy Jersey*, World Development, 22/1994, 237-250; M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002 analysed how offshore finance functions. Analysis of the regulation of OFC activity was made by P. Sikka, *Jersey: a Pawn in a Regulatory Game*, The Jersey Press, 12/1996, 3-6; and C.M. Le Marchant, *Financial regulation and supervision offshore: Guernsey, a case study*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore finance centres and tax havens: the rise of global capital*, London, 1999, 212-229; whereas S.C. Cobb, *Global finance and the growth of offshore financial centres: the Manx experience*, Geoforum, 1/1998, 7-21; A.C. Hudson, *Reshaping the Regulatory Landscape: Border Skirmishes Around the Bahamas and Cayman Offshore Financial Centres*, Review of International Political Economy, 3/1998, 534-564 studied the political and economic geography of "offshore". Furthermore, authors such as S. Roberts, *Small place, big money: the Cayman Islands and the international financial system*, Economic Geography, 3/1995, 237-256; R. Palan, *Offshore and the structural enablement of sovereignty*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore finance centres and tax havens: the rise of global capital*, Basingstoke, 1999, 18-42; S. Picciotto, *Offshore: The State as Legal Fiction*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore Finance Centres and Tax Havens: the Rise of Global Capital*, Basingstoke, 1999, 43-79 explored the role of the OFCs with the discourse of the State, sovereignty and jurisdiction; S. Roberts, *Confidence men: offshore finance and citizenship*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore finance centres and tax havens: the rise of global capital*, Basingstoke, 1999, 117-139 examined the interconnection between OFCs and onshore economies as mediated through political elites. A. Possekel, *Offshore financial centres in the Caribbean: potential and pitfalls*, Caribbean Geography, 2/1996, 81-97; D.D. Marshall, *Tax havens in the commonwealth Caribbean: a merchant capital-global finance connection*, Global society, 3/1996, 255-277 analysed the role of OFCs in developing countries, and the social anthropology of host OFCs. Some Authors discussed about the regulation of OFCs and the current reconfiguration of the "regulatory landscape". In this sense see S. Picciotto, J. Haines, *Regulating global financial markets*, Journal of Law and Society, 3/1999, 351-368; J. Christensen, M.P. Hampton, *The economics of offshore: who wins, who loses?*, The Financial Regulator, 4/2000, 24-26. J.P. Abbott, *Treasury Island or Desert Island? Offshore finance and Economic Development in Small Island Economies: the Case of Labuan*, Development Policy Review, 2/2000, 157-175 explored the role of OFCs in development policy, while E. Clark, *The Ballad Dance of the Faeroese: Island Biocultural Geography in an age of Globalisation*, Tijdschrift voor economische en sociale geografie, 3/2004, 284-297 studied the potential for applying the concept of offshore to illustrate the paradox between so-called "globalisation" and the local.

[6] C. Chavagneux, R. Palan, *Les paradis fiscaux*, Paris, 2007, 11.

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subject to tax, non-resident taxpayers benefit from a very tax-friendly environment, as well as from tax reductions targeted to certain types of operations or to foreign companies. The absence of income tax upon non-resident taxpayers and the restricted application of taxes on certain specific kinds of income are usually explained by the deliberate policy of local governments to attract foreign investment and/or funds, but in other cases the lack of taxes is due to local and systemic constraints.[7]

Secrecy and confidentiality constitute another very important attractive tax character provided for by tax havens. Some countries, for example, have specific bank secrecy laws protecting account holders from financial information disclosure and establish strong penalties if breached. Secrecy and confidentiality can also take the form of professional secrecy. As tax havens do not exchange information, high-tax countries, based on worldwide income taxation, therefore face the objective difficulty to assess the worldwide income of their resident taxpayers sourced in tax havens. Furthermore, professionals based in tax havens are often subject to the obligation to grant very strong confidentiality on their clients and their operations. The protection and the extent of bank secrecy may vary depending on the tax haven. Basically, most tax havens have improved and developed their statutes relating to bank secrecy in order to maintain a competitive position with other tax havens.[8] In order to enhance protection of bank secrecy, bank accounts consisting of pseudonyms or numbers are used,[9] or companies through nominees or with bearer shares are set up.

Relaxed corporate law is the third most typical main character of tax havens, which quite often provide foreign investors with the opportunity to incorporate a company in a very short time and at very low costs, and to benefit from anonymity on shareholders' identity, especially through the issue of bearer shares. As incorporation delays and exorbitant fees discourage business, tax havens' corporate law is specifically designed to accommodate international business corporations for non-residents and has features that are not found in high-tax jurisdictions. Usually, setting

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[7] S. Moerman, *The Main Characteristics of Tax Havens*, Intertax, 10/1999, 369, who gives the example of certain underdeveloped countries of the Caribbean, where the widespread level of poverty of the population makes it impossible to apply a viable taxation system based on income.

[8] See S. Moerman, *Ib.*, who refers to the case of Bahamas, whose Bank and Trust Company Regulatory Act 1965 specified that the disclosure of information concerning the operations of a bank or a trust company is prohibited to every person having known this information in the course of his professional obligations, unless this disclosure is ordered by the courts. Similarly, in 1966 the Cayman Islands enacted analogous provisions, creating heavy sentences against those persons who disclosed banking or commercial information, otherwise than under an order of the Cayman Islands courts. In this area, another interesting example is Switzerland, which is one of the main depositories of funds for persons wishing to stay anonymous and whose bank secrecy has got a very privileged reputation. Switzerland is commonly believed to have enacted bank secrecy legislation in 1934, in order to protect the funds of Jewish German clients from the Nazi persecution. On this matter, see R.U. Vogler, *Swiss Banking Secrecy: Origins, Significance, Myth*, Zurich, 2006.

[9] Transactions are treated anonymously among the employees, which help to maintain a high level of discretion.

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up a company is tax exempt and is not subject to specific controls or strict regulations. In addition, company records are not public or available to high-tax countries' authorities.

A fourth (non-tax) character of tax havens is the lack of exchange control. Most tax havens have no exchange controls or very minimal requirements, so that investors can transfer funds in and out of the tax haven on a moment's notice. Tax havens might also have a double system of exchange control that makes a distinction between residents and non-residents (as well as between foreign currencies and domestic currency). For these purposes, a company created in a tax haven but owned by a non-resident investor and carrying out business activity outside that jurisdiction, is generally considered as non-resident for exchange control purposes.

A tax haven also needs to have a stable currency, in order to be able to allow the free transfer of profits and capitals in convertible currencies, therefore reducing the interest in carrying out transactions within its territory. In addition, tax havens often have a currency linked to a currency easily convertible in other foreign currencies (mainly Euro, US dollars and sterling pounds).

Both political and economic stability ensure continuity of investment and a favourable business climate. A jurisdiction subject to military ouster, economic crisis, revolutions or similar phenomena can make foreign investors refrain from locating their assets there. Prosperity of a tax haven is therefore narrowly tied with stability and the ability to react and recover from political and economic storms.

A fifth character of tax havens is to provide a number of tax and non-tax incentives to attract foreign investors in order to stimulate the development of local industries and the creation of new jobs. Tax havens, for example, provide tax holidays, grants, and favourable loans.

The sixth character of tax havens is to provide high standards of financial services. The major international banks based in high-tax countries normally provide banking services to foreign investors through branches, companies or correspondents based in tax havens. Furthermore, tax havens normally provide foreign investors with ready access to local professionals, accountants, lawyers, auditors, financial analysts and managers of companies, who provide valuable support to offshore business.

The characters listed so far should not be considered exhaustive. Some commentators, for example, also include equitable treatment of foreigners, existence of free trade zones, local consumer and labour markets, and investment incentives.[10]

Different classifications of tax havens have been provided for in the literature. Not only tax havens fall within more than one category, but each of them can be

[10] See B.J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78, Canadian Tax Foundation, Toronto, 1986, 115 and E.R. Larkins, *Multinationals and Their Quest for the Good Tax Haven: Taxes Are But One, Albeit Important, Consideration*, The International Lawyer, 2/1991, 483.

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distinguished into many other sub-categories. Generally speaking, tax havens can take different forms. Typically they can be full-fledged sovereign States, but they can also take different variations.[11] They can be, for example, quasi-sovereign dependent territories, such as the US-affiliated territories in the Caribbean or the territories affiliated with Denmark (Greenland or the Faeroe Islands), autonomous bodies enjoying limited sovereignty such as autonomous regions within a country, such as Hong Kong in the People's Republic of China. In some other cases regions of a country, such as Campione in Italy and localities, such as free economic zones or duty-free zones (Shannon Airport in Ireland or Colon in Panama) can be considered as tax havens.[12]

With regard to the types of taxation, tax havens can be distinguished in income tax havens (which offer complete or partial shelter from income taxation);[13] import duties (excise) tax havens; estate tax havens; and tax havens with privileged regimes for the taxation of certain forms of activities, such as "flags of convenience", tax havens for captive insurance companies or International Business Centre regimes.

Depending on the particular activity that can be performed in the tax haven and benefiting from a favourable tax regime, it is possible to further distinguish in: free economic zones; flags of convenience; production havens; headquarters havens; sham havens or base havens; secrecy havens; and treaty havens.

Free economic zones (also known as exporting processing zone) are relatively small geographical areas within a country which offer export-oriented industries more favourable investment and trade conditions than those provided for by the host country. In free economic zones, goods are typically used in production of exports on a duty free basis. Free economic zones can grant extensive package of incentives, special economic concessions, as well as exemption from certain kinds of legislation which apply outside the zones. Additionally, free economic zones generally provide infrastructure and services necessary for manufacturing, such as roads, power supplies, transport facilities, as well as low-cost rent building.[14]

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[11] See M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 99, who provides a distinction of tax havens from a point of view of international public law.

[12] M. Orlov, *Ib.* The Author also includes in the distinction supranational bodies, including regional treaty arrangements and provides the example of the European Union and argues that as a consequence of the common tax policies, both tax and other relevant privileges granted in the European Union as a whole or one of its Member States might be exploited throughout this supranational body.

[13] Depending on the types of income tax relieved, this category might be further divided into: havens for individuals; havens for companies, including captive insurance companies, banks, holding companies; and havens for trusts.

[14] A typical example of EPZ is the zone established in Ireland near Shannon airport in 1959. Subsequently, both India and Puerto Rico established some other EPZ in 1966, the example of which was then followed by other countries and the number of EPZ began to grow rapidly in the 1970s. By

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Palan[15] defines “flag of convenience” those countries which offer inexpensive fees for ship registration and their maritime flag registration to owners from other countries, in addition to low or non-existent taxes and no practical restrictions on the nationality of the crew.[16] As a result, by transferring a ship from a genuine national register to a flag of convenience, an owner runs away from taxation, safety regulation and trade union organisations.[17].

Production havens are jurisdictions where actual industrial activities is transferred and which offer low corporate taxes or other tax reductions.[18] Production havens typically erode corporate income taxes and cause tax competition among States.[19]

Headquarters havens are jurisdictions that levy reduced corporate income taxes and that therefore provide incentives to firms to incorporate within their territory, wherever their shareholders are located.

Sham havens or base havens are those jurisdictions with no or very low income taxes. They typically serve both the corporate sector and individuals and they mainly deal with financial transactions. They are usually colonies or former colonies of onshore jurisdictions, small islands with few natural resources and limited labour, which normally host low corporate-tax financial intermediaries that may be little more

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the end of the 1990s, there were 116 EPZ in the globe, the majority of which was located in the Caribbean and East Asia.

[15] R. Palan, *The emergence of an offshore economy*, Futures, 1/1998, 69.

[16] R.A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983, 20.

[17] R. Palan, *Ib.*, argues that the US has played an important role in the most offshore instances. In order to ensure the cheap and reliable transport of bananas, the United Fruit Company created the Honduras registry and the Panamanian registry in 1920s, as a reaction to prohibition. During the Cold War, the US needed a fleet of neutral ships to face an eventual Soviet aggression and Liberia maritime sector developed soon, so that it became the “grand-daddy of offshore zero-tax jurisdictions”. Similarly the Bahamas, Antigua, the Cayman Islands, the Marshall Islands and Vanuatu were pushing aggressively into the market and the two thirds of the world’s merchant shipping is currently registered in such countries.

[18] An example of production haven is Ireland: the low corporate tax rate attracts companies within the jurisdiction and there is tangible value added. The same opinion is shared by J.R. Hines, *Do Tax Havens Flourish?*, in J M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99 who highlights that Ireland features a very low tax rate designed to attract foreign investment. It was for many years a low-income country by Western Europe standards, but its economy expanded very rapidly at the same time that worldwide foreign direct investment grew and it now features one of Europe’s highest living standards. Irish corporate tax rate appears to be successful because it is close to half of Ireland’s manufacturing employment in foreign-owned firms.

[19] R. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1596, for example, expressed great concern that the non-OECD countries have competed with each other and reduced their corporate tax bases alarmingly and sees the problem as steadily worsening.

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than an address for investment activity directed from elsewhere.[20] Some sham havens have also emerged as headquarters havens. Sham havens are also evolved in the rapidly rising phenomenon of "corporate inversions", in which corporations based in high-income countries simply shift their declared nationality to sham havens.

Secrecy havens are typically sham havens that also provide secrecy with any given level of corporate taxation. The lack of information exchange typically allowed by secrecy havens reduces income tax compliance by taxpayers resident in high-tax jurisdictions. Secrecy countries have a substantial competitive advantage in respect to portfolio investment and specialise in allowing personal income tax evasion by offering concealment from the home State tax authorities.[21]

Treaty havens are countries with very favourable network of double tax treaties. They are particularly suitable for intermediate holding companies. The benefits of treaty havens are low or no withholding taxes on income flowing into and out of the jurisdiction.

2. The likelihood of a country to become a tax haven

In a scenario of tax competition, in theory, every country could adopt those policy features typical of tax havens described above and therefore be defined as a "potential tax haven". When designing the regulatory framework, policymakers need to properly balance gains and losses of becoming and being a tax haven, given the structural, economic, legal, political and institutional variables that vary from country to country. Some States may decide to adopt policies with the specific view to gain an edge on their competitors, whereas some others refrain themselves from introducing new taxes, especially when their collection would require more resources than the expected revenue.[22] Countries seeking to attract and retain mobile investment and the associated tax revenues may be induced to reduce tax rates below the levels that would obtain in the absence of mobility.[23]

[20] R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 41. According to the Authors nearly all of the Caribbean and Pacific tax havens fall into this category.

[21] According to R.T. Kudrle, *Ib.*, Switzerland, Austria and Luxembourg, as well as a number of smaller rich territories are an example of secrecy jurisdictions, as they have employed banking secrecy for this purpose.

[22] In this sense, M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 99, who provides the example of the case of the UK and the US within the first group of States and mentions many Caribbean and Pacific islands within the second one.

[23] Q. Hong, M. Smart, *In praise of tax havens: international tax planning and foreign direct investment*, European Economic Review, 1/2010, 82.

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The provision of excessive tax benefits to foreign and domestic investors risks reducing tax collection to unacceptable levels. Attracting investment activities of foreign investors at low rates involve a trade-off between tax reductions and the resulting loss of revenue for public expenditures. A country can be said to become a potential tax haven, when the expected economic benefits are greater than the relative expected costs. Therefore, the greater the sensitivity of a country to the benefits and the lower its sensitivity to the related costs and risks, the greater is the probability that this country will become a tax haven. While benefits can be broadly considered in terms of attraction of foreign direct investment, costs and risks include national costs, loss of reputation and the resulting repatriation of some investment, together with the possibility of negative reactions (i.e. sanctions) by the international community.

Similar considerations are applicable to jurisdictions that exhibit non-tax features typical of tax havens. A country might chose, for example, to provide for lax financial regulation, whether the economic benefits expected from offering money laundering service exceed the related costs and risks. Again, costs and risks include the internal probability of terrorism development and organised crime, loss of reputation and the resulting repatriation of some investment, and the possibility of sanctions by the international community.

There are several economical, juridical and social variables which positively influence the probability of a country to become a tax haven. These are: the degree of openness of the economy, the closeness to major capital exporters, the endowment of natural or physical resources,[24] the stability of governments and of their legal system, the geographic isolation, the presence of efficient infrastructures, and the non-membership to any international organisations (which allows the jurisdiction to establish domestic legislation more freely). The combination of these elements varies significantly, leading to diversified outcomes. For example, empirical evidence shows that most countries labelled as tax havens are small island economies characterised by profound economic disadvantages. These latter commonly consist of restricted comparative advantages, diseconomies of scale, dysfunctional market structures, high transport costs, tendencies to be price-takers rather than price-makers, limited natural resources, small labour market, and deficiencies in professional and institutional knowledge and experience.[25]

A strong relationship has also been noted between market-oriented financial systems and common law jurisdictions, so that a common law country is considered to be

[24] See D. Dharmapala, *What problems and opportunities are created by tax havens?*, Oxford Review of Economic Policy, 24/2008, 661-679 for further discussions.

[25] H. Armstrong, R. de Kervenoael, R. Read, C. Li, *A comparison of the economic performances of different microstates, and between microstates and larger countries*, World Development, 26/1998, 636-656; L. Briguglio, *Small Island States and Their Economic Vulnerabilities*, World Development, 23/1995, 1615-1632; S.A. Royle, *A geography of islands: small island insularity*, London, 2001.

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more likely to become a tax haven.[26] Most countries normally labelled as tax havens have British legal origins and parliamentary systems, and use English as an official language.[27] English common law has a long tradition and case law history to draw upon and it is definitely the preferred choice of legal systems. Confidentiality in financial transactions is customary practice and required under common law.

Masciandaro[28] has theoretically discussed and empirically tested the relationships between specific country features, policymaker choices towards lax financial regulation, and national non-cooperative attitude with respect to the international effort to combat money-laundering phenomena. His econometric calculations showed that the probability that a country becomes a non-cooperative jurisdiction tends to be higher, the more it experiences economic growth problems, measuring those problems in terms of per-capita GDP and the level of land exploitation. In addition, the probability that a country becomes a non-cooperative jurisdiction tends to be higher, the more it has developed the flow of foreign deposits. Finally, through the uses of a joint Index of the terrorism risks and organised crime risks, it is shown that the probability that a country becomes a non-cooperative jurisdiction tends to be higher as the degree of terrorism and organised crime risks decreases.

The determinants for countries to become tax havens have been also scrutinised by Dharmapala and Hines.[29] They observed a strong relationship between governance quality and the likelihood of becoming a tax haven.[30] In other words, better-governed countries are more likely than others to become a tax haven.[31]

[26] H.L. Barber, *Tax Havens: how to bank, invest, and do business – offshore and tax free*, New York, 1992, 12 who underlines that half of all tax havens are based on English common law: most of these are former British colonies whose external affairs are still handled and protected by England. See also R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R.W. Vishny, *Legal determinants of external finance*, Journal of Finance, 52/2007, 1131-1150 and A.K. Rose, M.M. Spiegel, *Offshore Financial Centres: Parasites or Symbionts?*, Economic Journal, 523/2007, 1310-1335.

[27] D. Dharmapala, J.R. Hines, *Which countries become tax havens?*, Journal of Public Economics, 93/2009, 1060.

[28] D. Masciandaro, *False and Reluctant Friends? National Money Laundering Regulation, International Compliance and Non-Cooperative Countries*, European Journal of Law and Economics, 20/2005, 17-30.

[29] D. Dharmapala, J.R. Hines, *Which countries become tax havens?*, Journal of Public Economics, 93/2009, 1058-1068.

[30] By contrast, J. Slemrod, *Why is Elvis on Burkina Faso postage stamps? Cross-country evidence on the commercialization of state sovereignty*, Journal of Empirical Legal Studies 5, 2008, 683-712 observed some degree of overlap between the set of tax haven countries and those alleged by the OECD to facilitate money laundering activity, but finds no association between the quality of governance institutions and the likelihood of being designated a money laundering country. Thus, despite the overlap, the nature of the relationship between governance and tax haven status appears to differ from the relationship between governance and money laundering status.

[31] The basic empirical specification used to model the determinants of tax haven status includes the governance index along with the following controls: the log of GDP per capita, the log of population,

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In general, low income tax rates are introduced when countries reasonably expect to receive significantly greater foreign investment and tax base which is able to duly compensate the resulting budgetary costs or when the loss can be compensated by increasing other taxes (such as personal income taxes or value-added taxes).[32] Furthermore, population size has a negative and highly significant effect on the likelihood of being a tax haven,[33] except when the sample is restricted to small countries. Distance has a negative effect that is significant in most specifications.

The results of Dharmapala and Hines, according to which tax havens are better-governed countries than comparable non-havens, might appear inconsistent with the common view that tax havens are outlaw countries that disregard international norms.[34] A possible explanation of this fact is that poorly-governed countries have limited institutional capacities to raise tax revenue compared to better-governed countries and are therefore forced to rely on corporate taxes. Similarly, countries with high levels of corruption have incentives to impose higher statutory tax rates on both domestic and foreign firms, in order to strengthen the power of corrupt government officials, which might claim bribes from taxpayers. A more corrupt country is in fact less likely to become a tax haven. Another interpretation is that countries with

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indicators of UN membership and landlocked status, distance by air from major capital exporters, and regional dummies (based on World Bank regional classifications). The sample includes all countries for which the required data exist (with the sole exception of Liberia, due to the difficulty of measuring the quality of governance used in the regression after the social unrest and civil war). The governance index is observed to have a positive and highly significant association with the probability of being a tax haven. Africa has virtually no tax havens and has many countries with low governance scores.

[32] D. Dharmapala, J.R. Hines, *Ib.*, also observe that in world markets, small open economies are price-takers and have no incentive to tax foreign investors, since doing so simply distorts their economies without extracting resources from foreigners. Since the costs of taxing foreigners are borne by domestic factors in the form of lower wages and land prices, and these costs include deadweight losses due to inefficient taxation, domestic residents would be made richer by removing any taxes on foreign investors and instead taxing the returns to local factors of production. The experience of tax haven economies in the period since 1980 is consistent with the theory predicting significant associated economic benefits. J.R. Hines, *Do Tax Havens Flourish?*, in J.M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99 reports that tax haven economies grew at an average annual real per capital rate of 3.3% between 1982 and 1999, which compares favourably to the 1.4% growth rate of the world as a whole. Furthermore, the public finances of tax havens remain robust despite their low tax rates on foreign investment. Tax haven governments have proven able to tap revenue sources other than business taxes to finance significant levels of government spending, either through the greater economic activity that accompanies becoming a tax haven, or by imposing higher rates of other taxes.

[33] Such results is consistent with the theoretical predictions of R. Kanbur, M. Keen, *Jeux Sans Frontier: Tax Competition and Tax Coordination when Countries Differ in Size*, American Economic Review, 4/1993, 877-892, of N.A. Hansen, A.S. Kessler, *The political geography of tax h(e)avens and tax hells*, American Economic Review, 91/2001, 1103-1115, and as of J. Slemrod, J.D. Wilson, *Tax Competition With Parasitic Tax Havens*, Journal of Public Economics, 11-12/2009, 1261-1270.

[34] M.P. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, World Development, 9/2002, 1657-1673; L. Eden, R.T. Kudrle, *Tax Havens: Renegade States in the International Tax Regime?*, Law and Policy, 1/2005, 100-127.

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abundant natural resources may have incentives to impose high taxes (given that natural resources produce economic rents and lower the quality of government institutions),[35] and therefore are less likely to become tax havens.

There is also a relationship between the general structure of government (in short "governance") and the propensity for a country to become a tax haven, although this relationship has not been clarified in full. Only better-governed countries can credibly commit not to expropriate foreign investors or not to mismanage the economy in a way that prevents foreign investors from earning profits. Tax havens, therefore, tend to be small countries endowed with high-quality governance institutions.

3. "Tax havens" and "offshore financial centres": a blurred distinction

The term "tax haven" is often used interchangeably with other terms, such as "offshore financial centre",[36] "low-tax jurisdiction", "uncooperative jurisdiction", "secrecy jurisdiction" or even "offshore haven", but it is not often clear whether these terms have the same meaning. Broadly speaking, tax havens are widely understood to be jurisdictions offering tax privileges, while OFCs are usually regarded as jurisdictions that host branches or subsidiaries of major international banks, fund mangers, trust and company administrators, accountants and law firms. OFCs usually offer a number of advantages, including favourable taxation, in order to host a variety of financial activities, whereas the advantages provided by tax havens might attract banks, accountancy firms, fund managers and transform the tax haven into an OFC and thus the distinction between tax havens and OFCs is not always clear.[37] Although OFCs are usually tax havens, not all tax havens are also OFCs.[38]

[35] See J.D. Sachs, A.M. Warner, *Natural resource abundance and economic growth*, NBER, Cambridge, 1995, Working Paper No. 5398.

[36] See, for example, the use of the terms made by M.P. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, World Development, 9/2002, 1657-1673; R. Palan, *The emergence of an offshore economy*, Futures, 1/1998, 63-73; T. Dwyer, *'Harmful' Tax Competition and the Future of Offshore Financial Centres, such as Vanuatu*, Pacific Economic Bulletin, 1/2000, 48-69. Instead G. Marino, *Paradisi e paradossi fiscali*, Milan, 2009, 1, more broadly uses the term "offshore havens".

[37] A good example of this is the Island of Jersey. The island authorities emphasise Jersey's status as an OFC rather than as a tax haven. This reflects the differing perceptions of both types of centre, and the respectability of the term "OFC" as opposed to "tax haven". Many governments have a very negative view of tax havens, so that many small jurisdictions attempt to soften their role as tax havens or portray themselves as OFCs. See in this sense M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002, 17.

[38] According to T. Dwyer, *'Harmful' Tax Competition and the Future of Offshore Financial Centres, such as Vanuatu*, Pacific Economic Bulletin, 1/2000, 52, the term "offshore financial centre" is more accurate that "tax haven", as there is often more than one kind of perceived legal inadequacy or

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The term “offshore” is used to label quite different things. It often evokes images of the high seas, an area external to the State, some barge floating in the ocean where transactions can take place far from dry land. The term is quite commonly associated with other terms, as in “offshore finance”, “offshore investment”, and “offshore oil drilling”. It makes one think of the foreign direct investment of multinational enterprises,[39] an unregulated international financial market,[40] as well as a location in which dubious or nefarious activities take place.

According to Palan,[41] the term “offshore” is a designation of the status of the regulatory realms in which certain activities take place. An offshore financial centre is a space where financial activities hosted there are geographically and/or legislatively separated from States’ regulation[42] and where, consequently, transactions with non-residents outweigh those related to the domestic economy.[43] An offshore jurisdiction is in fact a country or a territory which provides non-resident investors with a less restrictive regulatory environment than that existing in their home country.

From a strict tax standpoint, the term “offshore” (as opposed to “onshore”) is used to describe situations in which funds are easily transferred out of the country of residence for tax planning or tax evasion purposes.[44] Therefore, offshore jurisdictions are characterised by differential degrees of regulations, including taxation.[45] According to Johns and Le Marchant,[46] for example, OFC typically host finance, as well as manufacturing activities, ship-chartering, aircraft-basing, film-making, property

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repression in the investor’s home or target jurisdiction providing the impetus to locate assets in an offshore vehicle.

[39] In the 1995 OECD study of global communication, entitled *The changing role of telecommunications in the economy: globalisation and its impact on National Telecommunication policy* OECD Digital Economy Papers No. 11, Paris, 1 January 1995, the OECD refers to foreign investment by national telecommunications carriers as “offshore”.

[40] R. Palan, *The emergence of an offshore economy,* Futures, 1/1998, 64, who mentions, as an example, the investment by Japanese multinational corporations in Malaysia.

[41] R. Palan, *Trying to have your cake and eating it: how and why the State system has created offshore*, International Studies Quarterly, 4/1998, 631.

[42] M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002, 4.

[43] L. Dixon, *Financial Flows via Offshore Financial Centres: as part of the international financial system*, Financial Stability Review, Bank of England, 10, June 2001, 105-116.

[44] R. Murphy, *Rethinking the language of “offshore”*, Mapping the Faultlines – Defining the Secrecy World, 2009, 14, available at http://www.secrecyjurisdictions.com/PDF/SecrecyWorld.pdf.

[45] R.B. Johnston, *The Economics of the Euromarkets*, London, 1983, 18 defines an offshore centre as “a small territory in which the conduct of international banking business is facilitated by favourable and/or flexibly administrated tax, exchange control and banking laws, and in which the volume of banking business is totally unrelated to the size and needs of the domestic market”.

[46] R.A. Johns, C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979*, London and New York, 1993, 27.

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development, cross-border equipment leasing, employment companies, mining and oil production and development, and writers' royalties.

In conclusion, the term "offshore" is an adjective that can be referred to different entities. There can be offshore enclaves, such as free trade zones, but also offshore transactions, which are subject to minimal State regulation.[47] Finally, the term "offshore" may refer to targeted permissive laws and regulations, such as financial and insurance laws typically offered by tax havens.

Different types of OFCs have been distinguished in the literature.[48] With regard to the actual degree of activities hosted there, Hampton[49] distinguishes between functional, compound, and notional OFCs. Functional OFCs are those centres where financial

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[47] R. Palan, *The emergence of an offshore economy,* Futures, 1/1998, 65.

[48] R. Palan, *Trying to have your cake and eating it: how and why the State system has created offshore*, International Studies Quarterly, 4/1998, 632 distinguishes among (i) spontaneous offshore sites; (ii) International Banking Facilities (IBF); and (iii) Tax havens. An example of spontaneous offshore site is the City of London, because it grew up spontaneously, due to its position as the heart of the offshore financial market. Under the 1947 Exchange Control Act, which reaffirmed the 1939 Currency (Defence) Act which established exchange controls at the beginning of the Second World War, some British banks were given permission to deal in foreign currency. In December 1951, the foreign market opened in London. Dealing in Sterling, however, was still restricted under the 1847 Act, so while all currencies were traded freely, Sterling remained controlled and could be sold and bought only by designated banks. Due to a deteriorating balance of trade, however, restrictions on credit were imposed in September 1957, including banning refinancing in Sterling. This then led to a parallel expansion of overseas borrowing and lending. In 1958 Britain returned full convertibility for non-residents. In that way, the Bank of England in effect walled off Sterling but allowed dealings in other currencies free of regulations. The new facilities offered by London generated interest particularly among other central banks and official institutions. From 1957 there ensued a period of progressive relaxation of exchange controls, culminating in the 1979 UK Banking Act, the first act of Thatcher government, which removed exchange controls. Since then London has never be considered effectively an offshore financial market. An IBF is a more stringent type of offshore market, in which companies must apply for a license to trade. According to Palan, examples of this type of OFCs are New York and Tokyo. The first one emerged toward the end of the 1970s as the result of a prolonged and complicated battle between the US Treasury, the Swiss government, and a number of Caribbean tax havens. With the active encouragement of the New York banking community, particularly Citybank and Chase, the US Treasury came to the conclusions that rather than fight the onset of offshore, the United Stated stood to gain more by encouraging its own offshore centres. A swift volte-face took place culminating in the establishment on December 1, 1980, of the New York offshore market, the New York IBF. In turn, the creation of the New York IBF spawned the creation of the Tokyo, spreading the effects of offshore much wider. Meanwhile the Singapore licensed a branch of the Bank of America to set up a special international department to handle transactions of non-residents. The Asian Currency market is a separate set of accounts in which all transactions with non-residents are recorded. Although Asian Currency Units are not subject to exchange controls, the banks are required to submit detailed monthly reports of their transactions to the exchange control authority. With regard to the third category of OFCs, i.e. tax havens, Palan highlights that practically every offshore centre can function as a tax haven to foreign residents and underlines that they are countries with (i) little or no income or corporate tax, (ii) strong bank secrecy laws, (iii) good telecommunication links with global markets, and (iv) public presentation as a tax haven.

[49] M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002, 5.

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activities actually take place, where banks and trust companies locate their branches and provide financial services such as offshore fund managers, trust companies and so on. Functional OFCs employ a significant proportion of local labour and their activities contribute to the GDP of the country in which they are located. Compound OFCs host a mixture of functional and notional activities. Companies locate there a number of shell offices that eventually become fully operation branches, employ a smaller proportion of the local labour force and contribute less than functional OFCs to the GDP of the country. Notional OFCs are those centres where “shell’” brass-plate or “cubicle” offices of banks make book entries of financial transactions and their contribution to the employment of the local labour force and to GDP of the country is very insignificant.

It has been observed[50] that the main users of OFCs are international companies, seeking to maximise their profits taking advantages of low-tax regimes or issuing securitised products through special purpose vehicles, individuals and companies aiming at protecting assets from potential claimants, and investors (individuals, investment funds, trusts etc.) looking for minimising income and withholding taxes and for avoiding disclosing investment positions. Similarly, OFCs are used by financial institutions to minimise income and withholding tax and to avoid regulatory “onshore” requirements or to assist customers in minimising income and withholding tax. OFCs are also used by insurance companies seeking to accumulate reserves in low-tax jurisdictions and to conduct business in responsive regulatory environments. Finally, OFCs are used for money-laundering purposes or to protect from law enforcement.

4. Offshore vehicles and transactions

The adjective “offshore” is used in conjunction with different nouns to denote potential uses of OFCs. From an analysis of the current literature it turns out that, in summary, one can speak of offshore financial centres, offshore financial markets, offshore banking, offshore companies, offshore funds, offshore trusts, and offshore captive insurance companies.

Offshore financial centres are those jurisdictions specialised in providing financial services to residents in other jurisdictions.[51] They host a level of financial activity by non-resident investors that is disproportionate to the size of the jurisdiction, and

[50] Financial Stability Forum (FSF), *Report of the Working Group on Offshore Centres*, available at http://www.financialstabilityboard.org/publications/r_0004b.pdf, 10.

[51] D. Masciandaro, *Offshore financial centres: the political economy of regulation*, European Journal of Law and Economics, 26/2008, 312.

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provide intermediary services for larger neighbouring countries, regulatory incentives to non-residents and a completely flexible management of foreign assets.[52]

Similarly, the term "offshore financial markets" labels those markets in which financial operators are permitted to raise funds from non-residents and invest or lend the money to non-residents free from most regulations and taxes.[53] Such a lack of regulation and taxation represents the main advantage of the offshore financial markets: financial intermediaries are not subject to the regulations that may inhibit expansion in their domestic markets and banks normally do not face restrictions such as interest rates ceilings, reserves requirements and exchange controls, withholding of interest income for tax and disclosure requirements. Owing to these competitive advantages, banks and other financial intermediaries can offer better services and rates when operating through the offshore financial markets and their growth in turn contributes to the development of the offshore financial markets.

In the literature there is criticism on long-term effects of the offshore financial markets.[54] Offshore financial markets are believed to undermine States' monetary and fiscal policies, to provoke a reduction of direct taxation which must be compensated by a correspondent increase of indirect taxation, and thus to be the source of inequalities. They are held to detach the financial system from the global production system.[55] Rather than servicing production and trade, offshore financial markets divert resources from the "real" economy into pure speculation,[56] and systematically divert resources from central banks towards private investors.[57] Last

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[52] A.K. Rose, M.M. Spiegel, *Offshore Financial Centres: Parasites or Symbionts?*, Economic Journal, 523/2007, 1310-1335.

[53] The definition is by R. Palan, *The emergence of an offshore economy,* Futures, 1/1998, 65, who underlines that most commonly the designation "offshore" financial market is used interchangeably with "Euromarket". This latter is a relatively unregulated international financial market which emerged in late 1958 in London. In response to the mounting speculation against the pound sterling after the Suez Canal crisis, the British government imposed restrictions on the use of pound in trade credits between non-residents. Consequently, British and other international banks sought to use US dollars in their international dealings. Transactions between non-residents that were mediated by banks located in London (whether British or not) were then considered to be taking place "offshore", i.e. not under the regulatory laws and supervision of the British State. Originally, therefore, the Euromarket was a booking devise. It was created when books for foreign-to-foreign accounts are kept separate from books for domestic financial and capital transactions. Since the early 1970s Euromarket type facilities were emulated worldwide and supplemented by all the major "hard" currencies. Hence, the term offshore financial market is now deemed more appropriate than Euromarket.

[54] R. Palan, *The emergence of an offshore economy*, Futures, 1/1998, 66, who estimates that about 80% of international banking transactions (in volume) takes place in offshore financial markets.

[55] See S. Strange, *Casino Capitalism*, Oxford, 1986.

[56] R.E. Allen, *Financial Crises and Recession in the Global Economy*, London, 1995.

[57] Q. Xiang, H.Q. Xie, H. Henderson, A.F. Kay, *Introducing competition to the global currency market*, Futures, 4/1996, 305-324.

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but not least, secrecy and speed of operations have proved a boon to money launders, drug traffickers and other criminals.[58]

The term "offshore" is used to refer to private or corporate banking activities. While private offshore banking consists of banking services rendered to wealthy individuals (i.e. retail banking), corporate offshore banking consists of banking services rendered to companies and sovereign States (i.e. wholesale banking). Private offshore banking includes a number of banking services that are offered to wealthy individuals and represents the oldest form of banking. Private banking is labelled "offshore", because its main advantages are not the return on investment or interest rates offered, but rather more favourable tax regimes and confidentiality. Normally, an offshore private bank account of an individual is not subject to tax in the host jurisdiction. More particularly, interest received from deposit accounts in most OFCs is paid gross. In addition, as many OFCs provide for strict bank secrecy legislation, according to which any disclosure of information may be a criminal rather than a civil offence, offshore private bank accounts also escape from the tax jurisdiction of the State of residence.

Corporate offshore banking refers to banking services provided to multinational companies. Although these companies have developed their own in-house treasuries to manage their global flows of different currencies, they normally set up offshore banks to handle their foreign exchange operations or to facilitate financing of an international joint venture. Furthermore, banks minimise tax payments on loan transactions by establishing branches or subsidiaries in OFCs, which provide offshore fund administration services. Profits arising from a loan (i.e. interest) can be paid tax free or are only liable to a minimal tax rate. This favourable tax regime, combined with a soft regulation, attracts loans through OFCs. Another key factor of attraction for banks is the reduced operational costs. Offshore bank branches have much lower start-up and running costs than offices in other centres. Small staff number and the lower rents relative to those in a finance centre make substantial cost savings.

The term "offshore" is also used to refer to corporate vehicles. "Offshore companies" are perhaps the most famous offshore vehicles which have drawn the attention of both international institutions and governments of high-tax countries. The advent of offshore companies and their recent proliferation has changed the way multinationals manage their global operations. Due to the "near zero" regulatory environment, incorporating subsidiaries in OFCs simplifies managing global operations.[59] Subsidiaries incorporated in OFCs by foreign parent companies often perform specific tasks, such as invoicing services and goods, exploiting copyrights, performing rights or patents and holding participations in a tax-free regime.

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[58] W.C. Gilmore, *International Efforts to Combat Money Laundering*, Cambridge, 1992.

[59] J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 142-182; R. A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983.

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Offshore companies are often used as special purpose vehicles, to engage in specific activities in a more favourable tax environment. Banks and financial institutions make use of these vehicles in order to benefit from a less restrictive regulations on their activities, such as raising capital in a lower tax environment, taking advantage of more liberal netting rules than those existing in home countries, replacing debts with cash. Similarly, offshore companies can be used as intermediaries to route payments of royalties, dividends and licence fees (so-called "letterbox" companies). The tax advantage they grant is based on the concept of tax deferral in the high-tax country, according to which the tax liability of the parent company is deferred until the dividend is received from the OFCs.[60]

The term "offshore" is also used in respect to investment vehicles. An "offshore fund", for example, is a mutual fund established in a low-tax country primarily for investment by residents of high-tax countries.[61] Investors holding shares in offshore funds can normally defer or avoid taxes on capital gains and capital transfer taxes and savings from the tax deferral over time could be substantial. Most offshore funds are untaxed by the host government as they are considered non-resident for local tax purposes. In addition, offshore funds have been used to circumvent two main areas of regulation: securities law and exchange controls, which are generally strictly applied in high-tax countries. Finally, the third factor of attraction of offshore funds is their secrecy, as the investment in shares in an offshore fund can be used to hide wealth from onshore tax authorities or families.

"Offshore trust" is another very frequent expression where the term "offshore" is used, and describes a particular type of trust. A trust is a common law institute that allows the separation of assets from their original owner, therefore offering a number of opportunities of tax savings. The original owner, the "settlor", gives over legal ownership to the trustees for the benefit of a third party, i.e. a "beneficiary". Trusts are often operated in conjunction with offshore companies either in the same OFC or in another jurisdiction. Wealthy individuals residing in high-tax countries are the major users of trusts, due to the three main advantages they offer: tax planning, asset protection and executorship. Owing to the separation of assets granted by the trust and the differences of tax regulation in civil law countries, the institute is often used to avoid or defer taxation in the home jurisdiction, if the assets are "parked" offshore. In addition, trust grants asset protection, as it can be used to place assets offshore thus

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[60] Aware of such practices, as it will be argued in Chapter 4, high-tax governments enacted strict regulations aimed at restricting the use of offshore companies, such as the so called "Controlled Foreign Companies Legislation". For a general overview of this matter, see B.J. Arnold, *The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens*, Canadian Tax Journal, 5-6/1985, 445-489.

[61] C. Doggart, *Tax Havens and Their Uses*, London, 2002, 25, who underlines that most offshore funds are "open-ended" investment companies, that is, they can expand by issuing new shares or contract by buying back or cancelling shares. The fund's assets may be a mixture of cash, securities or real estate.

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avoiding real or potential civil unrest in the home country and to avoid local inheritance and succession laws in the settlor's country.

Trusts often bypass strict legal obligations set forth by inheritance laws upon the rights of spouse or children, thus simplifying the administration of an estate at the death of the settlor. In those cases in which a settlor has assets located in different countries, the execution of the will risks being a long and complex procedure due to the different national applicable laws. By aggregating all the assets in the hands of a trustee, based in one jurisdiction, the procedure can be simplified and probably also avoid death duties.

Another frequent use of the attribute "offshore" is that in combination with "captive insurance companies". A captive insurance company is a subsidiary insurance company created and owned by a non-insurance organisation for the purpose of insuring the risks of its parent.[62] Setting up an offshore captive insurance company provides cost savings in terms of minimisation of the effect of onshore countries' taxation and regulation. As, normally, insurance premiums are tax deductible in the hands of the parent company, if such a deduction is allowed to premiums paid to offshore captive insurance companies, then the group's overall tax burden can be reduced. This is why such transactions are increasingly subject to anti-avoidance legislation and arm's length criteria.[63] Owning a captive insurance company allows access to the wholesale re-insurance market, which lowers the cost of insurance for the parent as the captive can charge wholesale, rather than retail, prices for insurance services. In this sense, an offshore captive insurance company offers substantial cost savings, especially for high commercial risks. In addition, the actual operational costs of a captive may be lower than those of a commercial insurance company with a large branch network.

5. The lack of a shared definition of "tax haven"

There is no single, clear, objective test which permits the identification of a country as a tax haven.[64] Some authors[65] emphasise the etymological significance of the expression, which means "tax harbour" or "tax oasis".[66] The origin of the terms

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[62] R.A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983, 142.

[63] L.J. Kemp, *The Use of Captive Insurance Companies*, Multinational Business, 1/1982, 1-8.

[64] R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981; In the same sense OECD, *International Tax Avoidance and Evasion: Four Related Studies. Issues on International Taxation no. 1*, Paris, 1987, 21.

[65] E. Chambost, L. Velo, *I paradisi fiscali in vista del 1992*, Como, 1992, 3.

[66] In French tax havens are referred to as "*paradis fiscaux*", in Italian "*paradisi fiscali*", and in German "*Steueroasis*".

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should therefore reside in the image of a business man, which, like a sailor seeking some shelter, must navigate the high sea of tax laws and its storms (i.e. tax inspections and taxation on his assets), in order to find a harbour where he can finally have some rest (i.e. the tax haven). Quite in line with this fantastic image, the Modern Dictionary for the Legal Profession more realistically defines tax havens as "tax shelters in a foreign country that is preferable to other countries because of that country's educated labour force, modern commerce system, advanced equipment and technology, good transportation, and good climate".[67]

In spite of the existence of many different definitions of "tax havens" in the literature,[68] a tax haven could be broadly defined as any country whose tax laws interact with those of another so as to make it possible to produce a reduction of tax liability in that other country. Tax havens have in fact been identified as "low-tax countries and special tax regimes that provide companies and individuals opportunities to reduce their tax burden".[69] In this very sense, the concept of "tax

[67] G.W. Beyer, *Modern Dictionary for the Legal Profession*, New York, 1996, 751.

[68] R.A. Johns, *Tax Havens and Offshore Finance: A study of Transnational Economic Development*, London, 1983, 20 defines tax havens as deliberate State strategies aimed to attract thereto international trade-oriented activities by minimisation of taxes and the reduction or elimination of other restrictions on business operation. According to J.R. Hines, E.M. Rice, *Fiscal paradise: Foreign tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 149-182 tax havens are countries with: (1) little or no income or corporate tax, (2) strong bank secrecy laws, (3) good telecommunication links with global markets, and (4) public presentation as a tax haven. A. Starchild, *Tax Havens for International Business*, Basingstoke, 1993, 1, argues that tax havens are those countries with tax legislation especially designed to attract the formation of branches and subsidiaries of parent companies based in heavily-taxed industrial nations. According to R.T. Kudrle, *Did blacklisting hurt the tax havens?*, Journal of Money Laundering Control, 1/2009, 34, the term tax havens usually refers to jurisdictions in which suspect activity looms large relative to the total economy and that gear their national policies towards one or more specific types of activity. L. Eden, R.T. Kudrle, *Tax Havens: Renegade States in the International Tax Regime?*, Law and Policy, 1/2005, 100-127 share the opinion that tax havens are renegade State in the international tax regime that typically have low or zero tax rates on personal and/or corporate income, secrecy laws on banking and other financial transactions, and few or no restrictions on financial transactions. M.A. Desai, C.F. Foley, J.R. Hines, *The demand for tax haven operations*, Journal of Public Economics, 3/2006, 513-531 consider as tax havens those low-tax jurisdictions that provide investors opportunities for tax avoidance. According to F.H. Fleck, R. Mahfouz, *The Multinational Corporation: Tax Avoidance and Profit Manipulation via Subsidiaries and Tax Havens*, Revue Suisse d'Economie Politique et de Statistique, 2/1974, 148, "Tax havens are a typical outcome of modern international finance, where huge amounts of money are daily moved around the globe. They are retreats for money prevalently owned by large corporations or individuals, who are domiciled in another country. This money usually tries to avoid (or rather to evade) high taxes at home or in the country of its origin, but, sometimes, it also seeks refuge and security in neutral countries, away from political instability and social conflicts". According to B.A. Garner (ed.), *Black's Law Dictionary*, St. Paul, Minn., 2001, 1474 a tax haven is "a country that imposes little or no tax on the profits from transactions carried on in that country".

[69] R. Zielke, *The Changing Role of Tax Havens – An Empirical Analysis of the Tax Havens Worldwide*, forthcoming in Bulletin for International Taxation, 1/2011, published online on 14 October 2010.

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haven" is mainly referred to the level of taxation of a given country, which is considered lower than a certain amount.[70]

Nevertheless, the definition provided above risks being too vague and imprecise, because every country in the world offers in practice some sort of haven from taxation and regulation for residents of other countries. As the combination of the complexity of modern national tax systems and the growth of capital mobility has practically rendered every country in the world a potential haven, there is confusion as to the true identity of tax havens.[71]

Given the lack of a common acknowledgment of tax havens, the most popular test to identify a tax haven is the so-called "smell" or "reputation test", which is accepted by the OECD[72] and which originally appeared in the Report by Richard A. Gordon in 1981[73] in the following formulation: "a country is a tax haven if it looks like one and if it is considered to be one by those who care".[74] Such an approach was subsequently acknowledged in the literature,[75] but was also subject to critics. It has in fact been highlighted that lacking the rigour of clear-cut criteria, such definition is arbitrary and ill-suited for scholastic research or policy formulation.[76]

According to some authors,[77] the first use of the expression "tax haven" dates back the 1950s, when it had a positive meaning of escape from the otherwise drastic tax

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[70] It is undeniable that the very first forms of tax havens consisted of some forms of savings (i.e. a shelter) that taxpayers could find from taxes levied by their home States. Accordingly, traditional definitions of tax havens depart from low or nil taxation as a strategic voluntary factor of attraction of business from one high-tax country, alone or together with the lack of effective exchange of information, which allows a foreign taxpayer residing in a capital export neutrality country to benefit from the low-tax regime. See R.T. Kudrle, *Tax Competition and the Tax Havens,* Global Economic Journal, 1/2008, Article 1, 2, according to whom the definition of tax haven derives from the tax savings such a jurisdictions offers to foreigners.

[71] OECD, *International Tax Avoidance and Evasion: Four Related Studies. Issues on International Taxation no. 1*, Paris, 1987, 21.

[72] See more broadly paragraph 7 below.

[73] R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981.

[74] R.A. Gordon, *Ib.*, 26.

[75] A.S. Ginsburg, *Tax Haven*, New York, 1991, 1. See also J J. Slemrod, J.D. Wilson, *Tax Competition With Parasitic Tax Havens*, Journal of Public Economics, 11-12/2009, 1261-1270, according to whom a tax haven is a jurisdiction that imposes no or only nominal taxes and offers itself as a place to be used by non-residents to escape tax in their country of residence.

[76] M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 96.

[77] See M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 96, according to whom the first use of the term in the English language literature was apparently in the work by C. Smith, *Tax Havens*, dating back to 1959. According to the Author, in the authoritative British Tax Review the term was mentioned for the first time in the article by G.S.A. Wheatcroft, *The General Principles of Tax Planning*, British Tax Review, 1963, 184.

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regimes of the developed countries. Gradually, the term started having a strong negative connotation, as low-tax regimes started being conceived as a form of erosion of tax bases of other countries and unfair tax competition. The negative feature of the term is, in addition, boosted by the criminal activities that quite often occur in these jurisdictions, such as money laundering, assistance to terrorism, bribery and corruption. This is the main reason why many jurisdictions strenuously refuse to be labelled as such, in spite of the low or inexistent level of taxation they provide.[78]

It is worth stressing that according to the commonly shared view, the expression “tax haven” refers to very small jurisdictions servicing high-tax countries.[79] These jurisdictions normally offer a minimal or no personal or corporate taxation in order to attract individuals, branches and subsidiaries of parent companies based in high-tax industrial countries,[80] and grant some form of bank secrecy law.[81]

6. The definition of tax havens provided by the OECD

The most important contributions to the definition of tax havens have been developed by international bodies, such as the Organisation for the Economic and Cooperative Development (OECD), the International Monetary Fund (IMF), the Financial Stability Forum (FSF), and he Financial Action Task Force (FATF). All the mentioned initiatives share in common the so called “name and shame approach”, which consists in blacklisting countries labelled as tax havens. As it will be argued below, such an approach represents the most effective instrument to force targeted jurisdictions to comply with high-tax countries’ desire. Although sharing the same effects, the various black lists aim at different purposes: while the OECD aims at countering harmful tax practices and the IMF looks at the banking sector, the FATF intends to curb money laundering and the FSF to protect the integrity of the financial system. The present paragraph analyses the definition of “tax havens”, as opposed to that of “preferential tax regimes” developed by the OECD.

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[78] M.P. Hampton, J.P. Abbott, *The Rise (and Fall?) of Offshore Finance in the Global Economy: Editors’ Introduction*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore Finance Centres and Tax Havens*, Basingstoke, 1999, 3.

[79] This will be argued in Chapter 2, paragraph 5.

[80] A. Starchild, *Tax Havens for International Business*, Basingstoke, 1993, 1; This is also confirmed by R.A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983; S.I. Banoff, B.W. Kanter, *States Compete to Save Taxes Owed to Other States*, Journal of Taxation, 3/1994, 382-384; and S.I. Banoff, B.W. Kanter, *The State as a Firm: Economic forces in Political Development*, Boston, 1994.

[81] In the opinion of L. Eden, R.T. Kudrle, *Tax Havens: Renegade States in the International Tax Regime?*, Law and Policy, 1/2005, 101, it is the combination of all these advantageous factors that renders a jurisdiction a tax haven.

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The definition of "tax havens" provided by the OECD in its Report[82] published in 1998 (hereinafter, the "1998 Report") is a leading one.[83] It influenced researches, studies and governments of high-tax countries that implemented specific anti-avoidance legislations based on the OECD's black lists to curb the phenomenon of tax base erosion by these jurisdictions. The 1998 Report openly declares its intent "to develop a better understanding of how tax havens and harmful preferential tax regimes affect the location of financial and other services activities"[84] and does not target manufacturing and non-service and non-financial commercial activities.[85] It focuses on geographically mobile activities, defines the factors to be used in order to identify harmful tax practices and sets out nineteen wide-range recommendations to counteract such practices.

After having identified as "harmful" what erodes the tax bases of other countries and distorts trade and investment, diminishing global welfare and undermining taxpayer confidence in the integrity of tax systems, the OECD draws a distinction between "tax havens", on the one hand, and "preferential tax regimes", on the other hand. "Tax havens" are those jurisdictions "able to finance their public services with no or nominal income taxes that offer themselves as places to be used by non-residents to escape tax in their country of residence", whereas "harmful preferential tax regimes" are those jurisdictions "which raise significant revenues from their income tax but whose tax system has features constituting harmful tax competition".[86]

The 1998 Report acknowledges the difficulty of coming up with a generally-agreed-on definition, nor does it provide for a technical meaning of the expression. Tax havens are defined as "countries that are able to finance their public services with no or nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence".[87] In the OECD's view, this category includes countries which do not have any interest in trying to curb the "race to the bottom" with respect to income tax, which actively contribute to the erosion of income tax revenues of other jurisdictions, and which are unlikely to cooperate in curbing harmful tax competition.[88] In a tax haven, the lack of, or the presence of the only, nominal taxation is combined either with the fact that it offers itself a place (or is perceived to be a place) to be used by non-residents to escape tax in their country of

[82] OECD, *Harmful Tax Competition: An Emerging Global Issue*, Paris, 1998.

[83] R.T. Kudrle, *Ending the Tax Haven Scandals*, Global Economy Journal, 3/2009, Article 5, 1.

[84] Paragraph 1 of the 1998 Report.

[85] The 1998 Report purports to cover not only OECD Member countries, but also non-OECD countries and it specifically states that it intends to influence these latter.

[86] Paragraph 42 of the 1998 Report.

[87] Paragraph 42 of the 1998 Report.

[88] On harmful tax competition, see Chapter 4 of the present work.

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residence, or with the fact that it seriously limits the ability of other countries to obtain information for tax purposes.

According to the 1998 Report, tax havens are fiscally sovereign territories and countries that use incentives of tax or non-tax kind to attract activities in the financial and other services sectors.[89] This is in line with the literature,[90] according to which tax havens generically refer to some typically small polities that appear to gear their corporate and personal income taxes to the enticement of foreign investment that is overwhelming financial rather than real. These jurisdictions typically have stable governments, good transportation and communications and freely convertible currencies.[91]

In the OECD's view, a combination of three factors seems to be required in order to identify a tax haven. First, the jurisdiction under consideration must offer foreign investors a more favourable tax regime[92]. Second, it must provide a reduction in regulatory or administrative constraints, such as lack of information exchange due to strict bank secrecy. Third, it must offer itself or be generally recognised as a place for non-residents to escape their home State taxation.

More specifically, the first requirement in respect of which a country can be defined as a tax haven, according to the OECD, is a more favourable tax regime aimed at attracting activities in the financial or in other services. This factor is normally identified with the expression "no or only nominal taxes", and describes the situation where the jurisdiction at hand provides for no or only nominal taxation on the relevant income, usually capital. Tax havens generally rely on the existing global financial infrastructure and have traditionally facilitated capital flows and improved financial market liquidity.[93] After the liberalisation and deregulation of financial markets by non-haven countries, tax havens' tax and non-tax advantages (which basically are tax minimisation and financial confidentiality, respectively) tend to divert financial capital of both multinational and individuals away from non-haven countries and have a large impact on the revenue bases of these latter. The 1998 Report clarifies that tax havens serve three main purposes: providing a location for holding passive investments ("money boxes"); providing a location where "paper" profits can be

[89] Paragraph 47 of the 1998 Report.

[90] R.T. Kudrle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to American Foreign Policy*, Pittsburgh, 2008, 184-201.

[91] According to O.H. Williams, E.C. Suss, C. Mendis, *Offshore Financial Centers in the Caribbean: Prospects in a New Environment*, The World Economy, 8/2005, 1173-1188 and J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, they differ from each other in many dimensions including specialisation in various financial activities and the extent to which they have been involved in scandals of various kinds. Some of the most successful havens, most notably the Cayman Islands, have a very high per capita income.

[92] This is what the 1998 Report calls "an environment with a no or only nominal taxation".

[93] Paragraph 47 of the 1998 Report.

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booked; and enabling the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries.[94]

The first factor alone is not sufficient to identify tax havens, because a country may be providing for a preferential tax regime, but competing fairly. Accordingly, in the OECD's view, this requirement should be combined with a second one, i.e. a reduction in regulatory or administrative constraint.[95] Such a factor consists of any domestic regulation that is less strict than that existing in the non-haven countries, it plays a key role in attracting non-resident investors' activities, and it is exemplified with the lack of information exchange.

Further to the two factors mentioned above, a third key element to identify a tax haven is envisaged in the 1998 Report's. In fact, a jurisdiction with no or only nominal taxation and a reduced regulatory or administrative constraint can be said to be a tax haven, whether it offers itself or is generally recognised as a place to be used by non-residents to escape tax in their country of residence.[96] In other words, tax havens are said so, because they cause harm to other countries deliberately. This subjective reputation test[97] requires the identification of a tax haven on the basis of how other countries perceive it, as if when people think that a give country is a tax haven, it is a tax haven.

Beside the combination of the above said factors (which are to be used to identify tax havens), according to the OECD, there exist some additional factors which (do not identify, but) confirm the existence of a tax haven. This means that such additional factors alone would not be able to label a country as a tax haven.

The first of these additional factors is the lack of effective exchange of information, which limits the access by tax authorities to the information required for the correct

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[94] Paragraph 49 of the 1998 Report.

[95] Likewise the absence of identification of a certain degree of taxation under which a tax system of a country could be considered as acceptable, the 1998 Report does not contain any definition of what a reduction in regulatory or administrative constraint is, nor gives an example of what an optimal level of this constraint should be in respect of which verifying such a reduction. However, it can be argued that the level it refers to should be that of high-tax industrialised countries, which form the OECD, and whose reduction of mobile activities (such as financial and other service activities) are of concern of the organisation due to the competition of tax havens.

[96] Paragraph 51 of the Report, which refers to The OECD Report *International Tax Avoidance and Evasion*, Four Related Studies, No. 1, 1987, 22. It can be argued that such an element is considered by the OECD as a defining factor, because, otherwise, under the combination of the other two (i.e. no or only nominal taxation and reduction in regulatory or administrative constraint), any country in the world could potentially fall within the OECD definition of tax haven. However, it can be questioned how a definition that should identify which countries are classified as tax havens could depend on what, beside such definition, it is generally considered or perceived as a place to be used by non-residents to escape tax in their country of residence (see paragraph 52 of the Report).

[97] Which J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 43 also calls "Smell test".

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and timely application of tax laws.[98] Domestic laws and administrative practices of tax havens normally allow business and individuals to benefit from strict secrecy regulations and forms of protection against scrutiny by their home State tax authorities. A low tax regime is, in fact, normally beneficial to non-resident investors whether exchange of information is prevented. Lack of effective exchange of information can be a consequence of laws or administrative practices in force in the tax haven and might allow business and individuals of other jurisdictions to benefit from protection against scrutiny by their home country tax authorities.

The second additional factor is the lack of transparency in the jurisdiction's legislative provisions or administrative tax practices, which prevents (or would prevent) effective exchange of information. Lack of transparency might be envisaged whether the details of the regime and/or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure. Such a factor appears to be linked to the first one above, because if no local laws compel appropriate transaction recording, there is no information for the authority to share.[99] Accordingly, lack of transparency is attractive for those investors wishing to hide the origins of their income or keep such income concealed in their home State.

The third additional factor is the lack of a requirement that the activities carried out in the tax haven be "substantial". In other words, the jurisdiction at hand facilitates the establishment of foreign owned entities without the need for a local substantive presence. This requirement is important, because it suggests that the jurisdiction may be attempting to attract investment and transactions that are purely tax driven. It may also indicate that a jurisdiction does not provide a legal or commercial environment or offer any economic advantages that would attract substantive business activities in the absence of the tax minimising opportunities it provides. The 1998 Report acknowledges that determination of when and whether an activity is substantial can be difficult. For example, financial and management services may, in certain circumstances, involve substantial activities. However, certain services provided by "paper companies" may be readily found to lack substance.[100]

As mentioned above, the other category of jurisdictions identified by the OECD, as opposed to tax havens, consists of the so called "harmful preferential tax regimes". Jurisdictions belonging to this latter group might have a significant amount of revenues which are at risk from the spread of harmful tax competition and are more likely to agree on concerted action. Preferential tax regimes not only provide for no or low effective taxation on the relevant income, but also restrict the regime to non-

[98] Under such a criteria, a country meeting the two criteria of the tax havens test, whether does not exchange information with foreign tax authorities regarding tax matter, but cooperating with investigations into fraud and money laundering is still labelled a tax haven.

[99] R.T. Kudrle, *Did blacklisting hurt the tax havens?*, Journal of Money Laundering Control, 1/2009, 35.

[100] As it will be better argued below, since 2001 the OECD has abandoned the "no substantial activities" criterion, as it was very difficult to define whether a country lacks substantial activities and it has emphasised that based on the lack of exchange of information.

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resident and isolate themselves from the domestic economy (so called “ring-fencing”), or lack of transparency and of access to information on taxpayers benefiting from a preferential tax regime.

Preferential tax regimes are special tax or non-tax measures with the aim of attracting highly mobile financial and other service activities.[101] They consist of the provision of favourable locations to hold passive investments, or, more simply, to allow to route capital flows across borders. Differently from tax havens, such preferential tax regimes were identified among the OECD member countries and their dependencies.[102] The apparent rationale of such a distinction is that while non-havens have a substantial domestic sector to serve as benchmark for tax comparison, tax havens do not and instead present the threat of “sham” activities. Havens are attacked as “jurisdictions”, while preferential tax regimes within the OECD are essentially treated as policy anomalies of OECD member countries.

Usually, the main purpose of a preferential tax regime is the attraction of economic activities (generally financial and other service activities, which produce passive investment income), that can be easily shifted in response to tax differentials.

According to the 1998 Report,[103] four are the key factors denoting the presence of a harmful preferential tax regime. The first factor is a low or zero effective tax rate on the relevant income, which may result either from a very low schedule rate or from the rules of definitions of the tax bases to which the rate is applied.[104] Harmful preferential tax regimes are characterised by a combination of this key factor with one or more of the others.

The second factor is ring-fencing. This is the only criterion that deviates from the tax haven standard, as it requires the activity to be substantial and consists of the application of tax benefits different from the tax treatment applied to domestic firms. Ring-fencing of the regimes has adverse effects over foreign tax bases, as it does

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[101] Paragraphs 57 and 58 of the 1998 Report.

[102] R.T. Kudrle, *U.S. Defection from the OECD “Harmful Tax Competition” Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to American Foreign Policy*, Pittsburgh, 2008, 197. It has been argued by J.C. Sherman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006 that in its Report, the OECD sought to “define what harmful tax competition was to make an argument for just why it was harmful, and to set out a response to the problem”. In reality, the OECD proposed two different approaches to curb the problem, based on the relative power of the offender. With respect to its own member States, the OECD decided upon a collaborative approach, opting for peer review and peer pressure to urge the elimination of potentially harmful preferential tax regimes. Conversely, with respect to the weaker, non-member countries, defined tax havens, the OECD took a confrontational and exclusionary approach, consisting in threatening to blacklisting the tax havens and apply the “defensive measures” to coerce their cooperation, if necessary.

[103] Paragraph 59 of the Report.

[104] While talking about tax havens, the OECD uses the wording “no or nominal taxation”, harmful tax regimes are identified by referring to “no or low effective tax rates”.

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not extend to domestic taxpayers. The 1998 Report[105] highlights that ring-fencing regimes might restrict the benefits to non-residents and might explicitly or implicitly exclude resident enterprises from taking advantage of their benefits. This can shift the revenue-reducing impact of the policy to other countries and can provide for a strong indication that a tax regime has harmful spill-over effects. Similarly, a preferential tax regime might aim at insulating the domestic economy from its own adverse effect and might prohibit enterprises established under the regime to operate in the domestic market. Such a prohibition can occur either by not applying special tax privileges or by otherwise neutralising them insofar as the enterprises carry on business in the regime-country's domestic market, or by forbidding transaction in the domestic currency in order to ensure that domestic monetary system is not affected by the regime.

The third factor mentioned by the 1998 Report is the lack of transparency in the operation of a regime. A tax regime's administration can be considered transparent whether (i) it sets forth clearly the conditions of applicability to taxpayers in such a manner that those conditions may be invoked against the authorities; and (ii) the details of the regime are available to the tax authorities of other countries concerned. Regimes not meeting these criteria are likely to increase harmful tax competition, since non-transparent regimes give their beneficiaries latitude for negotiating with the tax authorities and may result in inequality of treatment of taxpayers in similar circumstances.

According to the 1998 Report,[106] lack of transparency is due to the following different factors. First, it may arise because of favourable administrative rulings (e.g., regulatory, substantive, and procedural rulings), allowing a particular sector to operate under a lower effective tax environment than other sectors. Tax authorities may, for example, enter into agreements with a taxpayer or may agree to issue advance tax rulings in requested cases. However, where these administrative practices are consistent with and do not negate or nullify statutory laws, they can be viewed as a legitimate and necessary exercise of administrative authority. To assure equality in treatment, the ruling criteria should be well-known or publicised by the authority granting the ruling and available on a non-discriminatory basis to all taxpayers. Second, lack of transparency might depend on special administrative practices contrary to the fundamental procedures underlying statutory laws. These practices might encourage corruption and discriminatory treatment and make tax law enforcement by other countries more difficult. Thus, a regime where the tax rate and base are not negotiable, but where administrative practices and enforcement do not conform to the law or do not stipulate the conditions of applicability, may be considered as potentially harmful. Finally, lack of transparency is due to the absence of enforcement of domestic law, owing to the general domestic fiscal environment. Tax authorities might, for example, deliberately adopt a lax audit policy as an implicit

[105] Paragraph 62 of the 1998 Report.

[106] Paragraph 63 of the 1998 Report.

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incentive to taxpayers not to comply with the tax laws, which gives these latter a competitive advantage.

The fourth last factor considered as determining the harmful effects of a tax regime is the inability or the unwillingness of a country to provide information to other countries. Exchange of information can be hindered by domestic law that protects secrecy and prevents tax authorities from obtaining information. Likewise, even where there are no formal secrecy laws, there could be some difficulties in obtaining the information needed, i.e. when there is no annual general audit requirement for companies, no requirement for a public register of shareholders, the use of bearer shares, or when administrative policies or practices may be uncooperative and *de facto* impede the exchange of information.

Beside the above mentioned key factors identifying harmful preferential tax regimes, the 1998 Report mentions some additional factors.[107] These factors are: an artificial definition of the tax base (tax laws of some countries might provide for unconditional benefits or other rules allowing excessive deduction of costs), failure to adhere to international transfer pricing principles (which results in allocating excessive earnings to certain firms and might also depend on non-transparent or inappropriate use of advance rulings), excessive foreign source income exempt from residence country tax (that is a regime based on a territorial system, under which foreign-sourced income is exempt in the home State, then stimulating the location of activities for tax rather than business purposes), negotiable tax rate or tax base (between taxpayer and tax authority of the country sponsoring the regime), existence of secrecy provisions (which grants protection from enquiries by tax authorities of the home State), access to a wide network of tax treaties (which is exposed to abuse), regimes which are promoted as a tax minimisation vehicles (that can indicate whether a regime is seen and used primarily as a means of engaging in international tax avoidance and evasion), and regime encouraging purely tax-driven operations or arrangements (which allow taxpayers to derive tax benefits without being engaged in substantial activities).

The following table briefly outlines the characteristics of tax havens and preferential tax regimes, in the OECD’s view.

Tax havens	**Preferential tax regimes**
No or low effective tax rates	No or low effective tax rates
Lack of transparency	Lack of transparency
Lack of effective exchange of information	Lack of effective exchange of information

[107] Paragraphs 68-79 of the 1998 Report.

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No substantial economic activities	Ring-fencing of low-tax regimes

As above highlighted, it clearly emerges that tax havens and preferential harmful regimes share three of the four distinguishing key factors. Thus, the dividing line between a tax haven and a harmful preferential tax regime, in the OECD's view, is the presence of the only diverging factor, i.e. no substantial economic activities or ring-fencing of low-tax regime.

7. Other context-related definitions of tax havens (IMF, FSF, FATF)

Following a recommendation of a working group of the Financial Stability Forum, the International Monetary Fund (IMF) undertook a program in 2000 to assess 44 jurisdictions identified as OFCs and issued a Report which provides background information on the business of OFCs and on a number of initiatives taking place in various international fora concerning OFCs.[108] The Report describes offshore finance, and presents a number of definitions of OFCs.[109] Some Authors[110] pointed out that part of the IMF's reluctance to be involved in the project was that nearly half of the jurisdictions under investigations were not IMF members and that the program could have taken resources and focus away from the IMF's main tasks. In addition, some IMF members perceived the assessment task as being only loosely related to the institution's core responsibility.

The definition of offshore finance provided by the IMF is the provision of financial services by banks and other agents to non-residents. These services include both the borrowing and the lending of money to non-residents companies, other financial institutions, and other market participants, as well as deposit service from individuals and investing the proceeds in financial market elsewhere. Thus, the IMF defines as an OFC any financial centre where offshore activity takes place. This definition would include all the major financial centres in the world. A more practical definition of an OFC is a centre where the bulk of financial sector activity is offshore on both side of the balance sheet (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. On the grounds of this definition, according to the IMF, an OFC can be

[108] IMF, *Offshore Financial Centers – IMF Background Paper,* Washington DC, June 2000.

[109] Most of the IMF's discussion relates to banking activity, because that was the only sector for which statistics were available.

[110] P. Reuter, D. Truman, *Chasing Dirty Money. The Fight Against Money Laundering*, Washington, 2004, 88 highlight that in addition some Fund members perceived the assessment task as being only loosely related to the institution's core responsibility to ensure macroeconomic and financial stability.

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referred to as: (i) a jurisdiction that has relatively large numbers of financial institutions engaged primarily in business with non-residents; (ii) a financial system with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and (iii) a centre which provides some or all of the following services: low or zero taxation, moderate or light financial regulation, banking secrecy and anonymity.

If one adopts the broad IMF definition of OFC, there is a great variety of OFCs, ranging from those with regulatory standards and infrastructure similar to those of the major international financial centres[111] to those where supervision is non-existent. Thus, the IMF proposes the use of the following taxonomy of OFCs: International Financial Centres (IFCs), Regional Financial Centres (RFCs) and OFCs. IFCs[112] are large international full-services centres with advanced settlement and payment systems, supporting large domestic economies, with deep and liquid markets where both the sources and uses of funds are diverse, and where legal and regulatory frameworks are adequate to safeguard the integrity of principal-agent relationships and supervisory functions. IFCs generally borrow short-term from non-residents and lend long-term to non-resident. RFCs differ from IFCs, as they have developed financial markets and infrastructure and intermediate funds in and out of their region, but have relatively small domestic economies.[113] OFCs represent a third category, as opposed to IFCs and RFCs. They are smaller, provide more limited specialist services and skilled activities, so to attract major financial institutions, are more lightly regulated and taxed and have very limited resources to support financial intermediation.

Tax haves were also scrutinised by another high-income tax countries' initiative, i.e. the Financial Stability Forum (FSF), which in April 2000 focused its attention on threats to the stability of the world's financial system after the 1997 Asian financial crisis.[114] The FSF Working Group on Offshore Financial Centres was set up to review the uses and activities of OFCs and their significance for global financial stability. The Report on Offshore Centres[115] released on 5 April 2000 aimed at considering the

[111] The IMF mentions Hong Kong and Singapore.

[112] According to the IMF examples of IFCs are London, New York and Tokyo. In terms of assets, London is the largest and most established centre, followed by New York, the difference being that the proportion of international to domestic business is much greater in the former.

[113] The examples of RFCs given by the IMF include Hong Kong, Singapore (where most offshore business is handled through separate Asian Currency Units) and Luxembourg.

[114] The Forum was transformed into the Financial Stability Board at the G-20 summit that was held in London on 2 April 2009.

[115] Financial Stability Forum (FSF), *Report of the Working Group on Offshore Centres*, available at http://www.financialstabilityboard.org/publications/r_0004b.pdf. The FSF established an ad hoc Working Group on Offshore Financial Centres, which submitted the report for discussion at the FSF meeting in Singapore on 25-26 March 2000. The importance of the mentioned report can be highlighted by its transmission to the G-7 Ministers and Governors, to the G-20 Ministers and Governors, as well as to the heads of the International Monetary Fund and the World Bank.

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significance of OFCs in relation to financial stability in all its aspect, at identifying the key aspects of OFCs in terms of financial supervision, cross-border cooperation, and transparency, as well as at developing recommendations to strengthen the global financial system. In conducing this work, the Working Group settled at this purpose drew on OFC-related work undertaken by international institutions, standard-setting bodies and national authorities, the available analytic work on OFCs and considered the then recent episodes of financial crisis and the role of OFCs.[116] Taxation in OFCs has not been subject to analysis by the Working Group.[117]

According to the FSF, any jurisdiction can be considered “offshore” to the extent that it is perceived as having a more favourable economic regime than another, e.g. low corporate tax rates, light regulation, special facilities for company incorporation, or highly protective secrecy law.[118] Due to the difficulties of providing a clear and precise definition of OFCs, the FSF opts for welcoming a very broad one and labels as OFCs those jurisdictions that attract a high level of non-resident activity. While OFCs are commonly perceived to be small island States, a number of advanced countries have succeeded in attracting very large concentrations of non-resident business by offering economic incentives either throughout their jurisdiction or in special economic zone. Due to the great number of jurisdictions that might fall within the scope of such a definition, the FSF underlines that traditionally the term has implied some or all of the following characteristics, although not all OFCs operate this way: low or no taxes on business or investment income; no withholding taxes; light and flexible incorporation and licensing regimes; light and flexible supervisory regimes; flexible use of trusts and other special corporate vehicles; no need for financial institutions and/or corporate structures to have a physical presence; an inappropriately high level of client confidentiality based on impenetrable secrecy laws; and unavailability of similar incentives to residents.

The above definition seems to be in line with those provided in the literature: a less strict regulation than that of high-tax countries, including taxation, secrecy and financial activity, provokes an excess of business activity of non-resident investors compared to the volume of domestic business. The fact that the FSF does not specifically refer to “tax haven” should derive from the consideration that its main attention was not focused on tax regimes provided for by these jurisdictions, but rather on the stability of the financial systems.

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[116] It is worth noting that, according to paragraphs 13 and 16 of the Report, the FSF observes that there was a general recognition that significant work on OFCs was undertaken in other international fora, such as the Financial Action Task Force on Money Laundering, the OECD on tax competition, as well as bribery and corruption, and therefore duplication of work was avoided. As a result, the Group aimed at building on existing initiatives, where appropriate, and recommended new initiatives only where some gaps apparently existed.

[117] See the Report, page 10.

[118] Paragraph 18 of the Report. In this sense it clearly emerges that such a definition is very similar to that provided by the 1998 OECD Report on tax havens, especially as far as the general perception of their offshore status by other jurisdictions is concerned.

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Finally, also the Financial Action Task Force on Money Laundering (FATF) has also been concerned with the tax haven definition. FATF, which is also known with its French name “Groupe d’Action Financière” (GAFI), is the leading international body on anti-money laundering. After having established an *ad hoc* Group to tackle with the problem of what it defines “non-cooperative countries or territories” (“NCCTs”) and to discuss about future action to be taken against them, on 14 February 2000 it issued an initial Report on the issue of NCCTs, setting out twenty-five criteria to identify detrimental rules and practices which impeded international cooperation in the fight against money laundering. This Report also described a process designed to identify NCCTs and to encourage these latter to implement international standards in this area. Finally, the Report contained a set of possible countermeasures that FATF members could use to protect their economies against the proceeds of crime.

The Report set out twenty-five criteria to identify detrimental rules and practices which impair the effectiveness of anti-money laundering systems[119] and impede international cooperation in the fight against money laundering, and was followed by annual Reports containing lists of NCCTs.[120] The FATF Report prefers the expression NCCTs to that of OFCs.[121] The reason of such a choice can be found in the circumstance that FATF does not deal with taxation, but rather focuses its attention on those countries which it perceives to be non-cooperative in the global fight against money laundering and terrorist financing only.[122]

The criteria defining NCCTs are grouped into the following four categories[123]: loopholes in financial regulations; obstacles raised by other regulatory requirements; obstacles to international cooperation; and inadequate resources for preventing and detecting money laundering activities. Concerning loopholes in financial regulations, FATF furthermore distinguishes the following five criteria: no or inadequate regulations and supervision of financial institutions; inadequate rules for the licensing

[119] According to paragraph 7 of the 14 February 2000 Report, detrimental rules and practices obstruct international cooperation against money laundering, affect domestic prevention or detection of money laundering, government supervision and the success of investigations into money laundering. Deficiencies in existing rules and practices have potentially negative consequences for the quality of the international cooperation which countries are able to provide.

[120] The first Report was published on 22 June 2000 and listed fifteen countries regarded as uncooperative in the fight against money laundering. In subsequent annual Reports some countries were removed from the list and in the FATF “statement” released on 25 September 2009 only five countries were of concern.

[121] The term “non-cooperative” could be indeed misleading, as a number of countries which have appeared on the FATF list appear not because they deliberately propagate a culture which is perceived to assist money laundering and terrorist financing, but because they simply lack the infrastructure or resources to cope with relatively sophisticated financial criminals who try to operate there.

[122] Paragraph 1 of the 22 June 2000 Report clearly states that it has been established as the International standard for effective anti-money laundering measures.

[123] See Annex to the 14 February 2000 Report.

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and creation of financial institutions, including assessing the backgrounds of their managers and beneficial owners; inadequate customer identification requirement for financial institutions; excessive secrecy provisions regarding financial institutions, and lack of efficient suspicious transactions reporting system.

As far as obstacles raised by other regulatory requirements are concerned, the two criteria identified by FATF are: inadequate commercial law requirements for registration of business and legal entities; and lack of identification of the beneficial owner(s) legal and business entities. With reference to obstacles to international cooperation, the criteria consist of: obstacles to international cooperation by administrative authorities; and obstacles to international cooperation by judicial authorities. Finally, concerning inadequate resources for preventing and detecting money laundering activities, the criteria set forth are: lack of resources in public and private sectors; and absence of financial intelligence unit or of an equivalent mechanism.

8. The definition proposed by the Tax Justice Network: tax havens as "secrecy jurisdictions"

As a response to the OECD's activities,[124] the well-reputed Tax Justice Network (TJN), which conducts some relevant research on the tax haven phenomenon, in a very recent initiative coined the terms "secrecy jurisdictions".

TJN is an independent organisation launched in the British House of Parliament in March 2003. Without being aligned to any political party, TJN takes together, among the others, academics, accountants, economists, financial professionals, lawyers and journalists, who are dedicated to high-level research and analysis in the field of tax and regulation. In particular, TJN observes the role of taxation and the harmful impact of tax evasion, tax avoidance, tax competition and tax havens especially on developing countries and encourages reforms both at the international and national level.

Following the London G-20 summit in 2009 and the 2 April 2009 OECD black/grey list for categorising centres which fail to cooperate with other jurisdictions on tax and transparency issues, TJN launched the so-called "Mapping the Faultlines" project ("MFP").[125] MFP is an eighteen-month project aimed at looking at how secrecy operates through global financial markets in order to evaluate which places contribute to the secrecy that facilitates illicit financial flows, including flows from developed to developing countries. The main goals of MFP are: to define the problem of the secrecy world; to assess the way in which it facilitated illicit financial flows; to

[124] Chapter 5 of the present work is devoted to this subject.

[125] All reports and studies are published on the website http://www.secrecyjurisdictions.com.

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appraise its significance; and, finally to suggest where and how those flows were occurring.

The outset of MFP is the lack of a unanimously accepted definition in the literature of "tax havens" or "OFCs". It observes that what is generally referred to as "tax haven" does not really rely on tax, but rather on secrecy, which represents the main element of attractiveness of such jurisdictions. This includes: (i) strong bank secrecy and (ii) secrecy of legal entities. Tax considerations are, according to MFP's view, normally secondary to the provision of secrecy. As a result, MFP chooses to refer to those jurisdictions as "secrecy jurisdictions", which are therefore defined as "places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so".[126]

MFP is divided in two stages: Stage 1, the purpose of which is to identify secrecy jurisdictions and mechanisms used to facilitate illicit financial flows worldwide, including especially flows from developing countries; and Stage 2, the purpose of which is to recommend policy measures to address the issues identified in Stage 1. The starting point of MFP is that all countries have some attributes of secrecy jurisdictions, ranging on an imagined continuum from highly secretive to perfectly transparent. Therefore, MFP selects a set of indicators which allow an assessment to be based on how the legal and regulatory systems of a country or its dependent territories contribute to the secrecy that enables illicit financial flows. MFP intended to be as parsimonious as possible by selecting a relatively small number of indicators, in order to avoid unnecessary complexity and therefore ensure that its work could be carried forward without undue cost or delay caused by data gaps.

A number of ninety-one jurisdictions that appeared at least once in one tax havens or OFCs list elaborated by international organisations and the academic literature were those under scrutiny.[127] Locations listed only once were not analysed, as considered

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[126] Research Briefing "Secrecy Jurisdictions" issued ikn September 2010 by the TJN and available at www.financialtaskforce.org/wp-content/uploads/2010/10Secrecyjurisdiction.pdf.

[127] The list of tax havens under scrutiny by the MFP are: International Bureau of Fiscal Documentation 1977, quoted in C.R. Irish, *Tax Havens*, Vanderbilt Journal of Transnational Law, 3/1982, 449-510; C.R Irish, *Tax Havens*, Vanderbilt Journal of Transnational Law, 3/1982, 449-510, 1982; J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 149-182; Financial Stability Forum, *Report of the Working Group on Offshore Centres*, 2000; International Monetary Fund, *Offshore Financial Centers – IMF Background Paper*, Washington DC, June 2000; OECD 2000; Financial Action Task Force, *Report on Non-Cooperative Countries and Territories,* Paris, 2000; Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories: Increasing the World-Wide Effectiveness of Anti-Laundering Measures,* Paris, 2002; M.P. Hampton, J. Christensen, *Tax us if you can. The true story of a global failure*, London, 2005 for the Tax Justice Network; A. Zoromé, *Concept of Offshore Financial Centers: in Search of an Operational Definition* IMF Working Paper WP/07/87, 2007, 1-32; C. Levin, *A Bill to Restrict the Use of Offshore Tax Havens and Abusive Tax Shelters to inappropriately Avoid Federal*

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being of insufficient evidence of concern.[128] The result was a selection of sixty secrecy jurisdictions, which were subject to further study through the so-called “Financial Secrecy Index” (“FSI”), as hereinafter explained.

The methodological approach chosen to identify secrecy jurisdictions seems to be conceived as nothing but a *species* of a broader *genus*, i.e. tax havens or OFCs, as what is perceived tax havens or OFCs is the starting point of the MFP. The selection of a “secrecy jurisdiction” is based on a comparison of eleven lists of countries, which are already considered tax havens or OFCs according to different (subjective) definitions.

As above mentioned, the selection of the sixty jurisdictions was then subject to further analysis according to the FSI, which is an index conceived to reveal which secrecy jurisdictions are most to blame for supplying financial secrecy. FSI is based on two measurements: a qualitative measurement (i.e. the Opacity Score) and a quantitative measurement (i.e. the Global Scale Weighting). The Opacity Score looks at jurisdiction’s laws and regulations, international treaties and cooperation exchange processes. The assessment is given in the form of an opacity score, so that the higher the score, the more opaque is the jurisdiction. This is considered as the most important measurement because it assesses how aggressive a jurisdiction is in providing secrecy.[129] The Global Scale Weighting weights each secrecy jurisdiction according to its scale of cross-border financial services activity and attaches a weighting to take account of the jurisdiction’s size and overall importance to the

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Taxation, and for Other Purposes, Law Proposal, US Senate, 1st Session, 110th Congress, 17.2.2007, S.681, Washington DC (for the Stop the Tax Haven Abuse Act in the US); available at www.lowtax.net.

[128] However, the following changes were made: Niue (included in 5 lists) was eliminated from the survey as the IMF indicated in 2008 that it was no longer providing any significant secrecy jurisdiction service; Tonga and South Africa (both included in 2 lists) were removed from the survey for the same reasons; Delaware was identified as the main cause of concern in the USA (included in 2 lists); Austria (no listed) and Belgium (included in 1 list) were added because of their refusal to cooperate with the EU Savings Tax Directive, indicating serious secrecy jurisdiction activity.

[129] The Opacity Score is based on 12 indicators. Such indicators can be grouped by theme as follows: 1. Knowledge of beneficial owner (which consists of four additional indicators, i.e. the existence of formal banking secrecy; the existence of a Public Trust and Foundation Registry; availability of the information about the beneficial ownership of entities on public record online; and whether information about beneficial ownership of entities is submitted and kept updated by a competent authority); 2. Key aspects of corporate transparency regulation (which consist of three indicators, i.e. whether the secrecy jurisdiction allows redomiciliation of entities; whether the secrecy jurisdiction allows the registration of protected cell companies within their domain; and whether accounts of companies and other entities registered within it can be accessed by the public); and 3. International cooperation (which consists of five indicators, i.e. whether the jurisdiction responded to MF request of information; whether the secrecy jurisdiction participates in automatic information exchange (EU Savings Tax Directive); whether the secrecy jurisdiction has shown serious commitment to bilateral information exchange covering all tax matters (60 bilateral treaties); whether the authorities in the secrecy jurisdiction have effective access to banking information within their domain for information exchange purposes; and its FAFT rating).

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global financial market.[130] An arithmetical multiplication of the two measurements gives the FSI, which ranks secrecy jurisdictions according to their degree of opacity and the scale of their cross-border financial services activity.

The FSI was then applied to each of the sixty selected secrecy jurisdictions. On the grounds of these data, the MFP issued sixty Jurisdiction Reports, which reveal the opacity score for each secrecy jurisdiction and explain how the score can be improved upon. The result is that of the sixty jurisdictions included: forty-one have formal banking secrecy; none has a central registry of trusts and foundations publicly accessible via the internet (a key requirement to prevent financial abuse); fifty-four are without public company accounts on record; and fifty-nine do not require beneficial company ownership to be disclosed on public record. On the basis of the FSI, MFP elaborated a final Financial Secrecy Index Rank of the secrecy jurisdictions under scrutiny.[131]

Due to the fact that the MFP outcome is not in line with the recent OECD's work on jurisdictions surveyed by the Global Forum in implementing the internationally agreed tax standard,[132] the TJN expressed its comments upon the 2009 OECD's list system,

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[130] The Global Scale Weights captures the role of each jurisdiction in the global provision of financial services to non-residents in order to measure how big a player each jurisdiction is. By applying the method of research elaborated by A. Zoromé, *Concept of Offshore Financial Centers: in Search of an Operational Definition*, IMF Working Paper WP/07/87, 2007, 1-32, it relates the level of exports of financial services by each country to a measure of its national income or domestic financing need. More specifically, it is the ratio of the net financial services exports to GDP. The measurement of such a value is based on publicly available data about the trade in international financial services of each jurisdiction and, in case of missing data, on the IMF methodology to extrapolate from stock measures flow estimates. Although the operational and measurable indicators developed by Zoromé (and adopted by the MFP) are broadly considered as one of the most credible existing tests to identify OFCs, there are some questionable issues with the methodology adopted. First, the indicators used by Zoromé were used by the same researcher to elaborate a list of OFCs and to give a definition of OFCs. Such a list was taken into account by the MFP in order to select the first range of jurisdictions to put under scrutiny. In other words, the product of the research of Zoromé is a list of jurisdictions from which the MFP departs. The application of a methodology to a range of jurisdictions already selected under the same methodology cannot lead to some new results. Second, a statistical methodology shows only the relatively successful tax havens or OFCs. There are a good number of "failed" OFCs among the small Pacific Islands and some Caribbean islands which tried but failed to develop from being a tax haven to hosting a functional OFC, and hence do not show up in his methodology. Third, some data are not available for many of the territories identified by other agencies as both tax havens and OFCs. Consequently, this approach is limited in application and might result in incomplete outputs as a result of incomplete inputs. Fourth, Zoromé's methodology ends up labelling a whole jurisdiction as a OFC on the grounds of the "excessive" provisions of financial services by one of its geographical area (State or region, such as the U.S. for Nevada and Delaware, Russia for Ingushetia, Malaysia for Labuan or U.K. for the City of London).

[131] The Top 10 opaque States are: USA (Delaware), Luxembourg, Switzerland, Cayman Islands, United Kingdom (City of London), Ireland, Bermuda, Singapore, Belgium and Hong Kong. The FSI value of these mentioned jurisdictions is much higher than that of "traditional" tax havens, which are instead placed at the very bottom of the rank.

[132] The 2009 OECD work will be more deeply analysed in Chapter 5. Here it is worth only mentioning that the Global Forum established within the OECD has been the multilateral framework within which

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which is considered as “based on a weak standard of transparency”. According to the TJN, the OECD’s criteria “for making it onto the financial white list are hopelessly inadequate. (…) A financial centre can qualify by signing Tax Information Exchange Agreement (TIEAs) with other twelve jurisdictions. Any twelve jurisdictions will do, including other blacklisted financial centres and economically marginal microstates”.[133] The signature of twelve TIEAs by one jurisdiction is viewed by the TJN as not necessarily meaning that any information will be exchanged. Countries should in fact amend their domestic laws to allow them to theoretically exchange information for tax purposes, as well as implement mechanisms to obtain information.

Thus, according to the TJN, the bilateralism of TIEAs produces two related difficulties. First, the system has only led a few links between many players. Second, developing countries have been all but left out of the system. Multilateralism would be far more comprehensive and effective, but not in the terms provided by the OECD’s Model TIEA. The multilateral version of the TIEA is not considered by the TJN as a multilateral agreement in the traditional sense. It instead provides the basis for an integrated bundle of bilateral treaties, so each treaty partner would continue to negotiate individually with every other single treaty partner about whether or not to exchange information.

Finally, the TJN remarks that the OECD list system does not include OECD member States – like Delaware and the City of London – which are also secrecy jurisdictions, and as revealed by the FSI, are amongst the most important suppliers of financial

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work in the area transparency and exchange of information has been carried out by both OECD and non-OECD economies since 2000. The Global Forum’s main achievements have been the development of the standards of transparency and exchange of information through the publication of the Model Agreement on Exchange of Information on Tax Purposes in 2002 and the issuance of a paper setting out the standards for the maintenance of accounting records Enabling Effective Exchange of Information. Since 2006, the Global Forum has produced an annual assessment of the legal and administrative framework for transparency and exchange of information in over 80 jurisdictions. Further to the G20’s London summit the OECD Secretariat issued a list of jurisdictions that identifies (i) jurisdictions that have substantially implemented the standard, (ii) other jurisdictions that have committed to but not yet implemented the standard and tax havens that have committed to but not yet implemented the standard, and (iii) jurisdictions that have not committed to the standard. The internationally agreed tax standard on exchange of information, as developed by the OECD and endorsed by the UN and the G20, provides for full exchange of information on request in all tax matters without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanged. According to the OECD’s experts, a good indicator for distinguishing between those jurisdictions that have “substantially implemented” the internationally agreed tax standard and those that have not is whether a jurisdiction has signed twelve agreements on exchange of information that meet the OECD standard. This threshold will be reviewed to take account of (i) the jurisdictions with which the agreements have been signed (a tax haven which has 12 agreements with other tax havens would not pass the threshold), (ii) the willingness of a jurisdiction to continue to sign agreements even after it has reached this threshold and (iii) the effectiveness of implementation.

[133] TJN, *The Financial Secrecy Index and the OECD blacklist*, 7/10/2009, available at www.financialsecrecyindex.com/documents/FSI%20-%20OECD%blacklist.pdf.

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secrecy. MFP considers that its own approach overcomes the sampling deficiencies of the 2000 OECD black list and the "rather arbitrary nature of the black/grey/white list published by the OECD in 2009". These lists, in fact, excluded the UK (where City of London being widely identified as a key player in offshore finance) and the USA (where questions are frequently raised over the transparency of a number of States, not least Delaware, Nevada and Wyoming).

9. Definition of tax havens through inclusion in blacklists

Since one of the attributes of tax havens is reputation, international organisations (and subsequently domestic legislations) thought of attacking these jurisdictions' reputation by including them on "black lists" in order to reduce their attractiveness to investors. Such a political sanction imposed by the international community of States is commonly known as the "name and shame" approach,[134] and it is aimed at encouraging compliance by the targeted jurisdictions.[135]

In the academic literature, a first black list was prepared by Hines and Rice in 1990.[136] The authors departed from the consideration that tax havens are locations

[134] According to B. Zagaris, *Issues Low-Tax Regimes Should Raise When Negotiating With the OECD*, Tax Notes International, 5/2001, 524, in a practical and legal sense, the issuance of blacklists are (sic) not merely "naming and shaming" but the imposition of economic sanctions. The consequences of being included in black lists will be dealt with in Chapter 4.

[135] J. Grocott, *A time for tax transparency and clarity*, International Tax Review, 3/2010, 13. According to R.T. Kudrle, *Did blacklisting hurt the tax havens?*, Journal of Money Laundering Control, 1/2009, 37 three are the main effects of appearing in a black list. The first one is obviously the attack to reputation of the haven jurisdiction. This would undermine the investors' confidence to use tax haven for any purpose, so that money placed there would be expected to be withdrawn. Second, if the purpose the investor is served by continued laxity or recalcitrance in the face of successful external pressure for reform in competitive jurisdictions, then the volume of investment placed in the tax haven might be expected to increase. Third, if investor behaviour is overwhelming driven by factors other than the reputational attack made by the blacklist, there will be no independent effect or at least none large enough to be detected.

[136] J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, The Quarterly Journal of Economics, 2/1994, 149-182. It must be remarked that due to the lack of a common definition of tax haven in the literature, there are diverging opinions about the different criteria and indicators to use in order to include a jurisdiction in a black list. For example, J.R. Hines, *Do Tax Havens Flourish*?, in J.M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99, D. Dharmapala, J.R. Hines, *Which countries become tax havens?*, Journal of Public Economics, 93/2009, 1058-1068, focus on the size of tax haven activity looking at the direct investment they attract, whereas A.K. Rose, M.M. Spiegel, *Offshore Financial Centres: Parasites or Symbionts?*, Economic Journal, 523/2007, 1310-1335, look at the financial investments that flow through them. According to R.T. Kudrle, *Did blacklisting hurt the tax havens?*, Journal of Money Laundering Control, 1/2009, 39, although blacklisting could affect both, the stock of direct investment is typically slower to respond to changes in the economic environment and can be expected to be based on knowledge of local conditions greater than that of those drawing up blacklists. Hence, perturbation of some measure of financial investment would seem to provide the best test of the impact of blacklisting. Furthermore, one can focus on overseas holdings of assets from tax havens or the holding of assets in the havens

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with low taxes and as such they are attractive to business. Hines and Rice developed an econometric analysis that resulted in a list of forty-one jurisdictions identified as tax havens.

On 5 April 2000 the FSF issued a Report, in which it just compared the offshore financial sectors with each other and presented a black list.[137] Some months after, the FATF published a Report[138] in which fifteen territories were considered as non-cooperative and thus the FATF urged to adopt measures in order to remedy the deficiencies identified in its reviews. These territories were considered as delinquent due to: inadequate financial regulation including customer identification; the permission or mandating of excessive financial secrecy; a lack of a suspicious transaction reporting system; other regulatory problems including the failure to require adequate information on the beneficial owners of various kinds of businesses; obstacles to international cooperation due to administrative and judicial constraint; and inadequate anti-money laundering budgets and agency activity. Over the following months, some States were added, some others were removed and after 11 September 2001, the attention shifted on terrorist funding. In 2004 only six countries were still on the black list.

Similarly, following the 1998 Report and the recommendations here contained to counter harmful tax practices, the OECD issued a Report in 2000,[139] after a review process of the preferential tax regimes identified in the 1998 Report. The 2000 Report blacklists thirty-five countries which were found to meet the tax haven criteria identified in the 1998 Report (i.e. no or only nominal taxes; lack of effective exchange

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from abroad, and the focus can include inter-bank holdings or focus only on the activity of non-banks. J. Alworth, S. Andresen, *The determination of cross-border non-bank deposits and the competitiveness of financial market centres*, Money Affairs, 106-133, July-December, 1992, employ asset data for non-banks in various financial centres as the focus on their concern. J. Alworth, D. Masciandaro, *Public policy: offshore centres and tax competition: the harmful problem*, in D. Masciandaro (Ed.), *Global Financial Crime: Terrorism, Money Laundering, and Offshore Centres*, Aldershot, 2004, 209, employ a similar measure noting “deposits by non-banks [...] may likely capture tax evasion or money laundering”. H. Huizinga, G. Nicodème, *Are international deposits tax driven?*, Journal of Public Economics, 6/2004, 1093-1118 employ external liabilities and deposits from non-banks as their principal variable in a study with a declared purpose similar to that of Alworth and Andresen. P. Reuter, D. Truman, *Chasing Dirty Money*, Washington, 2004, 88-89 use data on total cross-border financial (banking system) assets to discuss the apparent stability of the top five offshore financial centres share over the period 1992-2003.

[137] According to the 2000 FSF Report, 2, the categorisation does not constitute judgments about any jurisdiction’s adherence to international standards, and the inclusion in a particular group does not imply that such a categorisation applies to all sectors of the financial system within an OFC.

[138] Financial Action Task Force on Money Laundering, *Review to Identify Non-Cooperative Countries and Territories: Increasing The Worldwide Effectiveness of Anti-Money Laundering Measures*, Paris, 22 June 2000.

[139] OECD, *Towards Global Tax Co-operation. Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs. Progress in Identifying and Eliminating Harmful Tax Practices*, Paris, 2000.

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of information; lack of transparency; and no substantial activities).[140] The black list did not include those jurisdictions that, despite meeting the mentioned criteria, made a public “advance commitment” to eliminate their harmful tax practices and to comply with the principles of the 1998 Report.[141] Over the years, the listed countries were subject to review process and some of them were removed from the list. While the criterion of the “lack of substantial activities” was abandoned,[142] the attack on secrecy in the services of tax evasion remained.

The list issued by the OECD on 2 April 2009, following the London G20 summit, abandons the criteria based on taxation, in order to better focus on cooperation on tax and transparency and exchange of information. It distinguishes between jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented it, other financial centres and jurisdictions that have not committed to the internationally agreed tax standard.

Also the TJN issued a black list containing secrecy jurisdictions, rather than tax havens. According to the TJN, secrecy is at the core of the problem and tax abuses are an outcome of secrecy. Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. The data assembled resulted in a list of sixty secrecy jurisdictions that were subject to further study through the FSI, as above explained.

The following table contains a summary of the above mentioned black lists to compare them together with an aggregate ranking listing the jurisdictions on the bases of the times of inclusion in the six different black lists considered here.

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[140] According to Recommendation 16 of the 1998 Report (paragraphs 149-151), the Forum was instructed to establish, within a year from its inception, a list of tax havens, taking into account the factors set out in Section II of Chapter 2 of the 1998 Report. This would have been an initial non-exhaustive list, subject to review by the Forum.

[141] See paragraph 17 of the 2000 Report.

[142] According to paragraph 27 of the *2001 OECD Progress Report on the OECD’s Projects on Harmful Tax Practices*, the determination of whether local activities are sufficiently substantial is difficult. Consequently, in interpreting the no substantial activities criterion, the Forum sought to determine whether there were factors that discouraged substantial domestic activities. In the light of the discussions with the jurisdictions, the Committee concluded that it should not use this method to determine whether or not a tax haven is uncooperative.

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Country	Hines and Rice	OECD 2000	IMF 2000	FSF 2000	FATF 2000/2002	OECD 2009	Times of inclusion
Antigua & Barbuda	✓	✓	✓	✓	✓	✓	6
Bahamas	✓	✓	✓	✓	✓	✓	
Belize	✓	✓	✓	✓	✓	✓	
Bermuda	✓	✓	✓	✓	✓	✓	
British Virgin Islands	✓	✓	✓	✓	✓	✓	
Cayman Island	✓	✓	✓	✓	✓	✓	
Cook Islands	✓	✓	✓	✓	✓	✓	
Gibraltar	✓	✓	✓	✓	✓	✓	
Liechtenstein	✓	✓	✓	✓	✓	✓	
Marshall Islands	✓	✓	✓	✓	✓	✓	
Monaco	✓	✓	✓	✓	✓	✓	
Panama	✓	✓	✓	✓	✓	✓	
St. Vincent & Grenadines	✓	✓	✓	✓	✓	✓	
St. Kitts & Nevis	✓	✓	✓	✓	✓	✓	
St. Lucia	✓	✓	✓	✓	✓	✓	
Andorra	✓	✓	✓	✓		✓	5
Anguilla	✓	✓	✓	✓		✓	
Bahrain	✓	✓	✓	✓		✓	
Cyprus	✓	✓	✓	✓	✓		
Dominica	✓	✓	✓		✓	✓	
Grenada	✓	✓	✓		✓	✓	
Guernsey	✓	✓	✓	✓	✓		
Isle of Man	✓	✓	✓	✓	✓		
Jersey	✓	✓	✓	✓	✓		
Malta	✓	✓	✓	✓	✓		
Nauru		✓	✓	✓	✓	✓	
Netherlands Antilles	✓	✓	✓	✓		✓	
Niue		✓	✓	✓	✓	✓	
Samoa		✓	✓	✓	✓	✓	
Turks & Caicos Islands	✓	✓	✓	✓		✓	
Vanuatu	✓	✓	✓	✓		✓	
Barbados	✓	✓	✓	✓			4
Lebanon	✓		✓	✓	✓		
Luxembourg	✓		✓	✓		✓	
Mauritius		✓	✓	✓	✓		

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Montserrat	✓	✓	✓			✓	
Singapore	✓		✓	✓		✓	
Switzerland	✓		✓	✓		✓	
Aruba		✓	✓	✓			**3**
Costa Rica			✓	✓		✓	
Hong Kong	✓		✓	✓			
Ireland	✓		✓	✓			
Liberia	✓	✓				✓	
Macau	✓		✓	✓			
Malaysia (Labuan)			✓	✓		✓	
Seychelles		✓	✓	✓			
Guatemala					✓	✓	**2**
Maldives	✓	✓					
Philippines					✓	✓	
San Marino		✓				✓	
Austria						✓	**1**
Belgium						✓	
Brunei						✓	
Chile						✓	
Egypt					✓		
Hungary					✓		
Indonesia					✓		
Israel					✓		
Jordan	✓						
Myanmar					✓		
Nigeria					✓		
Palau			✓				
Russia					✓		
Tonga		✓					
Uruguay						✓	
US Virgin Islands		✓					
Ukraine					✓		

These data clearly show that there exists no common view as to which country should be labelled as a tax haven. "Tax haven" is a term neither precise nor well-defined. The lack of precision in the use of this term results in different black lists based on various criteria. While some small jurisdictions (i.e. those included six or five times in the black lists under consideration) are broadly considered as tax havens and are notorious offshore financial centres, jurisdictions included in only two

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or one black list might provide for some favourable tax regimes to non-resident investors, but should not be a matter of concern.

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CHAPTER 2

ORIGINS, EVOLUTION AND IMPACT OF TAX HAVENS

After having highlighted in Chapter 1 the lack of a clear and unanimously acknowledged definition of the expression “tax havens”, this Chapter intends to discuss about the origins, the evolution and the impact of tax havens in order to better understand the phenomenon. The purpose of the analysis developed in the present Chapter is to understand whether the identification of the source of the tax haven phenomenon might be helpful to take action against them. To that purpose, it is demonstrated that tax havens have always existed in the form of “tax-minimisation strategies” by sovereign jurisdictions (paragraph 1) and that they have originated from the worldwide taxation principle, on which tax systems of modern high-tax countries are normally based (paragraph 2). In fact, the most common tax planning techniques used by multinational companies and wealthy individuals through tax haven jurisdictions (which are briefly described in paragraph 3) are based on the existing tax laws in their home countries. This thus demonstrates that the tax haven phenomenon has deep root in the experience of worldwide taxation by capital exporting countries, and has a great impact on other countries’ tax bases. Finally, the exam is focused on a quantitative analysis of the effects tax havens have on high-tax countries (which have drawn the most attention in the literature) and on developing countries (paragraph 4).

1. Origins of tax-minimisation strategies by sovereign jurisdictions

There is no unanimous consent about the origins of tax havens in the literature. However, since all existing stories denote a strong dependent relationship from States’ jurisdiction (and in particular taxation), it seems that there exists conceptual affinity between sovereignty, on the one hand, and tax havens and OFCs, on the other hand. According to some authors,[143] strategies of minimisation of taxation through the use of other polities deemed safe as asset havens date back to Greek and Roman times. Ancient Greek merchants used to store their merchandises in

[143] C. Doggart, *Tax Havens and their Uses*, London, 2002.

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islands near Athens, in order to avoid the payment of a 2% tax on imported goods.[144] In the mid-eighteenth century, similar techniques of storage of goods for tax purposes were used in Holland, England and France, when merchants put merchandise to be sold in domestic markets at disposal of their customers in some deposits without paying any tax.[145]

In the middle ages, cities of the Hanseatic League (like the City of London) granted resident traders an exemption from all taxes in order to stimulate the prosperity of commerce.[146] In the fifteenth century Flanders (currently Belgium), which was a thriving international commercial centre, imposed few restrictions on domestic or foreign exchange and freed much trade from duties.[147] English merchants supplied the needed raw materials, preferring to sell wool to Belgium rather than to England where they would incur numerous duties. In 1721 the American colonies shifted their trade to Latin America in order to avoid paying duties imposed by England.

Furthermore, in 1868 Prince Charles III of Monaco abolished “with one stroke of the pen all direct taxation”[148] as of 1869, after having authorised games in the casino that the French king Luis-Philippe had banned in France and which allowed him to collect revenues.[149]

Following the Monaco’s example, the practice of reducing corporate taxation can be traced back to the incorporation laws of New Jersey and Delaware. These States, in competition with West Virginia, Rhode Island and Maine, became known for enacting what Alfred Conrad called “strictly for export” laws.[150] Owing to the 1880s need of funds, Governor Abbet of New Jersey was persuaded by a corporate lawyer from New York to raise revenue by imposing a franchise tax on all corporation headquarters in New Jersey. Under such a new scheme, the State liberalised its corporate law to an extent that would make it advantageous for all corporations to be

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[144] C. Doggart, *Ib.*; R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981, 32.

[145] C. Chavagneux, R. Palan, *Les paradis fiscaux*, Paris, 2007, 27-28.

[146] R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981, 20.

[147] R. A. Gordon, *Ib.*

[148] A. Smith, *Monaco and Monte Carlo*, London, 1912, 125.

[149] It seems that he did so because he was fearful of the tax revolts he had seen in his youth and was anxious to show that he was not profiting from the newly established Monte Carlo casino. Nevertheless, since revenue from the casino paid for all the public affairs of Monaco, low taxation and the Mediterranean climate attracted many wealthy visitors and residents, and Monaco became the epitome of the cheerful, fabulously rich tax haven. It took about half a century for Monaco to integrate these laws into a veritable tax haven strategy.

[150] A.F. Conrad, *An overview of the laws of corporations*, Michigan Law Review, 4/1973, 621-690.

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organised there.[151] In 1898, during the debate about the drafting of a new general incorporation act, Delaware sought to emulate the success of New Jersey and it enacted a very liberal legislation to attract corporate business in its territory through the contribution of a group of lawyers from New York.[152]

The origins of OFCs are also obscure. According to Palan[153], the term "offshore" was probably coined in reference to those "offshore" radio stations such as radio Caroline in the UK or the Peace station in Israel which, emulating radio Luxembourg, evaded national broadcasting restrictions by locating on vessels situated just outside the territorial waters of their respective countries. These radio stations were literally "off-shore". The designation was then adopted widely in intuitive recognition that an underlying similar principle was in operation in finance, shipping, manufacturing, and telecommunication.

Such an origin contains a reference to a set of legal precedents and principles that inform the treatment of coastal waters, namely, the Law of the Sea. The tradition of thought that evolved with regard to the sea provides, however, a number of apparently contradictory interpretations. In Roman law, the sea belonged to all humanity and included rights to fishing. Offshore might then be interpreted as the area that belongs to all humanity, a commons, which is external to State sovereignty. However, the term "offshore" may have been adopted in allusion to a different understanding of the role of sovereignty rights over areas adjacent to the State. This interpretation remarks the existence of a close relationship between "offshore" and the concept of sovereignty.

The earliest political concern with coastal waters involved the distribution of favours by rulers, which included exclusive rights to shallow fishing grounds and to salt deposits in tidal marshes, exemption from port or harbour dues, and unhindered transit through narrow straits.[154] The Law of the Sea had to consider the strategic problems traditionally posed by the sea, namely the danger of foreign ships approaching the shores and bombarding at will. For security reasons, monarchs felt obliged to make claims to areas beyond the physical realms of the State, and this, in turn, led sovereigns to argue that the State's legal boundaries did not have to strictly correspond to their territorial boundaries.

The Law of the Sea therefore established two important principles: the principle of discontinuity between legal and physical boundaries and the principle of sovereign claims over a certain territory. While sovereignty is obviously territorial in nature, sovereign rights need not correspond to the physical space of the land. That meant

[151] R.W. Lindholm, *The Corporate Franchise as a Basis of Taxation*, Austin, 1944, 57.

[152] R.C. Larcom, *The Delaware Corporation*, Baltimore, 1937, 9.

[153] R. Palan, *Trying to have your cake and eating it: how and why the State system has created offshore*, International Studies Quarterly, 4/1998, 626.

[154] J.R.V. Prescott, *The Political Geography of the Oceans*, New York, 1975, 32.

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that sovereign claims were no longer bound strictly by the physical boundaries and/or special economic rights. This principle proved to be an important idea, because it opened the door for a definition of fictional or imaginary shores, the latter defined instrumentally. The term "shore", therefore, no longer served as a description of a geographical position of an area that lies between the sea and land, but could be used in legal parlance to describe juridical boundaries.

The second principle recognises the possibility of relative sovereign claims over certain territory. The term "offshore" therefore alludes to a well-established practice of limited sovereignty over certain territories. In the traditional sense offshore meant limited sovereignty over areas adjacent to the State. In the modern sense offshore means a voluntary reduction of State sovereignty so that certain areas or sectors are treated as if a State has only limited sovereignty over them.

Offshore evokes images of the high sea, of activities taking place far away from dry land. This makes one think of offshore as an "in-between" juridical realm where States are unable to apply their massive constraining regulation, including taxation.

With internationalisation of trade and investments the phenomenon of tax havens and offshore grew up intensively. The international fragmentation of production by companies and the decline of tariff and non-tariff barriers to international trade have been the two main factors influencing the birth of these safe spaces.

The proliferation and the growth of tax havens and offshore jurisdictions are therefore a consequence of the increasing sophistication and willingness of traditional capital to take advantage of different regulations among States. Since 1970s, due to the massive and rising taxation and regulations in their home countries,[155] taking advantage of development of communications and telecommunications, as well as of the expanding frontiers of tradable goods (which also allowed non-tradable goods to become tradable), multinational enterprises began relocating their factors of production[156] (and therefore the source of their profits) from OECD countries to other jurisdictions.[157] States affirmed their sovereignty by levying taxes on companies with subsidiaries and other business activity abroad, whereas exponents of capitalism

[155] According to R. Palan, *The emergence of an offshore economy*, Futures, 1/1998, 71, the OECD countries reacted to this enormous flow of investment towards these jurisdictions by legislating against the outflow of capital, by imposing new tariffs, quotas and a variety of informal barriers to trade In this sense, offshore is thus due to States' willingness to use their sovereign privileges to devise laws and regulations aimed at attracting business into their territory and is not an unregulated, free-for-all economic terrain, but only a relatively less regulated and untaxed economic realm that operates within the bounds of the State system.

[156] Such a reallocation of production can be respondent to the simple Heckscher-Ohlin-Samuelson model. If different countries have different factor endowments, this situation will generate either trade or reallocation of factor endowments through labour and capital transfer.

[157] R.Z. Aliber, *The International Money Game*, London and Basingstoke, 1976, 114 held that offshore might be thought of as the "externalisation of activities that has occurred because governments national State or local often regulate the same transactions or activities in different ways".

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demanded protection of their investments and remedies against multiple taxation (i.e. by the State hosting investment and the State of origin).

The need to conciliate these two exigencies led to three solutions. The first one, adopted by the richest countries, consisted in enacting a very important domestic law that regulated foreign business and that recognised contracts signed in a country other than the State of origin as well as legislative, executive or judiciary decisions issued by foreign authorities. The second solution entailed the proliferation of international agreements with the view to harmonising legislation on foreign investments.[158] The main purpose of these treaties was to grant investors of one contracting States and their assets the same level of protection as investors and assets of the other contracting State.[159] Finally, the third solution was to let private companies autonomously regulate problems deriving from international trade (like the *lex mercatoria* of the Middle Ages), when governments were not able to reach any agreement on the applicable rules. When domestic laws conflict with each other at the expense of international exchanges, there was ground to create a space where these laws do not apply or apply less strictly. The growth of over-regulation and over-taxation in the post-war years (especially in OECD economies),[160] on the one hand, and the increasing demand for permissive regulations, on the other hand, offered a number of microstates the opportunity to offer zero or near-zero regulations in order to attract business within their territories.

The introduction of a more permissive regulatory environment by such countries raised the gaps and the differences between national systems, which led to perverse competition in regulatory laxity and to gravitation by some institutions to the least

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[158] S. Sassen, *Losing Control? Sovereignty in the Age of Globalization*, New York, 1996, demonstrates that globalisation takes place through a “denationalisation” of national law. States and domestic parliaments enacted national rules to take into account the needs of foreign investors and the actors of financial markets (deregulation of domestic national markets, independence of central banks and so on). During the twentieth century, national and global needs are considered of the same importance and economic globalisation is an endogenous part of States’ choices. Data of the World Trade Organisation (WTO) show that usage of bilateral and regional treaties to regulate trade and investment matters greatly arises after the beginning of 1990s. Such agreements are the source of regulation of issues relating to competition, investment and environment protection, as well as those topics that do not find a multilateral consensus but that single States enact to give national firms a better protection than that negotiated within the WTO (this is the case, for example, of US with protection of intellectual property rights). See J.A. Crowford, R. Fiorentino, *The changing landscape of regional trade agreements*, WTO Discussion paper No. 8, 2005. Private arbitration between multinational flourish during the twentieth century with the development of global trade and direct investments abroad and international private law develops within this framework.

[159] It is within this framework that the birth of the free movements of workers, of the freedom of establishment and the non-discrimination clauses can be traced.

[160] R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 37-68.

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regulated centres.[161] Reduced tax rates, more favourable tax treaty networks, as well as other tax advantages can be specifically designed to attract intermediate holding companies and multinational enterprise, to attract financial business and consequently to boost the economy of the country.[162] This is why some analysts define tax havens as deliberate State strategies aimed at attracting "hot" money.[163] Permissive prudential regulation and lighter banking rules contributed to a reduction

[161] R.A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983, 6. See also D. Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, Harvard International Law Journal, 2/1991, 423-456. Also A. Miller., L. Oats, *Principles of international taxation*, Haywards Heath, 2006, 12.9 attribute the growth of tax havens to strong regulation in more developed countries. The Authors highlight that the balance of payments crisis that stroke the US in the early 1960s was considered a partial result from US multinationals' investments abroad. One of the solutions adopted by the government, through the introduction in 1963 of the Interest Equalisation Tax, was to limit flows of investment capital out of the country (mainly towards the higher interest rates available in Europe). Similarly, the heavy regulation of US domestic banking sector (the Authors give the example of banks' impossibility to charge interest on deposits made for under 30 days) provoked a massive movement of US money and capital to offshore financial centres, whose more relaxed legislation allowed holding of deposits and other investments also in foreign currencies. London soon became the main location for US funds held overseas and for overseas branches of US banks. Nevertheless, measures enacted by European governments to discourage foreign investors from investing in Europe (i.e. the German 25% withholding tax introduced in 1965 on interest paid by residents to non-residents) paved the way for alternative offshore locations. According to R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981, 18, from 1973 to 1979 total assets of US bank branches increased nine times in the Cayman Islands, eight times in the Bahamas, and four times in Panama and in 1975 125 US banks had 732 foreign branches in total, mainly in the Caribbean, due to the secrecy laws that those countries enacted.

[162] Historically, tax havens were primarily used by wealthy individuals, but in the latter half of the 20th century, their use by multinational enterprises has become widespread. According to A. Miller, L. Oats, *Principles of international taxation*, Haywards Heath, 2006, 12.9., one of the first offshore financial centres was the Netherlands Antilles which from 1953 onwards has benefited from an excellent range of tax treaties extended to it by the Netherlands.

[163] R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 151-176 defines that tax havens are quite simply abusing the system of sovereignty to advanced parochial interests. T. Naylor, *Hot Money and the Politics of Debt*, London, 1987, telling about the famous Mafia boss Meyer Lansky, informs that lawyers and financiers associated with him played a key role in drafting the financial legislation of some of the best-known Caribbean tax havens. In this sense, see also J. Robinson, *The Laundrymen: Inside Money Laundering, the World's Third Largest Business*, London, 1995, 133. A study commissioned by the French Parliament demonstrates that both Liechtenstein and Monaco have persistently and knowingly sought to attract hot if not criminal money. See A. Montebourg, *Rapport d'information déposé en application de article 145 du Règlement par la mission d'information commune sur les obstacles au contrôle et à la répression de la délinquance financière et du blanchiment des capitaux en Europe (1) No. 2311,* Assemblée Nationale, Onzième Législature, Enregistré à la Présidence de l'Assemblée Nationale le 30 mars 2000, Tomé 1 and 2.

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of both corporate and income tax, which are now lower than they were in previous decades[164].

2. The emergence of tax havens from worldwide taxation of resident taxpayers

Increased movements across national frontiers of goods and services, reduced transportation and communication costs, improvements in technologies and great mobility of capital and corporate activity are only a few of those factors resulting from globalisation. As taxpayers are very sensitive to differences in effective tax burdens, increasing volumes of cross-border investment resulted in the conspicuous production of foreign income flowing towards low-tax jurisdictions. The growth of tax haven usage and the emergence of investment in offshore jurisdiction is closely linked to the emergence of multinational enterprises and can be referred to as a product of globalisation.[165] The worldwide taxation principle can thus be considered as one of the factor setting the grounds for tax base erosion.

Facilitated by the gradual reduction or elimination of tariffs and trade barriers, the growth of international trade and the progressive removal of restrictions on the exportation and importation of financial capital made jurisdictional boundaries more mobile. Companies have now the chance to cross national borders very easily and to carry out business activities in several countries, exploiting comparative advantages of different locations. As globalisation facilitated the relocation of corporate activity from one country to another, companies have the opportunity to maximise their after-tax return of investment by easily shifting masses of income towards low-tax jurisdictions.

In this respect, globalisation resulted in the development of the most sophisticated techniques of tax planning.[166] While States try to attract and retain investment and

[164] According to R.A. Johns, C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979*, London and New York, 1993, tax havens played a critical role in the development of the global economy, in particular by acting as "*agents provocateurs*" for the promotion and expansion of boundless financial services. Such an assumption was criticised by R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 41, who affirmed that just because haven financial activity pioneered certain activities before the major economies felt comfortable making them legal at home does not demonstrate that the havens were necessary for the ultimate development of financial globalisation; still less does it explain their persistence in the face of greatly increased competition.

[165] R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 153 highlights that the process of integration of world market resulted in softening the physical borders of States and the strengthening of its juridical unit.

[166] R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 152 euphemistically uses the expression "international tax strategy", which better gives the idea of a process of putting a plan aimed at the maximisation of one's own benefit into operation in a skilful way. The incisiveness of such an expression can be appreciated for its ability to explain the

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the associated tax revenue, taxpayers develop strategies to maximise their after-tax return of investment by locating factors of production in those countries that offer a shelter against their home State's high taxes. It is clear that outside of an international context, tax havens would have no reason to exist. Only in an international environment, with great mobility of factors of production, taxpayers can exploit the disjunctures of the different national tax systems,[167] by relocating and redirecting transactions to different jurisdictions. States, in turn, try to attract investors by offering reduced tax rates, which can be below the levels that they would obtain in the absence of such mobility.[168]

Tax havens are thus a by-product of the complex system of relationships taking place in the international context and they constitute an important factor of international taxation. On the one hand, they are considered as a response by investors to the increase in States' regulation and taxation during the post-war period,[169] as the heavier the regulation and taxation, the keener investors are to avoid them by seeking a shelter from them.[170] On the other hand, tax havens are eroding States' sovereignty, i.e. the ability of States to steer and control economic and social activities within their territorial boundaries. In this respect, tax havens can be considered as a double-edged sword: they are a product of statehood and the cause of its potential dismantling.

Although in political and philosophical thought different definitions of States have been formulated, a State is normally considered as a unitary entity which owns all legitimate social powers and whose decisions are imposed on all its subjects.[171] The

main characteristics of the offshore phenomenon: its attractiveness resides in a less strict regulation and a lower taxation than those practiced by advanced industrial countries. According to the author this expression is another way of saying avoiding or evading taxes.

[167] In the concept of national tax systems the remedy against double taxation should be also included. Taxpayers might in fact exploit not only the tax treaty network of a specific country, but also the natural gaps of two different legislations in order to benefit from double non-taxation.

[168] According to J. Slemrod, *Are corporate tax rates, or countries, converging*?, Journal of Public Economics, 6/2004, 1169-1186 increased mobility can lead to a "race to the bottom" driving business tax rates to minimal levels, due to the fiscal externalities that mobility creates. There is evidence of a general decline in effective tax rates on capital in recent years, as it will be shown in Chapter 4.

[169] According to the Financial Stability Forum, *Report of the Working Group on Offshore Centres*, 5 April 2000, 8 the main contributing factor identified for historical growth of offshore banking and OFCs was the imposition of increased regulation (reserve requirements, interest rate ceilings, restrictions on the range of financial products, capital controls, financial disclosure requirements, high effective tax rates) in the financial sectors of industrial countries during the 1960s and the 1970s. Faced by a growing demand for permissive regulations, a number of microstates began to offer zero or near-zero regulations in order to attract business in their territories.

[170] Banking, insurance and ship registration are the three main pillars of the offshore business and the most heavily regulated industries in developed countries.

[171] The most influential definition of modern State is that by M. Weber, *Political Writings*, Cambridge, 1994, 310, according to which a State is that organisation that has a monopoly on legitimate physical violence over a specific territory. Such an entity imposes its own legal order over a territory, even if it is

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modern State is defined in terms of its territory, i.e. that physical geographic area over which each State has the monopoly of legitimate coercion. Such coercive power, normally exercised by public authorities, is the sovereignty of the State. The scope of the exercise of such sovereign powers is referred to with the term of art "jurisdiction". Jurisdiction is therefore fundamentally territorial, it is the substance of the sovereignty and it is exercised by means of laws directed to subjects through defined, abstract and fictitious categories.[172]

A tax system is normally based on legal categories establishing a special relationship between the taxing country and the taxed subjects. For example, the concept of residence is a legal category used by the State to identify those taxpayers that should be subject to worldwide taxation, so legitimising its right to exercise its sovereignty on an economic event taking place outside its territorial borders.[173] Source taxation is a set of legal categories allowing the right of the State to exercise its sovereignty on an economic activity carried on, even temporarily, by a non-resident within its territory. A multinational company, i.e. a firm carrying out business activity in more than one State, will be subject to the sovereignty of one State, when it operates through a minimum form of establishment within the territory of the host country. Such a minimum form of establishment is expressed through a legal category, i.e. "permanent establishment". Similarly, "legal personality", "citizenship",

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not legally recognised as a State by other States. In the classical liberal though of Emmanuel Kant, the State is also personified in its relationship with other States and conceived as a "horizontal" community of equal sovereign States, and the domestic national sphere dominated by the ultimate "vertical" authority of State law. S. Picciotto, *The end of offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization*, Paper for Conference on *Governing the Public Domain Beyond the Era of the Washington Consensus? Redrawing the Line between the State and the Market*, Robarts Centre for Canadian Studies, Toronto, 4th-5th November 1999, 3, underlines that the sovereignty of the State consists of an impersonal power, wielded by public authorities, and mediated by abstract concepts. These concepts are fluid and subject to interpretation, so that the exercise of State power is adaptable and contestable, trough interpretative practices. Hence, the modern State is an abstract form of political power, a kind of fiction, the substantive content of which can be continually re-imagined and rewritten.

[172] S. Picciotto, *The end of offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization*, Paper for Conference on *Governing the Public Domain Beyond the Era of the Washington Consensus? Redrawing the Line between the State and the Market*, Robarts Centre for Canadian Studies, Toronto, 4th-5th November 1999.

[173] By the end of the 19th century, with the spreading use of the corporate form, the UK, which had a dominant position in the international circulation of both goods and finance, imposed its income tax on all "residents" in respect of all their income from worldwide trade or business. The German Corporate Tax Law of 1920 introduced the new test of the "place of top management", and the Tax Court extended the application of the "organic unity" (*Organschaft*) principle, so that German-based corporate groups could be taxed on their worldwide profits including those earned through foreign subsidiaries. In the US, the income tax was based on "citizenship", so that US citizens and corporations formed under US laws were taxed on income from all sources worldwide. Conversely, France emphasised taxation at source of the revenue derived from an activity, or from movable or immovable property. This enabled a more differentiated approach to the question of jurisdiction, based on the location of the property on the earnings of a business establishment.

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"nationality", "trust", "partnership" and so on are only some of the copious examples of legal categories created by States to assert their tax jurisdiction. The State's power to regulate private activities and transactions in a world market is thus a process of creation and interpretation of these legal categories.[174]

At the international level, a corollary of this potentially unlimited power of the State is the principle of sovereign equality of States. The international system consists of an aggregation of sovereign States, each of which has exclusive powers within its own territory. International investment inevitably entails some contacts with more than one State. When economic and social relations transcend the boundaries of one State, claims to the exercise of powers and functions by different countries intersect and overlap. Cross-border investment clearly faces the problem of the concurrent and sometimes conflicting claims by States, as international transactions or activities are normally exposed to the regulatory requirements of the different States involved, each of which may have the power to enforce its jurisdiction upon the person or the asset involved in it. In tax terms, this is generally referred to as double taxation and it is unanimously accepted as curbing international investment.[175] Quite often, taxpayers try to benefit from the opposite phenomenon, i.e. double non-taxation, which occurs when a specific tax event falls within the regulation of none of the countries involved.[176] Investors can, therefore, relocate their activities, redefine their forms by exploiting the legal categories provided by the States and thus chose the degree of exposure to the jurisdiction of specific States.

With the emergence of the modern liberal State and with the shifting of taxation from consumption to income, taxes became the main link between State and citizens and the most direct intervention by the State in economic activity. It is thus not surprising that the avoidance of taxes started being implemented through the exploitation of disjunctures in the international State system. A company formed in one State could easily be managed outside this State to avoid taxes levied by this latter.[177] By

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[174] The most typical abstract category in economic relations is money. Monetary relationships are the expression in abstract legal terms of abstract economic relations. Legal forms can be used to redefine such relationships, to relocate where and whom payments are made, or the type of monetary assets (such as bank accounts, stocks or shares) are held.

[175] Double taxation is commonly avoided by States by means of unilateral or bilateral instruments, depending on whether the relevant instrument is provided for by domestic legislation or an international treaty. On this matter, see P. Baker, *Double taxation conventions and international tax law: a manual on the OECD Model Tax Convention on Income and on Capital*, London, 2001; D.R. Davies, *Principles of International double taxation relief*, London, 1985, A. Easson, *Taxation of foreign direct investment: an introduction*, The Hague, 1999; G. Gest, G. Tixier, *Droit fiscal international*, Paris, 1990; A. Knechtle, *Basic problems in international fiscal law,* Deventer, 1979; J. Malherbe, *Droit fiscal international*, Brussels, 1994; R. Rohatgi, *Basic International Taxation*, The Hague, 2002; M. Pires, *International Juridical Double Taxation of Income*, Deventer, 1989.

[176] On double non-taxation, see M. Lang, *Avoidance of double non-taxation*, Vienna, 2003.

[177] S. Picciotto, *Offshore: The State as Legal Fiction*, in M.P. Hampton, J.P. Abbott (Eds), *Offshore Finance Centres and Tax Havens. The Rise of Global Capital*, Basingstoke, 1999, 49 gives the example of what should be the first case of transfer of residence of companies. A company formed in

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exploiting the overlapping of legal categories and concepts elaborated by States, taxpayers can manipulate them in order to route global flows of income at their convenience and minimise their overall tax burden.[178]

By facing a growing demand for more permissive regulations and by offering a more investment-friendly environment, a number of micro-states lacking natural resources started offering zero or almost-zero regulation in order to attract business to their territories.[179] They offered investors protection from regulation and taxation of their home countries, without the need of any physical movement.[180] Since a sovereign State could legitimately exercise its powers to set forth a more competitive and attractive legislation than that applied in high-tax countries, investors started preferring these more convenient jurisdictions for incorporating a company or locating their residence.

An explanation of this phenomenon can be viewed in terms of the variants of the so-called Tiebout-type efficiency paradigm.[181] Writing about the competitive incorporation of American cities, Charles Tiebout postulated that different

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London in 1904 to develop land in Egypt, decided in 1907 (the year of the *De Beers* decision) to transfer its place of control to Cairo under a new board made up of Egyptian residents. So long as a business entity was seen to be managed wholly outside the UK, its foreign earnings could be sheltered from UK taxes, even if they resulted from the activities of UK residents.

[178] According to S. Picciotto, *The end of offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization*, Paper for Conference on *Governing the Public Domain Beyond the Era of the Washington Consensus? Redrawing the Line between the State and the Market*, Robarts Centre for Canadian Studies, Toronto, 4th-5th November 1999, wealthy individuals and powerful companies started employed lawyers and accountants in order to develop some strategies based on these legal concepts with a view to merely avoiding the unfairness of double taxation. An example of manipulation of such fictitious categories is the use of artificial legal persons that acted as intermediaries between the beneficial owner and the place of exploitation of an asset only to reduce taxation.

[179] According to R. Palan, *Trying to have your cake and eating it: how and why the State system has created offshore*, in International Studies Quarterly, 4/1998, 625-643, countries become tax havens from some combination of opportunism, desperation and luck. Some other authors do not share this viewpoint, believing that tax havens evolve as deliberate State strategies aimed at attracting “hot” money and consider tax havens as States deputed to abuse the system of sovereignty of other States. See R.T. Naylor, *Hot Money and the Politics of Debt*, London, 1987 and J. Robinson, *The Laundrymen: Inside Money Laundering, the World’s Third Largest Business*, London, 1995, 133. This perspective cannot be totally shared, because it is the result of an *ex post* evaluation of a perverse evolution of the phenomenon and cannot provide with a plausible explanation of the origin of tax havens. In addition, the same qualification of criminal cannot be detached from a legal category of the State which declares itself victim.

[180] S. Roberts, *Fictitious Capital, Fictitious Spaces: the Geography of Offshore Financial Flows*, in S. Corbridge, R. Martin, N. Thrift (Eds.), *Money, power and space*, Oxford, 1994, 91-115 underlined the fictional character of tax havens, namely that such relocation in the host country is purely juridical, as they offer “juridical” rather than “de facto” adobes. R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 163 points out that quite often money is not “really” deposited in tax havens, and companies do not “really” change location.

[181] A more detailed analysis is provided for in Chapter 3 below.

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jurisdictions provide individuals and firms with a bundle of public services and tax regulations.[182] He argued that individuals and firms are likely to choose jurisdictions that offer desirable bundles of regulations by moving to them, and are likely to move away from jurisdictions that offer less desirable bundles of regulations. Since municipal regulators want the business of these individuals and companies, the jurisdictions are compelled to compete with each other by offering the kind of regulations that the market wants. Such “market” in bundles of regulations, according to Tiebout, is likely to bring about optimal public service as taxpayers adapt to the economic system.

Tiebout’s theory represents the starting point of those theories which consider tax havens as a commercialisation of tax sovereignty. According to some authors,[183] the motive of these States is to draw rent surpluses from the income that otherwise would accrue to larger States. Some other commentators[184] consider this commercialisation of sovereignty to be an abuse of the rules and codes of sovereignty.[185] Others maintain that it is a perfectly legitimate strategy, but that it can lead to abuses in that it encourages tax evasion and money laundering.[186]

The growth of tax havens actually developed what can be defined as “tax planning industry” aimed at mitigating certain burdens of double taxation to minimising tax liability to zero by using certain jurisdictions. However, these jurisdictions flourished also because of the rising regulation and taxation practised by advanced industrial countries and the perception by taxpayers that the tax burden does not correspond to the amount of public services provided by their countries of residence. While State govern the economy and markets through public institutions, multinational enterprises take possession of these markets, influence institutions and replace

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[182] C. Tiebout, *A Pure Theory of Local Expenditures*, Journal of Political Economy, 5/1956, 416-424.

[183] M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002 and R.A. Johns, *Tax Havens and Offshore Finance: A Study of Transnational Economic Development*, London, 1983.

[184] R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981; A.C. Hudson, *Reshaping the Regulatory Landscape: Border Skirmishes Around the Bahamas and Cayman Offshore Financial Centres*, Review of International Political Economy, 3/1998, 534-564; D.D. Marshall, *Understanding Late-Twentieth-Century Capitalism: Reassessing the Globalization Theme*, Government and Opposition, 2/1996, 193-215; R. Palan, *Trying to have your cake and eating it: how and why the State system has created offshore*, International Studies Quarterly, 4/1998, 625-643; R. Palan, J.P. Abbott, *State Strategies in the Global Political Economy*, London, 1996.

[185] R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 172 says “prostituting their sovereign rights”.

[186] J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 149-182; R.A. Johns and C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979*, London and New York, 1993. According to these theories, such abuses can be corrected if stricter international standards are agreed to and acted upon.

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sovereign States that are unable to set forth a system of rules for the correct functioning of global market. In other words, the world economy has developed more quickly than international tax law institutes, which have been somehow unable to regulate such an expansion.

In this very sense, tax havens have been defined as “renegade States”.[187] According to this definition, a renegade State is a State whose practices are salient to an international tax regime but whose behaviour does not comply with the descriptive norms and practices of the set of implicit or explicit principles, norms, rules and procedures around which the expectation of the most industrialised States at the international level converge. There might be, however, reasons other than those by the so called international community for this peculiar renegade behaviour. First, a State may believe that the norms, rules and procedures which are shared by the most States are unjust or unfair and should not be followed. Second, a State might have domestic or foreign policy interests that conflict with these norms and rules, but such a State becomes a “renegade” simply because of its inability to dictate international standards which conform to its interest. Third, a State might take the position that the consequences of defying the regime’s norms and practices are negligible or worth less than the advantages from cheating.

The emergence of tax havens has also triggered a significant transformation of the international tax order,[188] which has now evolved towards an increased search for cooperation by States faced with the challenge posed by tax havens. When domestic systems and traditional legal categories began to be inadequate to handle the international activities of multinational enterprises, loss of revenue could be avoided only through interdependence and cooperation among States. Due to the cross-border mobility of factors of production, States needed to assist each other to ensure enforcement of their claims, and consequently States’ jurisdiction began to depend on the availability of effective enforcement with other States within their territories.

The emergence of tax havens from the traditional categories of the international tax orders can be explained by referring to the principle of residence taxation and the principle of source income taxation. According to the residence principle, the country of residence of the investor determines its tax liability and collects taxes on its worldwide income. The place where income is generated is assumed to be irrelevant. This principle allows the imposition of progressive and global income taxes on all the incomes of the residents of a given country. Income generated domestically and income produced abroad are subject to the same tax in the country of residence of

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[187] L. Eden, R.T. Kudrle, *Tax Havens: Renegade States in the International Tax Regime?*, Law and Policy, 1/2005, 107.

[188] S. Picciotto, *The end of offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization*, Paper for Conference on *Governing the Public Domain Beyond the Era of the Washington Consensus? Redrawing the Line between the State and the Market*, Robarts Centre for Canadian Studies, Toronto, 4th-5th November 1999, 3, held that the phenomenon of “offshore” statehood has been an important catalyst in the transformation of the international system.

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the taxpayer, therefore neutralising the more favourable tax regime existing in a foreign jurisdiction. The application of this principle promotes the so called "*capital export neutrality*",[189] because the allocation of investment among countries would not be influenced by the tax treatment of capital income in the countries that receive the investment and where the capital income would be generated. Under the principle of residence taxation, the only relevant tax consideration to the investors would be the tax rates of the place in which they reside and not of the countries where they invest their savings, so that foreign investments generating higher rates of return than domestic ones will be preferred.

Conversely, the principle of source taxation is based on symmetric and contrary considerations. Income produced by foreign investors within a jurisdiction is subject to the same level of taxes as income produced domestically by resident investors. In other words, this principle requires income be taxed by the country where it is produced, irrespective of whether the taxpayer is a resident or not. The principle of source taxation breaks the link between capital income tax and total personal income tax, especially when the taxpayer is a non-resident. The focus is on the income produced, i.e. the object of tax, rather than on the person receiving it. Accordingly, the principle of source taxation preserves the so called "*capital import neutrality*",[190] as it requires all foreign investors in a given jurisdiction be treated in the same way, regardless of the tax rates in the countries in which they reside or in which income originated.

The principle of residence taxation is generally preferred on equity grounds, because it is consistent with the application of a global and progressive income tax on all income of individuals and because it leaves a greater freedom of action to governments to use income tax for re-distributional purposes. However, the principle of residence taxation often allows indefinite tax deferral. Whereas the State of residence has the primary right to tax passive (investment) income, the State of source has the primary right to tax active (business) income produced within its territory. A resident investor carrying on business activity abroad through a subsidiary established in a foreign jurisdiction, can reduce or even defer home State taxation by simply not repatriating foreign profits.

The interaction between the principle of residence taxation and that of source taxation can give rise to some problematic issues. A typical conflict occurs when the two principles are applied at the same time. When a taxpayer residing in one State produces income abroad, such an income will be exposed to double taxation. In fact, whereas the State of residence taxes foreign source income according to the worldwide taxation principle, the State of source taxes the same income, because it was produced within its territory. If the taxpayer cannot benefit from any double

[189] P.B. Musgrave, *Capital export neutrality*, in J.J. Cordes, R.D. Ebel, J. Gravelle (Eds.), *Encyclopedia of Taxation and Tax Policy*, Washington, 2005, 45-46.

[190] P.B. Musgrave, *Ib.*

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taxation relief, its strategy of tax minimisation would consist of investing domestically only. By contrast, if the State of residence exempts foreign source income, whereas the State of source exempts income produced within its territory by non-resident investors, the arising double non-taxation situation would induce taxpayers to invest abroad only.

Discussing about the so called “Benefit Principle”, Avi-Yonah[191] identifies two categories of taxpayers, resident and non-residents, and for each category he further distinguishes between active (business) income and passive (investment) income. Active income should be primarily taxed at source,[192] while passive income should be taxed primarily at residence, according to the following table:

Residents		**Non-residents**	
Active	Passive	Active	Passive
Low tax	High tax	High Tax	Low Tax

According to Avi-Yonah, source-based taxation is consistent with a benefits perspective on justifying tax jurisdiction, as source jurisdictions provide significant benefits to corporations that carry on business activities within them, such as infrastructures or education, policies to keep stable exchange rates and low interest rates. Accordingly, active income produced by non-resident taxpayers should be subject to high tax rates. Similar considerations apply in the case of taxation according to the residence principle. As passive income is mainly derived by individuals, rather than companies, and individuals benefit from the redistributive tax policy of their home State governments, taxation of passive income derived by individuals should be subject to higher taxation.

The problem of tax havens can be framed within this context. The proliferation of tax havens is normally ascribed to the demand of reduction of tax liability by those taxpayers who reside in high-tax countries. By exploiting the interaction between the principle of residence taxation and that of source taxation, tax havens offers low

[191] R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, Bulletin for International Taxation, 4/2007, 130-139 argues that investment income is often earned by individuals, whereas business income is mainly derived by companies. In the case of individuals, the principle of residence taxation makes sense, as not only defining the residence of individuals is relatively much easier, but also they are part of a society and distributive policy consideration can be better addressed by their residence State. By contrast, in the case of multinationals, the principle of source taxation would be preferred, as their residence is harder to define, being the criterion of the place of effective management or control easy to manipulate. Multinationals, in addition, are not part of a society like individuals and distributive policy considerations are not so relevant.

[192] The source jurisdiction is in fact the first which has the opportunity to collect taxes on payments derived from within its borders.

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taxes not only to passive income derived by non-residents, but also to business income produced within their territory. In addition, as the capital export neutrality *de facto* allows the State of residence to neutralise the tax advantages provided to its resident investors by foreign jurisdictions, concealment of income or wealth produced within tax havens' territories impedes the fulfilment of such an objective of neutrality.

The unavailability of information is, in fact, another shortcoming associated with the principle of residence taxation. Residence taxation operates correctly as long as the tax administration of the home State of the investor has the possibility to acquire information about income sourced abroad. For obvious reasons, information provided by taxpayers cannot be assumed to be trustworthy and taxpayers may not provide information at all. Consequently, national tax authorities depend on the willingness and the ability of other national tax authorities to provide information. The main concern of tax authorises is international tax evasion, realised by simply not reporting or underreporting to the country of residence income produced abroad.[193] Tax havens not only show resistance in exchanging information, but also provide secrecy and confidentiality as a factor of attraction of foreign investment.

3. A brief review of the main tax planning techniques pursued through tax havens

As it has been underlined in Chapter 1, the most typical features of tax havens consist of: (*i*) the low levels of taxation, (*ii*) the high levels of secrecy they provide, and (*iii*) the lack of cooperative attitude. As a result, tax havens have always been associated to international tax evasion and to aggressive tax planning, as well as to other immoral and illegal activities. The present paragraph intends to briefly describe the main tax planning techniques enacted through tax havens (i.e. tax deferral, earning stripping, transfer pricing, and contract manufacturing) and the main tax haven users, which are companies and wealthy individuals.

Although the definition of illegal or abusive behaviours varies from country to country, quite often illegal activities involving tax havens relate to tax evasion and tax avoidance of other jurisdictions' domestic laws. Illegal non-tax-driven activities are money laundering, drug trafficking, terrorist financing, smuggling, and other forms of organised financial crimes.

There exists no common international definition of either tax evasion or tax avoidance, as they both depend on single countries' domestic legislation. However, it

[193] Economic integration is leading to an exponential growth in foreign-earned incomes and thus to growing possibilities for tax evasion. The prevalent current perception is that foreign income may be a synonym for evaded income. In this sense, a clear example is contained in the provisions of article 12 of Italian Law Decree 1st July 2009, no. 78, which establishes that investments and financial assets held in black listed countries in breach of reporting obligations are presumed constituted through evaded income, unless evidence is given to the contrary.

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is broadly acknowledged that they refer to two distinguished phenomena.[194] Tax evasion can be defined as intentional illegal behaviour, or as behaviour involving a direct violation of tax law, aimed at escaping payment of tax. Tax evasion is generally accompanied by penalties which may be sometimes criminal in nature.[195] A typical example of tax evasion is the deliberate underreporting of taxable income. By contrast, tax avoidance describes taxpayers' behaviours aimed at reducing tax liability which falls short of tax evasion.[196] Differently from other acceptable forms of behaviours, such as tax planning, the term "tax avoidance" often denotes an unacceptable or illegitimate (but not in general illegal)[197] tax savings. Tax avoidance phenomena are often within the letter of the law but against its spirit.

In other words, while tax evasion can be described as a conscious and deliberate violation of law in order to escape payment of a tax imposed by the laws of the taxing jurisdiction, tax avoidance describes the phenomenon of reducing the overall tax

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[194] A deep analysis of the two phenomena is out of the scope of the present work. There is, however, conspicuous literature on this matter. See OECD, *Tax evasion and avoidance – a report by the OECD Committee on Fiscal Affairs*, Paris, 1980; OECD, *International Tax Avoidance and Evasion: Four Related Studies. Issues on International Taxation no. 1*, Paris, 1987; P. Pistone, *Abuso del diritto ed elusione fiscale*, Padua, 1995; P. Baker, *Avoidance, evasion & mitigation*, ITPA Journal, 1/2000, 3-8; A.J. Sawyer, *Blurring the distinction between avoidance and evasion: the abusive tax position*, British tax review, 5/1996, 483-504; P. Laroma, *The concept of tax avoidance: UK and Italian perspectives,* Tax planning international: European tax service, 2/2010, 19-23; D. Spencer, *International tax evasion: enablers and shell corporations (part 1)*, Journal of international taxation, 4/2007, 44-62; D. Spencer, *International tax evasion: enablers and shell corporations (part 2)*, Journal of international taxation, 5/2007, 36-47; H. Hovind, *Investigation of tax and other fiscal evasion*, Asia-Pacific tax bulletin, 12/1996, 351-356; T. Graham, *Money laundering and foreign tax evasion: is foreign tax evasion a predicate offence for purposes of POCA 2002?*, Trusts & Trustees, 8/2008, 534-536; V. Tanzi, P. Shome, *A primer on tax evasion*, Diritto e Pratica Tributaria, 2/1994, 446-470; OECD, *Overview of the OECD's work on countering international tax evasion*, Paris, 2009; OECD, *Report on identity fraud: tax evasion and money laundering vulnerabilities*, Paris, 2009; R.H. Gordon, S.B. Nielsen, *Tax avoidance and value-added vs. income taxation in an open economy*, NBER, Cambridge, 1996, Working Paper No. 5527; W.I. Innes, *Tax evasion*, Scarborough, 1995; P. Merks, *Tax evasion, tax avoidance and tax planning*, Intertax, 5/2006, 272-281; M. Gely, *Tax offences: the hidden face of money laundering?*, Intertax, 10/2003, 328-349; M. Lobel, *Territorial taxation: an invitation to tax avoidance and evasion*, Tax notes international, 6/2009, 519-521; A. Sandmo, *The theory of tax evasion: a retrospective view*, National tax journal, 4/2005, 643-663; M.G. Allingham, A. Sandmo, *Income Tax Evasion: a Theoretical Analysis*, in A.B. Atkinson (Ed.), *Modern Public Finance. Volume 1*, Aldershot, 1991, 50-65; M. Bordignon, *A Fairness Approach to Income Tax Evasion*, Journal of Public Economics, 3/1993, 345-362.

[195] IBFD International Tax Glossary, "Evasion". The term "evasion" tends to be used in French-speaking countries to refer to the concept of tax avoidance, while "tax fraud" is used to refer to the concept of tax evasion.

[196] IBFD International Tax Glossary, "Avoidance". M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002, 34 defines tax avoidance as the practices enacted by tax payers aimed at arranging their business affair so as to minimise their tax liability.

[197] See J. G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress, 9 July 2009, 1, according to whom tax avoidance is sometimes used to refer to as a legal reduction in taxes, while evasion refers to as tax reductions that are illegal.

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burden by legal means and in apparent compliance with existing rules. The dividing line between tax evasion and tax avoidance is however often unclear.[198] Differences of tax laws from one country to another, attitudes of governments, courts and public opinion entail that illegal tax evasion in one jurisdiction could be permissible tax avoidance in another. Many activities performed particularly by multinational companies might be often referred to as avoidance, but could also be classified as evasion.[199] It is, therefore, evident that at the international level a transaction might be considered as tax evasion or tax avoidance, depending on the applicable laws.[200]

A typical form of tax evasion consists of the non-reporting of income. The most frequently omitted income from tax returns and transferred to tax havens are business profits, dividends, interest and royalties (investment income or passive income), as well as income from illegal activities. Income earned outside the State of residence may be physically or electronically transferred to a tax haven and be hidden there from the State of residence's tax authorities thanks to bank secrecy and confidentiality.[201]

Tax evasion might take different forms, which are all facilitated by the international financial globalisation and the easy access to internet transactions. For instance, taxpayers might set up tax haven entities at very low costs and then transfer to them assets (such as shares, bonds, rental properties, and intangibles which generate a continuing stream of passive income, or property transferred at an artificially low price) that generate rents, royalties, interest and other expenses which can be

[198] According to F.H. Fleck, R. Mahfouz, *The Multinational Corporation: Tax Avoidance and Profit Manipulation via Subsidiaries and Tax Havens*, Revue Suisse d'Economie Politique et de Statistique, 2/1974, 145-160, this distinction is a question of how the different tax laws are interpreted. C. Kindleberger, *Power and Money – the Economics of International Politics and the Politics of International Economics*, London, 1970, 181 prefers the term "escape from the jurisdiction" to avoid the problem of this distinction. It is worth noting that there exists in literature the opinion of some authors, according to which the use of tax havens by companies is due to circumstance that these latter peddle avoidance, not evasion, as governments hardly would announce overtly that they are offering illegal services for sale. See S. Bucovetsky, *Honor among Tax Havens*, Paper presented at the Tax Havens and Tax Competition Conference, 18-19 June 2007, Bocconi University, Milan, Italy, 2. In this sense, see also J. Slemrod, J.D. Wilson, *Tax Competition With Parasitic Tax Havens*, Journal of Public Economics, 11-12/2009, 1261-1270.

[199] A typical example is transfer pricing: firms charge low prices for sales to low-tax affiliates, and pay high prices for purchases from them. If these prices, which are supposed to be at arm's length, are set at an artificial level, then this activity might be viewed by some as evasion and by others as avoidance.

[200] It could also happen that within one single jurisdiction there is considerable debate as to whether a particular transaction constitutes tax evasion or tax avoidance.

[201] When discussing about individual tax evasion, R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 49 points out that the escape of taxation is manifestly perverse by allowing persons of high income and wealth to pay lower rates than statutorily mandated and, given the low level that maximum income tax rates come into effect in many European countries, lower effective rates than those with much lower incomes.

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deducted in the State of residence and are exempt in the tax haven.[202] Sometimes, tax haven entities are created to attribute the performance of some services, which are actually never performed, but which serve to generate fictitious costs that should be deductible in the high-tax jurisdiction.[203] Similarly, foreign trusts can be used for the same purposes and to protect income from taxation of certain assets in the home country of the settlor.

Further to a low or no taxation on income derived within their jurisdiction, tax havens provide foreign investors with the opportunity to avoid taxes on income earned elsewhere in the world and normally otherwise due to the State of residence. This kind of tax evasion can take different forms. Taxpayers may use financial arrangements, such as intra-firm lending in order to locate taxable income in low-tax jurisdictions and tax deductions in high-tax jurisdictions. They can artificially convert income to untaxed or less-taxed gains, spread income to other taxpayers with a lower marginal tax rate, split business activities to avoid taxes and lease and lease-back arrangements to take advantage of tax deduction.

Tax savings through tax havens normally occurs in three different ways: (i) activity can take place in the tax haven; (ii) activity can be assigned to the tax haven only for fiscal purposes and irrespective of the reality; or (iii) tax haven can mask real transactions through secrecy. In other words, tax havens can produce goods and services, they may shift claims among jurisdictions or hide tax claims. Quite often tax havens provide a combination of these three opportunities for tax savings, generating negative reactions from non-haven jurisdictions, which complain of suffering from tax base erosion and losses of tax revenue.[204]

The location and scope of international business activity, and more broadly corporate and individual behaviours, can be influenced by tax laws of other countries. Low tax rates, in fact, easily influence both the investment and the tax avoidance activities of foreign investors, as it is possible to structure a variety of transactions (i.e. intra-firm

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[202] J. Guttentag, R. Avi-Yonah, *Closing the International Tax Gap*, in M.B. Sawicky (Ed.), *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, Washington, 2005, 99-110, describe a typical way that US individuals can easily evade tax on domestic income through a Cayman Islands operation using current technology with little expense with current technology. The individual, using the internet, can open a bank account in the name of a Cayman corporation that can be set up for a minimal fee. Money can be electronically transferred without any reporting to tax authorities, and investments can be made in the US or abroad. Investments by non-residents in interest bearing assets and most capital gains are not subject to a withholding tax in the US.

[203] In the typical case, the tax haven entities are shell corporations incapable of performing the services without the assistance of the controlling shareholders.

[204] R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 38.

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borrowing, royalties payments, dividend repatriation, and intra-firm trade) in a manner that is conducive to tax avoidance.[205]

No or low-tax jurisdictions are often used by taxpayers resident in high-tax jurisdictions to defer their home tax on foreign sourced income. Typically, forms of investment through controlled foreign companies or similar entities based in tax havens are used to artificially channel income and avoid income tax. These structures are often used to defer income tax due by the shareholder in its home State until income produced by the controlled company is accrued or received. Many countries consider this tax deferral as an unjustifiable loss of tax revenue and an erosion of their capital export neutrality and enact the so called Controlled Foreign Companies (or "CFC") rules.[206] CFC rules may differ widely from country to country, even if they share common objectives, such as limiting the transfer of income to related non-resident companies, or pursuing a policy of capital export neutrality.[207]

Earning stripping is the denomination of another common practice typically carried out by multinational groups and mainly aimed at shifting profits from a high to a low-tax jurisdiction.[208] By exploiting the existing differences in domestic tax laws of the

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[205] There exists a conspicuous literature devoted to measure behavioural responses to international taxation and to document the magnitudes of the effects of low tax rates. It also focuses on the impact of corporate tax rates on investment behaviour as well as financial and organisational practices used to avoid taxes. See J.R. Hines, *Tax policy and the activities of multinational corporations*, in A.J. Auerbach (Ed.), *Fiscal Policy: Lessons from Economic Research*, Cambridge, 1997, 401-445 who reports tax elasticity of investment in the neighbourhood of -0.6, that means that a ten percent tax reduction (for example, reducing the corporate tax rate from 35% to 31.5%) is typically associated with six percent greater inbound foreign investment. M.A. Desai, C.F. Foley, J.R. Hines, *Chains of ownership, tax competition, and the location decisions of multinational firms*, in H. Herrmann, R. Lipsey (Eds.), *Foreign Direct Investment in the Real and Financial Sector of Industrial* Countries, Berlin, 2003, 61-98 studied the behavioural responses of US multinationals to international taxation. See also R.H. Gordon, J.R. Hines, *International taxation*, in A.J. Auerbach, M. Feldstein (Eds.), *Handbook of Public Economics*, vol. 4, Amsterdam, 2002, 1395-1995; M.P. Devereux, *The impact of taxation on the location of capital, firms and profit: a survey of empirical evidence*, Oxford University Centre for Business Taxation, Working Paper 07/02; J.R. Hines, *Lessons from behavioural responses to International taxation*, National Tax Journal, 52/1999, 305-322; H. Grubert, J. Mutti, *Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making*, Review of Economics and Statistics, 2/1991, 285-293; R. Altshuler, H. Grubert, *Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence*, Tax Notes International, 13/2004 (special suppl.), 1349-1362.

[206] On this matter see Chapter 4.

[207] OECD, *Controlled Foreign Company Legislation*, Paris, 1996, 98.

[208] Some broader analyses, out of the scope of the present work, could be found in: P.M. Daub, *An analysis of the earnings stripping regulations*, Tax Management International Journal, 9/1992, 379-397; A. Joseph, *Corporate inversions and earnings stripping*, Derivatives and financial instruments, 3/2008; 92-96; A. Joseph, *Corporate migration and transfer pricing*, International transfer pricing journal, 4/2008, 180-184; D.R. Hardy, P.D. Wigg-Maxwell, *Earnings stripping*, Bulletin for international fiscal documentation, 5/1990, 215-220; D.L. Rendroe, R.A. Gordon, F.D. Watson, A.P. Fogarasi, *Earnings stripping. An analysis of the proposed regulations under Section 163(j),* Tax Notes International, 10/1991, 1135-1162; R. Feinschreiber, *Earnings stripping rules limit interest deductions*,

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States where affiliated companies are established, it may result convenient for tax purposes to locate higher costs in high-tax countries and higher income in low-tax countries. The typical practice in this respect consists of raising the level of debt in the hands of the company established in a high-tax jurisdiction, which can normally deduct the interest payment for tax purposes. The associated company based in a tax haven will instead receive interest income, which can benefit from a total or partial tax exemption.

Earning stripping allows the group to reduce its overall tax liability by moving earnings from one country to another, and in order to limit the scope of this tax planning technique, high-tax countries normally provide for some specific legislation aimed at limiting the deductibility of interest (such as thin capitalisation rules).

International tax avoidance aimed at reducing the overall tax burden can also occur through transfer pricing. Transfer pricing is an economic term, which refers to the valuation process for transactions between related entities,[209] and it rules the phenomenon of profit shifting among firms from a high-tax to a low-tax jurisdiction (not necessarily a tax haven). As multinational enterprises transfer worldwide significant volumes of goods, services, capital and intangibles, all of which can be relevant for tax purposes in each State involved, prices of transactions can be artificially altered. The most typical practice consists of lowering the price (that normally would be applicable to transactions within non-related parties) of goods and services sold by affiliated companies in high-tax jurisdictions and raising the price of purchases of those bought by affiliated companies in low-tax jurisdictions, thus shifting income.

National authorities, under domestic legislation, can therefore question the transfer price of cross-border transactions, if they lead to an acceptable loss of tax revenue. In order to properly reflect income, tax authorities can re-determine price of transactions within a multinational group by applying prices of goods and services that would be paid by unrelated parties ("at arm's length"). The typical transactions affected by transfer price regulations enacted at the national and international levels are transfers of tangible property, transfers of intangible property rights, provisions of services, and provisions of finance.

Over the past decades, the OECD has devoted many studies on the international tax implications in transfer pricing issues and has published several Reports which provide a common framework within which the tax authorities and taxpayers can

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European taxation, 3/1992, 96-98; F.R. Gander, *Financing U.S. operations under the proposed "earnings stripping" regulations*, Tax Planning International, 10/1991, 3-13; R.L. Umbrecht, D.W. Liewellyn, *Planning pitfalls and opportunities for foreign owned corporations under the earnings stripping rules*, Tax Lawyer, 3/1994, 641-725; A.W. Granwell, J. De Carlo, M.A. Mayo, *Proposed earnings stripping regulations: limitations on interest deductions by corporations with related tax-exempt and foreign creditors*, Intertax, 8-9/1991, 405-414; R.L. Doernberg, *The enhancement of the earnings-stripping provision,* Tax Notes International, 16/1993, 985-994.

[209] R. Rohatgi, *Basic International Taxation*, The Hague, 2002, 412.

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judge the transfer price on cross-border transactions, as well as the methods for determination of the arm's length price.[210]

Similarly, international tax avoidance can take place trough the so called "contract manufacturing". This term (also used with that of "toll manufacturing")[211] describes a variety of arrangements adopted by companies belonging to a multinational group and aimed at minimising the overall tax burden. Such arrangements provide for the

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[210] OECD, *Le transfert technologique par le firmes multinationales*, Paris, 1977; OECD, *Transfer pricing and multinational enterprises: report of the OECD Committee on Fiscal Affairs 1979*, Paris, 1979; OECD, *Guidelines for multinational enterprises*, Paris, 1984; OECD, *Transfer pricing and multinational enterprises: three taxation issues*, Paris, 1984; OECD, *Tax aspects of transfer pricing within multinational enterprises: the United States proposed regulations: a report by the Committee on Fiscal Affairs on the proposed Regulations under Section 482 IRC*, Paris, 1993; OECD, *Transfer Pricing Report*, Paris, 1993; OECD, *Transfer pricing guidelines for multinational enterprises and tax administrations: part I: principles and methods: discussion draft*, Paris, 1994; OECD, *Transfer pricing guidelines for multinational enterprises and tax administrations: part II: Applications; Discussion Draft*, Paris, 1995; OECD, *Transfer pricing guidelines for multinational enterprises and tax administrations*, Paris, 1996-1999; *Transfer pricing guidelines for multinational enterprises and tax administrations*, Paris, 2001; OECD, *E-commerce: transfer pricing and business profits taxation*, Paris, 2005; OECD, *OECD transfer pricing guidelines for multinational enterprises and tax administrations*, Paris, 2009; OECD, *Transfer pricing and treaties in a changing world*, Paris, 2009.

[211] IBFD International Tax Glossary, "Contract Manufacturing". The term contract manufacturing is used in the United States to refer to manufacturing activities of a controlled foreign corporation (CFC) that are hired out by the CFC to a third party, the issue being whether the income from the manufacturing activity is treated as foreign base company sales income for purposes of Subpart F of the US Internal Revenue Code or is instead excluded from Subpart F Income under the exception that applies to manufacturing activities undertaken by the CFC itself. On this matter, see more broadly D.K. Dolan, *Contract manufacturing: is it dead or alive?*, Tax Management International Journal, 5/1997, 195-202; S.R.A. Bates, D.A. Kirkwood, *Contract manufacturing: is the war over?*, Tax notes international 1/2008, 61-72; E. Klaver, *Contract manufacturing regulations: a substantial contribution?*, Bulletin for international taxation, 12/2009, 600-608; J.A. Levenstam, M. Rollinson, J. Karasek, *The contract manufacturing regulations: an oversized solution*, Tax management international journal, 5/2009, 267-276; M.A. Di Fronzo, M.R. McClintock, *Contract manufacturing: still a viable strategy?*, Tax Notes International, 8/1998, 589-598; Y. Metcalfe, *Contract manufacturing: the goalposts move – fair play or foul?*, Bulletin for international fiscal documentation, 1/1999, 2-12; D.K. Dolan, C.M. DuPuy, P.A Jackman, *Contract manufacturing: the next round*, Tax Management International Journal, 2/1998, 59-66; W.W. Chip, *Contract manufacturing: time to take a new look*, Tax Planning International, 1/1998, 16-17; A. Joseph, *Controlled foreign corporations: tax treatment of contract manufacturing and emissions allowances*, Derivatives and financial instruments, 5/2008, 224-226; L.A. Abad, *A 'duty' to consider: the new IRS contract manufacturing rules*, Tax notes international, 3/2009, 199-202; OECD, E-commerce: transfer pricing and business profits taxation, Paris, 2005; A. Granwell, *IRS aims to clarify contract manufacturing rules*, International tax review, June 2008, 26-28; P.M. Daub, D.L. Hickey, J.M. Peterson, *New contract manufacturing regulations will have a major effect on supply chain structures*, Journal of international taxation, 6/2009, 18-37; S.R.A. Bates, Z.K. Perryman, *New contract manufacturing rules: changes, improvements, and unresolved issues*, Tax notes international, 10/2009, 911-922; S.K. Kaywood, *The new proposed contract manufacturing regulations under Subpart F*, International Tax Journal, 6/2008, 13-28; K. Reiter, *U.S. taxation of contract manufacturing agreements*, Tax Notes International, 12/2002, 1405-1423; P.M. Daub, J.M. Peterson, G.D. Sprague, *US: IRS issues subpart F regs on contract manufacturing*, Tax planning international transfer pricing, 4/2008, 3-11.

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"outsourcing" of part or all of a manufacturing process by one party (the "principal") to another party (the "manufacturer"). Normally, this latter party merely acts as an agent, the principal retaining title to the raw materials or unfinished products. Sometimes, the manufacturer acts on its own behalf, typically buying the raw materials or unfinished products from the principal and selling them back after carrying out the operations (so called "round trip transactions"). Depending on the case, either the principal or the manufacturer is based in a low-tax jurisdiction, as this allows reducing the overall tax burden. Quite often, under such arrangements the principal transfers or licenses the manufacturer intangible property, raising transfer pricing issues regarding the intangible property or the pricing of the manufacturing arrangements.

All these tax planning techniques mentioned above refer to international tax avoidance enacted by multinational companies, which are unanimously acknowledged in the literature to be the most active users of tax havens beside very wealthy individuals.[212] These two categories of taxpayers are normally resident in high-tax countries and have quite often similar needs centred on tax planning. The OECD itself seems to acknowledge that the major users of tax havens are taxpayers resident in high-tax jurisdictions,[213] and actions taken against these jurisdictions both multilaterally and unilaterally prove that the phenomenon is a matter of concern of wealth countries.[214] In this respect, it could be argued that tax havens would have no reason to exist without wealthy taxpayers of high-tax jurisdictions.

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[212] See M.P. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, World Development, 9/2002, 1657. It has been pointed out in literature that the definition of "wealthy" seems to vary between different banks. See M.P. Hampton, *The Offshore Interface. Tax Havens in the Global Economy*, Basingstoke, 2002, 18, according to whom in some banks the minimum amount to qualify for this title is an income of £0.5 million whereas other banks have lower or higher cut-off points. According to some estimates reported by the Author, in the United Kingdom, France, Italy, Germany and Spain there were around 100,000 families, each having more than $ 5 million of wealth.

[213] See paragraph 35 of the OECD Report, *Harmful Tax Competition: An Emerging Global Issue*, Paris, 1998, where the organisation expressly states: "(…) foreign direct investment by G-7 countries in a number of jurisdictions in the Caribbean and in the South Pacific island States, which are generally considered to be low-tax jurisdictions, increased more than five-fold over the period 1985-1994, to more than $ 200 billion, a rate of increase well in excess of the growth of total outbound Foreign Direct Investment. The Committee continues to attach importance to collecting additional data on developments in tax havens and in the use of preferential tax regimes".

[214] The United States Internal Revenue Service, for example, concluded a special study on international tax evasion by U.S. taxpayers. See R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981. Similarly, on 23 September 2009, Deloitte was commissioned to provide an overall evaluation of the importance of the British Crown Dependencies and Overseas Territories in the context of tax avoidance by UK companies. See Deloitte, *Understanding Corporate Usage of British Crown Dependencies and Overseas Territories – A Report to the Independent Review of British Offshore Financial Centres*.

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Let us start from the corporate users of tax havens. A significant contribution in this respect is provided by Desai, Foley and Hines,[215] who considered the characteristics of multinational parent companies with tax haven operations and observed that the most likely to operate in tax havens are large multinationals that are most active abroad. Such an observation is explained with the existence of economies of scale in using tax havens to avoid taxes in their home countries. The Authors also observed that certain groups are more likely than others to operate in tax havens; these are multinational parent industries, in which firms typically face low foreign tax rates, those that are technology-intensive, as well as multinational groups characterised by extensive intra-firm trade.[216]

This line of research shows that a multinational firm with profits in high-tax countries can benefit from tax havens, by simply reallocating such profits to those jurisdictions. Similarly, a multinational firm with profits in low-tax countries can also benefit from tax havens, by deferring the repatriation of these latter. Another element clarified by Desai, Foley and Hines is that firms operating in different industries and investing in different countries are exposed to different foreign taxes and try to reduce the overall tax burden. As a result, firms with extensive foreign investments are the most likely to use tax havens entities.[217]

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[215] M.A. Desai, C.F. Foley, J.R, Hines, *The demand for tax haven operations*, Journal of Public Economics, 3/2006, 513-531.

[216] For evidence on intra-firm trade, see K.A. Clausing, *The impact of transfer pricing on intrafirm trade*, in J.R. Hines (Ed.), *International Taxation and Multinational Activity*, Chicago, 2001, 173-194; K.A. Clausing, *Tax-motivated transfer pricing and U.S. intrafirm trade prices*, Journal of Public Economics, 9-10/2003, 2207-2223 and D.L. Swenson, *Tax reforms and evidence of transfer pricing*, National Tax Journal, 1/2001, 7-25. For evidence on intra-firm debt, see M.A. Desai, C.F. Foley, J.R. Hines, *A multinational perspective on capital structure choice and internal capital markets*, NBER, Cambridge, 2003, Working Paper No. 9715 and H. Grubert, *Taxes and the division of foreign operating income among royalties, interest, dividends and retained earnings*, Journal of Public Economics, 2/1998, 269-290. For evidence on intra-firm royalties, see J.R. Hines, *Taxes, technology transfer, and the R&D activities of multinational firms*, in M. Feldstein, J.R. Hines, R.G. Hubbard (Eds.), *The Effects of Taxation on Multinational Corporations*, Chicago, 1995, 225-248. For evidence on dividend repatriations, see M.A. Desai, C.F. Foley, J.R. Hines, *Repatriation taxes and dividend distortions*, National Tax Journal, 4/2001, 829-851 and J.R. Hines, R.G. Hubbard, *Coming home to America: dividend repatriations by U.S. multinationals*, in A. Razin, J. Slemrod, (Eds.), *Taxation in the Global Economy*, Chicago, 1990, 161-200. For evidence on differences in reported profitability in response to tax rates, see H. Grubert, J. Mutti, *Taxes, tariffs and transfer pricing in multinational corporate decision making*, Review of Economics and Statistics 2/1991, 285-293 and J R. Hines, E.M. Rice, *Fiscal paradise: foreign tax havens and American business*, Quarterly Journal of Economics 1/1994, 149-182. While these studies exclusively use data on US multinationals, E.J. Bartelsman, R.M.W.J. Beetsma, *Why pay more? Corporate tax avoidance through transfer pricing in OECD countries*, Journal of Public Economics 9-10/2003, 2225-2252 use country level data within the OECD to measure the prevalence of profit-shifting activities in a broader sample of countries.

[217] M.A. Desai, C.F. Foley, J.R, Hines, *The demand for tax haven operations*, Journal of Public Economics, 3/2006, 513-531 observed that greater foreign operations contribute increasingly to the likelihood of having a tax haven affiliate, whereas the opposite is true of greater domestic operations.

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Tax haven affiliates are more likely of parent companies in industries with greater intensities of sales to related parties abroad. They, in fact, allow the relocation of taxable income from high-tax to low-tax countries and the deferral of that part of home country taxation channelled upon the foreign affiliate. Similarly, R&D-intensive companies are the most likely to have tax haven affiliates, due to the easy and advantageous relocation of income deriving from intangible technology assets or intangible property.[218]

Desai, Foley and Hines also observed that if the value of potential tax savings associated with using tax havens increases more rapidly with firm size than the cost of establishing haven operations does, firms with extensive non-haven investments should have the greatest demand for tax haven operations. In this perspective, establishing tax haven operations clearly constitutes for multinationals a very important strategy to avoid taxes and raise corporate profits, as they appear suitable for reallocating income. Firms investing in economies that subsequently grow very rapidly expand their own foreign investments at faster rates than other firms, and are more likely to establish new tax haven operations confirming the role of scale in dictating the demand for tax haven operations. Ever-increasing levels of foreign direct investment, the rising R&D intensity of multinational firms, and the growing volume of world trade between related parties together imply that the demand for tax haven operations is likely to increase over time.

As mentioned above, the second main category of taxpayers benefiting from the use of tax havens operations consists of very wealthy individuals.[219] Like multinational firms, such individuals may take advantage of tax havens operations for several reasons. First, the low or no level of taxation in tax havens leaves greater after-tax profits. Second, the absence of exchange controls allows allocating resources on the basis of economic rather than tax considerations. Third, minimal government regulations generally insure that business and investment activities channelled into or through tax havens will not have the added administrative costs of compliance. Finally, bank secrecy and confidentiality offer the opportunity to benefit from anonymity in carrying on their activities, out of the view of competitors and free from the fear of politically and economically motivated sanctions.

There are some differences in the use of tax havens by multinational companies and wealthy individuals. The former are subject to obligations of reporting and normally

[218] These results on the demand for tax havens operation are in line with those of J.R. Graham, A.L. Tucker, *Tax Shelters and Corporate Debt Policy*, 17 August 2005, available at SSRN: http://ssrn.com/abstract=633042 or doi:10.2139/ssrn.633042, who evidence that larger firms with more foreign activity and greater R&D activity are those engaged in tax avoidance through corporate tax shelters.

[219] Most ordinary people (typically employees which are taxed at source) and almost all small and medium sized enterprises simply do not use offshore structures, because they simply have no utility in hiding an after-tax income or because they cannot access tax haven markets at the same low costs as multinationals.

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benefit from tax havens through tax avoidance strategies aimed at shifting profits from their home jurisdictions. Multinationals can easily avail themselves from tax haven affiliates and manipulate their profits in order to avoid corporate income and property taxes, which might be perceived as high and discriminatory, as well as in order to hide information from rivals, competitors, and governments. By contrast, individuals, not being subject to obligations of reporting, mainly benefit from the level of secrecy and confidentiality offered by tax havens and are more involved than multinational companies in forms of tax evasion. They normally take advantage of the growing international financial globalisation and the easy access to the internet transactions to purchase foreign investment directly and outside their home country or to put money in foreign banks and simply not report the income. Quite often, in addition, they use trusts and shell companies in order to benefit from no taxation or reduce that of their State of residence.

Both wealthy individuals and multinational firms are narrowly linked to international service firms, such as banks, other financial services providers, law and accountancy firms, which have enabled these subjects “to position themselves to obtain profits even in a disorderly world”.[220]

As above mentioned, although the majority of illegal activities involving tax havens are tax driven, tax havens are also quite often used to evade other laws.[221] For example, exchange controls and host government profit participation requirements can be evaded by transfer pricing abuses that shift profits to tax haven entities. Securities laws, particularly those requiring disclosure of share ownership, are evaded by using corporate confidentiality laws and bearer shares issued by tax haven entities to conceal common ownership and control.

Furthermore, tax havens are acknowledged to be used to launder or maintain slush funds for illegal political campaign contributions, bribes, piracy, counterfeiting, insider dealing, kick-backs, and other illegal payments.[222] It is common for criminal offenders

[220] R.B. Cohen, *The New International Division of Labour, Multinational Companies and Urban Hierarchy*, in M. Dear, A. Scott (Eds.), *Urbanisation and Urban Planning*, London, 1981, 290.

[221] See A. Giridharadas, *The Treasury Coddles Tax Cheats: Saved Havens*, New Republic, August 2001, 23; Le Monde (English Edition), *Mr. Bush and Dirty Money*, 17 May 2001 called “harmful tax competition” a “euphemism” for “countries taking part in tax evasion on a large scale, in some cases in laundering money from the worst sorts of trafficking as well”. J. Owens, *Tax Administration in the New Millennium*, 129 cited by J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 79 affirmed: “Individuals and corporations that engage in money laundering, bribery and other corrupt practices are also likely to engage in tax evasion and an acceptance that in some way tax evasion is morally defensible because it merely involves refusing to give your money to the government is likely not only to undermine the ethical basis of tax systems but also to encourage other international criminal activities. Similarly, the jurisdictions which tolerate or facilitate international tax evasion are in some cases, although not all, the same jurisdictions which facilitate laundering and bribery”.

[222] R. Ehrenfeld, *Evil Money: Encounters along the Money Trail*, New York, 1992; R.A. Johns, C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since* 1979, London and New York,

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to use tax havens for these kinds of activities, although some of these countries have been becoming more selective in their clientele. Funds of obscure origins, such as bribes, insider trading and fraud, can be easily hidden in shell companies based in these jurisdictions and escape from control of home States. Finally, States themselves can also use tax havens as money boxes to supply funds to other governments, opposition parties or terrorist groups[223] or to avoid economic sanctions imposed by other States.[224]

4. Current literature on the impact of tax havens upon developed and developing countries

This paragraph discusses about the impact of tax havens upon developed and developing countries. Economic research in this respect has first demonstrated that tax havens play a key role in the international capital market and in the internationalisation of economic activity. However, economic studies have subsequently tried to measure the impact tax havens play upon high-tax countries, in terms of tax base erosion. Although it is evident from data results that high-tax countries suffer from conspicuous revenue losses, some academic research (and in particular Hines) show the existence of positive spill-over effects on tax havens.

As already discussed in Chapter 1, the massive increase of regulation and taxation in the post-war OECD economies is one of the main factors that contributed to the growth of tax havens in recent decades.[225] The enormous expansion of global

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1993; M.P. Hampton, *Where Currents Meet: the Offshore Interface between Corruption, Offshore Finance Centres and Economic Development*, IDS Bulletin, 2/1996, 78-87.

[223] T. Clarke, J. Tigue, *Dirty Money*, Millington Books, USA, 1976; J. Bloch, P. Fitzgerald, *British Intelligence and Covert Action*, London, 1983; R.T. Naylor, *Hot Money and the Politics of Debt*, London, 1987.

[224] Examples include the ban on trade with South Africa being successfully breached by US firms using re-invoicing via offshore companies based in the Cayman Islands and Panama. See R.T. Naylor, *Hot Money and the Politics of Debt*, London, 1987. Another example is that of firms using the Cyprus OFC to avoid sanctions against Bosnia in 1993. See The Guardian, 3 April 1993; M. Theodoulou, *Cyprus Surrenders to Russian Invasion – Nobody Hurt*, The Observer, 8 May 1994.

[225] It is worth pointing out here that the assumption of the development of tax havens attributed to the increase of regulation of high-tax countries can be confirmed by some theories of J.R. Hines explained in J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 149-182. When discussing about tax havens from the American business standpoint, the Author observes that tax havens offer corporate taxpayers two tax advantages. The first is that earnings located in tax havens raise measured foreign earnings for the purpose of calculating the foreign tax credit limitation. The second is that firms with haven profits can earn interest on their residual tax liability for as long as they defer repatriation of those profits. Both possibilities can be attractive, although they are exclusive in that the first is triggered by repatriation, the second by deferral. The first advantage of tax haven is to exploit a parent's excess foreign tax credits. The parent reduces its overall tax liability if it can attribute to a haven affiliate profits actually earned in a high-tax country. Total taxes thereby decline by an amount equal to the difference

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business activity since the 1980s had the potential to significantly contribute to the economies of tax havens, as the demand for tax haven operations facilitating tax avoidance increased worldwide.[226]

Tax havens and OFCs in particular have been acknowledged to have played a key role in the development of the contemporary financial markets,[227] as they provided a useful and relatively inexpensive strategy of economic development for a number of small States and islands, they have facilitated the rise of global capital, increased the velocity and volatility of the global financial markets, and contributed to worldwide economic liberalisation.[228] Offshore companies development in such a near-zero regulatory environment opened up a secondary space of financial transactions. Offshore financial markets greatly contributed to the internationalisation of the economy and have been dominating world finance.

Important economic research has therefore been devoted to assess the economic activities attracted by, and carried out in, tax havens. Current research focuses on the impact and size of tax haven activities typically look either at the direct investment they attract,[229] and at the financial investment that flows through them.[230]

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between the two tax rates. One of the main advantages they provide it the opportunity of exploiting a parent's excess foreign tax credits. It clearly emerges that the factors of attraction of tax havens look tailored on domestic tax legislations of high-tax countries. In other words, without national tax laws of the most industrialised countries, tax havens would have no reason to exist. There are some other theories on the factors of development of tax havens in literature, which nevertheless do not seem convincing. According to R.A. Johns, C.M. Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979*, London and New York, 1993, tax havens have played a critical role in the development of the global economy, in particular by acting as "agent provocateurs for the promotion and expansion of boundless financial services". The fact that tax havens pioneered certain activities before high-tax countries does not explain whether they were necessary for the development of financial globalisation. In this sense, see R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 37-68.

[226] J.R Hines, *Do tax havens Flourish?*, in J M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99 shares this view and refers to Ireland as a prominent example of the performance of tax havens economies. Ireland was for many years a low-income country by Western European standards, but its economy expanded very rapidly at the same time that worldwide foreign direct investment grew, and Ireland now features one of Europe's highest living standards. Ireland features a very low corporate tax rate (12.5%) designed to attract foreign investment, and one that appears to be successful because close to half of Ireland's manufacturing employment is in foreign-owned firms.

[227] M.P. Hampton, J.P. Abbott, *The Rise (and Fall?) of Offshore Finance in the Global Economy: Editors' Introduction*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore Finance Centres and Tax Havens – The rise of Global Capital*, Basingstoke, 1999, 13.

[228] M.P. Hampton, J.P. Abbott, *Ib.*, 15.

[229] J.R. Hines, E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Quarterly Journal of Economics, 1/1994, 149-182; J.R Hines, *Do tax havens Flourish?*, in J M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99; D. Dharmapala, J.R. Hines, *Which countries become tax havens?*, Journal of Public Economics, 93/2009, 1058-1068.

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There are, however, some additional factors which played an important role in the development of tax havens. First, the cross-border expansion of corporate activity and the development of international trade generated an increasing demand for lightly taxed profit reallocation especially by multinational firms. Second, by reducing borrowing costs and stimulating investments, tax havens and OFCs partly contributed to the liberalisation of domestic markets and to the enlargement of its players. Offshore has exerted a great impact on international finance, spurring international financial deregulation, encouraging the lifting of various restrictions, and changing the character of international taxation. Capital mobility made funds flow from countries with high savings to those countries with better interest rate and better investment opportunities. Third, improvements in transportation and especially in communications have made the use of tax havens and OFCs for all purposes ever easier.

Once data have been collected in respect to the actual size of activities carried out in tax havens, a further line of research has expanded to assess the impact of tax havens on developed countries. Research conducted in this respect estimates the harmful effects of tax havens in terms of revenue losses suffered from non-haven jurisdictions, by using different data and techniques. However, results achieved do not lead to unanimous conclusions as to the positive or negative impact tax havens have upon non-haven economies. As a matter of fact, as far as the negative effects in terms of revenue losses are concerned, based on some examinations of tax returns for 1996-1998, the US Internal Revenue Service estimated that the revenue lost deriving from non-compliance with transfer pricing legislation amounted to $ 3 billion.[231] Chairman Levin of the US Senate Governmental Affairs subcommittee estimated that the size of “offshore havens” has grown from $ 200 billion in 1983 (thirty jurisdictions) to $ 5 trillion in mid 2001 (sixty jurisdictions), $ 3 trillion of which are in bank accounts.[232] The United Nations estimated about $ 8 trillion in “offshore companies and accounts”.[233] Oxfam presents a total figure of $ 6 to $ 7 trillion in “offshore centres” in 2000, of which $ 3 to $ 4 trillion are thought to be the savings of the wealthy.[234]

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[230] A.K. Rose, M.M. Spiegel, *Offshore Financial Centres: Parasites or Symbionts?*, Economic Journal, 523/2007, 1310-1335; A. Zoromé, *Concept of Offshore Financial Centers: in Search of an Operational Definition*, IMF Working Paper WP/07/87, 2007, 1-32.

[231] U.S. Department of the Treasury, IRS, Report on the Application and Administration of Section 482, 1999.

[232] C. Levin, *Opening Statement At Senate Government Affairs Committee Investigations Panel Hearing on Tax Havens,* Tax Notes Today, July 19, 2001, 139.

[233] D.J. Mitchell, *The Heritage Foundation, an OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy*, Backgrounder no. 1395, 2000, 12.

[234] Oxfam Policy Dept, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication*, 3, 2000.

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The Tax Justice Network mentioned in Chapter 1 estimates that the amount of funds held offshore by individuals is about $ 11.5 trillion.[235] This results in an annual loss of tax revenue on the income from these assets of about 250 billion dollars, which is five times what the World Bank estimated in 2002 was needed to address the UN Millennium Development Goal of halving world poverty by 2015.[236] According to the Tax Justice Network, this much money could also pay to transform the world's energy infrastructure to tackle climate change. In 2007 the World Bank endorsed estimates by Global Financial Integrity that the cross-border flow of the global proceeds from criminal activities, corruption, and tax evasion at $ 1-1.6 trillion per year, half from developing and transitional economies. In 2009 Global Financial Integrity's updated research estimated that the annual cross-border flows from developing countries alone amounts to approximately $ 850 billion - $ 1.1 trillion per year.

As regards academic studies, Avi-Yonah,[237] for instance, estimated that the tax loss resulting directly from the deferral of the tax on the earnings of all US subsidiaries was $ 2.2 billion in 1997 and this was estimated to rise to $ 3.4 billion in 2004. He also cited Dooley[238] as estimating tax motivated portfolio capital outflows from the US in 1980 through 1982 at $ 250 billion. Schneider and Enste[239] found a considerable "shadow economy" in OECD countries at the beginning of the nineties with a non-weighted average between 11.3% and 15.1% for all members. Altshuler and Grubert[240] estimated a loss of around $ 11 billion for 2002, of $ 13 billion for 2004 and $ 26 billion for 2007. Sullivan[241] estimated that, based on differences in pre-tax returns, the lost for 2004 was between $ 10 and $ 20 billion and reports an estimated $ 17 billion increase in revenue loss from profit shifting between 1999 and 2004.

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[235] http://www.taxjustice.net.

[236] According to some news published on 26 February 2002 on the World Bank internet site (available at http://web.worldbank.org), between $ 40 to $ 60 billion a year in additional aid is the price tag set by the World Bank to cut extreme global poverty in half and substantially improve health and education in developing countries by 2015. These targets are part of the UN's Millennium Development Goals, which the development community is joining forces to reach, and which will be the focal point of an upcoming conference on financing development in Monterrey, Mexico.

[237] R. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1579-1603.

[238] R. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1599.

[239] F. Schneider, D. Enste, *Shadow economies around the world: size, causes, and consequences*, International Monetary Fund Working Paper, WP/00/26, 11.

[240] H. Grubert, R. Altshuler, *Corporate Taxes in the World Economy. Reforming the Taxation of Cross-border Income*, in J.W. Diamond, G.R. Zodrow (Eds.), *Fundamental Tax Reform: Issues, Choices, and Implications*, Cambridge, 2008, 319-354.

[241] M.A. Sullivan, *U.S. Drug Firms Park Increasing Share of Profits in Low-Tax Countries*, Tax Notes International, 13/2004, 1143-1149.

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Christian and Schultz,[242] using rate of return on assets data from tax returns, estimated $ 87 billion was shifted in 2001, which, at a 35% tax rate, would imply a revenue loss of about $ 30 billion. Pak and Zdanowicz[243] examined export and import prices, and estimated that lost revenue due abnormal trade pricing amounted to about $ 53 billion in 2001. Clausing,[244] using regression techniques on cross country data, estimated profits reported as a function of tax rates and concluded that those revenues of over $ 60 billion are lost for 2004 by applying a 35% tax rate to an estimated $ 180 billion in corporate profits shifted out of the US.

According to some authors,[245] the difficulty to reach common data results as to the negative effects of tax havens on non-haven countries can be mainly attributed to the circumstance that estimates involve unreported illegal activity. The vast majority of the existing empirical works estimate the total amount of tax evasion and are not able to correctly identify that part of tax evasion resulting from investment flown towards tax havens.

A different line of research has showed that investment attracted by tax havens can have positive spill-over effects on nearby countries. Hines,[246] in particular, studied the possible economic activity diversion from higher tax countries as a result of tax base erosion attributed to havens. Concerns in this respect are commonly hampered in the case of nearby tax havens, which are claimed to divert tax bases that might otherwise be used to raise government revenue. Hines' findings suggest a different conclusion from what is normally claimed. Foreign tax haven activity, and nearby investment in higher-tax countries appear to be complementary: a 1 per cent greater likelihood of establishing a tax haven affiliate is associated with 2/3 per cent greater investment and sales in nearby non-haven countries. Such an observation implies that the availability of nearby tax havens stimulates, rather than diverts, economic activity within a region or a federation. According to Hines, therefore, tax haven operations may stimulate activity in nearby countries, by facilitating the minimisation of taxes in that country and elsewhere, or by reducing the cost of goods and services which are the inputs to production or sales in high-tax countries.

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[242] C.W. Christian, T.D. Schultz, *ROA-Based Estimates of Income Shifting by Multinational Corporations*, IRS Research Bulletin, 2005, at http://www.irs.gov/pub/irs-soi/05christian.pdf.

[243] S.J. Pak, J.S. Zdanowicz, *U.S. Trade With the World, An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports*, 31 October 2002 available at http://dorgan.senate.gov/newsroom/extras/pak-zdan.pdf.

[244] K.A. Clausing, *Multinational Firm Tax Avoidance and U.S. Government Revenue*, National Tax Journal, 4/2009, 703-726. Her method involved estimating the profit differentials as a function of tax rate differentials over the period 1982-2004 and then applying that coefficient to current earnings.

[245] R.T. Kudrle, L. Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, Stanford Journal of Law, Business, and Finance, 9/2003, 42.

[246] J.R. Hines, *Do Tax Havens Flourish?*, in J M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99.

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Tax-minimisation activity carries mixed implications for governments of nearby countries, because it may erode tax bases and therefore tax collections, implying that the greater economic activity associated with nearby tax havens might come at a high cost in terms of foregone government revenues. An evaluation of this effect relies, however, on careful consideration of the type of tax avoidance uses to which tax haven affiliates are put. In particular, it is possible that the use of tax haven operations by multinational firms permits governments of high-tax countries to refine their tax systems by subjecting multinational firms to different effective tax rates than domestic firms.

In addition to spill-over effects on nearby countries, Desai, Foley and Hines[247] also observed an important fact, i.e. that reduced costs of using tax havens (i.e. lower tax rate on firms' foreign investment) do not appear to divert activity from non-haven countries, and that reliable estimates of the magnitude of such diversion do not exist.[248] Firms facing reduced costs of establishing a tax haven operation respond in part by expanding their foreign activities in nearby high-tax countries. A careful use of tax haven affiliates, according to the Authors, permits foreign investors to avoid some of the tax burden and to keep foreign investment at levels exceeding those that would persist if tax havens were more costly.

Rose and Spiegel,[249] scrutinising OFCs, used the gravity model of trade to explain activity between two countries as being a positive function of the economic masses of the countries, and a negative function of the distance between them. In practice, population and real GDP per capita are used to proxy economic mass, and great-circle distance and a few other measures to proxy for economic distance. After controlling for these influences, they investigated whether there is any additional role for international measures. Rose and Spiegel observed both the determinants of OFCs and the consequences of OFCs for neighbouring countries. They empirically found that successful tax havens (which are likely to be OFCs) encourage bad behaviours in source countries, as they facilitate tax evasion and money laundering. At first blush, therefore, they are best characterised as "parasites", since they are designed to engage in activities detrimental to the well-being of their clients' home States. Nevertheless, tax havens can determine positive consequences, as they are observed to enhance the competitiveness of the local banking sector. Using a model of domestic monopoly bank facing a competitive fringe of the tax haven, they demonstrate that the proximity of this latter enhances the competitive behaviour of

[247] M.A. Desai, C.F. Foley, J.R. Hines, *Do tax havens divert economic activity?*, Economic Letters, 90/2006, 219.

[248] Similar view is shared by R. Bisvas, *International Tax Competition: globalisation and fiscal sovereignty*, London, 2002, 29, according to whom "In relation to distortions in tax structures, there is no evidence of any significant loss of revenue in home States from companies incorporating in 'tax havens'".

[249] A.K. Rose, M.M. Spiegel, *Offshore Financial Centres: Parasites or Symbionts?*, Economic Journal, 523/2007, 1310-1335.

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the monopoly bank and may increase the overall welfare. Thus, as proximity of one country to a tax haven is associated with a more competitive domestic banking sector and greater financial intermediation, tax havens are better characterised as "symbionts".

In the light of the above, without denying the tax base loss that high-tax countries suffer from tax haven transactions, it seems that the overall net effect of offshore investment on rich States should not be labelled *tout court* as negative. Anti-tax haven measures enacted in response of the claimed tax erosion, which will be object of discussion in Chapter 4, risk being disproportionate in respect of the overall net gains resulting from tax haven investments.

The current economic literature focuses on the impact of tax havens on developed countries, but it does not really address how tax havens impact on developing countries. According to recent studies, tax avoidance strategies involving tax havens impact on sums from developing countries, which therefore suffer from an adverse effect on their development programs.[250] As with the industrialised countries, revenue and foreign exchange losses resulting from tax haven activities are the most obvious concern of developing countries.

According to some news reported on 13 March 2009 on the Oxfam internet site[251], developing countries miss out on up to $ 124 billion every year in lost income from offshore assets held in tax havens. An analysis conducted for Oxfam by James Henry, former Chief economist at McKinsey& Co,[252] found that at least $ 6.2 trillion of developing country wealth is held offshore by individuals, depriving developing countries of annual tax receipts of between $ 64-124 billion. If money moved offshore by private companies was included, this figure would be much higher. The scale of the losses could outweigh the $ 103 billion developing countries receive annually in overseas aid, and capital flight is a growing problem with an additional $ 200-300 billion being moved offshore each year. According to Oxfam, wider reform of the financial system would reduce volatility, increase accountability and give developing countries a greater say in the management of the global economy.[253]

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[250] See more broadly J.C. Sharman, *International financial centres and developing countries: providing institutions for growth and poverty alleviation*, Commonwealth Secretariat, 2010; M. Keen, A. Simone, *Is tax competition harming developing countries more than developed?*, Tax notes international, 13/2004 (special suppl.), 1317-1325; C. Silberztein, *Transfer pricing: a challenge for developing countries*, OECD observer, no. 276-277, 2009/2010, 29-31; C.E. McLure, *Will the OECD Initiative on Harmful Tax Competition Help Developing and Transition Countries?*, Bulletin for International Fiscal Documentation, 3/2005, 90-98.

[251] http://www.oxfam.org.uk

[252] Quoted on the same internet website.

[253] In this respect, according to the news reported on the Oxfam internet website, the Oxfam Head of Policy and Advocacy, Kirsty Hughes, said: "Developing countries are losing billions of pounds every year that would provide a vital boost to their economies and could be spent on reducing poverty. This money could pay for health and education services, for protection against the deepening impact of the

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Once having identified the current economic literature on the impact of tax havens on developed and developing countries, it is worth focusing the analysis on the impact tax haven activities have on the economy of tax havens themselves. Benefits gained by tax havens in attracting foreign investment through the implementation of more favourable tax regimes are obvious. Host governments gain additional revenue, even at low tax rates, that would not otherwise have accrued. They also collect revenue from tax on the salaries of employees, and the profits of suppliers of goods and services, as well as value added tax or sales taxes, whether existing. However, the level of actual economic development prompted by foreign investors in tax havens is a different story. According to Irish,[254] for example, the extreme volatility of tax haven activities is incapable to promote alone sustained, stable economic growth with benefits for a large proportion of their indigenous population of tax havens. Economic development, in fact, requires an appropriate substantial base, such as strong linkages to other sectors of the economy. Most tax havens are small islands, whose economies are extremely fragile. They are typically based on agriculture and are exposed to natural disasters. This makes tax havens highly dependent on foreign aid and makes it hard to become competitive in manufacturing sector, mainly due to their small size. Their profound economic disadvantages commonly include restricted comparative advantages, diseconomies of scale, dysfunctional market structures, high transport costs, high level of openness to international trade, tendencies to be price-takers not price-makers, limited natural resources, small labour market, and deficiencies in professional and institutional knowledge and experience.[255]

It should be however noted that in the most established tax havens usually there can be immediate positive economic effects of foreign investment, because there are close links between the offshore economy and other sectors of the economy, such as tourism, construction, training of clerical and technical personnel, and development of local financial and professional expertise.[256] In addition, the enhancement of training

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economic crisis such as safety nets to help those who have lost jobs and for projects to protect poor people already affected by climate change. $ 16 billion a year would be sufficient to give every child a school place and $ 50 billion a year is needed to help poor countries protect their people from climate change. The current financial crisis shows our leaders can no longer afford to stand idly by whilst tax havens take billions of pounds from the pockets of taxpayers in rich and poor countries alike. Reform of tax havens would be an easy win for our leaders that would benefit ordinary people at home and abroad alike. There is no longer any excuse for delay."

[254] C.R. Irish, *Ib*.

[255] H. Armstrong, R. de Kervenoael, R. Read, X. Li, *A comparison of the economic performances of different microstates, and between microstates and larger countries*, World Development, 26/1998, 639-656; L. Briguglio, *Small Island States and Their Economic Vulnerabilities*, World Development, 23/1995, 1615-1632, S.A. Royle, *A geography of islands: small island insularity*, London, 2001.

[256] See M.P. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, World Development, 9/2002, 1664, who observe that a precondition for successfully hosting offshore finance might consists in all attributes that small island societies have, such as relatively strong cohesion, common attitudes and values, social normal, networks, culture, language and the role of trust.

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and employment programs in the tax haven sector might stimulate the indigenous work force and this might allow local people to be channelled later into employment in other sectors of the economy.

There are also infrastructural advantages: the presence of a critical mass of multinational subsidiaries in an industry will support development of the services they need, in turn making it easier for both foreign and local firms to set up the main industry. In general, multinational firms attracted in low-tax jurisdictions benefit local employees, as they offer training, good pay and conditions relative to local norms, the opportunity to travel and the sense of community obtained in a large firm. On the downside, the employment is more precarious than with smaller, more domestically centred firms, the skills obtained may not be transferable, and there is increasing dependence.

It should also be highlighted that according to recent findings[257] tax haven countries attract greater foreign investment than other countries of similar sizes and income levels do and that a partial result of this is the faster growth rate of tax havens compared to high-tax countries. Hines evidenced that since public sectors of tax havens are not noticeably smaller than those of other countries, the more favourable tax treatment they offer to foreign investors does not appear to have greatly impaired government finance, because the economic success of tax havens is reflected in the persistence of their policies. They appear to stimulate greater investment activity and to permit governments to tax more mobile international capital less heavily than purely domestic capital. The robust performance of their economies suggests that they are likely to continue offering favourable tax terms to foreign investors, despite the negative reactions of high-tax countries, worried about tax bases erosion.

However, as highlighted by Irish,[258] the level of benefit received from tax haven status and the likelihood that haven status will act as a catalyst for development diminishes with each new country entering the tax haven business. Consequently, as the competition for tax haven business grows, it probably will become more and more difficult for the established havens to sustain the level of benefits and linkages gained from tax haven status. It will also probably become even more difficult for new entrants to establish a level of benefits and linkages making tax haven status worthwhile.

[257] J.R Hines, *Do tax havens Flourish?*, in J M. Poterba (Ed.), *Tax Policy and the Economy*, vol. 19, Cambridge, 2005, 65-99. The Author also highlights that major tax havens have less than 1 percent of the world's population (outside the United States) and 2.3 percent of world GDP, but they host 5.7 percent of the foreign employment and 8.4 percent of foreign property, plant, and equipment of American firms. Per capita real GDP in tax haven countries grew at an average annual rate of 3.3 percent between 1982 and 1999, which compares favourably to the world average of 1.4 percent.

[258] C.R. Irish, *Tax Havens*, Vanderbilt Journal of Transnational Law, 3/1982, 499.

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CHAPTER 3

TAX HAVENS AND TAX COMPETITION: AN OVERVIEW AT THE CURRENT ECONOMIC LITERATURE

From a political and policy standpoint, both at the international and the national level, the problem of tax havens has commonly been dealt with in terms of tax competition. The more favourable tax regime provided by these jurisdictions to non-resident investors is commonly claimed to erode high-tax countries' tax bases. The present Chapter provides an overview at the current literature of tax competition. To that purpose, a definition of tax competition is first provided (paragraph 1), in order to demonstrate that at the international level the existing differences between tax systems do indeed affect taxpayers' choice of investments. Thus, States do compete among each other in order to attract foreign tax bases (paragraph 2). The analysis then focuses on the existing literature of tax competition (paragraph 3), providing an overview at the classical theory elaborated by Tiebout (paragraph 3.1.) as opposed to modern theories which are based on Oates' model (paragraph 3.2.). Whereas the classical theory predicates for the so called "beneficial effects" of tax competition, the modern thought achieves opposite results. According to modern literature tax competition lowers governments' expenditures below their efficient levels and results in an inefficient provision of public goods. Subsequent elaborations of the Oates' model on tax competition also conclude for the so called "wasteful effects" of tax competition, considering a number of different variables, such as capital taxation in small open economies; the presence of externalities; the presence of two factors of production, i.e. capital and labour; asymmetrical tax competition, i.e. between a large and a small region; and the response to tax competition by multinational firms (paragraphs 3.3.-3.7). The exam is finally focused on the effects that tax competition brought forward by tax havens has on high-tax countries (paragraph 4). In this respect, it is highlighted that the current literature does not share a common view: while some authors find no activity diversion from high-tax countries, some others conclude for the erosive effects of tax havens on high-tax countries. A minority theory which proposes to observe competition from the perspective of taxpayers, rather than of governments, is also briefly discussed (paragraph 5).

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1. The received view on tax havens: tax competition and tax base erosion

As it has been pointed out several times in the previous Chapters, at the international level the problem of "tax haven" has often been faced in terms of tax competition. The increasing great mobility of factors of production as a result of the economic globalisation processes has been held to be the cause of proliferation of the tax haven phenomenon. While national governments are sovereign in setting their tax policies, and taxpayers are opportunistic in choosing the location of their investments, States compete against each other in order to attract investment. The phenomenon of strategically using tax policies to attract mobile investment factors is commonly referred to as "tax competition", and often results in a situation in which governments offer a more favourable tax environment than that existing in other countries.

For example, Slemrod[259] has examined how taxes affect taxpayers' behaviours, and argued about the different factors influencing their choices. He provided evidence that tax rates and tax systems can affect the relative return to conducting real operations in different jurisdictions, and therefore the location of real activity. In addition, when the location is set, taxes are proven to also affect the jurisdiction to which taxable income is reported. Slemrod's model provided a minimal conceptual structure for evaluating to what extent and in what situations the opportunities for avoidance mitigate the real response to rage tax reforms. Tax competition appears to imply a situation of perfect tax neutrality, but this is not true when tax competition is considered in detail.[260] Tax competition and tax havens are, in fact, an overlapping matter of study, and different theories have been formulated.

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[259] J. Slemrod, *A General Model of the Behavioral Response to Taxation*, NBER, Cambridge, 1998, Working Paper No. 6582.

[260] For broader discussions on tax neutrality see J. Mintz, *The corporation tax: a survey*, Fiscal Studies, 16, 1996, 4; G. Rawlings, *Mobile People, Mobile Capital and Tax Neutrality: Sustaining a market for offshore finance centers*. Acc Forum 3, 2005, 289-310; R. Romstorfer, *Capital export and capital import neutrality in tax treaties*, in M. Stefaner, M. Züger, *Tax treaty policy and development*, Vienna, 2005; 63-82; A. Tontsch, *Corporation tax systems and fiscal neutrality: the UK and German systems and their recent changes*, Intertax, 5/2002, 171-189; J. Lang, *The influence of tax principles on the taxation of income from capital*, in P.H.J. Essers, A. Rijkers, *The notion of income from capital*, Amsterdam, 2005, 3-31; S. Smith, R. Barents, *Neutrality and subsidiarity in taxation*, London, 1996; E. Kemmeren, *Origin-based double tax conventions and import neutrality*, Rivista di diritto tributario internazionale, 2/2001, 103-123; R. Mason, *Tax discrimination and capital neutrality*, World Tax Journal, 2/2010, 126-138; K. Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community Law: an institutional approach: with comments by Johan Brands and Kees van Raad*, Deventer, 1994; J. Norregaard, J. Owens, *Taxing profits in a global economy*, Tax Notes International, 10/1992, 491-497; A.D. Kahn, *The Two Faces of Tax Neutrality: Do They Interact or are They Mutually Exclusive?*, Northern Kentucky Law Review, Vol. 18, 1990, available at SSRN: http://ssrn.com/abstract=991695.

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In this Chapter, a definition of tax competition will be first established. An overview of the existing literature on tax competition will be then provided, distinguishing between classical and modern theories. The focus of the analysis will be then restricted on tax havens, in order to try to observe their impact upon high-tax countries.

There are many outstanding definitions of tax competition in the literature. A good starting point is the definition provided for by Wilson and Wildasin,[261] according to which tax competition is any form of "non-cooperative tax setting by independent governments, under which each government's policy choices influence the allocation of a mobile tax base among regions represented by these governments". This definition emphasises the very important role taxation plays on independent governments, due to the inflows or outflows effects deriving from a decrease or an increase in mobile tax bases. The reference to a "non-cooperative tax setting" means that each government does not take into account the impact that its tax decisions have on other governments.[262] As tax reductions generate capital inflows and outflows across countries, and the resulting losses and gains of tax revenue are widely considered as welfare-decreasing or welfare enhancing, depending on the different variables which are taken into account.

A useful clarification has also been set out in the literature[263] between the term "tax-based competition" and "tax competition". Whereas the former describes competition among businesses located in various jurisdictions, which occurs because of the

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[261] J.D. Wilson, D.E. Wildasin, *Tax Competition: Bane or Boon?*, Working Paper prepared for the Office of Tax Policy Research/Institute for Fiscal Studies conference, "World Tax Competition", held on May 24-25, 2001, London, UK, 2-3. The Authors provide for other two definitions of tax competition. The first and very broad one is any form of non-cooperative tax setting by independent governments. The second definition, which is narrower, adds the requirement that each government's tax policy influences the allocation of tax revenue across government treasuries. This definition seems to be the most credited one in literature. See, for example, M.P. Devereux, S. Loretz, *What do we know about corporate tax competition?*, Paper presented at the Tax Havens and Tax Competition Conference, 18-19 June 2007, Bocconi University, Milan, Italy, who point out the existence of a great variety of definitions, but appraise this at hand because it encompasses the behaviour of welfare-maximising or non-welfare-maximising governments, in a small open economy or as strategic interaction between governments of two or more larger countries. Other studies, in fact, provide for other definitions, which take into account of the other variables under observation. A. Easson, *Tax Incentives for Foreign Direct Investment*, The Hague, 2004, 220 defines tax competition as "the attempt to attract investment that might otherwise go elsewhere by offering a relatively attractive tax environment to investors. The attraction may lie in generally low tax rates, in special incentives, or in other favourable tax provisions or practices that reduce the effective burden of taxation on the investor".

[262] Tax competition here refers to horizontal competition, as opposed to vertical tax competition. Whereas the former is the kind of tax competition taking place between governments at the same level, the latter refers to tax competition of governments of different levels, which normally arise in federal States, when governments of different levels impose a tax on the same base. See R. Boadway, M. Marchand, M. Vigneault, *The consequences of overlapping tax bases for redistribution and public spending in a federation*, Journal of Public Economics, 3/1998, 453-478.

[263] C.E. McLure, *Tax Competition in a Digital World*, Bulletin for International Fiscal Documentation, 4/2003, 146.

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characteristics of the different' tax systems (typically tax bases and tax rates), the latter refers to competition among countries that modify their tax systems with a view to attracting economic activities at the expense of other countries. Thus, while tax-based competition is a process that occurs in the private sector and is based on the characteristics of tax systems, tax competition is a process involving governments, which are interested in making their tax system more competitive.

Tax competition in income taxes can be further distinguished in three categories:[264] competition for the location of production and sales; competition for the residence of companies; competition for the income tax base. While the first two categories of competition involve competition for the location of "real" activities, the last class does not. The following analysis includes all the three mentioned categories.

2. The relationship between tax competition and tax neutrality

The economic literature broadly analyses whether tax competition distorts investment and trade and undermines the possibility of having a level playing field for competitors. In this respect, it is worth recalling that from a normative standpoint the efficiency of tax systems is commonly measured in terms of neutrality,[265] as they should be shaped so as not to affect the choices of investment of taxpayers and their efficient location of productivity factors.[266] Thus, in theory, a neutral tax system would not distort investment decisions, so that investments would be directed towards those sectors of the economy where the rates of return are higher.[267]

Proponents of tax neutrality argue that taxes should not be used to attract investment, but the fact is that tax systems are rarely neutral, as governments use the tax system to influence taxpayers' behaviour. There is indeed wide evidence that taxation influences corporate decisions, and tax planning is one of the clearest

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[264] C.E. McLure, *Ib.*

[265] P.B. Musgrave, *Capital export neutrality*, in J.J. Cordes, R.D. Ebel, J. Gravelle (Eds.), *Encyclopedia of Taxation and Tax Policy*, Washington, 2005. 45-46.

[266] The tax variable has an influence over the investment choices and can cause distortions in the financial markets. It can create barriers to foreign investment, as well as make other governments' incentives inefficient or ineffective. See for example A. Easson, *Tax incentives for foreign direct investment. Part I: Recent trends and countertrends*, Bulletin for fiscal documentation, 7/2001, 266-274, who highlights that the tax variable acquires more and more importance in the investment choices. Due to the mobility of capitals, it is easy for an individual to move capital and look for the most profitable investment. Consequently, countries feel a high pressure coming from the competitive environment and in some situations they are almost forced to introduce a certain type of incentives to attract investments and tax revenues and be competitive in the world market.

[267] R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 133, who also points out that exceptions to this rule may be when social rates of return deviate from private rates of return.

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examples of non-neutrality of tax systems.[268] The literature shows that tax systems are rarely neutral in design, and never neutral in effect, so that tax competition is likely to have a real impact.[269] Moreover, countries impose taxes at different rates and apply different rules to determine taxable income, so that effective tax rates vary considerably from one jurisdiction to another.[270] Investors are induced to take advantage of these tax differentials with a view to maximising their after-tax return on investment.

In addition to tax rate differentials, cross-border investment is often subject to double taxation, which reduces the net rate of return deriving from the investment. The State of residence generally levies taxes on the worldwide income of its resident investors, while the State of source generally levies taxes only on the part of income produced by a non-resident investor within its territory (so called "principle of territoriality").[271]

From the perspective of the investor, it is clear that cross-border location of the factors of production entails a problem of double taxation which discourages cross-border investment. The negative effect of double taxation on cross-border investment is described in the following terms.[272] Assume the absence of double taxation, a function of production with constant return to scale, the existence of one factor of production (i.e. capital), growing at a rate *r*, two States (respectively the home State, *h*, and the source State, *s*) in which taxes are levied at a progressive marginal rate

[268] M. Scholes, M. Wolfson, *Taxes and Business Strategy: A Planning Approach*, Upper Saddle River, 1992, 4, identified three non-neutral aims in the design of a tax system: wealth distribution, provision of infrastructure, and incentive effects. G. Robinson, *The unconventional minister: my life inside new labour*, London, 71 described how policy was formed on the assumption that firms would seek to manage their affairs to minimise taxation. R.S. Chirinko, *Do tax incentives work? The Real effects of the tax reform act: comment*, National Tax Journal, 9/1992, 291-297 argued that the introduction of tax incentives motivates managers to take the action desired by governments.

[269] S. Killian, *Where's the harm in tax competition? Lessons from US multinationals in Ireland*, Critical Perspectives on Accounting, 17/2006, 1070. The Author also argues that the greatest tax influence on corporate action is corporate tax, rather than taxes levied at a shareholder or employee level, although corporate taxes should be irrelevant, since they are not ultimately borne by the firm.

[270] P.B. Musgrave, *International Tax Differentials for Multinational Corporations: Equity and Efficiency Considerations*, in United Nations, Department of Economic and Social Affairs, *The Impact of Multinational Corporations on Development and on International Relations; Technical Papers: Taxation*, New York, 1974, 43-57.

[271] States are sovereign and free to establish both the cases when taxpayers should be considered as resident or non-resident and when income should be considered produced within its territory. This clearly determines whether and to what extent a certain form of investment is subject to taxation in that State. Neither customary international law nor Community law establish any rule which provides for some basic criteria on this matter. Therefore, a person can be considered as resident in two or more States at the same time and therefore be requested to pay tax on her/his worldwide income in both the residence and the source State. International conventions are the only instrument that can prevent such a situation.

[272] See more broadly R. Artoni, *Elementi di scienza delle finanze*, Bologna, 2005.

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t[273]. Under the principle of residence, in a domestic situation, return of investment R will result in:

$$R_h = r_h\,(1 - t_h)$$

whereas in a cross-border situation:

$$R_s = r_s\,(1 - t_h)$$

As tax rate is identical in both situations, return of investment only depends on the existing rate. A situation of equilibrium, in which the location of investment is irrelevant, would result only when $r_h = r_s$ because all income is taxed at the same tax rate t_h by the investor's State of residence. As the return of investment R depends on the interest rate r of every country, capital will be located in the country with higher interest rate. Under the principle of residence, taxation has no impact on the choice of investment, since it reduces both domestic and foreign investment for a margin equal to t.

Conversely, when the principle of territoriality applies, return of investment R is equal to:

$$R_h = r_h\,(1 - t_h)$$

and

$$R_s = r_s\,(1 - t_s)$$

In such a situation R depends on both r and the different tax rate t existing in the different States where capital is located. As maximisation of the overall after-tax rate of return requires $R_h = R_s$, the principle of territoriality does not allow the efficient location of resources unless $r_h = r_s$.

In fact, in a situation where $r_h = r_s$ investor will decide to locate capital in the State with the lowest tax rate, in order to maximise his overall rate of return. As a result, where factors of production can move freely, the choice of investment will be driven by tax considerations.

A practical example of such an assumption is the production of income abroad through a foreign entity based in a low-tax jurisdiction. This is a form of profit-maximisation strategy which exploits tax differentials. Since many non-haven industrialised countries do not tax foreign source profits earned by foreign subsidiary corporations until the profits are distributed from the foreign subsidiary to the domestic parent, a corporation residing in a high-tax country would be induced to set up a foreign entity in a low-tax country in order to indefinitely defer payment of taxes at home.

The same issue can also be analysed in terms of neutrality of the tax system. Taxation on the base of residence achieves the so called "*capital export neutrality*",

[273] A tax is considered progressive when, raising the taxable income, the average tax rate rises too. In other words, richer taxpayers pay more taxes.

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according to which a system of taxation is neutral towards exports of capital when a taxpayer obtains an after-tax return which does not depend on the localisation of his investment. Under the capital export neutrality, international investor residing in a State is in fact taxed like a domestic investor residing in the same State. The doctrine of capital export neutrality suggests that for an individual investor the tax system of State A or State B should not influence its decision of location of its investment. If two companies are equally productive and efficient, but located in two different nations, then they should stand equal chances of attracting the investment of the individual investor above, regardless of the tax regime of the country in which they are established. The goal is that invested resources should be put to their highest use, and should earn the largest return.[274]

The doctrine of capital export neutrality therefore suggests that different governments should adopt the same tax rates (for mobile capital) so that investment decisions do not reflect differences in tax levels, but instead only reflect the productivity of given production factors in individual countries.[275]

Conversely, taxation on the base of source achieves the so called "*capital import neutrality*". According to capital import neutrality, a system of taxation is considered neutral towards imports of capital where a taxpayer obtains an after-tax return in any country, independently of its residence. An international investor is in fact taxed in the source State like a domestic investor residing in the source State.

As cross-border investment is subject to double taxation, States generally agree on international conventions in order to establish in which cases and to what extent the State of the source of income may levy a tax and how the State of residence will eliminate the resulting double taxation. Two methods are the most used to eliminate the resulting double taxation: (*i*) tax credit and (*ii*) exemption.[276] When the State of residence provides a resident investor with a credit for tax paid abroad, capital export neutrality is achieved. The investor will be taxed on his worldwide income (which includes income produced abroad) at his home State tax rate. Conversely, when international double taxation is avoided through the exemption method, capital import neutrality is achieved. Income produced abroad by the investor will only be subject to

[274] As pointed out by R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 134, analogous arguments apply to trade. If the availability of good and cheap factor inputs in a country A are better than in country B, this should increase the productivity of any investment the individual investor makes in A and enable the individual investor to earn higher unit returns, regardless of the levels of taxation in the respective countries.

[275] C. Edwards, V. de Rugy, *International Tax Competition: A 21st Century Restraint on Government*, Cato Institute Report no. 431, Washington, 2002, available at http://www.cato.org/pubs/pas/pa431.pdf.

[276] International double taxation is generally faced by the State of residence either (*i*) by granting tax relief for tax paid in the State of source, or (*ii*) exempting income produced in the State of source, or (*iii*) granting a deduction of the foreign source income. Article 23 of the OECD Model Convention provides for the first two alternative methods.

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taxation in the State of source, this income being disregarded for tax purposes by his home State.

At the international level, income is taxed differently depending on its nature. Under the OECD Model Convention, the residence country has normally priority in the taxation of income over the source country.[277] While the source country is allowed to levy withholding taxes on these incomes and tax rates are generally more favourable than those provided for in domestic legislation (sometimes also to zero under some bilateral treaties), the residence State grants a relief from double taxation in the form above illustrated.

If the home country allows the exemption of foreign source income, a low-tax host country has a tax-based competitive advantage. It can offer foreign investors any form of incentive to attract foreign investment.

By contrast, if the home country grants a tax credit to relief its resident taxpayers from international double taxation, normally up to the tax which is attributable to the income which may be taxed domestically, it might "neutralise" any advantage granted by the low-tax host country. Worldwide income tax systems therefore prevent tax-based competition among host countries by absorbing any differences in taxation in various host countries.[278] A residence-based taxation combined with effective exchange of information violates capital import neutrality, as a resident of one high-tax country will not pay the same tax rate as a resident in a low-tax country, if both making an investment in a third country.

However, tax-based competition can also be facilitated by residence-based taxation, for the following reasons. First, generally, a residence State does not tax income produced abroad until it is repatriated in the form of dividend distribution. In theory, this does not provide an economic advantage since the present value of the tax is the same whenever it is ultimately paid.[279] However, the real present value of foreign tax credit, which is based on the nominal amount of tax paid when the income is earned, falls over time, shredding the "umbrella" protecting the high-tax regimes of host countries created by the foreign tax credit in the case of immediate repatriation. Second, if a firm has excess foreign tax credits because foreign taxes exceed the amount of domestic tax that would be paid on foreign-source income, the result is economically similar to exemption of marginal foreign-source income by the residence country. Third, if low-taxed income (commonly from passive investments)

[277] Exceptions to this rule are normally contained in articles 8(1) (Profits from the operation of ships or aircraft in international traffic), 8(2) (Profits from the operation of boats engaged in inland waterways transport), 12 (royalties), 13(5) (Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4 of article 13), 15(2) (income from employment, under certain conditions), 18 (pensions), and 19 (Government service).

[278] C.E. McLure, *Tax Competition in a Digital World*, Bulletin for International Fiscal Documentation, 4/2003, 153.

[279] See D.G. Hartman, *Tax Policy and Foreign Direct Investment*, Journal of Public Economics, 2/1985, 107-121.

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can be combined with high-taxed income (commonly business profits) in calculating the foreign tax credit limits, the result may approximate exemption of the latter. To prevent this, some countries that tax worldwide income and allow foreign tax credits might place various types of income in separate "baskets". Finally, some residence countries that tax worldwide income provide tax sparing under which foreign tax credits are allowed for taxes that are not actually paid due to preferential treatment in certain host countries.

Tax-based competition does not affect the location of real investment only. Transfer pricing and financial structure (e.g. the choice of debt and equity) can be manipulated to shift business income from high-tax countries to low-tax countries, including tax havens, and to shift deductions in the other direction. Whereas tax-based competition for real economic activity is a question of effective tax rates, competition for taxable income is a question of statutory rates.

Besides affecting source-based taxation, income shifting can have implications for the ability to use foreign tax credits. Shifting income from the residence country to the host country reduces the effective tax rate in the latter and thus the occurrence of excess foreign tax credits.

In conclusion, if one considers both tax rate differentials and the different types of neutrality on cross-border investment (i.e. capital import and capital export neutrality) it is clear that taxation is a key factor in investment and location decisions, and that the evaluation of profitability of investment is naturally driven by tax considerations in the context of a global world where factors of production move freely. Thus, it is reasonable to argue that international taxation might create some forms of tax-based competition, some of which might give rise to tax competition.

The following paragraphs will examine economic theories observing the effects of tax competition, which are held to be harmful by the modern literature. It is worth pointing out here that tax competition is claimed to be harmful because it affects relocation decisions and erodes tax bases. However, any form of taxation, especially in an international context, is proven to cause distortions and to be non-neutral upon choices of investment.

3. Current theories of tax competition in the economic literature

Most part of the existing literature analyses tax competition in terms of efficiency[280] and is based on an array of factors, such as the size of the countries, the degree of

[280] Some approaches also focus on the type of tax competition. For example J.K. Brueckner, *Strategic interaction among governments: An overview of empirical studies*, International Regional Science Review, 2/2003, 175-188 distinguishes between competition for resource flows and competition over other spillovers between countries, including information. F. Revelli, *On spatial public finance empirics*, International Tax and Public Finance, 12/2005, 475-492 addresses how these two forms of competition can be identified from each other and proposes the use of supplementary tests to estimate reaction functions directly and other elements of the model.

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economic integration, the availability of different tax instrument, the possibility of income shifting, and the conception of the government's objective function.[281] The efficiency of tax competition is, of course, an open issue. Musgrave,[282] for example, has argued that there can be both good and bad effects, depending on what type of competition it is looked at. According to the Author, in fact, tax competition can be good for a jurisdiction, if such a competition provides for the right services at low cost and helps in designing efficient and equitable tax systems; by contrast, competition can be bad if the jurisdiction offers low tax rates to attract capital and high income residents, as in the long run the public services will be at an inefficient level and the use of capital will be less efficient.

A unanimous view shared by the literature is that there is a positive relationship between tax competition and the mobility of capital. If a welfare-maximising government has to rely on a source-based tax on capital, then it will set the tax rate equal to the marginal benefits from providing a public good against the marginal costs of inducing capital to move abroad. The more these marginal costs are significant, the more mobile capital is. This is why tax rates tend to be lower the more mobile capital is.

Devereux and Loretz,[283] for example, distinguish between openness, capital mobility and trade mobility and point out that a country might be completely open, in the sense that there are no restrictions on flows of factors or goods, but the cost of moving capital can be so high that capital is imperfectly mobile. The distinction between costs of trade and costs of factor mobility can be useful to analyse tax competition. Assuming a model with two regions and with capital mobility, very high costs of trade will result in provision of goods and services on domestic markets only. Whether costs of trade are low, goods and services will be exported to the other region. Similar effects result in respect of costs of factor mobility, so that high costs will reduce mobility, whereas low costs will increase it. The level of taxation in both regions can increase or decrease according to trade costs and to mobility of capital.

The models proposed in the literature and reviewed in the following paragraphs are based on these assumptions, but lead to different conclusions. The first theory of tax competition elaborated by Tiebout (discussed in paragraph 3.1.), in fact, concludes for its efficient effect, as tax competition is held to induce governments to levy taxes equal to the cost of the public goods provided. A subsequent model elaborated by

[281] For example C. Fuest, T. Hemmelgran, *Corporate Tax Policy, Foreign Firm Ownership, and Thin Capitalization*, Regional Science and Urban Economics, 35/2005, 508-526 consider a model where the corporate income tax acts as a backstop to the individual income tax, such that tax competition results in lower corporate tax rates and a beneficial role for welfare-improving tax policy coordination.

[282] R.A. Musgrave, *Devolution, grants, and fiscal competition*, Journal of Economic Perspectives, 4/1997, 65-72.

[283] M.P. Devereux, S. Loretz, *What do we know about corporate tax competition?*, Paper presented at the Tax Havens and Tax Competition Conference, 18-19 June 2007, Bocconi University, Milan, Italy, 9.

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Oates (discussed in paragraph 3.2.), however, leads to opposite results, as tax competition is considered to lower governments' expenditures below their efficient levels and results in an inefficient provision of public goods. Further elaborations of this model are based on additional assumptions and conclude for the similar wasteful effects of tax competition. In this respect, the analysis will focus on these subsequent models which consider tax competition with other variables, i.e. capital taxation in small open economies (paragraph 3.3); the presence of externalities (paragraph 3.4); the presence of two factors of production, i.e. capital and labour (paragraph 3.5); asymmetrical tax competition, i.e. between a large and a small region (paragraph 3.6); and the response to tax competition by multinational firms (paragraph 3.7).

3.1. Efficient tax competition

First theories on tax competition classically date back to Tiebout,[284] according to whom competition for mobile households is welfare-enhancing, as it induces governments to impose efficient taxes and to provide efficient local public goods. The model developed by Tiebout is normally regarded as the theory of "efficient tax competition".

In particular, Tiebout's theory is based on several assumptions: each region's government is controlled by its landowners; landowners seek to maximise the after-tax value of the region's land and attract individuals to reside on their land; government offers public goods that are financed by local taxes, but there are many "utility-taking" regions, which implies that no region can alter the utilities that must be offered to individuals to induce them to reside there. Finally, government cannot feasibly reallocate goods and resources in a way that makes some individuals better off without making anyone worse off.

Given the level of public goods provided, a low-tax region will attract individuals, which will be induced to reside within that territory. Households "vote with their feet", i.e. they not only have the power to influence governments through their vote during the elections, but they also can freely move abroad and invest their resources in other countries.

In the Tiebout's model, local governments respond by tailoring their taxes and expenditures to the preferences of their residents. As a result of this competition, the efficient level of taxes in a given region will be set in a way that the payment of taxes by each resident individual will be equal to the cost of public goods provided to this latter. According to Tiebout's theory, therefore, the marginal-cost-pricing rule results in efficient migration decisions.[285]

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[284] C. Tiebout, *A Pure Theory of Local Expenditures*, Journal of Political Economy, 5/1956, 416-424.

[285] See for example R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 146, supporting Tiebout's theory.

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This theory mainly focuses on the impact of taxpayers' behaviours on governments, as taxpayers are viewed as capable to influence government's choices through their investment decisions, rather than simply being subjected to its authority.[286] Existing theories built on the classical Tiebout's model apply similar ideas and contain more elaborated assumptions, as well as more variables. For example, Tiebout's theory was applied to competition among jurisdictions for mobile firms, which benefit from public expenditures. In equilibrium with many competing governments, tax rate imposed upon firms reflects the cost of providing "public inputs" to the marginal firm. The result is an efficient division of firms across region.[287]

3.2. The so called "wasteful tax competition"

The modern literature on tax competition is based on the theories of Oates and constitutes a clear departure from the Tiebout's model. According to these theories, tax competition is considered to be "wasteful", because it lowers governments spending below their efficient levels and reduces tax rates to zero, therefore resulting in an inefficient level of output of public goods.[288]

Such an under-provision of public goods is predicted by Oates in the following terms: "The result of tax competition may well be a tendency towards less than the efficient

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[286] See W. Schön, *Tax Competition in Europe*, Amsterdam, 2003, 4.

[287] For original applications, see M.J. White, *Firm Location in a Zones Metropolitan Area*, in E. Mills, W.E. Oates (Eds.), *Fiscal Zoning and Land Use Controls*, Lexington, 1975, 175-201; and W.A. Fischel, *Fiscal and Environmental Considerations in the Location of Firms in Suburban Communities*, in E. Mills, W.E. Oates (Eds.), *Fiscal Zoning and Land Use Controls*, Lexington, 1975, 119-174. For subsequent elaborations see D. Wellisch, *The Theory of Public Finance in a Federal State*, New York, 2000.

[288] The literature on tax competition since W.E. Oates, *Fiscal Federalism,* New York, 1972, as reviewed in J. D. Wilson, *Theories of tax competition*, National Tax Journal, 52/1999, 269-304 and R.H. Gordon, J.R. Hines, *International taxation*, in A.J. Auerbach, M. Feldstein (Eds.), Handbook of Public Economics, vol. 4, Amsterdam, 2002, 1935–1995, has largely been theoretical, and focused on the possibility that tax competition may result in an inefficient under-provision of public goods. Further extensions of these models incorporate the political economy of fiscal policy and explore the consequences associated to the efficiency of tax competition, as in R.H. Gordon, J.D. Wilson, *Expenditure competition*, Journal of Public Economic Theory, 5/2003, 399-417; and E. Janeba, G. Schjelderup, *Why Europe Should Love Tax Competition – and the U.S. Even More So*, NBER, Cambridge, 2002, Working Paper No. 9334. Empirical efforts to consider the salience or consequences of tax competition include M.P. Devereux, B. Lockwood, M. Redoano, *Do Countries Compete Over Corporate Tax Rates?*, CEPR Working Paper 3400, 2002, who estimate parameters of reaction functions within the OECD to measure the extent to which tax competition has operated between 1982 and 1999, and E.G. Mendoza, L.L. Tesar, *A Quantitative Analysis of Tax Competition v. Tax Coordination under Perfect Capital Mobility*, NBER, Cambridge, 2003, Working Paper No. 9746, who stimulate the dynamics of tax competition within Europe. T. Büttner, *Tax base effects and fiscal externalities of local capital taxation: evidence from a panel of German jurisdictions*, Journal of Urban Economics, 1/2003, 110-128 analyses fiscal competition within Germany by considering the investment effects of tax policies in adjacent jurisdictions.

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levels of outputs of local public services. In an attempt to keep tax rates low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs".[289] Thus, according to this theory, the inefficiency of public services stems from the fact that in a kind of race to the bottom all governments behave this way, and none gains a competitive advantage. Therefore, all communities are worse off than they would have been if local governments had simply used the conventional measures of marginal costs in their decision rules.

This theory is based on the following assumptions: the world consists of a fixed number of identical regions; each region contains a mobile (capital) and an immobile factor (i.e. labour); within each region, competitive firms use a constant-returns technology to produce output from labour and interregionally-mobile capital; consumers use their income from capital and labour endowments to purchase output to use as the sole input into the production of a public good; public goods are financed only with a tax on the capital located within the borders of the region (i.e. source-based tax on capital); public goods and tax rate are set with a view to maximising residents' utility, subject to the budget constraint.

Assuming that the world economy's capital stock is fixed, a capital outflow from one region is nothing but a capital inflow for other regions. Such an inflow benefits these other regions, because the marginal value of capital exceeds the opportunity cost from their viewpoint, by an amount equal to the unit tax rate. A source-based tax on capital drives capital away and therefore results in a reduced tax base and in lower public goods. According to Oates and Schwab,[290] in order to finance public goods, capital tax rate will be raised to the point at which the cost of the public good, including the negative effects of a smaller capital stock, equals the benefits.

In a model in which both immobile and mobile factors are taxed, their results would lead to the conclusion that a source-based tax on capital shifts tax on the immobile factor. As a result, it would be better to tax the immobile residents directly, thereby avoiding the distortion to capital flows. These results are often interpreted as representing the wasteful effects of tax competition. For instance, according to Avi-Yonah,[291] tax competition makes both developed and developing countries shift the tax burden from (mobile) capital to (less mobile) labour. When taxation of labour increases and becomes politically and economically difficult, governments will have to cut services. As a result, globalisation and tax competition tend to lead to a fiscal crisis for countries that wish to continue to provide those government services to their

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[289] W.E. Oates, *Fiscal Federalism*, New York, 1972, 143.

[290] W.E. Oates, R.M. Schwab, *Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, Journal of Public Economics, 3/1988, 333-354.

[291] R.S. Avi-Yonah, *Globalization and Tax Competition : Implications for Developing Countries*, Banco Interamericano de Desarrollo, Departamento de Integraciòn y Programas Regionales, Divisiòn de Integraciòn, Comercio y Asuntos Hemisféricos, Instituto para la Integraciòn de América Latina y el Caribe, February 2001, available at http://www.fiscalreform.net/library/pdfs/global_tax_competition.pdf.

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citizens, at the same time that demographic factors and the increased income inequality, job insecurity and income volatility that result from globalisation render such services more necessary.

3.3. The interdependence of tax competition and capital mobility

The basic model of wasteful tax competition was further developed and considered in conjunction with capital taxation in small open economies. Zodrow and Miezkowski[292] and Wilson,[293] under this approach, made several assumptions: countries are identical and are unable to influence the world interest rate; in a given country each competitive firm produces a single and homogenous output, using two factors of productions: one is mobile (capital) and the other one is immobile (labour or land); region's residents inelastically supply immobile factor, because they are themselves immobile; the world capital stock is fixed and perfectly mobile across countries, which means that residents are free to invest their capital anywhere; firms output is sold to residents as consumption goods and to government as intermediate goods, which will be further used to provide public goods; income distributions are ignored, i.e. each region's residents are identical.[294]

Governments are assumed to maximise their residents' benefits under the public expenditures constraint and must identify the efficient capital tax rate. As public expenditures are financed by capital taxation, the tax burden is a function of the demand of capital within that region and of the cost of such capital. In other words, an increase of the demand of capital would result in higher capital taxation and higher tax revenue. A higher cost of capital would result in a decrease of the demand of capital. If capital is invested in that region, then the marginal product of capital will decrease and the marginal product of labour will increase. Firms will invest up to the point at which the marginal product of capital is equal to the demand of capital.

In order to maximise public expenditures, government needs to consider that an additional unit of expenditure must be financed by raising capital taxation, as well as that an increase of capital taxation results in an increase of the cost of capital and in a movement of the demand of capital for a negative amount. The model assumes that the after-tax return of capital is fixed in that region. Therefore, the increase of capital taxation does not reduce income of residents. The increase of taxation, as a result of the increased public expenditures, must be high enough not only to finance the marginal cost of the resources of public expenditures, but also to compensate the impact of capital outflow on tax revenue. As a result, the marginal benefit of public

[292] G.R. Zodrow, P. Mieszkowski, *Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods*, Journal of Urban Economics, 3/1986, 356-370.

[293] J.D. Wilson, *A Theory of Interregional Tax Competition*, Journal of Urban Economics, 19/1986, 296-315.

[294] In the Zodrow and Miezkowski's model each region's public good supply is financed by a tax on the capital employed within its borders and governments levy taxes on capital only.

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expenditure exceeds the marginal resource cost to compensate the tax-induced capital outflow.

In this model, taxation would constitute the discrepancy between the social value of an additional unit of capital and the social opportunity cost of this unit. In economic terms, taxation therefore would basically amount to the price imposed by the additional demand of a resource and the cost of this latter.

One of the main conclusions of this theory is that there is a discrepancy between the value and the opportunity cost of capital at the margin, and regions are harmed by capital outflows and benefits from capital inflow.[295] Devereux and Loretz[296] however argue that this conclusion is falsified by the data and point out that corporate tax rates around the world reveal that source-based taxes on corporate income persists. Devereux and Loretz basically claim that if the Zodrow-Mieszkowski theory were to be considered as the core model of tax competition, one would conclude that there is no competition.

However, the literature has reached different conclusions by considering some additional assumptions and variables. Wilson,[297] for example, extends the Zodrow-Mieszkowski model to a system of many regions that import and export two private goods. In a situation of equilibrium, the two regions choose a relatively low tax rate on capital and produce the capital-intensive good, whereas other regions choose a relatively high tax rate and produce the labour-intensive goods. No region produces both goods, because then a tiny reduction in its tax rate would discontinuously eliminate all production of the labour-intensive good, creating only capital-intensive production in its place. As a result, there would be a discontinuous jump in tax revenue, at almost no cost in terms of reduced wages. This diversity in tax rates is wasteful, since there are no *ex ante* differences between regions to justify it.

According to Wilson, the lack of a convergence in tax rates over time reflects certain amount of wasteful tax competition: some regions will not try to attract the capital-intensive industry and will choose high tax rates, as will settle for relatively high levels of public expenditures but low wage rates.

[295] According to another interpretation of these results, an increase of investments in a given region results in an increase of public expenditures, due to the increase of the demand of infrastructures and public goods. If capital is taxed to find the necessary resources to finance such an increase of the demand, inflows and outflows of capital would be indifferent to regions. However, if capital is not efficiently taxed, then taxation will represent the difference between the social value and the opportunity cost of capital at the margin.

[296] M.P. Devereux, S. Loretz, *What do we know about corporate tax competition?*, Paper presented at the Tax Havens and Tax Competition Conference, 18-19 June 2007, Bocconi University, Milan, Italy.

[297] J.D. Wilson, *Trade, Capital Mobility, and Tax Competition*, Journal of Political Economy, 4/1987, 835-856.

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This model is an extension of the Heckscher-Ohlin model of international trade to include mobile capital and a public good that is financed with a tax on capital.[298] The basis for trade in Heckscher-Ohlin model is comparative advantage based on exogenous factor-endowment differences. In this model, factor-endowment differences again determine trade, but they are endogenous.

3.4. Tax competition and externalities

Subsequent models of tax competition conclude for its wasteful effects by considering some additional variables to explain and measure the level of the resulting inefficiency. Such variables are more commonly referred to as "externalities", consisting of a cost (negative externality) or a benefit (positive externality) incurred by a party who did not agree to the action causing the cost or benefit.

Externalities are one of the most widely discussed market failures.[299] By definition, externalities occur when "firms or people impose costs or benefits on others without those others receiving the proper payment, or paying the proper price".[300] In other words, one actor imposes the costs/benefits and does not take the effects on some others into account, when making its economic decisions. Since the actor has no incentive to take this into account, it will continue imposing many negative externalities and a few of positive ones.

Externalities may take different forms. A first form of externality is the so called "pecuniary externality", i.e. the negative effects in the case of regions large enough to affect the product or factor prices confronting other regions. Pecuniary externalities lead to inefficient policy differences across regions, causing a misallocation of factors. For instance, the model developed by De Pater and Myers[301] considers large jurisdictions with different capital endowments. Capital taxes are assumed as a strategy to influence the interest rate in the international capital market. While capital importing countries tax domestic investment in order to reduce the interest rate, capital exporting countries do the opposite. This leads to an inefficient outcome, even if governments may use lump-sum taxes to finance public expenditure. Capital taxes will be inefficiently high in capital importing regions, owing to the pecuniary externalities resulting from the effect of tax policy on the interest rate.

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[298] E. Heckscher, *The effect of foreign trade on the distribution of income*, Ekonomisk Tidskriff, 1919, 497-512, translated as chapter 13 in American Economic Association, *Readings in the Theory of International Trade*, Philadelphia, 1949, 272-300; B. Ohlin, *Interregional and International Trade*, Cambridge, 1933.

[299] R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 131.

[300] P. Samuelson, W. Nordhaus, *Economics*, New York, 1987, 48.

[301] J.A. De Pater, G.M. Myers, *Strategic Capital Tax Competition*, Journal of Urban Economics, 36/1994, 66-78.

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The most common externality taken into account in the literature is the so called “fiscal externality”, namely the negative effects of one region’s public policies on the government budgets of another region.[302] For instance, Wildasin[303] finds that tax competition has negative effects, because when a region reduces its tax rate on mobile capital, it attracts and gains capital at the expense of another region, therefore reducing tax bases and tax revenue of this latter. The size of fiscal externalities is generally assumed to be dependent on the number of competing regions. If this number is large, then the elasticity of a single region’s capital supply with respect to its tax is small, since a rise in the tax rate depresses the return on capital, thereby dampening the impact of this tax change on the cost of capital.[304]

Fiscal externalities can be either vertical or horizontal, either positive or negative. Vertical externalities occur between national and sub-national governments, and in the absence of a world government are not relevant for international tax competition purposes. Horizontal externalities occur among governments at the same level and thus are very relevant to the international system. A positive fiscal externality occurs when a change in one jurisdiction’s tax policy results in tax revenue for another jurisdiction. By contrast, negative externality describes the situation in which a change in one jurisdiction’s tax policy results in tax loss for another jurisdiction.[305]

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[302] See R.H. Gordon, *An optimal taxation approach to fiscal federalism*, Quarterly Journal of Economics, 98/1983, 567-586 and J. Mintz, H. Tulkens, *Commodity tax competition between member states of a federation: Equilibrium and efficiency*, Journal of Public Economics, 2/1986, 133-172, according to whom taxes levied by jurisdictions can impose spillover costs on other jurisdictions. This can take the form of “tax base flight” whereby a jurisdiction’s tax results in mobile factors fleeing to low-tax jurisdictions. See G.R. Zodrow, P. Mieszkowski, *Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods*, Journal of Urban Economics, 3/1986, 356-370. Another important for of externality is the so called “tax base externality”, which describes the situation in which the tax rate set by one jurisdiction affects the tax revenue of another jurisdiction. Governments, whether local or national , may be deterred from raising government spending to the point at which marginal benefits equal marginal costs because of the prospect of mobile factors, and thus their share of the tax base, fleeing to lower tax locations. See T.J. Goodspeed, *Tax Competition and Tax Structure in Open Federal Economies: Evidence from OECD Countries with implications for the European Union*, European Economic Review, 2/2002, 357-374.

[303] D.E. Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and a Corrective Subsidy*, Journal of Urban Economics, 2/1989, 193-212.

[304] W.H. Hoyt, *Property Taxation, Nash Equilibrium, and Market Power*, Journal of Urban Economics, 1/1991, 123-131 shows that the equilibrium capital tax and welfare fall as the number of regions rises. See also M. Keen, M. Marchand, *Fiscal Competition and the Pattern of Public Spending*, Journal of Public Economics, 1/1997, 33-53 which further elaborated the Zodrow-Mieskowski model by focusing not only on the overall level of government spending, like this latter, but on the composition of such spending. According to their research, governments have an incentive to increase their expenditures on public inputs relative to public goods, since the former attract capital by increasing its productivity.

[305] The political intervention dealing with tax havens, as it will better emerge in Chapter 4, shows that since 1990s the high-tax countries and international organisations were particularly concerned by negative fiscal externalities. When a State becomes a tax haven and lowers its tax rates, it is assumed to reduce tax revenue of another jurisdiction, thus resulting in a tax base erosion effect.

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Theories of inefficient tax competition as a result of fiscal externalities are normally based upon the assumption that governments do not possess unlimited taxing powers. One limit, for example, is the goal to establish a tax system which is efficient and neutral. Furthermore, governments independently (or non-cooperatively) impose taxes to maximise the welfare of their domestic residents, although mobility of factors implies that this choice affects the tax base of foreign countries.

Subsequent developments of this approach[306] consider more than one region and suggest that an increase in the tax rate of one region benefits other regions, as raises this latter other region's capital inflows. As capital stock is fixed, the tax induced outflow of one region is an inflow for another region. Such an inflow of capital is a function of the first region's tax rate increase, which in the literature is referred to as a positive externality. Tax rates and public service levels are set inefficiently because governments set their tax rates only considering the welfare of their residents and disregard this positive externality caused by the decisions of other governments. In order to remove this positive externality, it would be necessary to remove capital mobility, so that domestic firms would exclusively use domestic capital. When borders are open, no government would be induced to raise public expenditures, given the costs resulting from the capital outflow.

The presence of positive fiscal externalities is also discussed by Fuest, Huber and Mintz,[307] whose model considers low taxes on source based capital taxes under tax competition. These Authors explain that tax competition is not efficient, because an increase in the capital tax rate in one region gives rise to a positive fiscal externality, since it triggers a capital outflow to other countries. They further discuss whether such a fiscal externality is due to distortionary capital taxes imposed by governments and conclude that the use of lump sum taxes, instead of those on income, would make the externality vanish. Such a conclusion draws their attention on the discussion about the relationship between welfare implication of tax competition and the tax instrument available to raise tax revenue[308].

Positive externalities are also taken into account in the models analysed by Wildasin[309] and DePater and Myers.[310] According to them, the positive externalities to which regions are exposed can be compensated with a government's corrective subsidy. Regions set different tax rates on the grounds of the existing different levels

[306] J.D. Wilson, *Theories of Tax Competition*, National Tax Journal, 6/1999, 275.

[307] C. Fuest, B. Huber, J. Mintz, *Capital Mobility and Tax Competition*, CESIFO Working paper No. 956, May 2003.

[308] C. Fuest, B. Huber, J. Mintz, *Capital Mobility and Tax Competition*, CESIFO Working paper No. 956, May 2003, 22.

[309] D.E. Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and a Corrective Subsidy*, Journal of Urban Economics, 2/1989, 193-212

[310] J. A. De Pater, G.M. Myers, *Strategic Capital Tax Competition*, Journal of Urban Economics 2/1994, 66-78.

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of endowment of technologies and residents' preferences. If tax rates differ, then two types of inefficiencies exist in the economy: one is the inefficient level of public goods as a result of the externalities, whereas the other is the misallocation of capital across regions, which makes the marginal product of capital relatively higher in high-tax regions. As a consequence, a central authority's intervention is required to redistribute revenue across government treasuries.

3.5. Redistribution of tax burden from capital to labour

Other extensions of tax competition theories can be considered as an evolution of the Zodrow-Mieszkowski model with an additional assumption: as governments impose source based taxes on both capital and labour to provide public goods, tax competition is considered as redistributing the tax burden from capital to labour.[311]

According to Bucovetsky and Wilson,[312] since the supply of capital is perceived as infinitely elastic by each individual country, the burden of a capital tax would be borne by labour. Therefore, tax competition leads to a situation of under-provision of public goods, due to a hypothetical situation in which the capital tax is zero and public expenditure is financed exclusively by the labour tax. In fact, an increase in the wage tax rate to finance more public expenditure causes a positive fiscal externality. The higher wage tax rate reduces labour supply and thus reduces the marginal productivity of capital in the country under consideration. Capital therefore flows to other countries, which benefit from a non-taxed capital inflow raising the marginal productivity of labour and, consequently, labour supply.

Higher capital mobility leads to a lower tax burden on capital and in the presence of two tax instruments, i.e. on mobile capital and on immobile labour, this latter is taxed more heavily than capital as capital mobility increases. As a result, if one country lowers its capital tax rate, investors will earn a net rate of return that is above the average interest rate after taxes. Since capital supply is perfectly elastic by assumption, the tax differential induces an immediate flow of capital from a second country to the first one. Thus, the tax reduction in the first country causes a negative fiscal externality in the second. The government of this latter is only concerned about the welfare of its residents and thus also fails to account for such externalities. As a result, this government follows the example of the first country and reduces its capital tax rate too. If all countries independently and simultaneously choose this strategy, as it is assumed in the standard tax competition literature, then countries would adopt suboptimal capital tax rates.

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[311] See more generally, C. Radaelli, *Harmful Policy Competition in the EU: Policy Narratives and Advocacy Coalitions*, Journal of Common Market Studies, 4/1999, 661-682 and H.W. Sinn, *The New Systems Competition*, Oxford, 2003.

[312] S. Bucovetsky, J.D. Wilson, *Tax Competition with two tax instruments*, Regional Science and Urban Economics, 3/1991, 333-350.

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Huber[313] analyses the taxation of mobile capital in an optimum income tax model, by adopting elements of both the tax competition and the optimum income tax literature. His model assumes that each country is identical and populated by high-skilled (high wage) and low-skilled (low wage) individuals. In line with the optimum income tax literature, he assumes that the government is able to observe and thus to tax the wage incomes (wage times labour supply), but not the skills (wages) of individuals. Individuals also earn income from capital, which is mobile across borders. In line with the tax competition literature, government is assumed to be unable to observe and thus to tax the capital income of residents. In this model, the level of public goods provision is assumed to be exogenous. This means that over- or under-taxation of capital reflects an inefficient mix of labour and capital taxes and is not related to inefficiencies in public goods provision. The government can impose a non-linear tax schedule on observable wage income. However, since skills (wage) are unobservable, an individual of one type can imitate the wage income of an individual of the other type by appropriately adjusting his labour supply. This gives rise to a (binding) self-selection constraint for the government's optimal tax problem. In line with much of the literature, Huber focuses on the case where the constraint is binding for high-skilled individuals, which indicates that redistribution runs from the high-wage earners to the low-wage earners.

The two types of labour, which are immobile, and mobile capital produce the output in each country. In an uncoordinated equilibrium, national governments in each country choose a non-linear tax schedule for wage income and the self-selection constraint of the high-skilled individual if such a government modifies the ratio between the high and the low wage. In this case, the capital tax is imposed by the government to weaken the self-selection constraint of the high-skilled individual. Depending on the effect on the relative wage, both positive and negative capital taxes can emerge in the uncoordinated equilibrium. Huber's model also shows that, if the production function is weakly separable between labour and capital, the capital tax does not affect the relative wage in such a way that the optimal capital tax in this case is zero.

One important insight of Huber's approach is the key role played by the wealth distribution. Depending on the distribution of wealth between the groups in the population of each country, a coordinated increase in capital taxes may raise or lower welfare. For the case of an egalitarian wealth distribution, welfare is not affected by a higher capital tax. From a policy perspective, however, it is plausible that high-skilled individuals are wealthier than low-skilled ones. If one assumes a weakly separable production function, a coordinated increase in capital taxes raises welfare, as it leads to favourable lump-sum redistribution from the high-skilled to the low-skilled individuals. For quite different reasons, the optimum income tax model may, therefore, yield the policy conclusion that, without tax coordination, capital tends to

[313] B. Huber, *Tax Competition and Tax Coordination in an optimum income tax model*, Journal of Public Economics, 3/1999, 441-458.

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be under-taxed. Finally, it is interesting to note that not only an increased mobility of goods and factors but also an unfavourable shift in the wealth distribution can support for supranational coordination of tax policy.

3.6. Asymmetrical tax competition

The models discussed so far assumed the existence of symmetric and small open jurisdictions. Further developments of such basic models are those of "asymmetrical tax competition", which focus on the effects of tax competition between a large and a small region, with different numbers of residents but same endowments of capital and labour.

Models of asymmetric tax competition assume large open economies to have some market power, i.e. they are able to influence the world interest rate through their tax policies, whereas the small country is faced with higher capital supply elasticity.[314]

In this model, since the large region demands more capital than the small one, for the largest an increase in its tax rate reduces the after-tax return of capital, which involves a greater amount of capital revenues. The cost of capital is less sensitive to tax changes in the large region than in the small one. This suggests that whereas the large region will compete less strongly for capital through tax rate reductions and therefore will end up with the highest tax rate, the small region will choose a lower tax rate on capital. Small regions, in fact, have a lower cost of capital in equilibrium and offer higher wage rates than in the large regions, as resident firms employ more capital per unit of labour.

The model of asymmetrical tax competition specifically developed by Wilson[315] leads to the conclusion that tax competition can be beneficial for small regions and wasteful for large ones. Assuming that there exist two identical jurisdictions except for the size of the labour force, and that the small region possesses the lower cost of capital in equilibrium per unit of labour, firms of small region employ more capital per unit of labour and therefore offer higher wages rates than in the large region. Consequently, residents of the small region are better off than residents of the large regions, depending on the differences of regional sizes. In this model the cause of such a situation is that the higher is capital tax raised by a country, the stronger the effect of

[314] Some other models of asymmetrical tax competition consider two large countries rather than a small and a large one and observe that a Nash equilibrium can be generated with positive or negative tax rates, depending on the incentives for companies to locate in each country. However, the different conclusions reached strictly depend on the assumptions they depart from. For example, A. Haufler, I. Wooton, *Country size and tax competition for foreign direct investment*, Journal of Public Economics, 1/1999, 121-139 and B. Ferret, I. Wooton, *Tax Competition and the International distribution of firm ownership: An invariance result*, CEPR Working Paper no. 5984, 2006 give diametrically opposed predictions about tax rates depending on whether there are one or two companies in the industry.

[315] J.D. Wilson, *Tax Competition with Interregional Differences in Factor Endowments*, Regional Science and Urban Economics, 3/1991, 423-451.

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its capital demand on the interest rate in the international capital market (i.e. the lower the elasticity of capital supply). As capital demand of the large country has a stronger impact on the interest rate than that of the small country, the large country raises a higher capital tax rate. Since the cost of capital is thus lower in the small country, per capital investment is higher and, hence, the wage rate is also higher. This advantage of being small implies that, if the size difference is sufficiently large, the small country may actually be better off under tax competition, where public expenditure is financed, on the margin, with capital taxes than in a coordinated equilibrium or a first-best situation where unrestricted lump sum taxes are available.

Similar conclusions have been reached by Kanbur and Keen[316] for commodity taxation. According to their model, by lowering their tax rates, small countries attract much capital in per capita terms, which in turn improves the welfare position of their residents. On the other hand, if large countries cut their tax rates, they receive a small amount of capital in per capital terms, which leaves the welfare of their residents almost unaffected. Also the model developed by Bucovetsky and Wilson[317] lead to similar results. By taking into account the taxation of immobile labour, as an additional tax instrument, they demonstrate that it is optimal for the small countries to finance public goods solely by labour taxes.

The intuition behind these results is that in a small open economy capital is supplied perfectly elastically, whereas the elasticity of labour supply is finite. Faced with this situation, governments should tax inelastic labour rather than elastic capital. On the other hand, in the large country the supply of capital is less than perfectly elastic, and thus large countries with a significant influence on the world capital market should tax both capital and labour.

Marceau, Mongrain and Wilson[318] contributed to the literature of asymmetric tax competition by elaborating a model in which the large and the small countries are defined as such not in terms of residents, but rather in terms of the endowments of "immobile capital". The country with the lowest endowment of capital/labour is more likely to set very low tax rates in order to attract mobile capital. They also extended their analysis to countries with different productivities. The same intuition applies: a country with the lowest productivity generates less tax revenue from its immobile tax base, and can consequently be aggressive. This implies that mobile capital may have the tendency to inefficiently locate in less productive countries. Depending on the

[316] R. Kanbur, M. Keen, *Jeux Sans Frontier: Tax Competition and Tax Coordination when Countries Differ in Size*, American Economic Review, 4/1993, 877-892.

[317] S. Bucovetsky, J.D. Wilson, *Tax Competition with two tax instruments*, Regional Science and Urban Economics, 3/1991, 333-350; S. Bucovetsky, *Asymmetric Tax Competition*, Journal of Urban Economics, 2/1991, 167-181; J.D. Wilson, *Tax Competition with Interregional Differences in Factor Endowments*, Regional Science and Urban Economics, 3/1991, 423-451.

[318] N. Marceau, S. Mongrain, J.D. Wilson, *Why Do Most Countries Set High Tax Rates on Capital?*, Journal of International Economics, 2/2010, 249-259.

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size of these productivity differences, this result could counteract the superior revenue-raising capabilities of non-preferential regimes.

3.7. Tax competition and multinational firms

The models so far analysed have focused on the effects that capital mobility competition has on potential host countries and analysed tax competition outcomes in the presence of small and large jurisdictions. Subsequent studies extended the analysis, considering a typical response by multinational firms to tax differences among jurisdictions, i.e. profit-shifting.[319]

Profit shifting is acknowledged to be an incentive to reduce tax rates and broaden tax bases.[320] Some authors show that profit shifting lowers the tax sensitivity of real investment, which suggests that profit shifting softens tax competition for real investments.[321] Others demonstrate that high-tax countries may benefit from profit shifting, since it allows them to establish a *de facto* differentiated corporate tax system with mobile multinational firms facing a lower effective tax rate than immobile domestic firms.[322]

Bucovetsky and Haufler[323] have presented a model where firms endogenously choose a national or a multinational form, in response to the tax advantages accorded to a multinational status and analysed the effects that the firms' endogenous choice of organisational form has on optimal corporate tax policy.

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[319] See for example E.J. Bartelsman, R.M.W.J. Beetsma, *Why pay more? Corporate tax avoidance through transfer pricing in OECD countries*, Journal of Public Economics, 9-10/2003, 2225-2252 and K.A. Clausing, *Tax-motivated transfer pricing and US intrafirm trade prices*, Journal of Public Economics, 9-10/2003, 2207-2223 for discussions about manipulation of transfer prices with a view to minimising global taxation. In a subsequent paper, K.A. Clausing, *Closer Economic Integration and Corporate Tax Systems*, Global Economy Journal, 2/2008, Article 2 investigates two aspects of international corporate taxation. First, she considers the question of how governments set corporate tax rates. There is substantial empirical support for the idea that lower tax rates are chosen when the corporate income tax base is more elastic, which is likely to be the case for smaller countries, and for open economies. Other determinants of corporate tax rates generally confirm theoretical expectations: countries with higher individual income tax rates choose higher corporate rates, perhaps due to the fact that the corporate income tax serves as a backstop for the individual income tax; also countries with a greater role for government, and thus a higher government consumption ratio, choose higher tax rates.

[320] A. Haufler, G. Schjelderup, *Corporate tax systems and cross country profit shifting,* Oxford Economic Papers, 52, 2000, 306-325.

[321] J. Mintz, M. Smart, *Income shifting, investment and tax competition: theory and empirical evidence from provincial taxation in Canada*, Journal of Public Economics, 6/2004, 1149-1168.

[322] Q. Hong, M. Smart, *In praise of tax havens: international tax planning and foreign direct investment*, European Economics Review, 1/2010, 82-95. According to their model, tax havens facilitate profit shifting by multinational firms and therefore improve efficiency.

[323] S. Bucovetsky, A. Haufler, *Tax Competition when firms choose their organizational form: Should tax loopholes for multinationals be closed?*, Journal of International Economics, 1/2008, 188-201.

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Specifically, they assumed a sequential game between two symmetric countries in which governments decide in a first stage on the degree of tax preferences for internationally mobile firms and in which firms can decide to invest in a multinational structure to benefit from tax savings or tax reductions. Governments are assumed to compete for mobile capital by means of statutory corporate tax rates, before firms make their investment decisions.

The fundamental trade-off for governments in this setting is that granting tax breaks to multinational firms softens tax rate competition, but a preferential tax policy also provides incentives for firms to choose a multinational structure with the sole purpose of benefiting from tax breaks. The non-cooperative equilibrium in tax discrimination strategies and corporate tax rates can be in one of two regimes. If the firms' choice of organisational structure is rather insensitive to tax preferences, then countries will choose a high degree of tax discrimination and maximum taxation of immobile firms. If, however, the firms' organisational structure responds elastically to tax preferences, then countries will choose moderate tax preferences for mobile firms and levy tax rates do not confiscate the return to immobile capital.

These results offer a possible reason why tax breaks for multinational firms are limited in practice, despite the high mobility of this tax base. In setting their discrimination policy, governments take into account the incentives given to firms to invest in a multinational structure, in order to reduce tax payments in subsequent periods. The model has been extended to account for countries of different size, and the simulation results indicate that small countries tend to grant more tax preferences than their larger neighbours while at the same time levying lower effective tax rates. This result is consistent with the observation that the vast majority of all reported cases of discriminatory tax regimes occurs in small countries. The explanation for this phenomenon given by their model is that substantial tax preferences reinforce the effects of low effective tax rates in the international competition for mobile capital, whereas the domestic revenue costs caused by tax preferences are mitigated when the overall tax level is low.

Fuest and Huber[324] analysed the welfare effects of coordinated tax increases, by comparing the effects of tax competition under the exemption system, the deduction system and the foreign tax credit system in the presence of multinational firm. Their analysis shows that capital taxes may be too high under tax competition if countries apply the deduction system or the credit system while taxes are too low under the exemption system. The reason is that under the exemption system, capital taxes are effectively purely source-based.

Haufler and Wooton[325] argued that in the presence of imperfect competition and transport costs, large countries may actually be at an advantage when countries

[324] C. Fuest, B. Huber, *Why capital income taxes survive in open economies: The role of multinational firms,* International Tax and Public Finance, 9/2002, 553-566.

[325] A. Haufler, I. Wooton, *Country Size and Tax Competition for Foreign Direct Investment*, Journal of Public Economics, 1/1999, 121-139.

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compete for foreign direct investment. Their model considers that there is a multinational firm that sells its output on a goods market with imperfect competition. Since there are transport costs, the firm will prefer to locate in the larger market, therefore giving rise to a locational rent for the large country, which may be exploited by tax policy, which means that the large country may raise higher taxes (or offer lower subsidies) than the small country and will still receive the investment.

Devereux, Lockwood and Redoano,[326] have developed the models introduced by Zodrow and Mieszkowski[327] and Wilson,[328] and have proposed a model that combines mobile capital with a model of profit-shifting via transfer pricing. Differently from previous models, which focused on capital income taxation only, they consider two instruments at the disposal of governments for determining corporate income taxes: tax rate and tax base. They observed that the statutory rate is used competitively to shift profits into other jurisdictions, and that in the home country the optimal choice of both statutory rate and the effective marginal tax rate react to change in each of these taxes in the foreign country and vice versa. Although statutory tax rates have significantly dropped, tax bases have been widely broadened. These Authors have identified two possible forms of tax competition: (*i*) over statutory tax rates for mobile profit and (*ii*) over effective marginal tax rates for capital. Their empirical work showed that there exists a strategic interaction in both forms of tax rate, but mainly in the statutory tax rate, which is generally present only between open economies, competing over mobile profits.

4. The erosion by tax havens of the tax base of high-tax countries

As previously highlighted, tax haven jurisdictions have played a central role in the debate over the scope and consequences of tax competition, as they are widely believed to induce high-tax large jurisdictions to compete for attracting foreign investment, thus provoking a reduction of their taxes below optimal levels. Over the past decades the average statutory corporate tax rate in high-industrialised countries has been observed to have dropped dramatically and this trend seems likely to continue,[329] and tax havens are broadly believed to accelerate this process of tax competition between governments.

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[326] M.P. Devereux, B. Lockwood, M. Redoano, *Do Countries Compete Over Corporate Tax Rates?*, CEPR Working Paper 3400, 2002.

[327] G.R. Zodrow, P. Mieszkowski, *Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods*, Journal of Urban Economics, 3/1986, 356-370.

[328] J.D. Wilson, *A Theory of Interregional Tax Competition*, Journal of Urban Economics, 3/1986, 296-315.

[329] See R. Griffith, A. Klemm, *What has been the tax competition experience of the last 20 years?*, Tax Notes International, 13/2004 (special suppl.), 1299-1315. For an overview of the effects on corporate tax rates within the European Union, see J. Gorter, R. de Mooij, *Capital income taxation in Europe:*

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In this respect the current economic literature does not share common opinions. On the one hand, according to Desai, Foley and Hines, and according to Johannesen the erosion of tax base of high-tax countries is debatable; on the other hand, according to Slemrod and Wilson there is a clear erosion effect.

Desai, Foley and Hines[330] presented a model to observe the influence of taxation on the activities of multinational firms to analyse the impact tax havens exert on non-haven jurisdictions. They showed that firms with growing activity in high-tax countries are also most likely to initiate tax haven operations. As tax haven operations allow taxpayers to reduce their overall tax burden, their tax-minimising incentive was scrutinised with a view to estimating the degree to which tax haven activities are complement to or substitute for non-haven activities. Contrary to many policy concerns and to common assumptions of modern tax competition literature, the findings of Desai, Foley and Hines showed that reduced costs of using tax havens (first of all a lower tax rate on firm's foreign investment) do not appear to divert activity from non-haven countries. Multinational firms establishing tax haven operations expand, rather than contract, their foreign activities in nearby countries other than tax havens. According to their findings, foreign investors stimulate investment in the host country and there is no empirical support in the behaviour of taxpayers that tax havens might encourage firms to substitute economic activity away from high-tax jurisdictions.

According to this approach, the available macroeconomic evidence indicates that countries have not reduced their taxation of foreign investment, or that of capital income, to anything approximating the degree implied by many models of capital tax competition. As a result, careful use of tax haven affiliates allows foreign investors to avoid some of the tax burden imposed by domestic and foreign authorities, thereby maintaining foreign investment at levels exceeding those that would persist if tax havens were more costly. High-tax countries are able to maintain high-tax rates while continuing to draw significant levels of foreign investment.

The model of tax competition developed by Johannesen[331] also does not necessarily imply that there is a negative impact of tax havens on high-tax countries' tax base. Johannesen considers a large number of identical countries competing for real investment and profits and a situation of asymmetric equilibrium between high-tax and low-tax countries. He highlights that low-tax countries engaged in aggressive tax competition for profits potentially face much larger tax elasticities of the corporate tax base than high-tax countries. The model stresses the importance of allowing for

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trends and trade-offs, The Hague, 2001. As it will be highlighted in paragraph 1 of Chapter 4 of the present work, the average corporate tax rate in Europe has dropped from 47.5% in 1980 to 22.30% in 2010.

[330] M. Desai, C.F. Foley, J.R. Hines, *Economic Effects of Regional Tax Havens*, NBER, Cambridge, 2004, Working Paper No. 10806.

[331] N. Johannesen, *Imperfect tax competition for profits, asymmetric equilibrium and beneficial tax havens*, Journal of International Economics, 2/2010, 253-264.

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heterogeneous tax elasticities of tax bases across jurisdictions in empirical applications. The Author then examines in this framework the role played by tax havens, and observes that tax havens affect the revenue of countries in various ways. They not only attract profits from other countries, thus reducing these latter's tax bases (so called "leakage effect"), but they also reduce the attractiveness of competition for profits, therefore inducing low-tax countries to raise their tax rates and to become high-tax countries (so called "crowding effect"). In some cases, the crowding effect dominates the leakage effect and the presence of tax havens increases tax revenues of countries.

This result has significant policy implications, as it raises doubt of whether the elimination of tax havens through cooperation by OECD countries would be desirable and feasible. In fact, if tax havens were eliminated, the incentive to engage in aggressive tax competition would persist. In the new equilibrium, it is therefore likely that some countries would take over the role as low-tax jurisdictions from tax havens, which could leave all countries worse off than they are when the presence of tax havens deters countries from engaging in aggressive tax competition.

Slemrod and Wilson[332] presented an elaborated equilibrium model of tax havens and tax competition considering profit shifting to tax havens, and their observations led to different conclusions from the Desai, Foley and Hines' model and from the Johannesen's model. According to their analysis, by providing tax evasion services to multinational firms, tax havens unequivocally reduce the welfare of non-haven countries, as tax administrations of these latter have to employ resources seeking to limit such tax evasion. Their outcomes address the reasons why countries are, and should be, concerned about the detrimental effects of havens on their residents' welfare.

In their model, Slemrod and Wilson considered a small open economy model of capital flows and tax havens are assumed to be "parasitic", as they both divert multinational firms' investments and lead to wasteful expenditure of governments' resources in the attempt to limit profit shifting. As a consequence, existing initiatives to limit tax havens activities and aimed at preventing further reduction of their tax bases below efficient levels are justified, and full or partial elimination of tax havens is found to be welfare-improving.

Slemrod and Wilson, in addition, scrutinised the decision of a country to become a tax haven and therefore to be parasitic on the revenue of non-haven jurisdictions, and demonstrates that small countries have a greater incentive compared to large countries to do so. To that purpose, tax havens are assumed as juridical entrepreneurs selling taxpayers protection from their home States' domestic taxation, in conformity of what Palan defined the "commercialisation of State sovereignty".[333]

[332] J. Slemrod, J.D. Wilson, *Tax Competition With Parasitic Tax Havens*, Journal of Public Economics, 11-12/2009, 1261-1270.

[333] See Chapter 2 paragraph 2 of the present work.

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The equilibrium price for this service depends on the demand for such protection, which in turn depends on the tax system, including the resources devoted to tax enforcement by the non-haven countries, and on the technology available to the parasitic tax havens. This price can take the form of cash or various “in-kind-benefits” provided to the tax haven.

According to Slemrod and Wilson, therefore, the activities undertaken by tax havens, mainly in the form of income shifting, facilitate what may be viewed as forms of legal tax avoidance or illegal tax evasion. As governments in the model are assumed to have access to two tax bases, i.e. mobile capital and domestic labour, and they are free to tax either bases at any rate, tax havens impact high-tax countries as they lead to higher capital income tax rates, to the enforcement of governments’ policies relying more on other revenue sources (such as taxes on wages), and to an overall reduction of levels of public expenditures and of the welfare of high-tax countries’ residents.

Diverging conclusions are reached by Hong and Smart,[334] who observed that restrictions to tax havens activities are not welfare-enhancing. An entire elimination of tax planning, in their view, can never be optimal. These findings derive from some empirical observations, showing that there is no evidence of a decline in marginal effective tax rates on capital in OECD countries, although this reflects both a decline in statutory corporate tax rates and reductions in investment allowances.[335] Ireland, for example, albeit enacting low-tax policies aimed at attracting headquarters operation in Europe, has drawn little policy response from the European Union.[336] These Authors thus predicted that future growth in tax haven activities may bring a more concerted policy response from high-tax countries, but at present this case is far from clear.

5. Tax competition: the perspective of governments vs. the perspective of investors

Although the existing different theories on tax competition lead to diverging results with respect to its harmful or welfare-enhancing effects and with respect to the cause

[334] Q. Hong, M. Smart, *In praise of tax havens: international tax planning and foreign direct investment*, European Economics Review, 1/2010, 82-95.

[335] Their observations are consistent with those of M.P. Devereux, R. Griffith, A. Klemm, *Corporate Income Tax Reforms and International Tax Competition*, Economic Policy, 17/2002, 449-495 and J. Slemrod, *Are corporate tax rates, or countries, converging?*, Journal of Public Economics, 6/2004, 1169-1186 and attributing any of these changes to the casual effects of competition from havens is considered more difficult.

[336] See also Chapter 6 in this respect.

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originating such results,[337] the literature shares the view that globalisation and the increasing mobility of factors of production impact governments' tax policy choices.[338] It is thus widely believed that international trade and free movement of capital across borders lead to tax competition. In the basic models, rather than investigating on the source of inefficiency, it seems that the potential source of such inefficiency is tax competition itself, which turns out to be a bad thing.

Except from Tiebout's classical doctrine on efficient tax competition, modern theories widely identify the following wasteful effects: tax competition distorts investment and trade; tax competition erodes States' tax bases and therefore reduces their ability to finance their welfare provision programmes; tax competition shifts the tax burden from capital to labour; tax competition raises capital endowments in small low-tax jurisdictions at the expense of large high-tax ones.

Tax competition is regarded as inefficient only by those jurisdictions which suffer from tax base erosion induced by the more attractive tax environment provided by low-tax countries. In this sense, it seems that models developed by the modern literature approach tax competition from high-tax countries' point of view only.[339] From this specific perspective outflows of tax bases suffered by high-tax countries are not compensated by correspondent reductions of public goods demand. Tax competition is consequently held by these countries to be harmful because it diverts tax bases that are necessary to finance public goods. Indeed, in the case of cross-border capital outflow, a reduction of the public goods supply can be compensated by the purchase of public goods in that foreign jurisdiction where capital is invested.

Tax competition is viewed by the current economic literature from the perspective of governments and leads to inefficiency and negative externalities. Tax competition can be however viewed from a diametrically different perspective, i.e. from the perspective of taxpayers. There is indeed a coherent, although minority, view according to which tax competition is good if ultimately viewed from the perspective of individual investors. This minority view is based on the seminal theory elaborated by Tiebout, according to which taxpayers do indeed "vote with their feet" and influence their home government's policy choices, therefore contributing to the

[337] In this respect, it has been argued that models of tax competition are still very far from reality in their abstraction. See J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 38.

[338] As quoted by G.P. Gilligan, *Overview: Markets, Offshore Sovereignty, and Onshore Legitimacy*, in D. Masciandaro (Ed.), *Global Financial Crime. Terrorism, Money Laundering and Offshore Centres*, Aldershot, 2004, 22, in May 1966, the Lyon G7 summit investigating on harmful tax competition, as requested by the OECD, concluded its communiqué as follows: "Globalisation is creating new challenges in the field of tax policy. Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment and could lead to erosion of national tax bases".

[339] In this respect, tax competition cannot be "harmful" for those jurisdictions which draw capital inflows.

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demand of public goods. Within this approach, as each country reaches an efficient level of taxation equal to the cost of public goods provided to each individual living in that region,[340] competition turns out to be good when it benefits consumers by triggering improvement in efficiency and quality, when it offers consumers the opportunity to discriminate between efficient and less-efficient providers of public goods, thus rewarding efficient governments.

Salin,[341] for example, critically argued that when a producer sees the arrival of the competitor likely to offer better products at lower prices, he fears that he might loose clients. As a result, he will make efforts to improve the quality of his products or to reduce prices too. It is this competition that is "harmful", but only for him. Salin argues that if the producer complains and the State sets the protections necessary to allow him to continue offering products that are less satisfactory for his clients than his competitors' products, there will be victims. Namely, the consumers deprived of potential gains and the other private producers deprived of their normal markets. The position of this Author is that it is not competition that is harmful, but the lack thereof.

In another line of research emphasis is placed on monopolies. In this view, the lack of competition is referred to as "monopoly", i.e. a market structure in which a single supplier produces and sells the product.[342] According to standard models of monopoly markets, a monopolist sets a single price for all consumers, thus resulting in a lower quantity of goods at a higher price than would firms under perfect competition.[343] Since the monopolist ultimately forgoes transactions with consumers who value the product or service more than its cost, monopoly pricing creates a deadweight loss, which refers to potential gains that went neither to the monopolist nor to consumers. Given the presence of this deadweight loss, the combined surplus (or wealth) for the monopolist and consumers is necessarily less than the total surplus obtained by consumers under perfect competition. Where efficiency is defined by the total gains from trade, the monopoly setting is less efficient than perfect competition.

When there is competition, even among the few, individual consumers and small firms are much better treated, as the scope for exploitation disappears. A monopoly (or a cartel), instead, exploit customers and suppliers, does not care about costs, does not innovate, and prices its products to maximise its own utility function. As

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[340] See paragraph 3 above.

[341] P. Salin, *Introduction*, in P. Bessard, *Tax Burned and individual rights in the OECD: an international comparison*, Institut Constant de Rebecque, June 2009.

[342] Indeed competition is universally hailed as a "good thing", and it is recognised as being socially superior to its opposite, namely a monopoly (or a cartel). See V. Curzon-Price, *Fiscal competition and the optimization of tax revenues for higher growth*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 156.

[343] As pointed out by R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 130, "collusion", "cartelisation" or "monopoly" are regarded as serious market failures.

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opposed to monopoly, free competition benefits consumers, as it improves efficiency and quality and provides these latter with the opportunity to discriminate between efficient and less-efficient providers of goods and services. Competition enhances economic performance and should therefore be celebrated, not persecuted.[344]

Similar arguments are shared by Teather,[345] who highlights that monopolists have no incentive to be efficient, and little need to provide what the consumers want. By transposing free competition models to government tax policies, he argues that governments, which are even endowed with coercive powers to collect what taxpayers owe them for the services they provide, can be regarded as ultimate monopoly suppliers. Governments are naturally inefficient and have an in-built tendency to increase their costs and activities, and therefore increase taxation. Essentially, governments are only prevented from taxing into penury by the threat of revolution or totally economic collapse. A fiscal monopoly tends to exploit its taxpayers to the largest extent possible, waste their money, and meet every financial shortfall with higher taxes rather than lower expenditure.[346]

If tax competition were observed from taxpayers' perspective (assuming taxpayers act as consumers in perfect competition models) and in line with model of free competition, quite probably the resulting capital outflows would be seen as leading to an efficient solution. Indeed, as argued by Mitchell,[347] fiscal rivalry generates positive results. In this respect, tax competition would rather provide incentives for taxpayers to act and produce, it would force governments to behave responsibly in order to attract economic activity, and the resulting tax base erosion, rather than being "harmful", would stimulate wiser and more responsible tax policies and would reduce their ability to overtax and therefore overspend.

Despite this minority view of tax competition, observed from a truly market perspective, both international and domestic attitudes towards "harmful" tax competition denote that current international approach adopted by States and organisations is more in line with modern theories of wasteful tax competition developed by the current prevailing economic literature. States' concerns about tax competition seem to acknowledge theories based on negative fiscal externalities. In the current global world, capital flies away from high-tax countries towards less (tax) regulated jurisdictions, thus eroding their tax bases necessary to sustain costly welfare they desire domestically. A "race to the bottom" would be the result, leading

[344] D.J. Mitchell, *The Economics of Tax Competition. Harmonization vs. Liberalization*, Index of Economic Freedom, Heritage Foundation, 2004, 25-38. R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 132, affirms: "Limiting (tax) competition means introducing serious market failures (cartels), so presumably there must exist strong reasons for doing so".

[345] R. Theater, *Harmful Tax Competition*, Oxford, 2002.

[346] V. Curzon-Price, *Fiscal competition and the optimization of tax revenues for higher growth*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 156.

[347] D.J. Mitchell, *Ib.*

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to a world where minimal and suboptimal tax rates are adopted in each nation. States, therefore, welcome solutions based on cooperation with a view to "isolating" naughty jurisdictions and refrain from imposing themselves the same rules on competition that they do impose upon taxpayers.[348] In order to reduce the claimed "race to the bottom" effect provoked by tax havens, it seems that they disregard one basic consideration, i.e. if capital taxation within high-tax jurisdictions was optimal, capital would not fly away to tax havens.

According to this minority view, the current attitude of governments leads to a paradoxical conclusion: if tax competition is the result of globalisation and if tax competition is harmful, then an efficient tax policy by national governments would require to prevent the free movement of factors of production and to close borders to international trade. In other words, the optimal solution would be some form of protectionism. This kind of tax protectionism would be contrary to the results of the basic economic theories on international trade that demonstrate that international trade is indeed beneficial.[349] International trade in fact results in a specialisation of each country's comparative advantage and is efficient, as a country will import goods whose production requires the intensive use of input which in the country is relatively low, and will export goods whose production requires the intensive use of input which in the country is relatively abundant.

[348] Market theories demonstrate that competitive markets function better than non-cooperative markets, and most States have some antitrust legislation to ensure that market remain competitive. See R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 130. The Author interestingly notes that within the context of VAT harmonisation, EU governments get together and set common tax rates that exceed the rates that had been set by them independently. If several private firms were to do the same thing in terms of agreeing to set a high joint price, it would be called "forming a cartel". This behaviour, applied to tax harmonisation, which can be inferred as opposed to tax competition, would be the equivalent of the attempt to maintain high taxes (prices) than would prevail under unregulated competitive conditions.

[349] See more broadly D. Salvatore, *International Economics*, New York, 2007.

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CHAPTER 4

THE RESPONSE OF INTERNATIONAL ORGANISATIONS AND HIGH-TAX COUNTRIES TO TAX HAVENS' COMPETITION

On the basis of the overview at the current literature on tax competition provided in Chapter 3, the present Chapter discusses the political and legislative initiatives undertaken at the EU, OECD and domestic level aimed at curbing the effects of tax competition by tax havens. In line with the modern economic literature, the received view by the international community is that tax competition does indeed provoke a "race to the bottom" effect (paragraph 1). Accordingly, this Chapter describes the concept of tax competition in the EU (paragraph 2), the Monti Package and the Code of Conduct (paragraph 3); it discusses the Reports issued by the OECD from 1998 to 2006 (paragraphs 4-8) and the effects that blacklisting has on targeted jurisdictions' reputation (paragraphs 9-10). Then, it offers an overview at the most common anti-tax havens measures enacted by single States' legislation (paragraph 11), as well as some remarks on the differences of the approaches of the EU and the OECD (paragraph 12).

1. Tax competition urges political intervention

In Chapter 3, the analysis has been focused on the economic literature of tax competition, in order to identify whether and to what extent tax competition can be "harmful". It clearly emerged that the positive or negative effects of tax competition diverge according to which perspective the phenomenon is observed from. A basic problem in defining "harmful" tax competition is in fact to establish who wins and who loses. From the view of a government that undergoes other countries' tax competition, this latter is undoubtedly harmful. Tax competition has been shown to provoke a reduction of domestic tax bases and a lower level of public goods (so called "race to the bottom"). Welfare States fear not to survive in a competitive environment where they are not able to retain sufficient tax bases to finance their welfare provision programmes.

Tax competition is thus assessed to specifically erode governments' ability to provide public goods, because taxpayers could abstain from paying taxes to one government by instead choosing to be subject to tax in another (low-tax) State. However, from these other countries' perspective, as well as from that of taxpayers not interested in

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the level of public goods provided by their home States, tax competition can be only beneficial.[350] As a result, it is not simple to draw a borderline between “fair” and “harmful” tax competition, as fairness and harmfulness are two sides of the same coin.

If, according to economic modern doctrines highlighted in Chapter 3, low-tax regimes draw capital away from high-tax countries, this however would not involve market failures in the sense of Pareto losses.[351] If country A adopts a low tax rate, which draws capital away from country B, then A would be assessed to impose a negative externality on B. However, this would stretch the meaning of “externalities” to the limits of credibility, because this would end up saying that all economic competition should be limited with a view to reducing the externalities the competitors impose on each other. This assumption, however, would not identify any market failure as a justification for limiting tax competition.

The present Chapter intends to observe tax competition from a legal perspective discussing the initiatives taken at both the international and the national level to react to the claimed tax base erosion.

From a strict legal standpoint, tax competition is neither defined nor regulated. The reason of such a legislative gap might reside in the fact that taxation is a typical expression of fiscal sovereignty and since a tax system that can be defined as “normal” does not exist, deviations from this normality and constituting harmful tax competition cannot be defined *a priori*. Furthermore, it seems that interests at stake may be various and it might be too hard to establish a set of rules able to properly balance all of them. For instance, at the European Community level, as it will be discussed below, tax competition might impact not only Member States’ tax bases, but also free competition within the single market and has certain relevance under the State aids rules.

The international legal framework faces the problem of the lack of binding legal effects of the instruments international organisations are endowed with. Differently from unilateral responses by single States, international measures normally operate as soft law instruments and exert pressure against targeted jurisdictions. Soft law instruments are proven to have a strong political force, but might be inadequate to have short-term effective results.

By contrast, unilateral domestic measures, which are instead enforceable and binding, can structure their counteraction to the challenge posed by tax havens by adopting two potentially alternative policies. On the one hand, countries facing tax

[350] J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 87 reports an interesting statement by Arthur Owen, Prime Minister of Barbados, which summarises the tax competition dilemma: “Those who gain market share call it exploiting competitive advantage. Those who lose market share call it harmful”.

[351] R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 143.

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competition might introduce tax incentives or advantageous tax regimes for domestic taxpayers, in order to neutralise their tendencies to emigrate abroad; the outcome would be a consequent reduction of their domestic tax burden.[352] On the other hand, those countries might enact a set of "countermeasures" also aiming at disallowing the advantageous regimes existing abroad (such as CFC rules, thin capitalisation rules, rules on residence and emigration, the denial of tax treaty entitlements, the non-deductibility of certain expenses and transfer pricing rules). Of course, a mixture of both policies (domestic incentives and foreign countermeasures) can be adopted.

The tax competition phenomenon attracted little attention until the mid-1990s, when it started drawing a lot of governmental concern as an emerging global issue. In the last decades the increased mobility of factors of production resulted in a drastic reduction of corporate income tax rates, partly compensated by a broadening of tax bases or by a shift to other taxes or budgetary cuts.[353] Albeit limited to European Member States only,[354] the following Table shows that corporate income tax has drastically fallen since 1980 and this trend seems likely to continue.

This is the main reason why tax competition started becoming a hot topic in the political agenda and, observed from the perspective of the governments involved, the problem was soon faced in terms of its "harmfulness".

COUNTRY	**YEAR**					
	1980	1990	1995	2000	2005	2010
Austria *	55	39	34	34	25	25
Belgium*	48	41	40,17	40,17	33,99	30,81
Bulgaria					15	10
Cyprus		42,5	25	29	10	10
Czech Republic*			41	31	26	19
Denmark*		40	34	32	30	25

[352] This is what W. Schön, *Tax Competition in Europe*, Amsterdam, 2003, 30 calls the "*If you can't lick 'em, join 'em*" approach.

[353] According to W. Schön, *Tax Competition in Europe*, Amsterdam, 2003, 20, personal income taxes have not been lowered in proportion, thus creating a shift of the tax burden to labour.

[354] It is worth highlighting that twenty of the thirty-three OECD member States are also member of the European Union and have distinguished in the Table with a star. Accordingly, these data can be used to observe the phenomenon among the majority of the OECD countries. For more accurate empirical analysis see J. Gorter, R. De Mooij, *Capital income taxation in Europe: trends and trade-offs*, The Hague, 2001.

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Estonia			26	26	24	21
Finland*	59	41	25	29	26	26
France*	50	37	36,67	36,67	34,93	33,33
Germany*	52,8	57,7	56,8	51,63	38,29	15
Greece*	43,4	46	40	40	35	24
Hungary*		50	19,64	19,64	17,68	19
Ireland*	45	43	40	24	12,5	12,5
Italy*	36,3	41,8	52,2	41,25	37,25	31,4
Latvia			25	25	15	15
Lithuania		35	29	24	15	15
Luxembourg*		39,4	40,9	37,45	30,38	21,84
Malta		32,5	35	35	35	35
Netherlands*	48	35	35	35	31,5	22,75
Poland*		40	40	30	19	19
Portugal*		36,5	39,6	35,2	27,5	25
Romania					16	16
Slovak Republic*			40	29	19	19
Slovenia*			25	25	25	20
Spain*	33	35	35	35	35	30
Sweden*		40	28	28	28	26,3
United Kingdom*	52	34	33	30	30	28
Average	**47,5**	**40,32**	**35,04**	**32,12**	**25,63**	**22,03**

2. The EU concept of harmful tax competition

At the European Community level, there exists another form of competition which benefits from a different degree of protection by its Institutions, and which is worth

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recalling here in order to be distinguished from tax competition this analysis deals with.

Competition is a paramount aim of the founding fathers of the European Community and one of the main areas of authority of the European Union. It is a consistent part of the completion of the European internal market and is protected by Section 1 of Chapter 1 of Title VII of the Treaty on the Functioning of the European Union.[355]

Free competition is an economic phenomenon which looks at companies and aims at impeding businesses to fix prices or carve up markets between them. Under the EU rules, companies with a dominant position in a particular market should not abuse that power to squeeze out competitors, nor should companies merge if this put them in a position to control the market. Under the supervision of the Commission, EU rules on free competition are targeted to achieve the perfect competition, i.e. that situation describing markets in which participants are not large enough to set the price of products.[356]

By contrast, tax competition, as already highlighted, refers to the policy enacted by one State and consisting in providing for tax measures aimed at attracting foreign investors. A country wishing to attract foreign companies or other taxpayers can offer them more favourable tax regimes than their home State do. Hence, free competition and tax competition refer to two different phenomena. Whereas the former looks at

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[355] On competition within the European Community see more broadly I. Van Bael, J.F. Bellis, *Competition law of the European Community*, Alphen aan den Rijn, 2010; A. Ezrachi, *EC Competition Law: an analytical guide to leading cases*, Oxford, 2008; A. Jones, B. Sufrin, *EC competition law: text, cases, and materials*, Oxford, 2008; T.M.J. Möllers, A. Heinemann, *The enforcement of competition law in Europe*, New York, 2007; F. Henning-Bodewig, *Unfair competition law: European Union and Member States*, The Hague, 2006; O. Odudu, *The boundaries of EC Competition Law: the Scope of Article 81*, Oxford, 2006; P.J. Slot, A.C. Johnston, *An introduction to competition law*, Oxford, 2006.

[356] A perfectly competitive market exists when every participant is a "price-taker", meaning that the said participant cannot influence the price of the products it buys or sells. Under perfect competition, any profit-maximising producer faces a market price equal to its marginal cost. This implies that a factor's price equals the factor's marginal revenue product. Specific assumptions on perfectly competitive markets have been formulated, but a deep exam of the different characteristics is out of the scope of the present research. It is however worth recalling the following most common assumptions: (i) presence of infinite buyers/infinite sellers (i.e. infinite consumers with the willingness and ability to buy the product at a certain price, infinite producers with the willingness and ability to supply the product at a certain price); (ii) zero entry/exit barriers (i.e. it is relatively easy to enter or exit as a business in a perfectly competitive market); (iii) perfect factor mobility (i.e. in the long run factors of production are perfectly mobile allowing free long term adjustments to changing market conditions); (iv) perfect information (i.e. prices and quality of products are assumed to be known to all consumers and producers); (v) zero transaction costs (i.e. buyers and sellers incur no costs in making an exchange); (vi) profit maximization (i.e. firms aim to sell where marginal costs meet marginal revenue, where they generate the most profit); (vii) homogeneous products (i.e. the characteristics of any given market good or service do not vary across suppliers); (viii) constant returns to scale (i.e. constant returns to scale insure that there are sufficient firms in the industry). See more broadly, W. Boyes, M. Melvin, *Microeconomics*, Boston, 2008, 210 et seq.; H. Gravelle, R. Rees, *Microeconomics*, Gosport, 2004, 170-189.

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companies and is always considered as beneficial, tax competition is a States' matter and it is normally regarded as harmful. In spite of these two major differences, however tax competition can undeniably impact free competition. In fact, tax measures enacted by one Member State and resulting in a reduction of another Member State's tax base might hinder the fair and free competition of the single market. As corporate decisions are sensitive to taxes in the selection of the location for investment, companies might locate or direct their factors of production on the grounds of fiscal considerations. Tax driven choices of investment are always considered to be a distortion of economic reality and must thus be regarded as an infringement of free competition.

The European Community therefore protects free competition from tax measures enacted by Member States under the principles of non-discrimination and the fundamental freedoms.[357] Within the single market, any person or any company residing in one Member State can freely take up residence or establish a subsidiary or a branch or perform any economic activity, under the same conditions as a person or a company resident in the host State. Member States' domestic legislation cannot prevent or discourage nationals of other Member States (commonly non-residents) to freely exert their freedoms within their territory, by treating them less favourably than nationals (commonly residents) in the same circumstances.[358]

In direct tax matters, discrimination usually occurs in respect of non-residents not receiving national treatment in the host State, or in respect of foreign-source (inbound) income which is not taxed in the same way as domestic income.[359] By

[357] See more broadly on this matter G. Avery Jones, *Carry on Discriminating*, European Taxation, 2/1996, 46-49; P. Farmer, *EC law and national rules on direct taxation: a phoney war?*, EC Tax Review, 1/1998, 13-29; M. Gammie, *The Role of ECJ in the development of direct taxation in the European Union*, Bulletin for International Fiscal Documentation, 3/2003, 86-98; L. Hinnekens, *Non discrimination in EC income tax law: painting in the colours of a chameleon-like principle*, European Taxation, 9/1996, 286-303; S. Van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, Amsterdam, 2002; F. Vanistendael, *Tax Revolution in European Union: the impact of non-discrimination*, European Taxation, 1-2/2000, 3-7; J. Wouters, *The Principle of non-discrimination on European Community Law*, EC Tax Review, 2/1999, 98-106.

[358] According to the European Court of Justice, in relation to direct taxes, the situation of residents and non-residents are not, as a rule, comparable since there are objective differences between them from the point of view of the source of the income and the possibility of taking account of their ability to pay tax or their personal and family circumstances. However, the Court has made clear that the rule has some exceptions when taking into consideration the percentage the income taxed in the host State represents in the worldwide income of the non-resident. Residents and non-residents can be in a comparable situation where, for instance, the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances. See Judgment of 14 February 1995*, Finanzamt Köln-Altstadt / Schumacker* (C-279/93, ECR 1995 p. I-225) paragraph 30.

[359] See for example Judgment of 28 January 1986, *Commission / France* (C-270/83, ECR 1986 p. 273); Judgment of 8 May 1990, *Biehl / Administration des contributions* (C-175/88, ECR 1990 p. I-

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contrast, restrictions are usually caused by exit taxes and similar measures applied by the origin State, hindering the cross-border situation as compared to a similar domestic situation.[360] Discrimination arises not only from the application of different rules to comparable situations, but also from the application of the same rule to different situations.[361] According to settled case law of the European Court of Justice (hereinafter "ECJ"), although fundamental freedoms are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as national of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its national or of a company incorporated under its legislation.[362] In other words, tax measures enacted by Member States should not hinder free and fair competition by discouraging investment within their territories by non-residents, nor should they obstruct residents to invest abroad. Domestic laws ensuring equal circumstances to both resident and non-resident investors are in fact a prerequisite for free and fair competition.[363]

Accordingly, the most frequent domestic tax provisions challenged before the ECJ provide for a less favourable treatment to non-resident investors of the host State compared to its resident investors in similar circumstances, rather than the opposite.

Without further discussing the fundamental freedoms and their scope in direct taxation, which is out of the scope of this work, it must be pointed out that tax competition can well be a form of discrimination. In fact, in those situations in which a

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1779); Judgment of 28 January 1992, *Bachmann / Belgian State* (C-204/90, ECR 1992 p. I-249); Judgment of 13 July 1993, *The Queen / Inland Revenue Commissioners, ex parte Commerzbank* (C-330/91, ECR 1993 p. I-4017); Judgment of 11 August 1995, *Wielockx / Inspecteur der directe belastingen* (C-80/94, ECR 1995 p. I-2493).

[360] Judgment of 27 September 1988, *The Queen / Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC* (81/87, ECR 1988 p. 5483); Judgment of 15 May 1997, *Futura Participations and Singer / Administration des contributions* (C-250/95, ECR 1997 p. I-2471); Judgment of 28 April 1998, *Safir / Skattemyndigheten i Dalarnas län* (C-118/96, ECR 1998 p. I-1897); Judgment of 16 July 1998, *Imperial Chemical Industries / Colmer* (C-264/96, ECR 1998 p. I-4695); Judgment of 13 April 2000, *Baars* (C-251/98, ECR 2000 p. I-2787). Owing to the evolution of the ECJ jurisprudence, the above mention distinction should not be interpreted in a strict sense. See more broadly on this matter A. Del Sole, *Discriminazioni e restrizioni fiscali. I principi della Corte di Giustizia delle Comunità Europee*, Milan, 2007.

[361] Judgment of 14 February 1995, *Finanzamt Köln-Altstadt / Schumacker* (C-279/93, ECR 1995 p. I-225) paragraph 30; Judgment of 11 August 1995, *Wielockx / Inspecteur der directe belastingen* (C-80/94, ECR 1995 p. I-2493), paragraph 17; Judgment of 27 June 1996, *Asscher / Staatssecretaris van Financiën* (C-107/94, ECR 1996 p. I-3089), paragraph 40.

[362] It must be noted that the application of different rules to resident and non-residents was initially defended as being one of the basic features of international tax law. However, the Court rejected this argument, claiming that it gave rise to a fundamental conflict with the fundamental freedoms. The argument focused, therefore, on the grounds that were put forward in defence of the unequal treatment.

[363] In this sense, F. Vanistendael, *Fiscal Support Measures and Harmful Tax Competition*, EC Tax Review, 3/2000, 155.

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domestic measure confers a tax advantage upon non-resident investors only (whether or not aimed at eroding other Member States tax bases) and it denies it to residents in similar circumstances, it might be claimed as constituting a "reverse discrimination" if certain requirements set forth by the ECJ are met. However, it seems that reverse discrimination does not benefit from similar "qualified protection" under the Treaty. In fact, when asked to rule against the prohibition of reverse discrimination, the ECJ stated that the EC Treaty and the fundamental freedoms do not cover such a matter, which is rather a pure domestic one.[364] Similarly, in those situation in which resident taxpayer benefit from a more advantageous tax regime in the host EU Member State and its home State tax legislation neutralises such an advantage (typically, under an anti-avoidance provision), this might well constitute a restriction to its inbound free movement of factors of production. Bearing in mind, for instance, the *Lankhorst-Hohorst* case,[365] German thin capitalisation rule which applied only in respect of cross-border transactions was judged in breach of the fundamental freedoms.

This position taken by the ECJ can be interpreted as denoting that even if tax competition inevitably impact on free competition, domestic provisions aimed at attracting foreign investors are not a serious matter of concern in the EC Treaty legal framework, nor are the possible indirect and negative effects those measures have on other Member States' tax bases. The ECJ repeatedly judged that diminution of tax revenue cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment.[366] Home State's domestic countermeasures aimed at neutralising tax advantages enjoyed in other Member States might risk being considered in contravention with the fundamental freedoms, if there is no sufficient ground for a legitimate justification.[367]

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[364] Judgment of 26 January 1993, *Werner / Finanzamt Aachen-Innenstadt* (C-112/91, ECR 1993 p. I-429). Such a restrictive approach was criticised by S. Van Thiel, *Free Movement of Persons and Income Tax Law: the European Court of Justice in Search of Principles*, Amsterdam, 2002, 373. This matter would require further development by the doctrine and the jurisprudence. See also D. Garcia, *Are There Reasons to Convert Reverse Discrimination into a Prohibited Measure?*, EC Tax Review, 4/2009, 179-191 whose analysis in the light of the ECJ case law, citizenship of the Union and the principle of equality stated in the Human Rights and leads to the conclusion that reverse discrimination should be prohibited.

[365] Judgment of 12 December 2002, *Lankhorst-Hohorst* (C-324/00, ECR 2002 p. I-11779).

[366] Judgment of 21 September 1999, *Saint-Gobain ZN* (C-307/97, ECR 1999 p. I-6161), paragraph 51; Judgment of 6 June 2000, *Verkooijen* (C-35/98, ECR 2000 p. I-4071), paragraph 59; Judgment of 8 March 2001, *Metallgesellschaft and others* (C-397/98 and C-410/98, ECR 2001 p. I-1727), paragraph 59; Judgment of 12 December 2002, *Lankhorst-Hohorst* (C-324/00, ECR 2002 p. I-11779), paragraph 79.

[367] See Judgment of 16 July 1998, *Imperial Chemical Industries / Colmer* (C-264/96, ECR 1998 p. I-4695), in which the ECJ allowed the Member States to apply anti-avoidance rules aimed at international tax structures only if the taxpayer employs an "artificial" scheme without substantial economic activity. Moreover, there exists conspicuous literature on the subject of the compatibility of the CFC rules and the fundamental freedoms: S. Whitehead, *CFC legislation and abuse of law in the*

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It seems arguable that at the EU level not all domestic measures aimed at conferring a tax advantage upon non-resident investors can be qualified *per se* “harmful”. In the light of the provisions of the EC Treaty, the only form of protection from harmful tax competition seems to be State aids rules, set forth in Articles 107-109 of the Treaty on the Functioning of the European Union. However, protection under these provisions can only be claimed when a given (harmfully competitive) tax measure distorts or threatens to distort competition within Europe, is based on State resources and is unjustifiable by the logic of the tax system considered.[368]

3. The European Community’s action against tax competition

The tax competition phenomenon came up also at the European Union level in the late 1990s. While EU Member States were jealously preserving their tax sovereignty against the growing areas of intervention of the European Institutions, taxation started becoming a cause of concern for the European integration and drew the attention of the European Commission.[369]

The economic developments resulting from globalisation, the freedom to move capital cross-borders, the growing capacity of multinationals to produce more mobile

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community, in D. Weber, *The influence of European law on direct taxation: recent and future developments*, Alphen aan den Rijn, 2007, 1-16; D. Evans, L. Delahunty, *E.U. perspective on U.K. CFC rules*, Tax planning international Review, 34/2007, 15-18; S. Whitehead, *Practical implications arising from the European Court’s recent decisions concerning CFC legislation and dividend taxation*, EC Tax Review, 4/2007, 176-183; G. Turner, *The legitimacy of CFC legislation within the Community*, The EC Tax Journal, 1/2007, 23-47; G.T.K. Meussen, *Cadbury Schweppes: the ECJ significantly limits the application of CFC rules in the member states*, European taxation, 1/2007; 13-18; T. Rønfeldt, E. Werlauff, *CFC rules go up in smoke - with retroactive effect*, Intertax, 1/2007, 45-48; B. Dodwell, C. Serrau, *Cadbury Schweppes: the future of CFC legislation*, Tax adviser, July 2006, 27; R. Fontana, *The uncertain future of CFC regimes in the member states of the European Union - part 1*, European taxation, 6/2006, 259-267; R. Fontana, *The uncertain future of CFC regimes in the member states of the European Union - part 2*, European taxation, 7/2006; 317-334; J. Schönfeld, *The Cadbury Schweppes case: are the days of the United Kingdom’s CFC legislation numbered?*, European taxation, 10/2004, 441-452

[368] See more broadly the Commission Notice 98/C 384/03 of 11 November 1998 enacted by the European Commission on the application of the State aid rules to measures relating to direct business taxation, *Official Journal*, C 384, 10 December 1998.

[369] Within the European Community legal framework, income taxation has always been a national prerogative, owing to the social and economic choices it requires, which do not fall within the common European objectives. It is worth recalling here that paragraph 1 of article 114 of Consolidated Version of the Treaty on the Functioning of the European Union (ex article 95 of the EC Treaty) establishes that the European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. Not being an area of its own proper tasks, the Community might intervene with a view of approximating and coordinating domestic laws which can impact upon the internal market.

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tax bases on the one hand, and the complexity of EU Member States countries and their high tax rates, which encouraged tax avoidance and tax evasion, on the other hand, have contributed to the emergence of the so called “black” economy. Firms and labour started going far from the eyes of their high-tax residence countries, with a clear impact on the levels of investment and employment of these latter.

These factors urged the Commission to take some steps and in 1996 it launched a new initiative in taxation,[370] taking into account the notion of “tax competition” for the

[370] Indeed, already in the 1960s the EU institutions had started taking some action in the area of taxation. It is just worth highlighting here that the initial intervention dates back to 1961, when the Council of Ministers of Finance directed the Commission to establish a working group to examine the effect of various taxes on capital transactions. The Commission appointed a Committee under the chairmanship of Neumark, in charge of analysing if differences in tax laws could constitute an obstacle, even only partial, to the realisation of the single market, and, in the latest case, how much these differences could be eliminated. See the Document *Guidelines for Corporate Taxation* of April 1990, SEC (90) 601 presented to the Council and the Parliament. In 1962 the Neumark Report was issued and its findings were that the existence of double taxation, different treatments of companies and securities based on nationality, as well as unnecessary tax burdens, could impede cross-border flows of capital. The Neumark Report recommended the adoption of certain measures aimed at harmonising national tax systems in three different phases. See *The EEC Reports on tax harmonization: the report of the Fiscal and Financial Committee and the reports of the Sub-groups A, B and C (The Neumark Report)*, Amsterdam, 1963. Similarly, the 1966 Segré Report focused on the distortions caused in the capital market by the differences existing in the national systems and pointed out the necessity to remove fiscal obstacles hindering the single market. See *The development of a European capital market: report of a group of experts appointed by the EEC Commission (The Segré Report)*, Brussels, 1966. Albeit the Commission decided to take action by submitting several proposals for Directives (see COM (75) 392 final, 23 July 1975), these latter did not encounter Member States’ consent. Finally, in late 1990, the Commission appointed a Committee under the chairman of Ruding in charge of studying the impact of taxation on the location of investment and the allocation of profits between businesses in different Member States. The Committee was asked to investigate whether differences in corporate taxation led to distortions affecting the single market, particularly to investment decisions and competition, and to make proposals for remedial action by the Community. The Ruding Report’s findings were that the existing differences in tax rates, double taxation, withholding taxes and unrelieved imputation taxes distorted capital flows and thus competition. It therefore proposed some recommendations aimed at eliminating double taxation of cross-border income flows and at harmonising the three components of corporate income taxes, i.e. rates, bases and systems. See *Reports of the Ruding Committee: Conclusions and Recommendations of the Committee of Independent Experts on Company Taxation*, European Taxation, 4-5/1992. See also: F. Vanistendael, *Comments on the Ruding Committee Report*, EC Tax Review, 1/1992, 3-33; A.L. Bovenberg, S. Cnossen, F. Vanistendael, J.W.B. Westerburgen, *Harmonization of company taxation in the European Community: some comments on the Ruding Committee Report*, Deventer, 1992; C.E. McLure, *Coordinating Business Taxation in the Single European Market: the Ruding Committee Report*, EC Tax Review, 1/1992, 13-21; B. Knobbe-Keuk, *The Ruding Committee Report – an impressive vision of European Company Taxation for the year 2000*, EC Tax Review, 1/1992, 22-38; R.G. Minor, *Ruding Committee Report unveiled. New measures proposed for company taxes in the EC*, Tax Notes International, 12/1992, 563-566; D. de Buitler, *The Ruding Report and the EC Commission’s response*, European taxation, 1/1993, 15-21; K. Messere, *A personal view on certain aspects of the Ruding Report and the EC Commission’s reaction to it*, European Taxation, 1/1993, 2-14. Reaction of the Commission to the Ruding Report are contained in the Communication to the Council and the European Parliament of 26 June 1992, SEC (92) 1118.

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first time. In April 1996, the Council of Economic and Finance Ministers (ECOFIN) at its meeting in Verona approved the document "Taxation in the European Union"[371] and established a "High Level Group on Taxation in the European Union", consisting of Personal Representatives of the Finance Ministers, and chaired by taxation and Single Market Commissioner Mario Monti. Task of the Group was "*reporting on the development of tax systems within the Union, taking account of the need to create a tax environment that stimulates enterprise and the creation of jobs and promote a more efficient environment policy*".[372] The view of the High Level Group was summarised in a Report published in October 1996 by the Commission,[373] which recommended actions by the Community as a result of "coordination" and in full account of the principles of subsidiarity and proportionality.[374]

Tax competition was regarded as an ambivalent concept. On the one hand, it was considered as an instrument to improve governments' tax policies. On the other hand, it was deemed to be a threat to the equity and the neutrality of tax systems. In other words, there was a "fair" competition, distinguished from a "harmful" one,[375] so that competition was considered as a double-edged sword.[376] It was held that tax competition was beneficial insofar as it fostered economic development, which could also result in a certain degree to harmonisation between the tax systems of the Member States.[377] However, over a certain limit, it was also held that tax competition could have detrimental effects on public revenue and social policies.

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[371] 20 March 1996, SEC (96) 487 final. See also European Commission, *Taxation in the European Union – Report on the Development of Tax Systems*, 22 October 1996 COM (96) 546 final.

[372] COM (96) 546 final, 22 October 1996, paragraph 1.5.

[373] *Taxation in the European Union: report on the development of tax systems*, 1996. The Report, with a cautious approach, echoed a much earlier Commission paper, *The Scope for Convergence of Tax Systems in the Community*, 1980, which had noted that tax sovereignty is one of the fundamental components of national sovereignty, and pointed to widely differing ideas about the functions of taxation.

[374] Paragraph 6.2. of the Report.

[375] The harmfulness of tax competition mainly resulted from the erosion of tax bases, as governments are forced to reduce their tax burden with a lower level of public goods and from the shift of taxes from mobile tax bases (capital) to immobile ones (labour).

[376] A.C. Santos, *Point J of the Code of Conduct or the Primacy of Politics over Administration*, European Taxation, 9/2000, 418.

[377] At the European level the problem of tax competition is often linked to that of tax coordination and harmonisation. As argued by A.C. Santos, *Ib.*, tax competition became a real concern of the Community at the time when the European Union abandoned the harmonisation approach in favour of a more flexible form of tax coordination based on the principle of subsidiarity for competence allocation between the Member States and the Union. See also the position on this matter of the Commissioner for Internal Market, F. Bolkestein, *Taxation and Competition: The Realization of the Internal Market*, European Taxation, 9/2000, 401-406, as well as that of B. Hendricks, *A View on Tax Harmonization and the Code of Conduct*, European Taxation, 9/2000, 413-414.

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4. The Monti Package and the Code of Conduct

The initial package of measures put forward by the Commission[378] was too broad in its scope, as it covered a number of "blocked dossiers" and formal proposals in the fields of both direct and indirect taxation. A subsequent revision limited the proposed areas of concrete intervention to the following three:[379] a code of conduct for business taxation; the elimination of distortions to the taxation of capital income (the minimum withholding tax on bank interest proposals); and measures to eliminate withholding taxes on cross-border interest and royalty payments between companies. On 1 December 1997, the ECOFIN Council approved the package of measures put forward by the Commission concerning the harmful tax competition between Member States and the harmonisation of taxation of savings, interests and royalties.

The central proposal of the package certainly was the Code of Conduct.[380] The Code of Conduct is a non-binding recommendation that covers those business tax measures (i.e. both laws or regulations and administrative practices) which affect, or which may affect, the location of business activity in the Community in a significant way. It identifies as "potentially harmful" those tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question.[381] Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

The starting point to identify potentially harmful tax measures therefore attains to the level of taxation existing in Member States, which the other regime should be

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[378] European Commission, *Towards Tax Co-ordination in the European Union: a package to handle harmful tax competition*, Brussels, 1 October 1997 COM (97) 495 final.

[379] European Commission, *A package to tackle harmful tax competition in the European Union*, 5 November 1997 COM (97) 564. Such proposal no longer included some indirect tax elements, i.e. increasing the powers of the VAT Committee, the taxation of investment gold, of passenger transport and of energy products, and the FISCALIS anti-fraud programme. The Commission would have pursued them in normal way. Action on fiscal State aid would have accompanied the code of conduct. A chronicle history of these measures can be found at P. Cattoir, *A History of the "Tax Package" – The Principles and Issues Underlying the Community Approach*, European Commission Taxation Papers, Working Paper no. 10, December 2006.

[380] Annex 1 of the Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning tax policy: Resolution of the Council and the Representatives of the Governments of the Member States, Meeting within the Council of 1 December 1997 on a code of conduct for business taxation, (98/C 2/01), Official Journal of the European Communities, C 2/1, 6 January 1998. European Commission, *Code of Good Conduct in the Field of Direct Company Taxation*, Official Document No. 2061, 3 December 1997.

[381] See paragraph B of the Code of Conduct. The action taken by the European Union in the removal of harmful tax regimes within the European Union is based on very similar criteria to those of the OECD. See J. Malherbe, *Harmful Tax Competition and the European Code of Conduct*, Tax Notes International, 2/2000, 151-154. See also E. Osterweil, *OECD Report on Harmful Tax Competition and European Code of Conduct Compared*, European Taxation, 6/1999, 198-202.

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compared to. A list of non-exhaustive five main factors is identified to assess whether such measures are harmful: (i) advantages are accorded only to non-residents or in respect of transactions with non-residents; or (ii) advantages are ring-fenced from the domestic market, so they do not affect the national tax base; or (iii) advantages are granted even in the absence of real economic activity and substantial economic presence within the Member State offering such advantages; or (iv) there has been a departure from rules for profit determination within a multinational group of companies, e.g. transfer pricing rules agreed within the OECD; or (v) the tax measures lack transparency, including relaxation of legal provisions at the administrative level in a non-transparent way.

It can be noted that the first two criteria are closely linked to each other and refer to tax advantageous measures which are granted to non-residents or in respect of transactions with non-residents, or whose effects are otherwise ring-fenced from the domestic market. The third criterion regards the absence of a real substantial economic activity, the fourth to the rules for profit determination, and the fifth to transparency. As it will be pointed out below, these criteria tend to be substantially similar to those identified by the OECD, although the initiative launched by this latter has currently focused its attention on transparency and exchange of information at the expense of the other criteria. At this point, it is worth underlining that if a measure is fully set out in national legislation, or is published in full in the form of regulations or guidelines and is not subject to any administrative discretion, that it can be regarded as transparent.[382]

Member States committed themselves not to introduce new harmful tax measures according to the above highlighted meaning, to respect the principles underlying the code when determining future policy, and to roll back existing laws and practices with a view to eliminating any harmful tax practice.[383]

A review process was also established, under which Member States were to keep each other informed about existing or proposed measures, which could fall within the scope of the Code of Conduct, and to request other Member States to provide information about, discuss and comment on, any tax measures of these latter that could be considered as harmful. Cooperation to fight against tax evasion and avoidance, notably in the exchange of information between Member States, is also

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[382] F. Nanetti, G. Mameli, *The creeping normative role of the EC Commission in the twin-track struggle against State aids and harmful tax competition*, EC Tax Review, 4/2002, 186.

[383] According to H. Hamaekers, *Tackling Harmful Tax Competition – a Round Table on the Code of Conduct*, European Taxation, 9/2000, 398, the final report was not accepted enthusiastically by all EU Member States. The Netherlands, for instance, criticised the criteria chosen to identify harmful tax competition, as they were a premise to a “pseudo-harmonisation”. Similarly, both the governments of the Netherlands and Luxembourg claimed that the list of those measures which affect a choice of business location mainly focused on measures relating to intra-group and financial services and offshore companies. Ireland argued that the list did not indicate in respect of each of the measures to what extent the effective level of taxation was lower than the levels which generally apply in the European Union.

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covered. Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives with respect to those territories, commit themselves to ensuring the application of principles aimed at avoiding harmful tax competition.

The Code of Conduct furthermore specifies that some of the measures contained therein may fall within the scope of the provisions on State aids and should therefore be evaluated separately under these latter rules. Indeed, specific tax measures derived from an exception to the general tax rules or from a discretionary administrative practice may be regarded as unacceptable State aid. They can consist of tax advantages only benefiting certain enterprises, productions, sectors and regions, unless there is a sufficient economic rationale which makes the specific measure necessary, as well as measures intended to assist regional development or to further protection of the environment, unless the measures are approved by the European Commission. Incentives aimed at a general economic policy are always acceptable if all enterprises can benefit.

Although this matter will not be object of discussion here,[384] it is worth highlighting that the European Commission has far greater power under the State aids provisions contained in the EC Treaty rather than under the more general principles set forth in the Code of Conduct. As a matter of fact, whereas the State aid provisions cover a substantial range of issues that can be resolved by both the Commission and the European Court of Justice, the Code of Conduct is nothing but a soft law instrument, which contains strong political declarations and requires a high level of commitment from all Member States, but it is deprived of any binding legal effect.

The Code of Conduct mandated the creation of a “follow-up Group” of national government representatives within which the day-to-day application of the Code could be discussed. Such a Group was established by the ECOFIN Council on 9 March 1998 under the chairmanship of Dawn Primarolo, former Financial Secretary to the UK Treasury, and met for the first time on 8 May 1998 (hereinafter referred to as “Primarolo Group”).

The Primarolo Group’s first task was to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which *prima facie* fell within the scope of the Code of Conduct. The Commission identified a number of tax schemes and classified them under the following five headings: (i) intra-group services; (ii) financial and insurance services, including “offshore” financial services in territories under the jurisdiction of Member

[384] See F. Vanistendael, *Fiscal Support Measures and Harmful Tax Competition*, EC Tax Review, 3/2000, 152-161. F. Nanetti, G. Mameli, *The creeping normative role of the EC Commission in the twin-track struggle against State aids and harmful tax competition*, EC Tax Review, 4/2002, 185-191. A.C. Santos, *Point J of the Code of Conduct or the Primacy of Politics over Administration*, European Taxation, 9/2000, 417-421; A. Fantozzi, *The applicability of State Aid Rules to Tax Competition Measures: A Process of “De Facto” Harmonization in the Tax Field?*, in W. Schön, *Tax Competition in Europe*, Amsterdam, 2003, 121-132.

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States (e.g. Gibraltar); (iii) special tax treatment for certain industrial or service sectors (e.g. the film industry); (iv) tax advantages for certain geographical areas (e.g. the Canary Islands); (v) other measures, including tax incentives for certain kinds of company (e.g. "micro" enterprises).

In order to evaluate the harmfulness of such categories, the Primarolo Group employed four criteria. First, a structural evaluation was applied to identify whether a regime was taken out of the context of local market and it had any influence on national tax base. Second, a territorial evaluation was needed to identify the presence of incentives and advantages to companies without a real activity on the territory. Third, an objective evaluation was practised to verify the respect of international rules for the determination of the earnings of the group. Finally, an evaluation was applied to consider the eventual application of general principles for administrative procedures.

The Primarolo Group's first interim report was published at the beginning of December 1998 and identified eighty-five measures in EU Member States which were of a harmful nature[385] grouped into five categories. With reference to tax measures connected to the provision of financial services to third parties, intra-group financing and the provision or licensing of intangible property in return for royalties payments, the Primarolo Group considered as harmful those features that provided for a reduced nominal tax rate, provided for fixed margins for pass-through financing without a regular review of those margins against normal commercial criteria, allowed the creation of substantial reserves which were in excess of the real underlying risks and which reduced taxable profits, or permitted the profits to be allocated between a head office and a branch in a way contrary to the arm's length principle, that could lead to a reduced effective rate of tax on the company as a whole.

All EU Member States, with the exception of Austria, were found to have tax measures in contrast with the Code of Conduct in respect of the following categories: coordination, distribution and service centres; holding company regimes; financial services and offshore companies; sector specific measures; regional incentives; and catch-all category of other measures.[386] The Primarolo Group was further mandated to monitor the "roll back" of those tax measures identified as harmful. Member States had to rescind them by the end of 2003. At the same time, the Primarolo Group

[385] The Group analysed two hundred and eighty-two potentially harmful measures: eighty-five were in the first report, whereas in the final one issued on 19 November 1999 sixty-six measures were considered as harmful.

[386] Some specific regimes would have been target of further investigation. For instance, Belgian and Luxembourg coordination centres, Dutch financial company and royalties rulings, Gibraltar and Madeira special purpose companies, Luxembourg and Dutch holding companies, as well as tax-free zones in a number of countries were to be under scrutiny. See, for example, the Proposal for appropriate measures under Article 93(1) of the EC Treaty concerning the International Financial Centre and Shannon custom-free airport zone, Official Journal C 395/14, 18 December 1998.

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monitored the "stand-still", with a further report due at the end of 2000 on the extent to which it had been observed.

5. The 1998 OECD Report

In the late 1990s the tax competition phenomenon also drew the attention of another international organisation. In May 1996, the OECD member countries decided to study the problem and called the OECD to develop measures to counter the distorting effects of what the organisation defined "harmful" tax competition on investment and financing decisions. The OECD, as it has been previously highlighted in Chapter 1, issued a Report in 1998, urged by the requests of the G-7 countries at the Lyon Summit in June 1996.[387] In response, the OECD's Committee on Fiscal Affairs launched its project on harmful tax competition, setting up a separate task force known as the "Special Sessions on Tax Competition" in January 1997 to examine the problem.

The initial result was the preparation of a Report that was adopted by the Committee on 20 January 1998, approved by the OECD Council on 9 April 1998, and adopted by the ministers on 28 April 1998[388] (hereinafter referred to as "1998 Report"). As it will be underlined below, Luxembourg and Switzerland abstained and issued statements indicating reasons for their refusal to vote in favour of the 1998 Report.[389] The 1998 Report marks the beginning of the OECD campaign against tax havens and harmful tax competition, which has been defined as a "rhetorical strategy, relying on moral and reasoned suasion and speech acts".[390]

[387] A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1037 reports the affirmations of the heads of government in their communiqué, which reads as follows: "Tax schemes aimed at attracting financial and other geographically mobile activities can create harmful tax competition between States, carrying risks of distorting trade and investment, and could lead to the erosion of national tax bases. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices". See also H.J. Ault, J.M. Weined, *The OECD's Report on Harmful Tax Competition*, National Tax Journal, 1998, 608.

[388] OECD, *Harmful Tax Competition: An Emerging Global Issue*, Paris, 1998.

[389] Annex A of the Report reproduces statements issued by Luxembourg and Switzerland.

[390] J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 70. Interestingly, the Author points out that four are the main principles on which this project relies on, i.e. law enforcement, sovereignty, consistency and equality in argument. The OECD labelled the small States as "tax poachers" and associated them with criminal activities (the law enforcement principle), while targeted jurisdiction insisted on the legitimacy of their behaviour. Then, the OECD argued that tax haven-driven tax competition undermined others' fiscal sovereignty by creating a race to the bottom (sovereignty), whereas tax havens claimed that the OECD itself was violating their sovereignty by seeking to dictate and impose foreign tax laws upon them. Moreover, the OECD reasoned that its hostility to "harmful" tax competition did not detract from its strong support of competition overall, nor was the exclusionary conduct of the campaign in conflict with its developmental and cooperative mission (consistency), whereas those jurisdictions pointed out the OECD's double standards given the

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The first issue addressed in the 1998 Report is tax competition, which the OECD acknowledges to be a consequence of the increased globalisation and of the interaction of domestic tax systems. Globalisation is in fact recognised to have fundamentally reshaped the relationships among domestic tax systems and the removal of non-tax barriers to international commerce and investment has boosted the integration of national economies and increased the potential impact that domestic tax policies can have on other economies. On the one hand, globalisation has also been the inspiring motive of several tax reforms, which have focused on base broadening and rate reductions, and has encouraged countries to reduce tax barriers to capital flows and to adapt domestic tax systems to the new global environment. On the other hand, globalisation has paved the way to the emergence of multinational enterprises and to the development of refined strategies aimed at minimising and/or avoiding taxes through shifting profits among different jurisdictions.

In the 1998 Report's view, the term "tax competition" is used to mainly describe the three following phenomena, which can all influence the location of investment: (i) competition to attract substantial foreign direct investment, such as manufacturing; (ii) competition to attract the more mobile types of direct investment, such as financial services and centres for multinational enterprises; and (iii) competition to attract passive, portfolio, investment. Without providing a general definition of what is considered as constituting "tax competition" or what its nature is,[391] but rather focusing on the three different types it can take form, the 1998 Report expressly declares to only focus on "geographically mobile activities, such as financial and other service activities, including the provision of intangibles".[392] Accordingly, the scope of the Report is limited to the second of the three forms of competition highlighted above.[393]

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similar practices existing among its members. Finally, the OECD presented itself as an ideal interlocutor, fully seized of the need for reasoned discussion, dialogue, and listening to alternative points of view (equality in argument), while tax havens claimed that the OECD violated the basic norms of a debate between equals by trying to set the agenda unilaterally. From the 1998 Report, however, it emerged that almost all OECD States employed some offending activities in their attempt to maintain policy competitiveness. For example, the US foreign sales corporations that allow some exporters to escape the corporate income tax were criticised; these devices were also later condemned by the WTO. Several pieces of legislations considered in 2003 contained provisions replacing foreign sales corporations with other tax incentives for business.

[391] The inadequate discussion of the nature of tax competition in the 1998 Report is remarked, among the others, by J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, Georgetown Law Journal, 3/2001, 543-604.

[392] Paragraph 6 of the Report. It is worth highlighting that the Report does not deal with money laundering or financial crimes, which are often acknowledged to occur through tax havens.

[393] In this sense see also R.T. Kudrle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to American Foreign Policy*, Pittsburgh, 2008, 190. The Author also argues that the Report fails to acknowledge that the distinction between the first (i.e. manufacturing) and the second (i.e. financial services) form of tax competition "is largely one of degree with (nearly) zero value-added

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The Committee recognises that the distinction between regimes directed at financial and other services, on the one hand, and at manufacturing and similar activities, on the other hand, is not always easy to apply. However, tax incentives designed to attract investment in plant, building and equipment have been excluded from the Report. Similarly, tax treatment of interest on cross-border saving instruments, particularly bank deposits, is not considered, as the Committee at that stage was examining the feasibility of developing proposals to deal with cross-border interest flows, including the use of withholding taxes and exchange of information.[394] The Report thus expressly refers to those tax regimes tailored to attract "investment or savings".[395]

The 1998 Report consists of three main chapters dealing with (i) global tax competition; (ii) how to tell when a tax haven and a preferential tax regime is "harmful" and (iii) how to counteract "harmful tax competition". In the following paragraphs each part will be object of analysis. It will emerge that almost the entire OECD's attention focuses on tax havens and that the emphasis on exchange of information seems to be more relevant as a matter of evasion of tax on passive income, rather than of avoidance of tax on geographically mobile activities.

5.1. Approaching the problem of global tax competition

As it has been pointed out above, the 1998 Report does not contain any clear and concise definition of the terms "harmful tax competition",[396] but rather describes "harmful tax practices" as those practices that "affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally".[397]

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in the claimed polity marking one end of the spectrum". Real "harmful" tax competition, such as tax haven banking, instead involves a combination of the second and the third (i.e. "passive portfolio" investment) or a combination of the first with the third (such as Luxembourg's historic banking practices that allow safe and effortless tax evasion by other Europeans). R. Avi-Yonah, *Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1563, criticises the failure of the 1998 Report to distinguish satisfactorily between healthy and harmful tax competition and expressed disappointment that the OECD had restricted its project to the mobile services sector only, without discussing the problem of production tax havens.

[394] Paragraph 12 of the 1998 Report.

[395] Paragraph 29 of the 1998 Report.

[396] According to A. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 462 the authors of the Report "repeatedly assert its existence as self-evident and ask the reader to credit 'elephant tests' ('you'll know one when you see it') as the basis for separating beneficial from 'harmful' international tax preferences".

[397] Paragraph 4 of the 1998 Report.

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Described in these terms, it seems that the major matter of concern of the OECD is the emerging tax avoidance techniques developed by multinational firms as a result of globalisation.[398] According to the OECD, these behaviours, in fact, have a negative impact on governments' tax policies, as they provoke erosion of domestic tax bases, alter the structure of taxation and hamper the application of progressive tax rates and the achievement of redistributive goals. From the 1998 Report it turns out that multinationals enterprises are indeed acknowledged to have developed global strategies and softened their links with countries[399] and together with technological innovation and the expansion of international financial markets they have altered the structure of tax systems.[400] According to the OECD, this phenomenon, which is nothing but one result of globalisation, can have both positive and negative effects:[401] on the one hand, the removal of barriers to international commerce and investment, as well as the integration of the economies, has been the driving force behind tax reforms aimed at reducing tax rates and at broadening tax bases and at improve the "fiscal climate" for investment; on the other hand, globalisation opened up new ways by which taxpayers can develop strategies aimed at exploiting interactions of tax systems with a view to diverting financial and other geographical mobile capital, therefore distorting patterns of trade and investment and reducing welfare. Owing to the erosion of national tax bases,[402] in fact, part of the tax burden is shifted from mobile to relatively immobile factors and from income to consumption.

Similarly, tax competition might produce negative effects upon some countries and positive effects upon some others. According to the OECD,[403] some countries might indeed view investment incentives as a policy instrument to stimulate new investment, whereas others might consider investment incentives as diverting real investment from one country to another. Similarly, countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. Furthermore, negative effects may also occur when taxpayers exploit unintentional mismatches between existing tax systems to the detriment of either or both countries.

The negative effects resulting from these practices are appropriately defined by the OECD as "harmful",[404] because they do not reflect different judgements about the

[398] See paragraph 23 of the 1998 Report.

[399] Paragraph 22 of the 1998 Report.

[400] Paragraph 23 of the 1998 Report.

[401] Paragraphs 23 and 27 of the 1998 Report.

[402] This phenomenon is commonly referred to as "beggar-my neighbour" regime. See for example F. Vanistendael, *Fiscal Support Measures and Harmful Tax Competition*, EC Tax Review, 3/2000, 156.

[403] Paragraph 27 of the 1998 Report.

[404] Paragraph 29 of the 1998 Report.

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appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects relating to every country's tax sovereignty, but are tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries' taxes. Accordingly, in the OECD's view, "harmful" are those measures which provoke the following results:[405] (i) distorting financial and, indirectly, real investment flows; (ii) undermining the integrity and fairness of tax structures; (iii) discouraging compliance of all taxpayers; (iv) re-shaping the desired level and mix of taxes and public spending; (v) causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and (vi) increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

According to the OECD, when a given practice has only some of these effects, it will be necessary to consider and weight the harm they cause.[406] Should they erode other countries' tax bases, such practices would be doubtlessly labelled as "harmful tax competition".[407] As any regime can be harmful even where it is difficult to quantify the adverse economic impact it imposes, governments are asked to take measures, including intensifying their international co-operation, to protect their tax bases and to avoid the worldwide reduction in welfare caused by tax-induced distortions in capital and financial flows.[408]

It has been argued that the OECD's initiative is only aimed at protecting direct taxation, on which its member governments rely, and has nothing to do with economic efficiency, but rather with the political preferences of the said governments.[409] The OECD's concept of harm indeed does not refer to the economy

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[405] Paragraph 30 of the 1998 Report.

[406] It is interesting to underline an exercise made by M. Ellis, *Are Measures to Curb Harmful Tax Competition Necessary?*, European Taxation, 3/1999, 79 aimed at verifying whether the criteria set forth by the 1998 Report to assess the "harmfulness" of a given regime really stand up and whether ring-fencing is more harmful than tax reductions across the board. The Author looked at paragraph 30 of the 1998 Report and replaced the words "preferential tax regime" by "income tax". The outcome was that: "income tax distorts financial and indirectly real investment flows; income tax discourages compliance by taxpayers; income tax causes undesired shifts of part of the tax burden to less mobile tax bases such as labour and property and consumption; and income tax increases administrative costs and compliance burdens on taxpayers and tax authorities". Surprisingly, by applying the same standards used by the OECD, one might come to a conclusion which is not really far from the truth. Accordingly, income taxes are bad and should be abolished.

[407] A. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 462 argues that all tax-preference schemes have those effects and that the trick by which to decide when they inflict harm and when they do not is left explained.

[408] Paragraph 37 of the 1998 Report.

[409] A. Wright, *More on 'Harmful' Tax Competition: A Response to Messrs. Osterweil and Francke*, Tax Notes International, 30 November 1998, 1715. According to the Author, direct taxes are noted for being economically inefficient, as they distort economic decisions and impose what economists call "excess burdens" on total economic output and incomes.

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globally considered nor evaluates it the overall effects. Without being supported by empirical data, it only focuses on the detrimental effects that some measures have on tax systems of some jurisdictions, which are nothing but its member countries.

5.2. Identification of Harmful Tax Regimes

The Report identifies three main broad categories of situations in which the tax levied in one country on income from geographically mobile activities (such as financial and other services activities) is lower than the tax that would be levied on the same income in another country.[410] These are summarised as follows: (i) countries that generally impose no or only nominal tax, which are referred to as "tax havens"; (ii) countries that collect significant revenues from individual and corporate income taxes, but whose tax systems have "preferential features", that allow the relevant income to be subject to low or no taxation, which are referred to as "preferential tax regimes"; and (iii) countries which collect significant revenues from individual and corporate income taxes, but at relatively low effective rates, which are referred to as "normal tax regimes".

The distinction between the definition of "tax havens" and "preferential tax regimes" has been already drawn in Chapter 1 and will not be further object of discussion. Here it is only worth recalling that in the OECD's view tax havens are those jurisdictions with the following characteristics: (i) impose no, or only nominal, tax on the relevant income, and in which one or more of the following factors are present: (ii) lack of effective exchange of information; (iii) lack of transparency; (iv) absence of a requirement that the activity in question be substantial[411]. By contrast, "harmful preferential tax regimes" are identified on the ground of the following factors:[412] (i) a low or zero effective tax rates on the relevant income, and one or more of the following: (ii) "ring fencing" of the regime; (iii) lack of transparency; and (iv) lack of effective exchange of information. "Normal" tax regimes conversely are those which have a relatively low general tax rate and do not provide special concessionary treatment for income from financial and other services. These do not fall within the scope of the Report.[413]

In the light of the criteria mentioned above, the essential difference between a "tax haven" and a "preferential tax regime" is that the former does not tax income, whereas the latter taxes income differentially in some way.[414] Indeed, if any tax regime deviates from a "general standard rule" (assuming that such a rule exists and

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[410] Paragraph 40 of the 1998 Report.

[411] See paragraphs 52-56 of the 1998 Report.

[412] See paragraphs 60-79 of the 1998 Report.

[413] Paragraph 41 of the 1998 Report.

[414] A. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 462.

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establishes a generally accepted level of taxation), then it will be defined as "preferential". So, if this preferential tax regime has some negative effects on other countries' tax system, then any form of tax advantage different from this standard will be assessed to constitute a "harmful tax regime". In this sense, harmful tax regimes would exist anywhere in the world, but in the OECD's view the expression seems to be used more as an attribute of the OECD member countries, as opposed to "tax havens" that refers to entire jurisdictions.[415]

5.3. Counteracting harmful tax competition

Due to the above highlighted harmful effects of tax competition by tax havens and preferential tax regimes, the Report sets forth some recommendations in order to tackle the issue and reduce its potential harm. The OECD stresses that the proposed measures are typically implemented through unilateral or bilateral action by the countries concerned.[416] A critical note on this matter would be that "the countries concerned" would only be high-tax jurisdictions and those feeling harmed by preferential tax regimes, as countries targeted in the Report would have no interest in removing the favourable tax treatments existing in their jurisdictions. However, according to the OECD, there are some limits to such a unilateral or bilateral approach. First, the jurisdictional limit of power of tax authorities does not allow them to take the necessary measures against harmful tax competition. Second, a country wishing to neutralise through a domestic tax measures the tax advantage resulting from harmful tax competition, in some situation, will put its taxpayer in a situation of competitive disadvantage compared to taxpayers of other countries. Finally, any form of monitoring of harmful tax competition and of enacting countermeasures imposes significant administrative costs, while uncoordinated unilateral measures result in compliance costs upon taxpayers.

A coordinated action, which takes into account the measures already into place with a view to reinforcing them and which develops some new ones, should therefore be preferred in order to tackle harmful tax competition.[417] Accordingly, the OECD

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[415] In this sense see also R.T. Kudrle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to American Foreign Policy*, Pittsburgh, 2008, 184-201. It is worth recalling the position of M.J. Langer, *Harmful Tax Competition: Who Are the Real Tax Havens?*, Tax Notes International, 25/2000, 2832, who highlights that the identification of some potentially harmful member countries preferential regimes occurred on the grounds of a self-review process and the results of this self-review are completely lacking of credibility.

[416] Paragraph 87 of the 1998 Report.

[417] See M. Blumberg, *The OECD Report on harmful tax competition: Is 'Harmful Tax Competition' Actually Harmful?* LL.M. Tax Program Paper, Osgoode Hall Law School, 24 January 2001, available at http://www.globalphilanthropy.ca, who underlines that both the unilateral and the multilateral approach involve a "first competitive disadvantage" which no one wants to take. In order to support the implementation of well-balanced system, counteracting the negative effects of the harmful tax competition, it is fundamental to implement a multilateral approach. J.C. Sharman, *Havens in a Storm:*

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recommendations are distinguished into the following three main categories, depending on the increasing complexity in their implementation due to the number of elements and countries which are involved: (i) recommendations concerning domestic legislation and practices, which depart from domestic laws and indicate their effectiveness; (ii) recommendation concerning tax treaties, which deal with ways of ensuring that the benefits of tax treaties do not unintentionally make policies constituting harmful tax competition more attractive or prevent the application of domestic counteracting measures, as well as endure an effective use of exchange of information; (iii) recommendation for intensification of international cooperation, which include the Guidelines and put forward new ways through which countries will be able to act collectively against harmful tax competition.

These recommendations, which will be further examined below, try to assess the issue of harmful tax competition from different perspectives. Some of them aim at dissuading countries from introducing harmful tax rules, while some others are suggested in order to eliminate advantages from existing policies. In other cases, recommendations try to tackle tax evasion and tax avoidance. Moreover, since this issue needs to be constantly monitored and adjusted according to the economic and politic developments, the Report also promotes and supports the creation of a Forum of discussion. This is particularly appropriate, due to the complexity of the matter and the necessity of different approaches depending on the situations. For instance, whereas in the case of tax havens the aim is to create a deterrent for their creation, in that of harmful preferential tax regimes the purpose is the provision of incentives for their modification or elimination.

5.4. The OECD’s recommendations to curb harmful tax competition

The 1998 Report contains a number of recommendations addressed to member States to counteract harmful tax competition. These recommendations are divided into three groups: (i) recommendations regarding domestic legislations and practices; (ii) recommendations regarding the use of tax treaties; and (iii) recommendations to intensify international cooperation in response to harmful tax competition.

In the first group, the first recommendation is the introduction of the Controlled Foreign Companies (CFC) rules, under which certain income (typically base company and passive income) of an entity or of a trust resident in a low-tax jurisdiction is attributed and taxed currently in the hands of its resident shareholders. CFC rules aim at eliminating the benefits originated from the deferral of domestic tax of foreign source income and at dissuading the shifting of income to countries with a low effective tax rate. The recommendation concerns the introduction of the CFC

The Struggle for Global Tax Regulation, New York, 2006, 44, points out that the report emphasised the need for a collective response because of the tendency for individual remedial actions to displace rather than fix the problem, akin to a Prisoner’s Dilemma situation generating a race to the bottom.

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rules for countries that still do not apply them, and the correct evaluation of the appropriate cases for its application for those which have already enacted them.

The second recommendation concerns the introduction and the correct implementation of Foreign Investment Fund (FIF) or equivalent rules. These provisions are aimed at contrasting the deferral of domestic tax through the acquisition of shares in foreign mutual funds, which might escape the CFC rules. FIF rules constitute an effective tool against regimes that offer favourable tax treatment in order to attract foreign passive investment from resident individual, rather than corporate, shareholders.

The third recommendation regards restrictions on participation exemption and other systems of exempting foreign income. Those countries that apply the exemption method to eliminate double taxation of foreign source income should consider adopting rules targeted at ensuring that foreign income benefiting from harmful tax competition does not qualify for the exemption in the residence country. Some possible restrictions should therefore be designed on the basis of the countries from which the foreign income originates, the type of income and the effective rate of tax to which the income has been subjected.

The fourth recommendation attains to the adoption of foreign information reporting rules concerning international transactions and foreign operations of resident taxpayers, as well as exchange of information under the provisions of Article 26 of the OECD Model Tax Convention.

The fifth recommendation regards rulings, i.e. administrative decisions concerning the particular position of a taxpayer that may be obtained in advance of planned transactions. In order to curb distortions and unequal treatment of taxpayers due to the lack of public information on this regime, countries should make public the conditions for granting, denying or revoking such decision, as well as protect taxpayer confidentiality.

The sixth recommendation concerns the measure aimed at restricting the application of transfer pricing rules by domestic tax authorities in a way that would constitute harmful tax competition.

Finally, the seventh recommendation regards the access to banking information for tax purposes. Countries should in fact review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities.

A second group of seven recommendations is devoted to the use of tax treaties to deal with harmful tax practices. The first recommendations here concerns greater and more efficient use of exchange of information. Countries should undertake programs to intensify exchange of information concerning transactions in tax havens and preferential tax regimes, which is essential for the proper functioning of certain domestic counteracting measures. Countries should make information available to

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other countries and indicate the particular measure from which the taxpayer benefited as well as the regime under which the measure was granted.

The second Recommendation attains to the entitlement of treaty benefits. The OECD warns about the risk that a wide tax treaty network might open up the benefits of harmful preferential tax regimes offered by treaty partners. Every single case should therefore be scrutinised and existing provisions should be analysed in order to limit the application of benefits granted by tax treaty rules to entities and income covered by practices constituting harmful tax competition.

The third recommendation concerns the clarification of the status of domestic anti-abuse rules and doctrines in tax treaties. Differently from tax treaties, domestic tax laws generally include various anti-abuse rules and doctrines to counteract harmful tax practices. The OECD therefore suggests that the OECD Model Tax Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention.

The fourth recommendation regards the introduction by the Committee of a list of provisions used by countries to exclude from the benefits of tax conventions certain specific entities or types of income. Such list should be used by member countries as a reference point when negotiating tax conventions and as a basis for discussion in the Forum.

The fifth recommendation concerns tax treaties with tax havens. Countries should terminate their tax conventions with tax havens and not enter into tax treaties with them in the future.

The sixth recommendation regards coordinated enforcement regimes, such as joint audits and coordinated training programmes. Countries should undertake coordinated enforcement programs, such as simultaneous examinations, specific exchange of information projects and so on, in relation to income or taxpayers benefiting from practices constituting harmful tax competition. This recommendation is aimed at a general collaboration among countries and consists in a combination of information and audit powers.

The last recommendation regards assistance in recovery of tax claims. Countries should be encouraged to review the current rules applying to the enforcement of tax claims of other countries and the Committee should pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose.

As above highlighted, tackling harmful tax competition required a coordinated action by countries, as unilateral or defensive measures by individual countries may prove ineffective. The OCED therefore suggested a third group of recommendations for intensifying international cooperation, consisting of : (i) the adoption of a set of Guidelines aimed at ensuring that member countries refrained from adopting preferential tax regimes constituting harmful tax competition and gradually eliminated those harmful preferential tax regimes that currently exist; (ii) the creation of a

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subsidiary body of the Committee, the Forum on Harmful Tax Practices, in charge of monitoring the implementation of the Recommendations; (iii) the preparation of a list of tax haven jurisdictions; and (iv) the development and active promotion of principles of Good Tax Administration relevant to counteracting harmful tax practices.

The Guidelines recommended by the OECD for dealing with harmful preferential tax regimes in member countries and mentioned above are the following:[418] (i) to refrain from adopting new measures, or extending the scope of, or strengthening existing measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices; (ii) to review their existing measures for the purpose of identifying those measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices. These measures will be reported to the Forum on Harmful Tax Practices and will be included in a list within two years from the date of the approval of the Guidelines by the OECD Council; (iii) to remove within a five-year period from the date of the approval of the Guidelines by the OECD Council, the harmful features of their preferential tax regimes; (iv) each member country which believes that an existing measure or a proposed or new measure of itself or of another country constitutes a harmful tax practice may request that the measure be examined by the member countries through the Forum on Harmful Tax Practices, which may issue a non-binding opinion on that question; (v) to coordinate, through the Forum, their national and treaty responses to harmful tax practices adopted by other countries; and (vi) to use the Forum to encourage actively non-member countries to associate themselves with the Guidelines.

The OECD also recommended member countries that had particular political, economic or other links with tax havens to ensure that these links did not contribute to harmful tax competition and, in particular, that countries that had dependencies that were tax havens ensured that the links they had were not used in a way that increased or promoted harmful tax competition. Finally, the OECD recommended to develop and actively promote Principles of Good Tax Administration, which should guide national tax authorities in the enforcement of the Recommendation included in the Report, and that the new Forum engaged in a dialogue with non-member countries in order to promote such Recommendations and Guidelines.

The 1998 Report can be regarded as the first shot in the campaign against tax havens,[419] which was aimed at sending a clear political message that the OECD member States were prepared to intensify their cooperation to counter harmful tax practices. In order to keep maintaining an institutional focus on tax competition as a very important international issue, dialogue with non-member countries and international organisations was required. This would have eased public commitments

[418] See the 1998 Report, Box III, 56.

[419] J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 45.

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by targeted jurisdictions and multilateral sanctions based on international reputation upon non-complying countries.

The OECD concluded the 1998 Report by identifying some topics relating to the harmful tax competition matter which were not analysed in depth in the Report, but which needed to be subject to further examination in the context of the Forum, which played a key role on this project.[420] These topics are the following: (i) rules providing for restriction of deduction for payment to tax haven entities or imposing a reversal of the burden of proof in case of such payments. (ii) rules imposing withholding taxes on certain payments to residents of countries that engaged in harmful tax competition; (iii) domestic and conventional residence rules aimed at counteracting the use of foreign corporation to avoid domestic taxes; (iv) application of transfer pricing rules and guidelines which started from an analysis of the true functions performed by each part of a group of associated enterprises; (v) thin capitalisation rules, aimed at addressing cases of tax base erosion attributable to the thin capitalisation of resident companies by non-residents and at safeguarding against the tax-free repatriation of domestic profits to entities located in tax havens. (vi) new financial instruments, that may have had the potential to be used to assist harmful tax competition; and (vii) non-tax measures, which may also have addressed harmful tax competition.

It is worth highlighting that two member countries, i.e. Luxembourg and Switzerland, dissociated from the recommendations contained in the 1998 Report and declared that they would not be bound by it. Switzerland first considered vetoing the Report, but then decided to abstain in order not to prevent other member countries wishing to do so from adopting it. Although both Luxembourg and Switzerland acknowledged that the potential harmful effects of tax competition needed concerted action, in their view the Report took a “partial and unbalanced approach”.[421] They did not agree with some of its features, such as its scope limited to financial activities, and their impression was that its target was the abolishment of bank secrecy, rather than countering harmful tax competition. Luxembourg also objected to the scope of the

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[420] As it will better emerge in the following Chapter, the Forum on Harmful Tax Practices would have led the entire project on harmful tax competition. The Forum would have been mainly used to review progress made in the removal of provisions that impeded access to banking information in the context of counteracting harmful tax practices. A. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 461, defines the Forum as an “international tax crimes tribunal” that “would not only monitor and expose ‘harmful’ international tax preferences, but would also oversee enforcement steps to bring offending member governments into conformity with the report’s guidelines by the end of the year 2005”. He continues: “The forum would also coordinate OECD efforts to proselytise among the heathen – non member governments, mainly in the “underdeveloped” countries – to forsake bad tax preferences and mend their ways (or else?)”.

[421] See paragraph 2 of the Swiss statement. The Luxembourg statement does not contain numbered paragraphs. Subparagraph B of paragraph 2 of the Swiss statement expressly declares: “The Report presents the fact that tax rates are lower in one country than another as a criterion to identifying harmful preferential tax regimes. This results in unacceptable protection of countries with high levels of taxation, which is, moreover, contrary to the economic philosophy of the OECD”.

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report being extended to the taxation of passive investment income, since that subject was already the focus of another study.[422]

6. The 2000 OECD Report

Following the publication of the 1998 Report and to carry out the work on identifying harmful preferential tax regimes, the Forum requested each member country to perform a self-review process of its preferential regimes in the light of the criteria listed in the 1998 Report. In the meanwhile, cross-country reviews were carried out by study groups with respect to specific types of preferential regimes and a peer review process was then undertaken for each reported regime. Three Working Groups were established within the Forum to review the regimes, meeting and working intensively between November 1999 and May 2000. On 26 June 2000 the OECD Committee on Fiscal Affairs published a new Report[423] (hereinafter referred to as "2000 Progress Report") summarising all progress made on this matter.[424] The following analysis of the 2000 Progress Report will be divided in three parts: (i) member countries' preferential regimes; (ii) tax haven work; and (iii) common approach to adopt defensive measures.

As far as member countries' preferential regimes are concerned, among the preferential regimes reviewed, the Forum identified forty-seven of them as potentially harmful.[425] A preferential tax regime was labelled as "potentially harmful" if it had

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[422] R. Sanders, *The Fight Against Fiscal Colonialism. The OECD and Small Jurisdictions*, The Round Table: The Commonwealth Journal of International affairs, Issue 365, July 2002, 9 reports that in a statement to the OECD Council, Luxembourg declared that it "does not share the Report's implicit belief that bank secrecy is necessarily a source of harmful tax competition". In addition, the Author remarks, Luxembourg's representatives said that Luxembourg "cannot accept that an exchange of information that is circumscribed by the respect of international laws and respective national laws be considered a criterion to identify a harmful preferential tax regime and a tax haven".

[423] OECD, *Towards Global Tax Co-operation. Progress in Identifying and Eliminating Harmful Tax Practices*, Paris, 2000. R.T. Kudrle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to American Foreign Policy*, Pittsburgh, 2008, 197 argues that the original 1998 Report "got the entire project off to a bad start. The title has been acknowledged to be a major gaffe". As too little attention was given to harmful tax competition, the project soon changed its name into "harmful tax practices".

[424] In 2000, the OECD published a second Report, i.e. OECD, *Improving Access to Bank Information for Tax Purposes*, Paris, 2000, focused in particular on how bank secrecy laws in many tax havens impeded their cooperation with international tax information requests. In paragraph 20, the said Report contains the following statement, which might best describe the purpose of the OECD project on harmful tax competition: "(...) all Member countries should permit tax authorities to have access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information".

[425] Paragraph 11 of the 2000 Progress Report contains a list showing each country's preferential tax regime. The list actually contains sixty-one measures of twenty-one of the (then) twenty-nine member countries, as some of them fall within more than one of the nine categories identified, i.e. insurance,

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features suggesting that the regime had the potential to constitute a harmful tax practice, even though it had not been determined whether the regime was actually harmful.[426] The Forum would have developed a set of application notes to serve two main purposes. On the one hand, they would have provided guidance to member countries in making the assessment about the potential harmfulness of their regimes and then in removing their harmful features by April 2003.[427] On the other hand, the application notes would have assisted the Forum in verifying whether member countries and cooperative jurisdictions had met their respective commitments to remove harmful tax practices within established timetables.

As far as tax haven work is concerned, the 2000 Progress Report contains the first black list of tax havens issued by the OECD, which includes those jurisdictions meeting the tax haven criteria established in the 1998 Report and not having made any advance commitment to eliminate their harmful tax practices.[428] Such list was to be amended in the future and to be completed by 31 July 2001, taking into account commitments made by the listed jurisdictions to eliminating harmful tax practices. The commitment at hand consisted in a public political commitment made by a jurisdiction to adopt a schedule of progressive changes to eliminate its harmful tax practices by 31 December 2005. A jurisdiction making this commitment was asked to develop with the Forum an acceptable plan within six months describing how it intended to achieve its commitment, the timetable to do that and milestones to ensure steady progress.

It is worth remarking that the issue of this black list, not endowed with binding effect but aimed at building peer pressure against some countries, unleashed targeted jurisdictions' negative reactions.[429] These latter complained that they were treated as

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financing and leasing, fund managers, banking, headquarters regimes, distribution centres regimes, service centre regimes, shipping, and miscellaneous activities. Although holding company regimes and similar preferential tax regimes (existing in Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Luxembourg, the Netherlands, Portugal, Spain, and Switzerland) might constitute harmful tax competition, these are not included in the list, owing to the complexities raised by them and the difficulties for the Forum to reach conclusions upon their status. Future study of these regimes would have been a high priority in the ongoing work of the Forum. See paragraph 12 of the 2000 Progress Report.

[426] Paragraph 10 of the 2000 Progress Report.

[427] In respect of taxpayers benefiting from such regimes on 31 December 2000, the benefits they derived were to be removed by 31 December 2005. See paragraph 15 of the 2000 Progress Report.

[428] None of the jurisdictions included in the list had made any commitment before the OECD Project. The tax haven list included the following thirty-five jurisdictions, which are all OECD non-member countries: Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, St. Lucia, St. Christopher & Nevis, St. Vincent and the Grenadines, Tonga, Turks & Caicos, US Virgin Islands, Vanuatu.

[429] See R.T. Kudrle, *U.S. Defection from the OECD "Harmful Tax Competition" Project: Rhetoric and Reality*, in D.B. Bobrow (Ed.), *Hegemony Constrained. Evasion, Modification, and Resistance to*

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"career criminals", as opposed to the OECD members, which were the "minor offenders", and all the OECD project was defined as "unbridled display of imperialistic arrogance"[430]. A critical view moved to the whole programme was that the OECD's mission was "to ostracise, penalise and ultimately destroy the world's low-tax nations and territories"[431] and "to criminalise territorial regimes and thwart competitive tax policy".[432]

In order to continue the dialogue and to encourage jurisdictions to make commitments to the tax competition work, it was recommended that the coordination

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American Foreign Policy, Pittsburgh, 2008, 197. The OECD's project was accused to be an instance of "fiscal colonialism" by Ronald Sanders, Antigua and Barbuda's High Commissioner in London. See R. Sanders, *The Fight Against Fiscal Colonialism. The OECD and Small Jurisdictions*, The Round Table: The Commonwealth Journal of International affairs, Issue 365, July 2002, 1-36.

[430] E.W. Hull, *The OECD Imperialists: Implications for the Island of Nevis*, Tax Notes International, 9 October 2000, 1678. Some other authors, sharing the same view, accused the OECD of being "a taxpayer-funded international bureaucracy that receives tax-exempt salaries, jets around the world in business class and maintains a private wine cellar". See D.J. Mitchell, *OECD War on Low-tax Countries*, Washington Times, 20 August 2000, B1. Some other critics come from A. Townsend, *The global schoolyard bully: the Organisation for Economic Cooperation and Development's coercive efforts to control tax competition*, Fordham International Law Journal, 25, 2001, 215, who accused the Organisation of behaving like a "global schoolyard bully", as well as from V.E. James, *Twenty-first century pirates of the Caribbean: how the Organisation for Economic Cooperation and Development robbed fourteen Caricom countries of their tax and economic policy sovereignty*, University of Miami Inter-American Law Review, 34, 2002, 1, who referred to the OECD as the "twenty-first century pirates of the Caribbean".

[431] D.J. Mitchell, *OECD War on Low-tax Countries*, Washington Times, 20 August 2000, B1.

[432] *Centre for Freedom and Prosperity Issues Memo to Low-Tax Countries Regarding the OECD Paris Task Force Meeting*, Tax Notes International, 5 March 2001, 1113. Nobel Prize winner Milton Friedman defined the OECD as "a bunch of Paris-based bureaucrats", a "tax cartel" whose "ill-conceived project" and "unwise proposal" boosts the underground economy by inducing taxpayers to hide, shelter, and underreport income. See M. Friedman, *Economists Urge U.S. President to Reject OECD Initiative*, World Tax Daily, 2001, 107. Similarly, A.W. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 461 argued that the OECD Report proposed a "cartel" to "permit national governments to regain their clout in defining and enforcing tax bases, setting rates, and favouring the deserving". See also A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1054 who summarises the Centre for Freedom and Prosperity Foundation's view (i.e. a non-profit organisation which publishes studies and conducts seminars in favour of market liberalisation), according to which "the OECD aims to restrict tax competition and can thus be likened to a cartel. Tax competition, like other forms of competition, is a good thing, and cartels are a bad thing. Therefore, the OECD initiative is a bad thing". Furthermore, see the position of M.J. Langer, *Harmful Tax Competition: Who Are the Real Tax Havens?*, Tax Notes International, 25/2000, 2831, according to whom "The OECD is essentially a cartel consisting of the world's richest countries, most of which are high-tax jurisdictions" and "The OECD's policies are clearly designed to assist its member countries, rather than the world at large. No one other than its own members has ever given it a mandate to tell other countries how to behave. It functions to help its members even if that means harming other countries whose policies are detrimental to those of OECD members".

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of a common approach to defensive measures should not have been undertaken with respect to jurisdictions that had committed to the tax competition work.

The cooperative approach based on dialogue included: (i) the development of a model tax information exchange agreement or a multilateral agreement; (ii) the creation of a multilateral framework under the Forum for consultation with cooperative jurisdictions, on exchange of information and other relevant issues pertaining to the elimination of harmful tax practices; (iii) an examination of the types of assistance that jurisdictions would have needed in the transition, recognising that an initial reduction in certain financial and other service activities may occur in some jurisdictions as a result of complying with the principles of the Report; (iv) encouraging jurisdictions to initiate cooperative programmes to improve tax administration and enforcement by availing themselves from existing organisations.

It might be argued that the dialogue that the OECD encouraged between OECD member countries and those jurisdictions labelled as tax havens looks like a "stick and carrot" approach. Whereas countermeasures to competition caused by targeted countries were the stick, the OECD was persuaded that a cooperative environment might have better helped fulfil its objectives (the carrot), rather than doing that resisting to each other's reactions. In fact, as above highlighted, paragraphs 26 and 27 of the 2000 Progress Report warn jurisdictions making a scheduled commitment to eliminate harmful practices that "they might suffer an initial reduction in some financial and other service activities". Warning them about this unpleasant effect, the OECD somehow promised to assist cooperative jurisdictions in restructuring their economies and their tax systems, together with other international and national organisations interested in doing that. Member States were called to do the same and they were invited to examine how their bilateral assistance programmes might have been retargeted to take into account the special needs of those jurisdictions.

Finally, as far as the common approach to adopt defensive measures is concerned, the 2000 Progress Report acknowledged that being harmful tax competition a global phenomenon, its solution required global endorsement and participation. Countries outside the OECD had to play a key role in this work, since a number of them were either seriously affected by harmful tax practices or had potentially harmful regimes, causing distortions on the global financial markets.

The work of the Forum aimed at eliminating harmful tax practices had therefore to be dealt with on a global basis. Non-member economies were therefore invited to associate themselves with the 1998 Report and to agree to its principles. A common approach, rather than unilateral actions, was recommended with a view to facilitating the ability of countries to take defensive measures promptly and effectively against jurisdictions persisting in their harmful tax practices.[433] Defensive measures, on the one hand, were to be able to reduce the risk that these jurisdictions gained a

[433] It can be argued that this tactic confirms the "stick and carrot" approach highlighted in the previous paragraph.

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competitive advantage over cooperative countries, and, on the other hand, be proportionate and prioritised according to the degree of harm caused by a particular jurisdiction.

Besides the defensive measures suggested in the 1998 Report, the Committee on Fiscal Affairs declared it would have worked to consider other possible measures, to finalise its recommendations, and to adopt an implementation strategy and timetable. Member countries, and others cooperating with the initiative, would have been then invited to adopt the recommended measures, to the extent possible and appropriate within their national systems, to be applied against uncooperative tax havens.[434]

The defensive measures proposed by the 2000 Progress Report were the following: (i) to disallow deductions, exemptions, credits, or other allowances related to transactions with uncooperative tax havens or to transactions taking advantage of their harmful tax practices; (ii) to require comprehensive information reporting rules for transactions involving uncooperative tax havens or taking advantage of their harmful tax practices, supported by substantial penalties for inaccurate reporting or non-reporting of those transactions; (iii) for countries that did not have CFC or equivalent rules, to consider adopting them, and for countries that had them, to ensure that they applied in a fashion consistent with the desirability of curbing harmful tax practices; (iv) to deny any exceptions that may otherwise have applied to the application of regular penalties in the case of transactions involving entities organised in uncooperative tax havens or taking advantage of their harmful tax practices; (v) to deny the availability of the foreign tax credit or the participation exemption with regard to distributions that were sourced from uncooperative tax havens or to transactions taking advantage of their harmful tax practices; (vi) to impose withholding taxes on some payments to residents of uncooperative tax havens; (vii) to enhance audit and enforcement activities with respect to uncooperative tax havens and transactions taking advantage of their harmful tax practices; (viii) to ensure that any existing and new domestic defensive measures against harmful tax practices were also applicable to transactions with uncooperative tax havens and to transactions taking advantage of their harmful tax practices; (ix) not to enter into any comprehensive income tax conventions with uncooperative tax havens, and to consider terminating any existing conventions unless certain conditions are met; (x) to deny deductions and cost recovery, to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in uncooperative tax havens; and (xi) to impose "transactional" charges or levies on transactions involving tax havens.

[434] Paragraph 34 of the 2000 Report. The final sentence states: "Countries may also take note of the defensive measures for purposes of combating any harmful tax practices that persist after the time by which they are expected to be removed". This statement could also be interpreted in the sense that the same defensive measures might have been applied against other member countries that had failed to eliminate their own harmful tax practices.

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The 2000 Report also reminded of Recommendation 17 of the 1998 Report, in order to urge member States to also consider the possibility of non-restricting defensive measures to tax measures only. They could in fact react by imposing non-tax measures, consisting in non-granting economic assistance to tax havens and in exploiting associated or dependent territories of some member countries to reduce the tax havens' harmful tax competition.[435] Finally, the OECD stressed that the success of the project depended upon OECD member countries being prepared to strengthen the parts of their administration dealing with international issues and to ensure that the organisation has the budget resources necessary to carry out this work.

7. The 2001 Progress Report

Following the 2000 Report, which had promised a new list of uncooperative tax havens, on 14 November 2001,[436] the OECD issued a new Report[437] (hereinafter referred to as "the 2001 Progress Report") describing the significant evolution till that time of the OECD's strategy against harmful tax competition.

Compared to the two previous reports, the one at hand is characterised for a different attitude, which is more inclined to dialogue and cooperation between the listed tax havens and the OECD member countries.[438] Coordinated defensive measures (cooperation), rather than unilateral ones (confrontation), would have therefore put in place with the view of mitigating the impact of erosive effects of the phenomenon on the grounds of dialogue and consensus. It must be pointed out that the United States, supported by New Zealand, changed its attitude towards the OECD's project that was considered "too broad" and this induced the OECD to modify its approach. According to some Authors,[439] the new Republican administration of George W Bush, which came to office in January 2001, caused the OECD to review the entire project, which was till that moment strongly supported by the Democratic government of Bill Clinton and by Lawrence Summers, his Treasury Secretary. Owing to the collaboration with some Caribbean governments, the new US Secretary of the Treasury, Paul H. O'Neil, caused the OECD to amend its initiative. O'Neil in May 2001 announced that due to its discrepancies with the Bush administration's tax and

[435] See paragraphs 36 and 37 of the 2000 Progress Report.

[436] The Report was expected to be issued by 31 July 2001, but while the OECD's Committee was still engaged in negotiations, Spain threatened to veto it because of the manner in which it referred to Gibraltar and its relationship to the United Kingdom. See C. Scott, *Spain Delays OECD Tax Haven Agreement*, Tax Notes International, 1/2001, 143.

[437] OECD, *The OECD Projects on Harmful Tax Practices: the 2001 Progress Report*, Paris, 2001.

[438] For an overview, see J.M. Weiner, *OECD Forum on Harmful Tax Practices Marks Fifth Year*, Tax Notes International, 3/2003, 233-238.

[439] R. Sanders, *The Fight Against Fiscal Colonialism. The OECD and Small Jurisdictions*, The Round Table: The Commonwealth Journal of International affairs, Issue 365, July 2002, 18,

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economic priorities, US could no longer support the Report. As a consequence, the OECD modified its approach in November 2001 focusing on what O'Neil called its "core element", i.e. the need for OECD countries to be able to obtain specific information from other countries upon request in order to prevent non-compliance with their tax law. It can be argued that one of the reasons why the US administration supported a removal of the "substantial activity" criterion in favour of that based on exchange of information resides in the need to protect some well known places for registering companies with no substantial activities and their "ring-fenced" regime, i.e. Delaware and Montana.

The deadline to make a commitment to cooperate was extended to 28 February 2002.[440] The "tax haven" label, which was based till that time on "no substantial activities", started being replaced with that of "uncooperative tax haven", depending on the cooperative or uncooperative attitude of jurisdictions. Coordinated defensive measures, in addition, would not have applied to uncooperative tax havens until they would have applied to similarly situated OECD member countries.[441]

It is worth highlighting that the 2001 Progress Report marks a significant change of the OECD's approach towards tax havens. As just mentioned, the criterion of identification of tax havens based on "substantial activities" in the first Report slowly started evaporating to be finally abandoned in favour of an exclusive focus on tax haven secrecy.[442] As it will be shown in the following paragraphs, the OECD project originally aimed at curbing what it defined "harmful tax competition" would have ended up being a struggle to repeal "tax secrecy" and enforce an effective exchange of information. However, the 2001 Progress Report does not contain any definition of "effective exchange of information" or "transparency", but it only stated that

[440] It was originally established by 31 July 2001, the date on which the Report was expected to be issued, and then by 30 November 2001.

[441] *OECD Announces Memorandum of Understanding on Tax Havens*, Tax Notes International, 25 December 2000, 2893.

[442] R.T. Kudrle, *The OECD's Harmful Tax Competition Initiative and the Tax Havens: From Bombshell to Damp Squib*, Global Economy Journal, 1/2008, Article 1, 7 pointed out that little commentary has focused on the "substantial" activity criterion for the tax havens. In the 1998 Report, this criteria was described as "the absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven" (paragraph 52), while in the 2000 Progress Report it is described as the behaviour of a jurisdiction that "facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy" (paragraph 7). However, the Author highlights that the criterion was already effectively gone before the outcome of the American election of 2000 was known. In addition, if the OECD had attempted to pursue the criterion seriously, a definition of "substantial" would have posed lots of difficulties and many tax havens could have claimed different degrees of non-negligible value-added relative to organisation of comparable activity and similar size in high-tax countries.

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appropriate safeguards would have been implemented to ensure that information was used for the purpose for which it was sought.[443]

The 2001 Progress Report is divided into four parts, which deal respectively with (i) member country work, (ii) non-member country work, (iii) tax haven work, and (iv) framework of coordinated measures, which will be illustrated below.

With regard to the work related to Member countries,[444] the OECD highlighted that this focused on developing application notes, which would have assisted the said Member countries in determining whether preferential regimes were, or could have been applied to be, harmful and in determining how to remove the harmful features of such regimes. Emphasis was then given to the importance of involving the business community in the development of the application notes. As a result, the Committee for Fiscal Affairs started consulting the Business and Industry Advisory Committee (BIAC), which had established a liaison group to work closely with Member countries in taking forward this work.

As far as non-OECD Member countries is concerned, the Global Forum made some progress and started discussions and meetings with countries in Asia, South America and Africa. Ministers and senior officials of 27 member countries and 29 non-Member countries along with the IMF, World Bank, Commonwealth Secretariat and four tax organisations had the chance to discuss the global implications of harmful tax practices and address them in an international symposium held in Paris in June 2000. A subsequent meeting held in September 2001 under the auspices of the Global Forum brought together OECD Members, committed jurisdictions and non-member economies to consider experiences with harmful tax practices, exchange of information and certain draft application notes.

A great part of the 2001 Progress Report is dedicated to tax haven work. Following the bilateral and multilateral dialogue established with the thirty-five jurisdictions listed in the 2000 Progress Report, eleven new formal commitments to eliminate harmful tax practices were made.[445] The discussions greatly improved the

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[443] Paragraph 38 of the 2001 Progress Report. Paul O'Neil, supporting this replacement of criteria, in the Statement before the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, OECD harmful Tax Practice Initiative, 18 July 2001 held that "transparency means two things: (i) the absence of non-public tax practices, such as secret negotiation, or waiver, of public tax laws and tax administration rules; and (ii) the absence of obstacles, such as strict bank secrecy or the use of bearer shares, to obtaining financial or beneficial ownership information within a jurisdiction".

[444] Paragraphs 12 and 13 of the 2001 Progress Report.

[445] The jurisdictions that made commitments were: Aruba, Bahrain, Bermuda, Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, San Marino and the Seychelles. In addition, Tonga had meanwhile made legislative changes and taken administrative actions to address those areas that led to its initial identification as a tax haven, and without making any commitment, it was not considered for inclusion in any list of uncooperative jurisdictions. See paragraph 22 of the 2001 OECD Progress Report and *OECD Takes Tonga Off the Tax Haven List*, Tax Notes International, 3 September 2001, 1156. In this respect, see also J.C. Sharman, *Havens in a Storm:*

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understanding of the jurisdictions regarding the objectives of the harmful tax practices work and almost all the jurisdictions indicated in discussions that they agreed with the broad principles underlying the harmful tax practices project.

However, some jurisdictions interested in making commitments raised concerns about the commitment process, regarding its transparency, the need for greater detail regarding the harmful features to be eliminated, the application of the no substantial activities criterion,[446] the application of a framework of coordinated defensive measures to tax havens as of 31 July 2001 and the timeframe for developing implementation plans.[447]

The OECD responded that the difficulties of determining whether local activities were sufficiently substantial (as it had already highlighted in paragraph 55 of the 1998 Report) imposed to abandon the criterion of the lack of substantial activities to identify a tax haven.[448] Accordingly, commitments would have been only sought with respect to transparency and effective exchange of information, in order to determine which jurisdictions could be considered as “uncooperative tax havens”.[449]

As above anticipated, the deadline to make formal commitments was extended to 28 February 2002 and the period to develop implementation plans of these commitments was prolonged from six months to one year.[450] These statements can be considered as drawing the transition from the original criterion based on the lack of substantial activities to that of transparency and exchange of information, which would have played a substantial key role in the OECD tax havens’ saga.[451]

The Struggle for Global Tax Regulation, New York, 2006, 74, who points out that, like Tonga, also the Maldives and Barbados were struck off the list without making any commitment.

[446] A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1044 points out that despite the compromise reached with the United States, the 2001 Progress Report did not enjoy unanimity within the OECD. Luxembourg and Switzerland, having abstained from the 1998 and 2000 Reports, again withheld their approval. In addition, Belgium and Portugal also abstained. Their objection was that, having committed themselves to the elimination of their own ring-fencing provisions favouring foreign companies, they opposed the removal of the “substantial activities” criterion for other countries.

[447] Paragraph 24 of the 2001 Progress Report.

[448] Paragraph 27 of the 2001 Progress Report.

[449] Consequently, as stated in paragraph 29 of the 2001 Progress Report, those jurisdictions that had already made commitments prior to the issuance of this report would have been informed that they could choose to review their commitments in respect of the no substantial activity criterion.

[450] As clarified in paragraph 35 of the 2001 Progress Report, these modifications do not affect the application of the 1998 Report and 2000 Progress Report to member countries and non-member economies. In addition, the factors in the 1998 Report used to identify tax havens remained unchanged.

[451] The scope of tax transparency and exchange of information will be discussed more in detail in Chapter 5.

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Uncooperative tax havens were, therefore, asked to commit to:[452] (i) establishing a legal mechanism allowing to provide information to tax authorities of another country upon request that may be relevant to a specific tax inquiry; (ii) implementing appropriate safeguards to ensure that the information obtained and provided is used only for the purposes for which it was sought; (iii) providing adequate protection of taxpayers' confidentiality to preserve the integrity and the effectiveness of exchange of information programmes; (iv) providing information requested for the investigation and prosecution of a criminal tax matter, without a requirement that the conduct being investigated would constitute a crime under the laws of the requested jurisdiction if it occurred in that jurisdiction; (v) providing information requested in the context of a civil tax matter, irrespective of whether or not the requested jurisdiction has an interest in obtaining the information for its own domestic tax purpose; (vi) agreeing to have administrative practices in place so that the legal mechanism for exchange of information would function effectively and could be monitored.

In order to pursue its new collaborative programme on effective exchange of information, a working group of OECD member countries held in September 2000 discussed on the opportunity to develop an instrument able to provide a legal framework for effective exchange of information and at the same time to adequately protect the confidentiality of taxpayer information and prevent use of the information for unauthorised purposes. The group, whose work was still in progress, considered the types of information that should be available for exchange and the means by which the information could be obtained.

As above anticipated, since bilateral and multilateral defensive measures to a problem which is global in nature were limited in their effectiveness, the OECD welcomed a more cooperative environment, in which countries with similar concerns could support each other's efforts to counter the effects of harmful tax practices. Coordinated defensive measures were acknowledged to serve to protect the competitive position of those jurisdictions that had eliminated harmful tax practices with respect to jurisdictions that had not committed to do the same.

The following several considerations would have guided the Committee in the design of a framework of defensive measures: defensive measures should have been proportionate and targeted at neutralising the deleterious effects of harmful tax practices; defensive measures could be adopted at the discretion of individual countries; and each country was free to choose to enforce defensive measures in a manner that is proportionate and prioritised according to the degree of harm that a particular practice has the potential to inflict.

[452] See paragraph 38 of the 2001 Progress Report.

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8. The 2004 and 2006 Progress Reports

Further to the 28 February 2002 deadline established in the 2001 Progress Report for tax havens to make a formal commitment to cooperate with respect to transparency and exchange of information, on 18 April 2002 a new black list of uncooperative tax havens was issued. By that date, of the thirty-five jurisdictions still labelled as tax havens, only seven countries remained.[453]

On 4 February 2004, the OECD Committee on Fiscal Affairs issued a new Report (hereinafter referred to as "the 2004 Progress Report") on the progress made till that date in the work on eliminating harmful tax practices.[454]

Subsequent to the more cooperative approach characterising the 2001 Progress Report, the 2004 Progress Report confirmed the OECD strategy to pursue its project against harmful tax practices on the grounds of a "constructive ongoing dialogue"[455] and a fair and equal competitive context between OECD member and non-member countries. Full relevance was given to transparency and exchange of information at the expense of the original criterion based on the lack of substantial activity. This change of criterion of identification was claimed as the OECD's success in linking the tax competition phenomenon with tax evasion, money laundering, and terrorist financing to exert considerable pressure on listed States. States labelled as tax havens were in fact accused of inappropriate conduct by undermining the integrity of other countries' tax system, by tempting capital away and finally by facilitating international criminal activity through their financial secrecy and lax regulation.[456]

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[453] As reported by R. Goulder, *OECD Updates Tax Haven Blacklist, Claims Progress in Curbing Harmful Tax Competition*, Tax Notes International, 4/2002, 375-380, the black list of the uncooperative tax havens was unveiled by Gabriel Makhlouf, Chair of the OECD's Committee on Fiscal Affairs, at a London press conference and included Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru and Vanuatu. Vanuatu on 20 May 2003 and Nauru on 12 December 2003 also agreed to cooperate and they were thus removed from the list. By the time of the 2004 Progress Report, only five jurisdictions still remained. For a historical view about commitments made by the different jurisdictions see C. Scott, *As OECD Tax Haven Deadline Passes, Half Hold Out*, Tax Notes International, 10/2002, 1031-1033. It is worth pointing out that when the black list was issued, the atrocities of 11 September 2001 had occurred. The terrorist attack on the Twin Towers and the Pentagon contributed to the change of approach by the United States and especially its Treasury. As reported by R. Sanders, *The Fight Against Fiscal Colonialism. The OECD and Small Jurisdictions*, The Round Table: The Commonwealth Journal of International affairs, Issue 365, July 2002, 26, on 23 September 2001 President Bush required jurisdictions to establish a new counter-terrorism economic sanction and export control regime under the threat of more economic penalties. The US introduced the Patriot Act imposing a number of measures aiming at offshore financial centres, which were believed to have provided terrorist organisations the necessary funds. The belief that al-Qaeda organisation and Osama Bin Laden had used offshore financial centres to implement his attacks caused the U.S. Treasury to temper its criticism towards the OECD's initiative.

[454] OECD, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*, Paris, 2004.

[455] Paragraph 27 of the 2004 Progress Report.

[456] J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 81.

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Another reason for such a change of perspective might be found in the increasing number of participating jurisdictions to the project[457] and the need to share common views, as well as in the strong political relevance of the matter at discussion. Certain objectives could be in fact reached only through a softer and more cooperative approach, rather than assuming an inflexible and strict position.

Like the previous report, the 2004 Progress Report consisted of several parts, dealing respectively with: (i) progress made in the work as to OECD member countries; (ii) non-member countries committed to transparency and effective exchange of information; (iii) framework of coordinated defensive measures; and (v) future work. These parts will be illustrated as follows.

As far as member country work is concerned, the OECD's results with respect to harmful tax regimes were being achieved. Eighteen of such regimes were abolished or were in the process of being abolished, fourteen were amended so that any potentially harmful features were removed and thirteen were found not to be harmful based on further analysis.[458] The Netherlands' Risk Reserves for International Financing, Portugal's Madeira International Business Centre, Belgium's Co-ordination Centre and Iceland's International Trading Company regimes were treated as abolished on this basis. The Australian Offshore Banking Unit regime and the Canadian International Banking Centre regime caused some concerns under the ring fencing criterion. However, having regard to the limited nature and reduced scope and size of these regimes, they were found not actually harmful because they did not appear to have created actual harmful effects. The relevant countries in addition apply very high standards on transparency and exchange of information for tax purposes. Shipping regimes, which were identified as potentially harmful in 2000, were determined not harmful on the grounds of the guidance developed in the shipping application note and none of them raised any transparency or exchange of information concerns.

Holding companies and similar preferential regimes, which were not identified as potentially harmful in the 2000 Progress Report owing to their complexities, were in the meanwhile acknowledged as serving a legitimate purpose in allowing the repatriation of foreign source income without incurring multiple levels of taxation. Switzerland was ready to agree on effective exchange of information in the context of bilateral tax treaties and holding companies. Luxembourg declared that the 1929 holding company regime would have been amended, following the 2003 EU Code of Conduct. Holding regimes of Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Luxembourg (participation exemption), Netherlands, Portugal and

[457] See paragraph 27 of the 2004 Progress Report.

[458] See paragraph 12 of the 2004 Progress Report, where it is also highlighted that the Committee decided that "where a regime is in the process of being eliminated, it shall be treated as abolished (…) if (1) no new entrants are permitted into the regime, (2) a definite date for complete abolition of the regime has been announced, and (3) the regime is transparent and has effective exchange of information".

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Spain, were found not to be harmful. A number of tonnage tax regimes for shipping activities, which were introduced since 2000 by Belgium, Denmark, Finland, France, Ireland, Spain and the United Kingdom, and the Netherlands Advance Pricing Agreement/Advance Tax Ruling Practice and the Belgium Advance Tax Rulings Practice were also examined and found by the Forum not to constitute harmful tax practices.

With satisfaction, the OECD acknowledged that, since the 2001 Progress Report, the number of OECD non-member countries and jurisdictions that had committed to the principles of effective exchange of information and transparency had increased from eleven to thirty-three.[459] The vast majority had taken action to improve transparency by immobilising or abolishing bearer shares, and many of them have enhanced transparency by regulating trust and company service providers and ensuring that they maintained ownership information on the entities to which they provided services. Only five jurisdictions (i.e. Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco, and the Republic of the Marshall Islands) had not made commitments to the principles of transparency and exchange of information and they were included in a List of Uncooperative Tax Havens issued by the Committee in April 2002, as revised in May 2003 and December 2003.

Progresses were also made with respect to establishing the legal framework that would have permitted exchange of information to take place, and agreements to exchange information were entered into. In fact, in 2002 a Model Agreement on Exchange of Information on Tax Matters was published by the OECD with the view to assisting member countries, cooperative tax havens, and other countries in the negotiations of bilateral or multilateral agreements for effective exchange of information on tax matters.[460] The said Model Agreement was developed by a working group established by the Global Forum among representatives from OECD member countries and delegates from a number of tax haven jurisdictions and represents the standard of effectiveness required to fulfil the commitments entered into by cooperative tax havens.[461] As it will be discussed in detail in Chapter 5, the purpose of the Model Agreement is not that of prescribing a specific format in which the standard of exchange of information should be achieved. Parties are in fact left free to use other instruments, such as double tax treaties, to effectively exchange information and thus fulfil their commitment.

The 2004 Progress Report emphasised that the effectiveness of exchange of information for tax purposes strictly depends on the availability of reliable information,

[459] Paragraph 19 of the 2004 Progress Report.

[460] OECD, *Agreement on Exchange of Information on Tax Matters*, Paris 2002. The text of the Model Agreement can be found at http://www.oecd.org/ as well as *OECD Releases Model Tax Information Exchange Agreements*, Tax Notes International, 29 April 2002, 420. See also OECD, *OECD Releases Model Agreement on Exchange of Information in Tax Matters*, Paris, 18 April 2002.

[461] See paragraph 3 of the Model Tax Information Exchange Agreement.

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foreseeably relevant to the tax requirements of a requesting jurisdiction, and on the existence of legal mechanisms that enable the information to be obtained and exchanged. This requires standards for the maintenance of accounting records and access to such records. In order to develop standards relating to transparency, the OECD, under the auspices of the Forum, supported the creation of the Joint Ad Hoc Group on Accounts (JAHGA), called at developing common standards for transparency to facilitate effective exchange of information for tax purposes both within and outside the OECD. The JAHGA worked to make sure there was a proper balance between the requirement to ensure access to reliable financial information and the need to avoid placing unnecessary compliance burdens on taxpayers and administrations.

It discussed existing practices regarding the maintenance and access to accounting records, the circumstances under which a country or a jurisdiction should have the responsibility for ensuring reliable accounting records, the nature of the accounting records that generally should be kept, how the reliability of such accounts can be ensured, and how long such records should be retained.

The OECD expressed its view that possible defensive measures had to remain flexible and therefore an exhaustive list of measures to be used could not be produced. However, the following measures currently used by OECD member and non-member countries to neutralise the deleterious effects of harmful tax practices were identified: (i) provisions aimed at disallowing any deduction, exemption, credit or other allowance in relation to all substantial payments made to persons located in countries or jurisdictions engaged in harmful tax practices; (ii) thin capitalisation provisions restricting the deduction of interest payments to persons located in jurisdictions engaged in harmful tax practices; (iii) legislative or administrative provisions having the effect of requiring any resident making a substantial payment to, or entering into a transaction with, or owning any interest in, a person located in a country or jurisdiction engaged in a harmful tax practice, to report that payment, transaction or ownership to the tax authorities; (iv) legislative provisions allowing the taxation of residents on amounts corresponding to income that benefits from harmful tax practices that is earned by entities established abroad in which these residents have an interest and that would otherwise be subject to substantially lower or deferred taxes; (v) denying the exemption method or modification of the credit method where the foreign country engaged in harmful tax practices levied no or nominal tax on most of the income arising therein; (vi) legislative provisions ensuring that withholding taxes at a minimum rate applied to all payments of dividends, interest and royalties made to beneficial owners benefiting from harmful tax practices; (vii) special audit and enforcement programs to coordinate enforcement activities involving entities and transactions related to countries and jurisdictions engaged in harmful tax practices; (viii) terminating, limiting and not entering into tax treaties with countries and jurisdictions involved in harmful tax practices.

Work was subsequently continued to focus on the development and the implementation of the transparency and exchange of information standards and the

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establishment of a level playing field. The OECD members intensified their dialogue with other non-OECD economies through bilateral contacts and through Global Forum events, while the Committee pursued its work aimed at improving exchange of information such as the revision of Article 26 and taking forward the principles agreed in the 2000 report on Improving Access to Bank Information for Tax Purposes.[462]

Subsequent to the 2004 Progress Report, in 2006 the OECD issued a new Progress Report[463] that only focused on the progress made in connection with the work on potentially harmful preferential tax regimes of OECD member countries. In the light of the progress made till 2004, there were only three regimes on which the Committee did not reach a conclusion at the time of the 2004 Progress Report, i.e. the proposed Belgian co-ordination centre regime, the Swiss "50/50 practice," and the Luxembourg 1929 holding company regime. In June 2005 Belgium informed the Committee that the proposed coordination centre regime would no longer be put into effect, so that it could be considered as abolished, whereas Switzerland withdrawn the Circular that authorised the 50/50 practice and ensured that the regime at hand would have been gradually phased out. With regard to the Luxembourg 1929 holding company regime, the Committee acknowledged the amendments to the regime approved in 2005, but concluded that the harmful feature of lack of effective exchange of information made the regime in its then current form still harmful.

Given that all the 47 regimes (with the said exception of Luxembourg) identified as harmful in the 1998 Report were abolished or amended as to be not harmful, the Committee considered that this part of the project had fully achieved its initial aims. Subsequent work in this area would have thus focused on monitoring any continuing and newly introduced preferential tax regimes identified by member countries.

While it was developing the lists of offshore jurisdictions and uncooperative tax havens, the OECD took a number of steps to advance global tax information exchange. In 2001, it established the Global Forum on Taxation, with participants drawn from OECD member countries and non-member offshore jurisdictions, to discuss transparency and tax information exchange issues.[464]

As previously mentioned, in 2002 the OECD issued a model Agreement on Exchange of Information on Tax Matters that States could sign on a bilateral or multilateral basis to meet their commitments to tax information exchange. In 2004, to further promote the OECD's work, the G20 Finance Ministers issued a communiqué supporting the OECD's tax information exchange initiative and model agreement.[465]

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[462] For a description of developments in this area, see OECD, *Improving Access to Bank Information for Tax Purposes: The 2003 Progress Report*, Paris, 2003.

[463] OECD, *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries*, Paris, 2006.

[464] See OECD, *OECD Pursues a Global Dialogue on International Taxation*, Paris, 1 October 2001.

[465] G-20, Meeting of Finance Ministers and Central Bank Governors: Communiqué at 9 (21 November 2004), which reads as follows: "The G-20 therefore strongly supports the efforts of the OECD Global

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9. The implementation of black lists as measures against tax havens' reputation

As mentioned in Chapter 1, the OECD black lists are the most influential in the project against tax havens.[466] In fact, in the OECD's attempt to regulate tax competition, the organisation gained a great deal of its political power in the international community of States from its ability to label and categorise. By relying on its authority and pre-eminence among economically-oriented international organisations, the OECD's use of the expression "tax havens" started being regarded as endowed with a pejorative meaning.[467]

The 1998 OECD Report indeed first introduced a sort of "reputation test" to define the boundaries of the concept of "tax havens". [468] The OECD itself acknowledged that the term "tax haven" was potentially applicable to many and perhaps all countries because of its intrinsic vagueness. Tax havens were thus defined by the OECD as those countries, which have no or nominal taxation combined with the fact that they "offer themselves as" places, or "are perceived to be" places, to be used by non-residents to escape taxes in their home State.[469] Therefore, the reputation test is based on how third parties perceive a particular jurisdiction. If the term "tax haven" had been used only to label any country having a low or zero rate of tax on all or certain categories of income, or offering a certain level of secret and confidentiality, this definition, applied literally, would have included many industrialised countries.[470]

Forum on Taxation to promote high standards of transparency and exchange of information for tax purposes and to provide a cooperative forum in which all countries can work towards the establishment of a level playing field on these standards".

[466] According to J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 104, the use of the expression "tax havens" is a means to exert political pressure on non-compliant jurisdictions by threatening their reputation.

[467] As highlighted in Chapter 1, lacking a unanimously-accepted definition of tax havens, there is so little agreement as to objective features that distinguish between tax haven and non-tax haven jurisdictions. However, the term "tax haven" is an unfavourable judgment on a jurisdiction's stability, probity and standing in the international community. As J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 104 points out, the OECD has in a sense created tax havens, by particular way it has chosen to label. All the existing definitions of tax havens, in fact, seem to depart from the OECD's definition.

[468] On the concept of reputation, see J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 109-112.

[469] For a deeper analysis of the definition of the term, see Chapter 1.

[470] On this topic see the analysis developed in Chapter 6, paragraph 1.

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This is the explanation of the reputation test: a country is a tax haven if it looks like one and if it is considered so by other countries.[471]

Thus, due to the extreme flexibility of the term and the difficulty of compiling an objective list of tax havens, the OECD, aided by the FSF and FATF initiatives, decided to issue the so called "black list". The aim of a black list is nothing but threatening the reputation and thus the viability of small Sates' financial sectors. The word "tax haven" evokes the notion of tax evasion, money laundering and illegal drug profits, none of which a respectable country wants to be associated with. The success of a tax haven depends, in fact, on reputation more than any other factor. As tax havens offer perfectly substitutable services (although some of them have some level of specialisation in order to create or enter niche markets), reputation is the main point of differentiation among them.

In order to attract greater volumes of investment and more lucrative business, tax havens must have well-established financial systems and cultivate their image as secure and stable.[472] Successful tax havens are particularly dependent on a kind of reputation that is closely bound to "trust", as those investing in the tax havens are typically making a very large bet that they will get their money back. There is indeed a reverse relationship between information and reputation: from the rationalist point of view, the more information is available, the more important reputation becomes. From a more sociological perspective, the less information available, the more actors are likely to be influenced by reputation. Thus reputation can be considered as the main asset of a tax haven, but at the same time its vulnerability. A loss of reputation of a tax haven means a loss of foreign investment.

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[471] See R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981 26. See also R. Palan, *Tax Havens and the Commercialization of State Sovereignty*, International Organization, 1/2002, 151-176, and R. Palan, J.P. Abbott, *State Strategies in the Global Political Economy*, London, 1996, 168 who pointed out that the "complexity of modern national taxation systems, combined with greater capital mobility, has rendered practically every country in the world a potential tax haven from some type of taxation and regulation for residents of other countries".

[472] G.P. Gilligan, *Overview: Markets, Offshore Sovereignty and Onshore Legitimacy*, in D. Masciandaro (Ed.), *Global Financial Crime: Terrorism, Money Laundering, and Offshore Centres*, Aldershot, 2004, 44 points out that some investors may prefer more costly financial centres precisely because some may have a better reputation for stability, investor protection and transparent regulatory standards. After being associated with drug trafficking in the 1970s and 1980s, the Cayman Islands marketed itself under the motto "Reputation is our most important asset". See A.C. Hudson, *Placing Trust, Trusting Place: On the Social Construction of Offshore Financial Centres*, Political Geography, 17/1998, 928 and A.C. Hudson, *Off-shores On-shore: New Regulatory Spaces and Real Historical Spaces in the Landscape of Global Money*, in R. Martin (Ed.), *Money and the Space Economy*, Chichester, 1999, 139-154. The IMF Report, *Caribbean Offshore Financial Centers: Past, Present, and Possibilities for the Future*, Working Paper no. 88, Washington, 2002, 18 also supports this findings and states that "it is most likely that the major competitive factor in the current international environment is a country's established reputation".

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In this respect, blacklisting can be viewed in a wide sense as a political sanction. The so called “name and shame” strategy can be perceived as the means chosen by international organisations to exert pressure on obstinate small States via threatening their reputation in the eyes of international investors. In fact, as expected by the OECD, countries appeared on the OECD 2000 list immediately reacted denying they were tax havens.[473] This approach is understandably highly criticised by the targeted countries.

The “tax havens” 2000 OECD list and the “uncooperative tax havens” 2002 OECD list did not create a normative obligation under international law, as it will be further discussed in Chapter 6. However, the blacklists were rapidly adopted and broadly reproduced among member and non-member States. Due to the difficulties of providing for an unambiguous definition of tax havens under domestic law (which somehow would impose to explore domestic legislation of all countries of the world), there is a tendency to rely on pre-existing lists, especially and more reliably those provided by well-reputed international organisations, such as the OECD.[474]

Normally, unilateral measures against tax havens are based on these lists and may specify a number of countermeasures aimed at the countries included in these lists. These black lists are thus used to identify countries in respect to which some unfavourable treatment, but do not include a procedure for determining which jurisdictions qualify. They can establish a duty to report all transactions with listed jurisdictions, or punitive withholding taxes applied to such transactions. They may disallow deductions when transactions involve listed jurisdictions. Citizens residing in tax haven may be liable for personal income tax even after they have cut all other ties with their home country. CFC rules and specific transfer pricing regulations might be also applicable on the grounds of black lists.

The main outcomes of appearing in a black list widely diffuse and reverberate down and across three levels: States, financial intermediaries, and individual investors. Appearing in a black list lowers investors’ confidence in their ability to use the tax haven for any purpose. This results in a reduction or withdrawal from blacklisted jurisdictions both of investors and of accountancy, insurance, banking and legal services providers. Individual investors, after having heard directly or indirectly of

[473] According to Special Report – The Bahamas, Lloyd’s List, 10 March 2000 Bahamas told the OECD that the term was “deeply offensive”. J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 107 tells that Pricewaterhouse Coopers in Aruba explained a new package of laws operative from 2003 as necessary “to dispel the image of Aruba as a tax haven”. Similarly, as reported by Taxnews.com, 6 August 2003, the Chief Executive of the Guernsey Promotional Agency stated: “The biggest challenge is to remove the description of the island as an offshore tax haven and replace it with offshore financial centre”.

[474] The report issued by the Pacific Islands Forum Secretariat, *International Tax and Banking Issues*, Economic Ministers’ Meeting, Majuro, Marshall Islands, June 2003 claims that the OECD 2000 list of tax havens was incorporated in national blacklists in countries including Argentina, Brazil, France, Italy, Peru, Mexico, Spain and Venezuela, which have often neglected or refused to remove jurisdictions even after they had made commitments to the OECD in 2002.

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international organisations black lists and of the enforcement of anti-tax havens domestic legislation, are likely to steed clear from blacklisted countries.[475]

As a result of blacklisting, multinational financial services providers withdrew from particular blacklisted jurisdictions. Others applied special restrictions to transactions from blacklisted jurisdictions or imposed extra fees to cover the cost of increased scrutiny, even when these measures are not required or recommended by their respective national governments. In addition, blacklisting produces pressure at the State level, as it can be interpreted as a threat for future economic damages or a decline of business if no commitment is made.

Paradoxically, if the purpose the investor is served by continued laxity or recalcitrance in the face of successful external pressure for reform in competitive jurisdictions, then the volume of investment placed in the haven might be expected to increase.[476]

10. The actual impact of blacklisting

The blacklisting instrument clearly represents the cornerstone of the international effort to fight tax havens. The fact that most jurisdictions placed on the first black lists were removed from the subsequent releases should lead to the conclusion that de-listed tax havens enacted regulatory measures in compliance with the “international standards” (i.e. the consent in a given time of those third parties which perceived a given jurisdiction as a “tax haven”). At first glance, the overall result of the blacklisting mechanism should be judged positive. If blacklisting a jurisdiction hurts its reputation, then matters of honour should lower money launderers, tax evaders, and obscure investors.

The academic literature put under observation different data in order to measure how and to what extent tax haven countries responded to blacklisting. Masciandaro[477] observed that, notwithstanding the black list threat, some jurisdictions delayed or

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[475] According to J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 120, the new more confrontational strategy on the part of the OECD from 1998 was very much designed to generate publicity and media attention and in deed the lists achieved just this, not only in the specialist financial journals but also the general press.

[476] D. Masciandaro, *False and Reluctant Friends? National Money Laundering Regulation, International Compliance and Non-Cooperative Countries*, European Journal of Law and Economics, 20/2005, 26 argues: “The main difficulty for a lax financial regulation (LFR) country is credibly solving the commitment problem. Then, what is a better choice for an LFR country than having the international community – not exactly its closest friends – certifying a non-cooperative attitude”.

[477] D. Masciandaro, *False and Reluctant Friends? National Money Laundering Regulation, International Compliance and Non-Cooperative Countries*, European Journal of Law and Economics, 20/2005, 18. The Author calls this phenomenon “reluctant friend effect”, in contrast with the so called “false friend effect” which refers to those jurisdictions enacting insufficient regulatory reforms to prove to have changed their non-cooperative attitude.

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failed to change their rules, thus confirming their non-cooperative attitude. Analysing this phenomenon, he argued that tax haven countries offer financial services to terrorism and organised crime by adopting lax financial regulations and that lax financial regulation is treated as an independent variable. Although any regulatory reform consistent with the international standards is sufficient to prove that the country is attempting to become a cooperative jurisdiction, he developed the assumption that lax financial regulation may be a strategic dependent variable for national policymakers seeking to maximise the net benefits produced by any public policy choice. As a result, given the structural features and endowments of their own countries, policymakers may find profitable to adopt financial regulations that attract capital of illicit origin (money laundering services) or destination (terrorism finance services), therefore choosing to be a non-cooperative jurisdiction.

Listing is defined by Masciandaro as “a sort of third party bonding”, which produces two effects. First, it cements the commitment of the country. Second, it increases the transaction-specific nature of investments in reputation. In this view, then, the actual effect of blacklisting is to increase the expected national benefits rather than improve international political enforcement: a country engaged in money laundering that finds itself blacklisted probably will not exit the market, but rather reinforce its position. The overall result of Masciandaro’s analysis is that blacklisting *per se* does not produce the expected effects, as blacklisting should in fact be also closely related to other appropriate initiatives and countermeasures by the international community, which are to be evaluated in medium-to-long term.

Kudrle[478] employs the autoregressive, integrated, moving average (ARIMA) analysis developed by Box and Jenkins[479] to search for the impact of blacklisting[480] and

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[478] R.T. Kudrle, *Did blacklisting hurt the tax havens?*, Journal of Money Laundering Control, 1/2009, 33-49.

[479] G.E.P. Box, G.M. Jenkins, *Time-Series Analysis: Forecasting and Control*, San Francisco, 1970.

[480] Rather than making the value of a dependent variable a function of the values of a series of independent variables in a single or multiple equation system, the dependent variable is related only to its own past values and stochastic error terms. A dummy variable captures the date of the appearance on a black list. In order to remove common trends affecting all of the havens, the dependent variable is the share of the jurisdiction in the total value of the corresponding category of the Bank for International Settlements for “Offshore centres”. ARIMA results are reported for each jurisdiction on the OECD list, the FATF list or both. The “begin” entry records the dummy result for the appearance of that jurisdiction on that black list and the “end” entry records its departure. The “begin” intervention is also tested for one quarter earlier and one quarter later, and the most significant of the three coefficients is shown. Many of the jurisdictions that appear on both lists were tagged by the FATF in its first round, and, for those, only one dummy captures “begin”. The corresponding coefficient and its standard error are presented in the OECD cell. Various can be the responses to the results. They certainly confirm that appearing on one of the black lists reduces the level of activity, as there is less evidence of increased activity.[480] As a result, the most common assumption would be that appearing on a black list would have a stronger and more immediate effect than being removed from it. Hence, more attention is warranted to the coefficients marked “begin”. Of the thirty-eight jurisdictions for which there were sufficient data for the analysis, only eight jurisdictions had no significant “begin”

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reveals ten jurisdictions with significant inconsistencies: three showed one kind of impact from the OECD black list and another from the FATF black list; six showed an inconsistent result across the various investment measures for the same blacklisting (of either kind) and one showed both inconsistencies. Of the twenty-three jurisdictions that had any consistent significant results, there were eight that had one significant coefficient (either “begin” or “end”), six that had two (of either kind), and nine that had three or more. Of the jurisdictions with any consistent significant results, eighteen were “expected”, i.e. investment was depressed by blacklisting or revived by its removal, while five were “perverse”, consistently with Masciandaro’s suggestion that some jurisdictions may actually embrace blacklisting, as pointed out above.

Kudrle does not interpret all his analysis by concluding that blacklisting made an important systematic difference in the volume of banking system-related tax haven fortunes. He argues the possibility that investors based their behaviour largely on factors other than whether or not a jurisdiction had been officially castigated abroad. According to Kudrle, these results must raise doubts about the direct importance of “speech acts” on the ability of tax havens to attract and hold foreign financial investment when such acts are not directly linked with something more tangible, either real developments in the havens or policy action beyond rhetoric from abroad. The havens remain highly vulnerable to the sticks and stones that foreigners might ultimately deploy, but both participants and academic commentators may have overstated the power of words alone to inflict harm.

In the light of the above results, it seems that blacklisting mechanism is not broadly considered as a successful instrument, although black lists so far issued are not entirely without effect. It cannot be denied that de-listed tax jurisdictions started complying with international regulatory initiatives. However, blacklisting does not seem to be a suitable measure to promote cooperation by the targeted States. Black lists are in fact quite often very arbitrary and incomplete, due to their strong political nature.[481] In conclusion, research shows that blacklisting can be reputed neither as an effective instrument to reduce money laundering and tax abuses nor as an appropriate strategy for building new regulations in the area of international taxation.[482]

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coefficients, and of this group three had significant “end” coefficients, so only five jurisdictions showed no signs of response at all by this very loose standard.

[481] G. Rawlings, J.C. Sharman, *National Tax Blacklists: A Comparative Analysis*, Journal of International Taxation, 9/2006, 64 argue that a problem with the current blacklists is that such lists tend to be out of date, inaccurate, and arbitrary and that multilateral listings like that of the OECD have been converted into outright blacklists by national governments in a punitive and discriminatory way.

[482] J.C. Sharman, *International Organisations, Blacklisting and Tax Haven Regulation*, presented at the European Consortium on Political Research Joint Sessions, Uppsala, Sweden, 13-18 April 2004 provides evidence to support his argument that blacklisting has been indeed effective in causing material damage to tax havens considered to be non-compliant with various multilateral regulatory initiatives.

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11. The standard domestic countermeasures to protect tax bases

Countries have reacted to the massive growth of tax haven sectors by enacting specific legislation and administrative rules aiming at curbing transfers to tax havens, and judicially attacked tax haven transactions as shams. The main purpose of these measures was to prevent local taxpayers from sheltering income in tax havens through the use of formal structures lacking economic substance.

In order not to unduly restrict legitimate international trade and cross-border investment activities, domestic anti-tax haven regulations generally draw a line between tax haven operations and legitimate international business activities, and apply only with reference to the former. What is interesting to note is that unilateral anti-tax haven responses by high-tax countries evidence a collective reaction to the phenomenon. In spite of the obvious different technicalities of the regulations enacted, which take into account the different legal traditions of these countries, most anti-tax haven domestic measures are based on a common model, and the OECD played a key role promoting the circulation of that model, aimed at neutralising the advantages or the more favourable tax treatment provided in the targeted host jurisdiction.[483]

The most common unilateral measures enacted by most States are: (i) controlled foreign companies legislation (CFC legislation or CFC rules), (ii) transfer pricing, (iii) re-characterisation of income, (iv) disallowance or limitation of expenses deduction, (v) rules on tax residence, (vi) thin capitalisation rules, and (vii) check-the-box regulation. A concise summary of those domestic measures will be provided here. An in depth analysis of such measures is indeed out of the scope of the present work. The reason of providing a review of them is that their basically common feature is that they are addressed to blacklisted countries.

CFC rules are a set of domestic provisions that has enormously spread during the last decades.[484] Following the 1998 Report, when the OECD suggested its members

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[483] Typically, these unilateral domestic countermeasures are enacted with respect to jurisdictions labelled as tax havens. However, recent trends demonstrate that the scope of the anti-tax haven legislations has been slowly broadened so that to apply with respect to forms of investment in those jurisdictions where the level of taxation is sensibly lower than that existing in the State of residence of the investor.

[484] See more broadly on this subject: B.J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78, Canadian Tax Foundation, Toronto, 1986, P. Eckl, *The Tax Regime for Controlled Foreign Corporations,* European Taxation, 1/2003, 2-7; F. Stockmann, *Controlled Foreign Corporations,* Darmstadt, 2001; B.J. Arnold, *Controlled foreign corporation rules, harmful tax competition, and international taxation, Report of proceedings of the first world tax conference: taxes without borders*, Toronto, 2000; 17:1-17:26; A.M.C. Smith, *Controlled foreign corporation regime: partial exemption for non-resident investors,* Asia-Pacific tax bulletin, 3/1999, 87-93; L. Burns, *Controlled foreign companies. Taxation of foreign source income*, Melbourne,

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to apply their CFC rules strictly or even to introduce them where they did not exist,[485] a great number of high-tax jurisdictions apply CFC rules not only in respect to tax havens, but also to companies based in other countries, which nevertheless benefit from a reduced taxation. In spite of the differences in scope and application under each domestic tax laws, most CFC rules share common features. As income produced abroad through foreign companies or other similar entities is usually taxed after it is received in the home State of their recipient, CFC rules aim at curbing the phenomenon of deferring income tax at home until such foreign income is repatriated. The main outcome of CFC rules is the attribution of foreign income to its resident shareholders, irrespective of any distribution. Some CFC legislations are based on the so-called "piercing the veil approach", according to which the foreign entity is considered as fiscally transparent (or "look-through approach"). Some others adhere to the so called "deemed distribution of dividends approach", under which income produced upon the foreign entity is taxed in the hands of the resident shareholders, like if a distribution of dividend occurred.

As far as the items of income which is subject to attribution, existing models can be based either on the so called "jurisdictional approach" or on the so called "transactional approach". The former consists of attributing all income produced by the foreign entity, irrespective of its source. The latter, by contrast, the shareholder's home State only subjects to tax passive income, which is typically more mobile, i.e. dividends, interest and royalties.

It is also worth highlighting that the foreign jurisdiction, whose entity is subject to the CFC rules, can be identified by some countries through black lists or through some methods of comparison which consider domestic and foreign tax. More particular, these latter can consist of a comparison of either (*i*) nominal tax rates (the rates of tax specified in tax statutes), or (*ii*) effective tax rates (taxes actually paid as a percentage of "real" income and not of taxable income), or (*iii*) actual taxes paid (to what would have been paid in the country of residence of the CFC's shareholders).

1992; M. Lang, *European Union – CFC Legislation and Community Law*, European Taxation, 9/2002, 374-379; M. Lang, *CFC legislation: Domestic Provisions, Tax Treaties and EC Law*, Vienna, 2004. M. Lang, *CFC regulations and double taxation treaties*, Bulletin for international fiscal documentation, 2/2003, 51-58; M.N. Mbwa-Mboma, *Treaty trumps domestic CFC rules*, International tax review, 9/2002, 18-20; C. Sacchetto, *Compatibilità della legislazione CFC Italiana con le norme convenzionali e con l'ordinamento comunitario*, Diritto e pratica tributaria internazionale, 1/2002, II, 13-38; D. Sandler, *Tax treaties and controlled foreign company legislation: pushing the* boundaries, The Hague, 1998; D. Sandler, J. Li, *The relationship between domestic anti-avoidance legislation and tax treaties*, Canadian tax journal, 5/1997, 891-958; G. Turner, *The legitimacy of CFC legislation within the Community*, The EC Tax Journal, 1/2007, 23-47; S. Whitehead, *CFC legislation and abuse of law in the community*, in *The influence of European law on direct taxation: recent and future developments*, Alphen aan den Rijn, 2007, 1-16; J.D.B. Oliver, *The OECD Model and Controlled Foreign Company Regimes*, Intertax, 11/1995, 556-557.

[485] OECD, *Harmful Tax Competition: An Emerging Global Issue*, Paris, 1998, paragraphs 40-42. In 1996 the OECD also released a specific study on this matter. See OECD, *Controlled Foreign Company Legislation*, Paris, 1996.

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Normally, domestic legislations provide for different requirements under which the CFC rules apply, in respect of the minimum shareholding capital in the foreign entity, the type of foreign entities falling within these provisions, and qualifying as a controlled foreign company, the residence of the foreign entity, the modality of attribution of foreign income, and foreign tax credit. Quite often, indeed, CFC rules can be avoided under certain circumstances, which may attain to the substantial economic activity carried out by the foreign entity, to certain levels of income or to lack of an effective tax advantage in practice. Normally, the resident shareholder is in charge of providing evidence of their existence.

The expression "transfer pricing" refers to the valuation process for transactions between related parties. For tax purposes, it describes the practice typically enacted within a multinational group to establish prices of intra-firms transactions in order to shift profits between different countries (not necessarily tax havens).[486] Artificial prices would result in a reduction of taxable profits in high-tax jurisdiction and in an increase of taxable profits in low-tax jurisdiction. Transfer pricing issues arise in a wide range of cross-border transactions, such as transfers of tangible property, transfers of intangible property rights through outright sale or gift and royalties, provision of services (including financial ones), rental of property and leasing agreement, and cost-sharing agreement.

Transfer pricing legislation commonly allows tax administration to re-determine the price of the transaction at issue according to the arm's length principle, i.e. the price that would have been paid between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market. Over the past decades, transfer pricing has drawn the attention of the OECD, which studied its implications and provided for a common framework within which the transfer price of transactions can be determined by the tax authorities of the countries involved and

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[486] There is conspicuous literature on this matter. See more broadly J.C. Pagan, J.S. Wilkie, *Transfer Pricing Strategy in a Global Economy*, Amsterdam, 1993; G. Maisto, *Transfer Pricing in the Absence of Comparable Market Price*, IFA Cahiers Vol. 77A, General Report, 1992; C. Adams, R. Coombes, *Global transfer pricing: principles and practice*, London, 2003; S.R.F. Plasschaert, *International transfer pricing*, Deventer, 1988; R. Turner, Study on transfer pricing, Ottawa, 1996; A.W. Stroud, C.D. Masters, *Transfer pricing*, London, 1991; C.R. Emmanuel, M. Mehafdi, *Transfer pricing*, London, 1994; T. Miyatake, *Transfer pricing and intangibles*, Amersfoort, 2007; S.R.F. Plasschaert, *Transfer pricing and multinational corporations: an overview of concepts, mechanisms and regulations*, Hants, 1979; J.F. Spierdijk, *Transfer pricing and multinational enterprises*, Deventer, 1981; B. Gouthière, S. Edge, *Transfer pricing: European rules and practice*, Washington, 1995; N. Boidman, *Transfer pricing: foreign rules and practice outside of Europe*, Washington, 1995; S.R.F. Plasschaert, *Transfer pricing in multinational enterprises: a clarification of concepts and issues*, Antwerp, 1979; G. Maisto, *Transfer pricing in the absence of comparable market prices*, Deventer, 1992; J.P. Warner, *Transfer pricing: introductory materials*, Washington, 1995; D.I. Meyer, A.D. Webber, *Transfer pricing: judicial strategy and outcomes*, Washington, 1995; M. Markham, *The transfer pricing of intangibles*, London, 2005; G. Maisto, *The transfer pricing penalties report*, Brussels (European Commission), 2005; S.G. Sherwood, S.P. Hannes, J.P. Goeke, *Transfer pricing: records and information,* Washington, 1995; J.C. Pagan, J.S. Wilkie, *Transfer pricing strategy in a global economy*, Amsterdam, 1993; J.P. Warner, H.B. McCawley, *Transfer pricing: the Code and the Regulations*, Washington, 1995.

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taxpayers. In addition, the OECD proposed a number of methods of computation of prices, based on comparable prices, margin, profits, similar transactions or functions. Transfer pricing quite often raises double taxation issues, as arm's length price re-determined by tax authority of one of the State involved might be not accepted by the tax authority of the other jurisdiction.

Some countries can face tax base erosion enacted through the use of low-tax jurisdictions by re-characterising certain categories of income, which are subject to different tax treatment. For instance, when capital gain is taxed more heavily than a dividend, re-characterisation rules operate to convert dividends into capital gains if the dividend is paid to avoid capital gains tax. The same rule can apply whether capital gains are taxed more favourably than dividends. Similarly, thin capitalisation rules re-characterise disallowed interest into dividend, usually for withholding tax purposes.

Another domestic anti-avoidance rule consists of limiting or denying deduction of expenses paid to entities or persons resident in zero or low-tax jurisdictions. This provision aims at preventing taxpayers from diverting tax bases in low-tax jurisdictions and can apply to related and unrelated parties. Some jurisdictions allow the deductibility if they are economically justified, or provide for a specific shifting of the burden of proof to the taxpayer as to the effective and substantial character of the payment. To that purpose, domestic legislation can require extensive documentation to be provided to the tax authority.

As tax competition results in the emigration of taxpayers, the establishment of foreign subsidiaries and the transfer of assets, high-tax countries commonly rely on some substantial criteria in order to determine their taxpayers' residence and, accordingly, their unlimited tax liability. Whereas it is widely accepted that tax residence of individuals commonly refers to his or her habitual adobe and that of companies in the place of effective management, there exist a number of rules aimed at preventing fictitious transfers of residence in low-tax countries or imposing exit taxes. Accordingly, whether an individual emigrates to a low-tax jurisdiction, her or his home State of residence might consider her or him still resident within its territory for a certain period or unless she or he provides evidence to actually live and have substantial economic interests in the other jurisdiction. By contrast, the transfer of seat of a company might be regarded itself as raising tax liability. Exit taxation aims at preventing taxpayers to escape from taxation on "hidden reserves" in shareholding, business assets or pensions.

The fictitious residence provisions are generally based on a presumption that a company incorporated under the law of a country continues to be tax resident in that country even where the effective management is relocated to another country, but sometimes, where the residence is based on incorporation, continued residence is based on effective management.

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The term “thin capitalisation” is commonly used to describe “hidden equity capitalisation” through excessive loans.[487] Thin capitalisation rules target the artificial use of debt instead of equity by shareholders with the sole purpose of benefiting for a more favourable tax advantage. Debt in fact commonly bears interest, which is deductible from the taxable income, whereas dividends are not. Interest payments to shareholders, which fall within the scope of these rules, are treated as dividends on equity capital for tax purposes.

There exist several different approaches (or combinations of them) to determine the minimum level of interest which triggers thin capitalisation rules. Some countries may adopt the arm’s length approach, which is based on the general principles of transfer pricing and refers to whether and under which conditions an unrelated party would have provided debt funds on the same basis as the related party. Other jurisdictions established a specific minimum debt/equity ratio, whereas some others curb the practice at hand relying on their general anti-avoidance provisions.

The term “check-the-box” refers to a particular typical legislation of the US aimed at determining the classification of domestic and foreign business entities as a corporation, a partnership or a disregarded entity. Unincorporated entities can “check” or thick a box on a form and therefore elect their classification for tax purposes. In the case no election is made, the default rules on the liability of the entity apply and the entity will be treated either as a corporation or as a partnership. Entity deemed as a *per se* corporation cannot make any election. The origin of such a regulation resides in the need to prevent profit shifting by companies through entities based in low-tax jurisdictions, by simplifying questions of whether a firm was a corporation or a partnership.

Under check-the-box rules, foreign entities, which may be recognised as corporations by one jurisdiction and disregarded entities by another, offered resident companies the opportunity to shift profits. This situation typically occurred in the case of passive income, where a subsidiary based in a low-tax jurisdiction received interest from another subsidiary located in a high-tax country, where interest is normally deductible. If one jurisdiction considers the entity in the low-tax country as a disregarded one, no interest payment is deemed to occur, being this latter and its parent company the same subject. Hence, under the check-the-box rules such problems can be avoided.[488]

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[487] OECD, *Issues on International Taxation no. 2 – Thin Capitalisation*, Paris, 1987.

[488] The same technique can be applied through contract manufacturing arrangements. For a more detailed overview on this matter, see D.R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, Tax Notes International, 6/2007, 589-623; For a discussion of reverse hybrids see J.M. Calianno, J.M. Cornett, *Guardian Revisited: Proposed Regs Attack Guardian and Reverse Hybrids*, Tax Notes International, 4/2006, 305-316.

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In addition to hybrid entities that achieve tax benefits by being treated differently in the US and the foreign jurisdiction, there are also hybrid instruments that can avoid taxation by being treated as debt in one jurisdiction and equity in another.[489]

12. Differences between the EU and the OECD approaches

In the late 1990s tax competition became a matter of great concern for high-tax countries and coordinated action at the international level was the form of reaction considered as effective. At the time of the 1998 Report, the OECD comprised twenty-nine countries, including all the then fifteen EU Member States. However, actions taken by the two Organisations do not really seem to match.

Albeit targeting the same phenomenon, there are some differences between the EU and the OECD approach. The attention of both the EU and the OECD is drawn by a specific type of tax competition, i.e. tax competition which they both define "harmful" because of its negative effects on their members. This means that the two organisations share a common background idea: tax competition is not always harmful, and they only address those tax measures that can be harmful to fair and healthy competition.

There are however some differences between the EU and the OECD approach. Unlike the Code of Conduct, the 1998 Report does not define harmful tax competition as such,[490] while the Code of Conduct does. It should however be pointed out that tax competition addressed by the OECD seems to have the same meaning as in the Code of Conduct. The definition of harmful tax competition provided for in the Code of Conduct is based on a comparison between tax measures of the Member States in question and those applied by another Member State.[491] In these terms, and focusing on the European Community geographical borders only, the tax measure at hand is identified as potentially harmful whether it provides for a lower level of taxation, including no taxation at all, together with the other five main factors, which have been above illustrated. Harmful tax competition in the meaning of the Code of Conduct

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[489] See S. Foley, *U.S. Outbound: Cross border Hybrid Instrument Transactions to gain Increased Scrutiny During IRS Audit*, http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24101&SID=692834&TYPE=20. A. Kraymal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, Houston Business and Tax Law Journal, 2005, http://www.hbtlj.org/v05/v05Krahmalar.pdf.

[490] Some commentators have accordingly criticised it for its lack of clarity. See A. Wright, *Harmful Tax Competition: An Emerging Global Issue*, Tax Notes International, 17 August 1998, 461; M. Gaffney, *Competition: More Harm than Good?*, International Tax Review, 26/1998, 46. Interestingly, R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 151 highlights that the OECD's report does not analyse which costs tax competition actually imposes, but only the possible policy measures that may be undertaken to limit such competition.

[491] Paragraph D of the Code of Conduct.

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thus coincides with the “beggar-my-neighbour” policy identified by the OECD, although this latter is examined by the OECD from a wider geographical perspective.

A second difference between the EU and the OECD approach is that the Code of Conduct constitutes one of a series of measures in the tax field, which also included a proposed Directive on the taxation of savings[492] and a proposed Directive on withholding taxes on interest and royalties with respect to cross-border payments between associated companies, whereas the OECD approach is not (and cannot be) articulated in a coherent set of binding rules.[493]

A third difference between the EU and the OECD approach regards their scope. The 1998 Report only covers “geographically mobile activities, such as financial and other service activities, including the provision of intangibles”, and does not include manufacturing or non-service and non-financial commercial activities. By contrast, the Code of Conduct focuses on business tax measures which affect, or may affect, business activity within the Community.[494] Thus, it clearly emerges that the scope of

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[492] As part of the “tax package” aimed at combating harmful tax competition, the European Community decided to draw up a legislative instrument to overcome existing distortions in the effective taxation of savings income in the form of interest payments. Savings income in the form of interest payments from debt claims constitutes taxable income for residents of all EU Member States. However, owing to the free movement of capital and the absence of any coordination of national systems for taxing savings income in the form of interest payments, and in particular the treatment of interest received by non-residents, residents of Member States are often able to avoid any form of taxation in their Member State of residence on interest they receive in another Member State. The resulting distortions in the movement of capital between Member States were therefore considered as incompatible with the internal market, as they encouraged tax evasion on savings income and increased tax pressure on income from less mobile sources. The Savings Directive (Council Directive 2003/48/EC of 3 June 2003) builds on the consensus reached at the Feira European Council of 19 and 20 June 2000 and the subsequent ECOFIN Council meetings of 26 and 27 November 2000, 13 December 2001 and 21 January 2003. The consensus lies in the setting up of an automatic exchange of information system between all Member States except for Belgium, Luxembourg and Austria, which will be given a transitional period during which, instead of providing information to the other Member States, they must apply a withholding tax to the savings income covered by this Directive.

[493] An initial proposal for a Directive to abolish withholding taxes levied on payments made between parent companies and subsidiaries of different Member States was presented by the Commission at the end of 1990. Although this proposal was included in 1992 among the priorities for the establishment of the Single Market, the Council was unable to reach a consensus. The Commission had to withdraw the proposal at the end of 1994 in spite of the need to adopt a Community instrument in this area so as to eliminate double taxation completely. Based in particular on the 1998 Commission proposal, the Directive was finally approved in 2003 (Council Directive 2003/49/EC of 3 June 2003) and is designed to abolish withholding taxes levied on interest and royalty payments made between associated companies of different Member States.

[494] The limited scope of the Code of Conduct, restricted to corporate income tax only, has been considered as one of its shortcomings by M. Ellis, *Are Measures to Curb Harmful Tax Competition Necessary?*, European Taxation, 3/1999, 79. The Author argues that the background idea is that capital is mobile and labour is not, and this argument ignores that in the reality high qualified labour is very mobile. Differently from employees, employers are very mobile and the provision of income tax incentive on labour may therefore be a far more effective measure to attract investment than corporate tax incentive.

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the activity covered by the Code of Conduct is much broader than that of the 1998 Report. The fact that this latter only focuses on those mobile activities and does not deal with investments involving substantial economic activity makes one think that the OECD is actually concerned about tax evasion resulting from tax secrecy in host countries, rather than tax avoidance strategies enacted by multinational firms[495] (which also erode their members' tax bases).

A fourth difference between the EU and the OECD approach is that the 1998 Report draws an important distinction between tax havens and harmful preferential tax regimes, while the Code of Conduct does not contain any definition of tax havens.

There is a final relevant difference between the EU and the OECD approach, which attains to the "power" of the two organisations, and which entails a different use of the instruments at their disposal to fulfil their purposes.[496] While the European Union is endowed with institutions effectively able to bind Member States to adopt measures designated to eliminate harmful tax competition, the OECD can only derive its influence from its ability to persuade members. The campaign initiated by the OECD has been considered as an attack on low-tax countries in general,[497] rather than an initiative devoted to protect "healthy" tax competition. OECD member countries had difficulties to keep their high level of taxation because of tax competition and consequently tried to restrict this latter and to compel more competitive countries to raise their taxes.[498]

Avi-Yonah hailed the Report as "a major achievement" [499] and "an indispensable first step",[500] considering the commitments made by tax havens to cooperate with the OECD member countries. Moreover, the OECD initiative can be appreciated for having developed a more inclusive and cooperative approach to the problem of tax

[495] According to M. Ellis, *Are Measures to Curb Harmful Tax Competition Necessary?*, European Taxation, 3/1999, 79, in this way the OECD has chosen politically much safer ground because it is very difficult for a politician to come up in defence of paper companies and its recommendations have limited value.

[496] In this sense, see E. Osterweil, *OECD and the EU: Two Approaches to Harmful Tax Competition*, EC Tax Journal, 3/1999, 89; E. Osterweil, *OECD Report on Harmful Tax Competition and European Union Code of Conduct Compared*, European Taxation, 6/1999, 202.

[497] See A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1055, who argues that the initiative was specifically aimed against United States.

[498] As reported by J.C. Sharman, *Havens in a Storm: The Struggle for Global Tax Regulation*, New York, 2006, 87, Owen Arthur, Prime Minister of Barbados, on 8 January 2001 asserted that the OECD was in favour of the market only when it worked to member States' advantage, and the campaign against tax competition was simply an attempt to reverse the verdict of free and fair competition.

[499] R.S. Avi-Yonah, *Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1573.

[500] R.S. Avi-Yonah, *Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 7/2000, 1562.

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havens: before the project was launched, “tax havens” and “non-tax havens” did not communicate, but this situation changed, perhaps because it became clear to the tax havens that they were vulnerable to coordinated action. The OECD also promoted the participation of tax havens in the process: the Global Forum created by the OECD collected more than sixty OECD and non-OECD member countries and was aimed at achieving a global level playing field based on transparency and effective exchange of information in tax matters.[501]

[501] OECD, *A Process for Achieving a Global Level Playing Field*, Paris, 2004.

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CHAPTER 5

THE ERA OF TAX TRANSPARENCY

The analysis developed in the present Chapter deals with the most recent initiatives undertaken at the OECD level against those jurisdictions labelled no longer as “tax havens”, but as “uncooperative jurisdictions”. Starting from the 2001 Report, the attention of the OECD has shifted to the “uncooperative jurisdictions” paradigm, therefore putting emphasis on the cooperative attitude of the targeted jurisdiction in exchanging information for tax purposes. Since the recent G-20 and G-8 summits, lack of transparency and exchange of information have started being perceived as the main obstacles to the proper enforcement of domestic tax legislations of high-tax countries, based on the worldwide taxation principle. In this respect, an analysis of the OECD’s instruments through which exchange of information can take place is first provided, i.e. Art. 26 of the OECD Model Convention (paragraph 1) and the Model TIEA (paragraph 2). Then the exam focuses on the OECD’s standard on exchange of information (paragraph 3) and provides an analysis of the two criteria under which a given jurisdiction is included in or removed from the most recent OECD black list, i.e. “transparency” and “exchange of information” (paragraph 4). Subsequently, after providing a description of the joint OECD/Council of Europe Convention on mutual administrative assistance (paragraph 5), the exam is focused on the EU instruments allowing exchange of information in tax matters, i.e. the mutual assistance directive (paragraph 6), the EU Savings Directive and the recent proposals of amendments (paragraphs 7-8), and the Commission’s Communication on “good governance in tax matters” (paragraph 9). Finally, the attention is shifted to one of the most remarkable examples of individual initiative undertaken by States to collect information for tax purposes from foreign entities, i.e. the US 1999 “Qualified Intermediary” regulation and the US 2010 “Foreign Account Tax Compliance Act” (paragraph 10).

1. Art. 26 of the OECD Model Convention (“Exchange of Information”)

Paragraph 9 of the Commentary of Article 26 of the OECD Model Convention outlines the main types of exchange of information, which are the following: exchange of information on request, automatic exchange of information, and spontaneous exchange of information.

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Exchange of information on request is a specific procedure aimed at gathering information with reference to a specific case regarding tax position of a single or of a group of taxpayers. The practical features of this form of exchange of information will be dealt with in the paragraph below on TIEA. The OECD's campaign on transparency and exchange of information is based on the commitment by uncooperative countries to agree to the exchange of information on request.

Automatic exchange of information consists of a systematic flow of information about one or various categories of income sourced in one State and received in the other Contracting State.[502] This form of exchange of information is becoming more and more a standard procedure among high-tax countries, thanks to the new technical possibilities offered by information technology.

Spontaneous exchange of information can occur in the case of a State having acquired certain information, which it supposes to be of interest to the other State. This mostly happens in those cases of serious attempts of tax frauds, often linked to criminal consequences.

The three types discussed above can also be combined and States can use other techniques to obtain relevant information, such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.[503] These forms will not be discussed here.

It is interesting now to briefly illustrate the main features of the most common instruments existing at the OECD level allowing international exchange of information in tax matter. Provisions governing exchange of information are normally contained in Article 26 of bilateral double tax treaties based on the OECD Model Convention. Double tax treaties are comprehensive agreements between two States mainly aimed at avoiding double taxation in cross-border investments. Although the main purpose of such instruments is that related to double taxation, preventing tax evasion and tax avoidance is included among its objectives.[504]

The very first version of Article 26 dates back to 1963 and underwent several amendments in the following years, the most relevant ones in 1977. The original

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[502] There is no standard approach to exchange information under this form and both the OECD and tax administrations are further developing it. In this respect an attempt of harmonisation can be found in two OECD proposals. The first one, the OECD Council Recommendation C(81)39 concerning a standardised form for the automatic exchanges of information under international tax agreements, 5 May 1981, aims at setting some common principles but it has largely been ignored and results somehow outdated. The second one, the OECD Council Recommendation C(92)50 concerning a standard magnetic format for automatic exchange of tax information, 23 July 1992, addresses practical topics such as the adoption of a common magnetic format for transmitting information.

[503] See paragraph 9.1 of the Commentary on Article 26, which refers to another OECD documents in which a description of these techniques is contained. See OECD, *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*, Paris, 1994.

[504] C. Garbarino, *Manuale di Tassazione Internazionale*, Milan, 2008, 223-224.

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version, in fact, was strictly functional to the application of the Convention.[505] The following version extended the scope of the exchange of information also to the carrying out of the domestic laws of the Contracting States,[506] but still within the limitation set forth in Articles 1 and 2 of the Convention.[507] The previous wording "in accordance with this Convention" was replaced with "not contrary to the Convention", leaving therefore room for a much broader application of exchange of information. The 1977 version, in addition, allowed exchange of information concerning taxpayers residing in third countries, and taxes not falling within the scope of the Convention.

In 2005 two new paragraphs were added (i.e. paragraphs 4 and 5) and some meaningful changes to the text of the Article occurred in order to broaden its scope.[508] At present, the word "necessary" in paragraph 1, setting the scope of

[505] The 1963 version of Article 26 read as follow: "The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation there under is in accordance with this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment or collection of the taxes which are the subjects of the Convention".

[506] The 1977 version of Article 26 read as follow: "The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of the provisions of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article 1. Any information received by a contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of the State and shall not be disclosed to any persons or authorities (including courts and administrative bodies) other than those involved in the assessment, collection of, enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public proceedings or in judicial decisions".

[507] While the 1963 version was defined as a "narrow exchange of information clause", the 1977 one was referred to as "an extensive exchange of information clause". See M. Widmer, *Exchange of Information*, European Taxation, 5-6/1981, 164.

[508] The 2008 version of Article 26 read as follow: "1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2. 2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. 3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation: a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State; b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; c) to supply information which would disclose any trade, business, industrial,

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exchange of information, has been replaced with the expression "foreseeably relevant", which is much broader.[509] The standard of "foreseeable relevance" is defined by the Commentary as "to the widest possible extent",[510] as long as a functional link exists between the requested information and the position of taxpayers of the requesting State.[511] The wide scope of exchange of information, which includes taxes of every kind and description imposed in the Contracting States,[512] encounters only one limitation, i.e. information should be given only insofar as the taxation under the domestic taxation laws concerned is not contrary to the Convention.

Exchange of information under Article 26 is mandatory (owing to the use of the word "shall" in the first sentence)[513] and could be a valid tool of application of the Convention. Without exchange information, some conventional provisions requiring coordination would risk being not applicable.[514]

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commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy *(ordre public*). 4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information. 5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person".

[509] It is worth pointing out that paragraph 1 of the UN Model contains an additional sentence, that states that "in particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes". The OECD Model, instead, contains no reference to the purpose of exchange of information.

[510] Paragraph 5 of the OECD Commentary on Article 26.

[511] According to paragraph 5 of the OECD Commentary on Article 26, exchange of information should be provided to the widest possible extent and Contracting States 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.

[512] It is worth noting that according to paragraph 5.1. of the OECD Commentary to Article 26, the information covered by paragraph 1 is not limited to taxpayer-specific information, as the competent authorities may also exchange other sensitive information related to tax administration and compliance improvement, for example risk analysis techniques or tax avoidance or evasion schemes.

[513] An exception to such a wording is found in double tax treaties signed by Switzerland, where "shall" is replaced by "may". In such a case, exchange of information cannot be deemed as mandatory, but is rather a faculty of Contracting States. See A. Contrino, *La Convenzione tra l'Italia e la Svizzera contro le doppie imposizioni*, in C. Garbarino (Ed.), *Le Convenzioni dell'Italia in materia di imposte sul reddito e patrimonio*, Milan, 2005, 955.

[514] Exchange of information might result necessary, for instance, to ascertain the residence of payers or beneficiaries, to allocate taxable profits between associated companies, to carry out a mutual agreement procedure, and so on.

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Paragraph 2 of Article 26 addresses the limits of confidentiality to the use of information exchanged to protect taxpayers' rights to privacy. It establishes that any information received shall be treated as secret in the same manner as information obtained under the domestic laws of the requesting State[515] and shall be disclosed only to persons or authorities (including courts and administrative bodies)[516] concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions

Paragraph 3 addresses three limits to the exchange of information for the benefit of Contracting States involved in this form of cooperation and aims at avoiding asymmetrical situations in which one of the two Contracting States is, for whatever reason, required to do more in its efforts than the other Contracting State. Accordingly, the very wide scope of exchange of information, as well as the protection of confidentiality, cannot impose on a Contracting State one of the following obligations:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).

Paragraph 4 establishes that the requested State shall use its information gathering measures[517] to obtain the requested information, even though the requesting State may not need such information for its own tax purposes. Such a provision has cleared previous doubts as to whether requested State should have exchanged only information possessed or whether should have actively looked for the information in order to satisfy the other State's requests. This matter was further complicated by the

[515] The original version of Article 26 in the 1963 OECD Model Convention simply read that "Any information received by a Contracting State shall be treated as secret". Such a stricter notion of secret established an obligation which prevented the circulation of information gathered out of the archives of the competent tax authorities of the requesting State.

[516] According to paragraph 12.1 of the OECD Commentary on Article 26, information can also be disclosed to oversight bodies, which include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State.

[517] According to paragraph 19.7 of the OECD Commentary on Article 26, the term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information.

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domestic tax interest requirement, under which a Contracting State could only provide information to the requesting State only if this latter had an interest in the requested information for its own tax purposes.[518] The second sentence of paragraph 4 accordingly establishes that the obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

Paragraph 5 deals with tax-relevant information held by banks or other financial institutions and establishes that limitation set forth in paragraph 3 do now allow Contracting States to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

This provision is nothing but the expression of the OECD's disfavour towards bank secrecy. The express reference to the inapplicability of the limitations set forth in paragraph 3 confirms that bank secrecy can never represent a legitimate reason for declining any request of information.[519]

It must be pointed out that Austria, Belgium, Luxembourg and Switzerland reserved the right not to include paragraph 5 in their conventions.[520] Austria was authorised to exchange information held by a bank or other financial institution where such information is requested within the framework of a criminal investigation which is carried on in the requesting State concerning the commitment of tax fraud. Switzerland would have proposed to limit the scope of this Article to information necessary for carrying out the provisions of the Convention.[521] This reservation

[518] As pointed out by R. Russo, *The 2005 OECD Model Convention and Commentary: An Overview*, European Taxation, 12/2005, 565, a domestic tax interest requirements refers to laws or practices that would prohibit one tax treaty partner from obtaining or exchanging information requested by another tax treaty partner, unless the requested tax treaty partner had an interest in such information for its own tax purposes. The new formulation of paragraph 4 of Article 26 clarifies that the contracting States should obtain and exchange information, irrespective of whether or not they also need the information for their own purposes. See also J. Owens, *International Taxation: Meeting the Challenges – The Role of the OECD*, European Taxation, 12/2006, 557, who remarked that some of the serious impediments to achieving the effective exchange of information were: dual incrimination rules, domestic tax interest requirements, excessively strict bank secrecy rules, and a narrow definition of what constitutes tax fraud.

[519] A confirmation of this approach can be found at OECD, *Improving Access to Bank Information for Tax Purposes, the 2007 Progress Report*, Paris, 2007.

[520] See paragraph 23-26 of the OECD Commentary on Article 26.

[521] In Switzerland's view, as the purpose of tax treaties is solely to prevent international double taxation, a clause on exchange of information in a double tax treaty was not necessary, as information required for the correct application and for the prevention of an abuse of the convention can be exchanged already within the existing framework of its provisions on the mutual agreement procedure, the reduction of taxes withheld at source, etc. See paragraph 23 of the OECD Commentary on Article 26 of the 1977 Model, confirmed by the Swiss Federal Supreme Court on 20 November 1970 regarding the Switzerland-Sweden tax treaty of 16 October 1948, which did not contain an exchange

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should not apply in cases involving acts of fraud subject to imprisonment according to the laws of both Contracting States. Belgium reserved the right that where paragraph 5 was included in one of its conventions, the exchange of information held by a bank or other financial institution was restricted to the exchange on request of information concerning both a specific taxpayer and a specific financial institution. When in 2009 the standard of transparency and exchange of information was universally endorsed, these four States (appeared on the 2 April 2009 black list) lifted their reservation to Article 26 of the OECD Model.[522]

2. The Model Tax Information Exchange Agreement (TIEA)

The other instrument to exchange information for tax purposes is the Tax Information Exchange Agreement (TIEA). With a view to promoting international cooperation in tax matters through exchange of information, the OECD Global Forum Working Group on Effective Exchange of Information[523] developed a Model of Tax Information Exchange Agreement ("Model TIEA") in April 2002.[524] The Model TIEA is a non-binding instrument that serves as a model for assisting contracting States in their bilateral or multilateral negotiations[525] and a number of bilateral agreements have been based on this Model. The role of TIEAs in the framework of international taxation has been emphasised by the OECD work on harmful tax practices and, like Article 26 discussed above, it represents the standard of effective exchange of information for the purposes of the OECD's project.

The Model TIEA consists of three parts. The first introduces the basic concepts and explains the context. The second consists of the articles, with the multilateral version

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of information clause. On 31 March 1994, Switzerland amended the wording of its reservation to state that an exchange of information clause is to be included in tax treaties, but the scope of exchange will be limited to information necessary for carrying out the provisions of the treaty. See paragraph 24 of the OECD Commentary on Article 26 of the 1994 Model. On 15 July 2005, Switzerland amended its reservation again and agreed that the reservation did not apply in regard to tax fraud that is subject to imprisonment under the laws of both countries. The reservation was finally withdrawn by the Swiss Federal Council with decision of 13 March 2009, so that currently Switzerland adopts the OECD standard on exchange of information.

[522] See paragraph 11 of the 2010 OECD Progress Report, OECD, Promoting Transparency and Exchange of Information for Tax Purposes, Paris, 3 September 2010.

[523] The Working Group consisted of representatives from OECD Member countries as well as delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

[524] A deep analysis of such an instrument is out of the scope of the present work. The background and the procedure by which the Model Agreement was drafted and its substance are in J. Barnard, *Former Tax Havens Prepared to Lift Bank Secrecy*, Bulletin for International Taxation, 1/2203, 9-13.

[525] Paragraph 5 of the *Introduction to the Agreement on Exchange of Information on Tax Matters* specifies that such multilateral version "*should not be considered a multilateral agreement in the traditional sense*" but rather as "*the basis for an integrated bundle of bilateral treaties*".

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presented alongside the bilateral version. The last part is a detailed Commentary to each article.[526]

Although dealing with the same matter as Article 26 of the OECD Model Convention, there are however some differences between the Model TIEA and this latter. Not only Article 26 has been amended according to some innovations of TIEA, but also this latter was developed after the introduction of the notion of harmful tax competition.[527] Accordingly, whereas Article 26 was functional to the application of the tax Convention (in the light of the original limitations of scope above underlined) and the avoidance of tax evasion and tax avoidance was one of its purposes (together with the elimination of double taxation), the Model TIEA was conceived from its very beginning as a tool to curb harmful tax practices. The Model TIEA is therefore the standard-setting document for rendering exchange of information the tool to defy harmful tax competition, rather than a mean to carry out the mutual enforcement of Contracting States' domestic tax laws. Furthermore, whereas Article 26 is composed of five short paragraphs, the Model TIEA consists of sixteen articles and therefore provides for more analytical and innovative features that cannot be found in Article 26.[528]

In spite of the differences outlined above, the structure of the Model Agreement is based on that of Article 26 of the OECD Model Convention. Article 1 sets the object and scope of the Agreement and, like Article 26, contains the expression "foreseeably relevant", as regards the information suitable to exchange. As it has

[526] The status Commentary on the Model Agreement is comparable to that of the Commentary on the OECD Model Convention and according to J. Barnard, *Former Tax Havens Prepared to Lift Bank Secrecy*, Bulletin for International Taxation, 1/2203, 11, it is even stronger as concerns the multilateral version. This latter should be deemed a treaty in itself, and the Commentary is published at the same time and as part of the same document.

[527] It must be pointed out that the introduction of the Model TIEA states that "the purpose of this Agreement is to promote international cooperation in tax matters through exchange of information". Considering that the OECD's approach to curb harmful tax practices has already changed in 2001towards enhancing cooperation, rather than assuming a strict position based on confrontation, the Model TIEA origins are narrowly linked to the entire OECD tax havens project. This can be confirmed by two other circumstances. First, the Model TIEA was developed within the Global Forum, which comprehended both OECD member States and delegates from low-tax jurisdiction (i.e. Aruba, Bermuda, Bahrain, Cayman Island, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino), and is a compromise between the reluctance of these latter jurisdictions (which had no interest in exchanging information, and not receiving any kind of benefit in return) and OECD members claiming cooperation in tax matters. Considering that works on this Model agreement date back to 1998, it took four years to reach such a compromise. Second, the TIEA served as a model especially for those jurisdiction with no or low-tax systems which had no interest in concluding double tax treaties. In addition, the former version of Article 26 of the OECD Model encountered many more limitations than in its current one.

[528] Although Article 26 has been amended according to some innovations introduced by the Model TIEA, it is interesting to note that according to the Introduction contained in OECD, *Manual on the Implementation of Exchange of Information for Tax Purposes*, Paris, 23 January 2006, "there should be little practical difference between" Article 26 and the Model TIEA.

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been previously underlined, such a wording, instead of the notion "necessary", aims at preserving from conservative approaches to the exchange of information and from enabling requested countries to decline cooperation whenever the requesting country could not certify that the requested information was essential to an on-going investigation. On the other hand, however, the notion of "foreseeable relevance" risks causing symmetrical distortions, such as excess of requests, both in terms of frequency and content. In this regard, as previously mentioned, the so-called "fishing expeditions" are prohibited.[529]

Article 2 contains some new provisions (not present in Article 26) aimed at clarifying the jurisdictional scope of the Agreement and establishes that a requested State is not obliged to provide information which is neither held by its authorities nor is in the possession or control of persons who are within its territorial jurisdiction.

While Article 3 identifies tax covered by the Agreement (and includes taxes on income or profits, on capital on net wealth, as well as estate, inheritance and gift taxes),[530] Article 4 contains a list of definitions, and Article 5 deals with the standard procedure for exchange of information, i.e. exchange of information upon request. Information upon request is the only form of exchange of information provided for by the TIEA. Its scope is very wide and covers both civil and criminal tax matters, irrespective of whether the conduct being investigated constitutes a crime under the laws of the requested State if such conduct occurred in the requested State.[531] Exchange of information upon request should occur according to the "reciprocity principle".[532] However, it should be noted that in those cases in which no or low-tax jurisdictions are the recipients of requests of information, it is likely that such an exchange would be unilateral rather than reciprocal.

Like Article 26, Article 5 of the TIEA refers to the expression "information gathering measures", and the lack of any definition of this expression[533] leaves up to the

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[529] See paragraph 3 of the Commentary on TIEA.

[530] In this respect, the scope of the Model Agreement is narrower than the Joint OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and the EU Directive on Mutual Assistance in Tax Matters. It is also narrower than the scope of Article 26, which instead includes "taxes of every kind and description".

[531] This is the abolishment of the so called "dual criminality clause", previously embedded in the Model TIEA. According to X. Oberson, *The OECD Model Agreement on Exchange of Information – A Shift to the Applicant State*, Bulletin for International Taxation, 1/2003, 16, this principle is an important protection which may be justified on at least two grounds. First, it is based on the "cooperation principle", namely a State should not be obliged to grant assistance and thus cooperate to repress conduct that is not regarded as criminal under its own law. Second, it is also a means to protect the constitutional rights granted in the requested State. The principle of dual criminality is also a protection of the constitutional rights of persons resident in the requested State, as it prevents that State from granting assistance that is not based on a domestic legal provision.

[532] See Par.15.1 of the OECD Commentary concerning the Exchange of Information.

[533] Quite vaguely, and tautologically, the Commentary to Art. 26 only says that "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to

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Contracting States the definition of the most appropriate instruments to gather information, according to domestic tax practice.

As far as the scope of the exchange of information is concerned, Article 5, paragraph 4, establishes that competent authorities should have the authority to obtain and provide upon request the following information: (i) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees; (ii) information regarding the ownership of companies, partnerships, trusts, foundations, “Anstalten” and other persons, including, within the constraints of Article 2, ownership information on all such persons in an ownership chain; in the case of trusts, information on settlors, trustees and beneficiaries; and in the case of foundations, information on founders, members of the foundation council and beneficiaries. Further, this 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 such information can be obtained without giving rise to disproportionate difficulties.

The Model Agreement lifts bank secrecy not only for criminal tax matter, but also for ordinary tax investigations, and, as mentioned, abolishes the dual criminality clause. The criminal conduct must be defined as such according to domestic law of the requesting State and the requirement that information be provided only whether the conduct at hand would be subject to prosecution under domestic law of the requested State is explicitly forbidden. This requirement should prevent tax havens from avoiding their obligations of exchanging information with a very lax criminal law.

In order to obtain information, the tax authority of the requesting State must: (i) identify the taxpayer under examination or investigation, the nature of the information requested and the form in which it wishes to receive that; (ii) inform about the tax purpose for which the information is sought; (iii) report reasonable grounds for believing that the requested information is available in the requested jurisdiction; (iv) if possible, communicate the name and the address of any person believed to have the requested information. In addition, the request of information must contain a statement that the request is in conformity with the law and administrative practices of the requesting State, that if the requested information was within the jurisdiction of the requesting State then the competent authority of this latter would be able to obtain the information under its domestic laws or in the normal course of administrative practice and that it is in conformity with the Agreement. Because of these limitations, it has been noted that “it appears that the value of information exchange is primarily limited to confirmation rather than discovery of evasion”.[534]

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obtain and provide the requested information; see Par.19.7.2 of the OECD Commentary concerning the Exchange of Information.

[534] M.A. Sullivan, *U.S. Citizens Hide Hundreds of Billion in Cayman Accounts*, Tax Notes International, 9/2004, 898.

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Article 6 regulates tax examinations abroad (which are not dealt with in Article 26), whereas Article 7 (like paragraph 2 of Article 26) deals with the possibilities of declining a request. As underlined, as exchange of information is grounded on the principle of reciprocity, a requested State can legitimately refuse to exchange information whether the requesting Party would not be able to obtain it under its own law. The same can occur when requests are not in conformity with the Agreement, when disclosure is contrary to *ordre publique*, or when the requested information would disclose any trade, business industrial, commercial or professional secret or trade process or would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative, where such communications are produced for the purposes of seeking or providing legal advice or produced for the purposes of use in existing or contemplated legal proceedings.

Differently from Article 26, Article 7 contains a further limitation to exchange of information. Requests can be also declined if the information is requested by the requesting State to administer or enforce a provision of the tax law of the requesting State, or any requirement connected therewith, which discriminates against a national of the requested State as compared with a national of the requesting State in the same circumstances.

Confidentiality is dealt with in Article 8, which does not differ from the provisions contained in paragraph 2 of Article 26. Accordingly, any information received by the requesting State must be treated as confidential and may be disclosed only to persons or authorities (including courts and administrative bodies) in the jurisdiction of the Contracting State concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Agreement. Such persons or authorities are obliged to use such information only for such purposes and disclosure of such information is admitted only in public court proceedings or in judicial decisions. No disclosure is allowed to any other person or entity or authority or any other jurisdiction without the express written consent of the competent authority of the requested Party.

Differently from Article 26, the Model TIEA contains some more specific provisions, some of which are also functional to the agreement. Article 9 deals with allocation of costs incurred in providing assistance, Article 10 sets forth an obligation to implement domestic legislations aimed at enacting the Agreement, Article 11 identifies the language of the exchange, Article 12 provides for limitations by other international agreements, Article 13 regulates mutual assistance procedure, Article 14 depositary's functions, Article 15 the entry into force of the agreement and Article 16 its termination.

The brief analysis of the Model TIEA outlined above shows that Article 26 and the Model TIEA, both being the grounds for the commitment to the standard of transparency and exchange of information requested by the OECD to uncooperative jurisdictions, are in a close functional relationship. As previously underlined, the current version of Article 26 has acknowledged some important amendments in 2005

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due to the relevant interpretative and practical issues raised when the Model TIEA was issued.[535] However, both Article 26 and Model TIEA can be distinguished from each other for a number of reasons. While Article 26 is enshrined in the context of double tax treaties, TIEAs somehow represent a more specific instrument adopted by a limited number of countries. Even though sharing similar functions and purposes, the technicalities regulated in the Model TIEA make this instrument a sub-category of a broader model, which is contained in Article 26. It should be borne in mind that this latter provision served as a laboratory to test and then develop forms of effective exchange of information which are regulated in more details in the Model TIEA. A direct amendment of Article 26, according to the exigencies of fulfil effective cooperation, was likely to encounter more opposition than introducing a new instrument to this purpose.

3. OECD's new standards for exchange of information

As it has been underlined in Chapter 4, the OECD's project against harmful tax competition was initially organised as a campaign against corporate tax avoidance, because it targeted those regimes attracting geographically mobile activities, such as financial and other service activities, including the provision of intangibles. The project by that time did not consider tax evasion related to cross-border savings instrument, such as bank deposits, because a separate OECD working party was dealing with that matter in the meanwhile.[536]

Starting from 2001, when the Global Forum on Taxation was established with participants from OECD member and non-member countries, the project started focusing its attention on improving transparency and increasing effective access to exchange of information.[537] Little or no tax on income was no longer sufficient for the OECD to find that a jurisdiction was engaged in harmful practices.[538] Under the pressure from the United States, the OECD soon overshadowed the "substantial

[535] As underlined in paragraph 4 of the OECD Commentary on Article 26, the reviewing of Article 26 has taken into account recent developments in the matters of exchange of information and changes occurred to achieve consistency with the Model Agreement on Exchange of Information on Tax Matters.

[536] Paragraphs 6 and 12 of the 1998 Report.

[537] See OECD, *OECD Pursues a Global Dialogue on International Taxation*, Paris, 1 October 2001. It is worth recalling that Recommendation no. 7 of the 1998 Report (paragraph 111) stated: "in the context of counteracting harmful tax competition, countries should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities". At that stage, secrecy was considered one of the targets of the OECD's campaign, more concerned about no or low-tax regimes. Once all commitments by tax havens were made, the attention was paid on transparency and exchange of information.

[538] The OECD reiterated this in the introduction to its 2004 Progress Report: "Although a low or zero effective tax rate is a necessary starting point of an examination of a preferential regime, it alone is not sufficient to find harmfulness".

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activities" test,[539] and lack of transparency and effective exchange of information became the key factors to determine whether a low or no-tax jurisdiction was considered to be an uncooperative tax haven.[540]

After the issue in 2002 of the Model TIEA by the OECD, in 2004 full relevance was given to the criteria of transparency and exchange of information for identifying (no longer "tax havens" but) "uncooperative jurisdictions". Supported by the G-20 Finance Ministers,[541] the entire campaign originally focused on tax havens and then based on a great emphasis on exchange of information seemed to give more relevance to tax evasion on passive investment income rather than tax avoidance on geographically mobile activities. [542]

In 2006, when all the harmful regimes identified by the OECD were abolished or amended according to the OECD guidelines,[543] the OECD released a new report assessing the legal and administrative frameworks for tax transparency and tax information exchange in eighty-two countries.[544] Purpose of this report was to determine what was "required to achieve a global level playing field in the areas of transparency and effective exchange of information for tax purposes".[545] In October 2007, an update was issued,[546] but the OECD claimed the existence of restrictions on access to bank information for tax purposes in three OECD countries (i.e. Austria, Luxembourg, Switzerland) and in a number of offshore financial centres (i.e. Cyprus, Liechtenstein, Panama and Singapore), in spite of public commitments made by

[539] See paragraph 27-28 of the 2001 Progress Report. This change was made in order to secure continued US Cooperation in the project following the change of administration in 2001, as was noted by both A. Hishikawa, *The Death of Tax Havens?*, Boston College International and Comparative Law Review, 2/2002, 389-418 and A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004,1043-1044.

[540] See A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1061: "The dropping of the 'no substantial activities' criterion effectively meant that a tax haven could be labelled as uncooperative only if it failed the transparency test or refused to exchange information".

[541] G-20, Meeting of Finance Ministers and Central Bank Governors: Communiqué at 9, 21 November 2004.

[542] A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 10/2004, 1038. In this sense, see also C.E. McLure, *Will the OECD Initiative on Harmful Tax Competition Help Developing and Transition Countries?*, Bulletin for International Fiscal Documentation, 3/2005, 90-98, according to whom the original project seemed to have started being focused on preventing evasion of residence-country taxes on portfolio investments by individuals. In addition to increased and more effective exchange of information, the project emphasised improved records of ownership of companies and trusts and improved accounting, without which it is difficult to provide access to information in a useful manner.

[543] With the exception of the Luxembourg 1929 holding companies, as highlighted in Chapter 4.

[544] OECD, *Tax Co-operation: Towards a Level Playing Field*, Paris, 2006.

[545] Paragraph 7 of the OECD Report, *Tax Co-operation: Towards a Level Playing Field*, Paris, 2006.

[546] OECD, *Tax Co-operation: Towards a Level Playing Field*, Paris, 2007.

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these countries to implement standards on transparency and exchange of information developed by the Global Forum.[547]

The turmoil provoked by the recent financial crisis boosted the need of governments to retrieve tax bases emigrated cross-borders in order to face their intervention in the economic sectors. Like never before, uncooperative jurisdictions became a very hot topic in the political agenda[548] and, threatened by international tax avoidance and tax evasion resulting from tax secrecy, both domestic governments and international organisations declared war to them.[549]

Tax transparency was in fact the focus of the G-20 Summits in Washington, London, Pittsburgh and Toronto.[550] On 2 April 2009, at the time of the G-20 summit in London claiming for a list of tax havens,[551] the OECD's Secretary-General issued a new Progress Report on jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed standard on transparency and exchange of information for tax purposes.

The report distinguished the following four groups of jurisdictions: (i) jurisdictions that had substantially implemented the internationally agreed tax standard;[552] (ii) tax havens that had committed to the internationally agreed tax standard but have not

[547] See OECD, *OECD Report Progress in Fighting Offshore Tax Evasion, but Says More Efforts Are Needed*, Paris, 10 December 2007.

[548] For example, in the G-20 summits in Washington, London, and Pittsburgh, and the G-8 summits in L'Aquila and Lecce, and Hokkaido, political leaders expressed their commitment to tackle tax evasion, and their willingness to take action against non-cooperative jurisdictions.

[549] Jeffrey Owens, Director of the Centre for Tax Policy Administration of the OECD, expressly declared: "The threshold of tolerance of tax evasion has dropped to zero". See J. Owens, *Moving Towards Better Transparency and Exchange of Information on Tax Matters*, Bulletin for International Taxation, 11/2009, 557-558.

[550] At the G-20 Summit held in London on 2 April 2009, the G-20 leaders stated: "We stand ready to take agreed action against those jurisdictions which do not meet international standards in relation to tax transparency. To this end we have agreed to develop a toolbox of effective counter measures for countries to consider". See the Declaration on Strengthening the Financial System (Annex to London Summit Communiqué) available at http://www.pittsburghsummit.gov/resources/125091.htm.

[551] According to some articles of the web press, ahead of the G-20 summit meeting in London, French President Nicolas Sarkozy declared: "We want clear precision of what a tax haven is, not a place where you pay few taxes, but a place that doesn't give information on the origin of funds. We want one or several lists of financial centres that don't cooperate with regard to (the OECD criteria.)" See http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afTpUUPzppmU&refer=home.

[552] The list includes 26 OECD member States (i.e. Australia, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom, United States) and 14 OECD non-member States (i.e. Argentina, Barbados, China, Cyprus, Guernsey, Isle of Man, Jersey, Malta, Mauritius, Russian Federation, Seychelles, South Africa, United Arab Emirates, and US Virgin Islands).

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yet substantially implemented it;[553] (iii) other financial centres that had committed to the internationally agreed tax standard but have not yet substantially implemented it;[554] and (iv) jurisdictions that had not committed to implement the internationally agreed tax standard.[555]

The eighty-four jurisdictions included in the four categories were those which were surveyed by the OECD's Global Forum on Taxation, i.e. the OECD member countries, those participating in the OECD's Committee on Fiscal Affairs as "Observer" countries (Argentina, Chile, China, Russia, South Africa), as well as jurisdictions that met the tax haven criteria and other financial centres. It can be noticed that currently OECD member countries are thirty-three and that in the 2009 list neither Israel nor Slovenia were mentioned. Israel deposited its instrument of accession to the OECD Convention on 7 September 2010, whereas Slovenia did it on 21 July 2010. The list would have been updated according to whether each country had reached the minimum threshold of the twelve minimum agreements on exchange of information. Consequently, the original Progress Report dated 2 April 2009 was followed by a new Progress Report on 6 November 2009. This latter contained the four groups of jurisdictions listed in the original Progress Report and took into account of the commitments made by listed jurisdictions by that time.[556]

The whole 2009-2010 OECD campaign focuses on the standards of transparency and exchange of information, as developed by the OECD and primarily contained in Article 26 of the OECD Model Tax Convention and the 2002 Model TIEA.[557] The "internationally agreed standard" has been articulated and refined by OECD and non-OECD countries in the context of the OECD's Global Forum on Taxation, together with the development of an availability and reliability standard for accounting records. This standard was endorsed by the G-20 Finance Ministers in 2004 and by the UN Committee of Experts on International Co-operation in Tax Matters in October 2008. It serves as a model for the vast majority of bilateral tax conventions entered into by

[553] The list includes 31 jurisdictions, all of which are OECD non-member countries (i.e. Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Dominica, Gibraltar, Grenada, Liberia, Liechtenstein, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent & Grenadines, Samoa, San Marino, Turks and Caicos Islands, Vanuatu).

[554] The list includes 5 OECD member countries (Austria, Belgium, Chile, Luxembourg, and Switzerland) and 3 OECD non-member countries (i.e. Brunei, Guatemala, and Singapore).

[555] The list includes all OECD non-member countries (i.e. Costa Rica, Malaysia (Labuan), Philippines, Uruguay).

[556] The 6 November 2009 list included no country in the group of jurisdictions that had not committed to the internationally agreed tax standard, as all jurisdictions surveyed by the Global Forum had committed to it. Aruba, Austria, Bahrain, Belgium, Bermuda, British Virgin Islands, Cayman Islands, Gibraltar, Luxembourg, Monaco, the Netherlands Antilles, San Marino, and Switzerland were included in the group of country that had substantially implemented the standard.

[557] Paragraph 13 of the OECD Report, *Promoting Transparency and Exchange of Information for Tax Purposes*, Paris, 3 September 2010, which will be discussed below.

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OECD member and non-member countries and requires: (i) existence of mechanisms for exchange of information upon request, where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of the treaty partner; (ii) absence of any kind of restrictions on such exchange due to bank secrecy or domestic tax interest requirements; (iii) availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request in a timely manner; and (iv) respect for taxpayer's right and strict confidentiality rules for information exchanged.

As it will be argued below, any jurisdiction requesting information must establish that the information is "foreseeably" relevant to the administration and enforcement of its tax laws and so-called "fishing expeditions" are not admitted. The scope of the information that may be requested is very broad. If the information requested is "foreseeably relevant", then this will cover any and all information that relates to the enforcement and administration of the requesting jurisdictions' tax laws, including information relating to interest, dividends or capital gains, bank information, fiduciary information relating to trusts, or ownership information of companies.[558]

As previously mentioned, the basis for distinguishing between those jurisdictions that had "substantially implemented" the internationally agreed tax standard and those that had not was identified by the experts of the Global Forum in the signature of twelve agreements on exchange of information meeting the OECD standard. Such agreements could consist of either TIEAs or bilateral tax treaties containing Article 26 of the OECD Model. This threshold would have taken into account:[559] (i) the jurisdictions with which the agreements have been signed (a tax haven which has twelve agreements with other tax havens would not pass the threshold), (ii) the willingness of a jurisdiction to continue to sign agreements even after it has reached this threshold and (iii) the effectiveness of implementation. The implementation of the standards entailed for a jurisdiction to continue negotiating information exchange agreements. In fact, as the internationally agreed tax standard involves agreeing to the exchange of tax information with countries that require it in order to properly administer their own tax laws, jurisdictions refusing to agree to the exchange of information on the grounds that they have already "substantially implemented" the standard, will make them not fully compliant with the standards.

The OECD standard has been considered "nearly worthless", as information exchange under this standard is sporadic, difficult and unwieldy for tax administrations.[560] Moreover, it might be argued that the OECD standard of transparency is indeed a good start, but it is inadequate and weak. Exchange of

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[558] Paragraph 15 of the 2010 Report.

[559] OECD, *Countering Offshore Tax Evasion*, Paris, 17 June 2009, 2.

[560] L.A. Sheppard, *Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, Tax Notes International, 13/2009, 1139-1145.

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information upon request is a very basic but specific form of exchange of information, as it requires that the requesting State already has some evidence about what it is seeking. It can be in addition argued that the minimum twelve-agreements threshold is too low and quite arbitrary, as it does not ensure a proper and effective exchange of information and allows "any" jurisdiction to sign an agreement with "any" other twelve jurisdictions.[561] Furthermore, since a tax haven is better off with non-cooperation, a bilateral agreement binding it to exchange information could effectively work if the non-haven contracting party can offer a greater benefit than the incentive tax havens have to cheat and to remain non-transparent.

On 31 August 2009, the OECD issued the fourth annual report[562] containing the assessment by the Global Forum on transparency and exchange of information in the area of taxation. The report covers eighty-seven jurisdictions, including all the major financial centres around the world and highlights progress made by the Global Forum up to that date, which are the following. All OECD countries now accept Article 26

[561] In this respect it is worth mentioning the agreements signed between the following jurisdictions: Aruba and Saint Lucia (10 May 2010), Faroes Islands and Saint Lucia (19 May 2010), Faroes Islands and Dominica (19 May 2010), Faroes Islands and Antigua and Barbuda (19 May 2010), Aruba and Cayman Islands (20 April 2010), Faroes and St. Vincent and the Grenadines (24 March 2010), Faroes and St Kitts and Nevis (24 March 2010), The Faroe Islands and Bahamas (10 March 2010), Faroe Islands and Andorra (24 February 2010), Belgium and Belize (29 December 2009), Belgium and Saint-Kitts and Nevis (18 December 2009), Belgium and Gibraltar (16 December 2009), Faroes Islands and Cook Islands (16 December 2009), Faroes Islands and Samoa (16 December 2009), Faroes Islands and Turks & Caicos (16 December 2009), Faroes Islands and Anguilla (14 December 2009), Liechtenstein and St Kitts & Nevis (11 December 2009), Belgium and St Lucia (7 December 2009), Belgium and St Vincent & the Grenadines (7 December 2009), Belgium and Antigua & Barbuda (7 December 2009), Bahamas and Belgium (7 December 2009), St. Lucia and The Netherlands Antilles (2 December 2009), Liechtenstein and Antigua & Barbuda (24 November 2009), Belgium and Liechtenstein (10 November 2009), Antigua and Barbuda and Netherlands Antilles (29 October 2009), Netherlands Antilles and Cayman Islands (29 October 2009), Belgium and Andorra (23 October 2009), Aruba and Bermuda (20 October 2009), Faroes Islands and Gibraltar (20 October 2009), Liechtenstein and St Vincent & the Grenadines (2 October 2009), Bermuda and Netherlands Antilles (28 September 2009), The Bahamas and San Marino (24 September 2009), Monaco and Liechtenstein (21 September 2009), Monaco and Andorra (18 September 2009), Monaco and Bahamas (18 September 2009), Andorra and San Marino (21 September 2009), Andorra and Liechtenstein (18 September 2009), Austria and Gibraltar (17 September 2009), Austria and Andorra (17 September 2009), Austria and Monaco (17 September 2009), Austria and St Vincent & the Grenadines (14 September 2009), Aruba and British Virgin Islands (11 September 2009), Netherlands Antilles and British Virgin Islands (11 September 2009), Netherlands Antilles and St Kitts & Nevis (11 September 2009), Aruba and St Kitts & Nevis (11 September 2009), The Faroe Islands and Aruba (10 September 2009), The Faroe Islands and Netherlands Antilles (10 September 2009), The Faroe Islands and San Marino (10 September 2009), Monaco and Samoa (7 September 2009), San Marino and Samoa (1 September 2009), Aruba and St. Vincent and the Grenadines (1 September 2009), Monaco and San Marino (29 July 2009), Belgium and Monaco (15 July 2009), Faroes and British Virgin Islands (19 May 2009), Faroes and Bermuda (16 April 2009), Faroes and Cayman Islands (1 April 2009), Faroes and Guernsey (28 October 2008), Faroes and Jersey (28 October 2008), Faroes and Isle of Man (30 October 2007).

[562] OECD, *Tax Co-operation 2009: Towards a Level Playing Field*, Paris, 2009.

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(Exchange of Information) of the OECD Model Tax Convention, as updated in 2005, following the withdrawal in March 2009 by Austria, Belgium, Luxembourg and Switzerland of their reservations to Article 26. Hong Kong, China and Macao, China endorsed the standards at the 2005 Global Forum meeting in Melbourne and they have enacted legislation to implement the standards. Singapore endorsed the standards on 10 February 2009 and proposed relevant legislation in June 2009 intended to comply with the internationally agreed tax standard. Since the beginning of 2008 more than seventy-five TIEAs based on the OECD model have been signed. Andorra, Liechtenstein and Monaco, which the OECD identified in 2002 as uncooperative tax havens, have endorsed the OECD standards and indicated their willingness to change their domestic the OECD standards, as well as their willingness to change their domestic legislation and to enter into agreements for the exchange of information for tax purposes. Niue, identified as a tax haven by the OECD in 2000, reported to have eliminated its offshore sector and dissolved all of its international business companies, trusts, partnerships or other offshore entities. Brunei, Costa Rica, Guatemala, Malaysia, the Philippines and Uruguay have all endorsed the OECD's standards of transparency and exchange of information and agreed to implement them. These developments mean that all the countries surveyed in the Global Forum are now committed to the standard.

The above mentioned report was published in conjunction with the fifth meeting of the Global Forum in Los Cabos, Mexico, on 1-2 September 2009. In that occasion, 178 delegates from 70 jurisdictions and international organisations were called to discuss about progress made in implementing the international standards of transparency and exchange of information for tax purposes, and how to strengthen the work of the Global Forum. In the context of the need of governments to protect their tax bases from non-compliance with their tax laws, the main objectives for the meeting were to: (i) agree on restructuring the OECD Global Forum to expand its membership and ensure its members participate on an equal footing; (ii) agree on how to establish an in-depth peer review process to monitor and review progress made towards full and effective exchange of information; and (iii) identify mechanisms to speed-up the negotiation and conclusion of agreements to exchange information and to enable developing countries to benefit from the new more cooperative tax environment.

The Global Forum was restructured and strengthened, and it now includes ninety-five members on an equal footing.[563] It put in place a peer review process in order to

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[563] Jurisdictions members of the Global Forum are: Andorra, Anguilla, Antigua and Barbuda, Argentina, Aruba, Australia, Austria, Bahamas, Bahrain, Barbados, Belgium, Belize, Bermuda, Brazil, British Virgin Islands, Brunei Darussalam, Canada, Cayman Islands, Chile, China, Cook Islands, Costa Rica, Cyprus, Czech Republic, Denmark, Dominica, Estonia, Finland, France, Germany, Gibraltar, Greece, Grenada, Guatemala, Guernsey, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Isle of Man, Israel, Italy, Jamaica, Japan, Jersey, Kenya, Korea, Liberia, Liechtenstein, Luxembourg, Macau, Malaysia, Malta, Marshall Islands, Mauritius, Mexico, Monaco, Montserrat, Nauru, Netherlands, Netherlands Antilles, New Zealand, Niue, Norway, Panama, Philippines, Poland, Portugal, Qatar, Russian Federation, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines,

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ensure that international standards of transparency and exchange of information for tax purposes are not only put in place, but that they operate effectively. To that purpose, a fifteen member Steering Group in charge of assisting the Global Forum was established to prepare and guide future work.[564] The peer review process is composed of two phases: Phase 1 reviews the legal and regulatory frameworks; Phase 2 assesses the practical implementation of the standard. The reports will include recommendations to improve the situation in the reviewed jurisdictions.

On 3 September 2010, the OECD issued a new Report (hereinafter referred to as "2010 Report"), containing a background information brief on the work in progress.[565] According to the 2010 Report, progress made towards full effective exchange of information has no precedent. The standards on transparency and exchange of information exchange on request, including bank and fiduciary information, is now universally endorsed and the UN has incorporated the OECD standard in the UN Model Tax Convention in October 2008.[566] Since 2009, almost five hundred information exchange agreements have been concluded by jurisdictions which were identified by the OECD as not substantially implementing the standard in the progress report dated 2 April 2009. Since that day, the twenty-nine jurisdictions labelled as uncooperative have been removed from that category for having signed at least twelve agreements to the standards. The 2010 Report emphasises that in 2009 the standard has been universally endorsed, as the four OECD countries (Austria, Belgium, Luxembourg, and Switzerland) removed their reservation to Article 26 of the OECD Model Tax Treaty on exchange of information. The three non-cooperative tax havens which refused to endorse the standard (Andorra, Liechtenstein, and Monaco) finally did so in March 2010. Costa Rica, Malaysia, Philippines and Uruguay finally committed to implement the standard. Similarly, Brazil, Chile and Thailand withdrew their reservation to Article 26. Austria, Andorra, the Bahamas, Chile, Hong Kong, China, Liechtenstein, Macao, China, Malaysia, Panama, the Philippines, San Marino and Singapore have passed legislation aimed at implementing their commitments to the international tax standard. Costa Rica and Guatemala have initiated important legislative changes intended to allow them to meet the international tax standards. These are the main significant results achieved

Samoa, San Marino, Saudi Arabia, Seychelles, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, Turks and Caicos Islands, United Arab Emirates, United Kingdom, United States, United States Virgin Islands, Uruguay, Vanuatu.

[564] The composition of the Steering Group is made up of the Chair (currently Australia) and Vice-Chairs of the Global Forum (currently China, Germany and Bermuda), along with the Chair (currently France) and Vice-Chairs (currently India, Japan, Singapore and Jersey) of the Peer Review Group, and five other members (Brazil, Cayman Islands, South Africa, Switzerland, United Kingdom and United States).

[565] OECD, *Promoting Transparency and Exchange of Information for Tax Purposes*, Paris, 2010.

[566] Paragraph 4 of the 2010 Report.

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towards a level playing field as regards exchange of information for tax purposes. The OECD and the Global Forum will monitor their consistent implementation.[567]

4. A few remarks on "Transparency" and "Exchange of Information" in the recent OECD approach

In the last two paragraphs the evolution of the OECD policy in the last few years in respect to tax havens has been reviewed. This new approach is based on two key concepts that are "exchange of information" and "transparency". The aim of this paragraph is to highlight how these two concepts are defined and applied by the OECD when implementing its policy in the last few years.

According to the 2001 Progress Report, the word "transparency" (tautologically) refers to the "lack of non-transparent features of a given jurisdiction's tax system".[568] It specifically refers to rules departing from established laws and practices within that jurisdiction and considers whether a taxpayer may benefit from "secret" tax rulings or from any form of negotiation of tax due (both with respect to tax rate or tax base) with the tax authority. Thus, a transparent tax system, according to the OECD, requires financial accounts to be drawn up in accordance with generally accepted accounting standards and that such accounts either be audited or filed. However, some exceptions to this standard may be warranted where the transactions of an entity are *de minimis* or the entity is engaged solely in local activities and does not have foreign ownership, beneficiaries, management or other involvement. Transparency further requires that governmental authorities have access to beneficial ownership information regarding the ownership of all types of entities and to bank information that may be relevant to criminal and civil tax matters. The information to be maintained to meet the transparency criterion should be available for exchange pursuant to legal mechanisms for exchange of information.[569]

It is clear that such an interpretation by the OECD of the concept of transparency is closely related to tax havens and is functional to exchange of information. As a matter of fact, exchange of information, as a tool to combat international tax evasion and tax avoidance, can effectively take place only whether data to be exchanged are available.[570] Availability of data to be exchanged would be effective once governmental authorities can access information regarding beneficial owners of companies, partnerships and other entities organised in their jurisdiction, including

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[567] Paragraph 12 of the 2010 Report.

[568] See paragraph 37 of the 2001 Progress Report.

[569] *Ib.*

[570] Paragraph 25 of the 2004 Progress Report emphasises: "Exchange of information for tax purposes can only be effective when reliable information, foreseeably relevant to the tax requirements of a requesting jurisdiction, is available or can be made available in a timely manner and there are legal mechanisms that enable the information to be obtained and exchanged".

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collective investment funds, information on the identity of the principal (as opposed to agent or nominee) of those establishing trusts and foundations. Availability of data would be also effective when financial accounts are drawn according to common rules, when they are audited or filed and when tax authorities can access such accounts. Last but not least, transparency implies power of tax administration to access relevant bank information.

To promote the development of common standards of transparency to be applied both within and outside the OECD, especially in relation to financial accounting requirements, as it has been underlined in Chapter 4, a Joint Ad Hoc Group on Accounts was set up in 2002.[571] The Group's objective was to ensure that, in the development of such common standards of transparency, there was a proper balance between the requirement to ensure access to reliable financial information and the need to avoid placing unnecessary compliance burdens on taxpayers and administrations.

By contrast, "exchange of information" is the actual pursuit of information sharing between countries that are compliant with transparency. Secrecy and lack of access to information are widely acknowledged to be the key factors of tax havens' success. They in fact facilitate tax evasion and tax avoidance both by individuals and closely-held corporations, especially on the most mobile tax bases. It is evident that commitments by tax havens to implement standards based upon effective exchange of information constituted a significant victory in the battle against international tax evasion and tax avoidance launched by the OECD.

Exchange of information, when related to tax haven operations, is a typically non-tax measure aimed at curbing tax base erosion and is strictly linked to the worldwide income taxation principle. States taxing their residents on income produced both domestically and abroad have a strong interest in having information about income produced cross-borders, in order to enforce their tax legislation according to the capital export neutrality principle. Theoretically, exchange of information should be of no interest for those jurisdictions adhering to the principle of capital income neutrality, as for them income produced abroad is in theory irrelevant for domestic tax purposes. However, with the OECD's support, as it has been shown in Chapter 4, anti-tax haven legislations of these countries are in practice aimed at protecting the tax claims on foreign income. As a matter of fact, by neutralising the more advantageous effect of no or low taxation in the foreign jurisdiction, a capital-export country actually treats foreign-source income abroad as if it was produced domestically and therefore claims to subject foreign income to control through

[571] 2004 Progress Report, paragraph 25. Additionally, in November 2002 the OECD published a "template" on transparency standards, in particular with regard to obtaining information about the beneficial ownership of companies. The report, though not directly related to the tax competition project (it was prepared by the steering group on corporate governance, and originated from the work of the Financial Stability Forum working group on Offshore Financing Centres), nevertheless covers some of the same issues. See B. Zagaris, *OECD Proposes New Transparency Standards*, Tax Notes International, 9/2002, 870-875.

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exchange of information and administrative cooperation. Indeed, this is true even if the home State at hand applies the capital income neutrality.[572]

Once all preferential tax regimes were removed, during the 2009-2010 campaign, high-tax countries then focused on catching hidden tax bases. Lack of transparency and tax secrecy were attacked as dangerous tax havens' weapons against integrity of their tax systems.

As a matter of fact, exchange of information serves three main practical purposes for tax administrations: (i) the information received can be used to ascertain facts in relation to income and capital of a tax treaty partner; (ii) the information received may assist the country in administrating and/or enforcing its own domestic laws, thus reducing international tax evasion;[573] and (iii) the exchange of information serves as a mechanism that enables tax authorities to solicit cooperation from foreign governments and more effectively prosecute tax and related white-collar crimes.[574]

According to the literature,[575] there exists no principle in international law establishing an obligation of cooperation between States in the field of international taxation. International custom law, indeed, does not allow States to interfere in the territorial sphere of each other, unless there is mutual consent in this sense. States cannot assess or collect their tax claims in foreign jurisdictions, unless the foreign State agrees. Based on the lack of any international custom law imposing an obligation to this form of mutual assistance, in the past the most common approach to exchange of information was to deny any form of cooperation in cross-border tax matters. States, simply, were not allowed to claim or collect taxes in foreign jurisdictions.

Exchange of information was also hindered by practical difficulties,[576] as it is a burdensome and time-consuming process. In fact, tax authorities of the requested

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[572] A typical example is France, which normally does not subject to taxation income produced abroad. However, under domestic law, when income is produced in a tax haven, it is taxed domestically.

[573] According to V.P. Belotsky, *The prevention of Tax Havens Via Income Tax Treaties*, California Western International Law Journal, 17/1987, 43-62, the exchange of tax information between countries in relation to reducing international tax evasion and measures to avoid and prevent treaty shopping are paramount factors that must be included in any tax treaty to curtail tax haven abuses. With regard to this issue, R.A. Gordon, *Tax Havens and Their Use by United States Taxpayers – An Overview*, A Report to the Commissioner of Internal Revenue Submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981, 14, observed that "exchange of information provisions in the existing tax treaties with tax havens are simply inadequate because they do not override local bank or commercial secrecy laws".

[574] B. Zagaris, *Dollar Diplomacy: International Enforcement of Money Movement and Related Matters – A United States Perspective*, George Washington Journal of International Law and Economics, 22/2003, 445-449.

[575] R. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, The Hague, 1999, 118.

[576] F.A. Mann, *The Doctrine of Jurisdiction in International Law Revisited after Twenty Years,* Recueil des Cours, 1984, volume 186, III, 44.

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State have to deal with documents written in a foreign language and filed under different regulations and procedures. Quite often, moreover, such difficulties were even more significant in the case of requests of information addressed to developing countries, which do not have sufficient resources to provide efficient assistance.

At present, exchange of information is established in multilateral and bilateral international agreements, so that an obligation to exchange relevant data is established upon the signatory States only.

Four are the main sources for exchange of information: (i) international conventions, either bilateral or multilateral, specifically regulating mutual assistance between contracting States; (ii) provisions governing exchange of information embedded in bilateral double tax treaties; (iii) rules set within a regional context, such as the European Savings Directive; (iv) unilateral instruments enacted by a single State, such as the system envisaged by the Qualified Intermediary Agreements.

The scope of the obligation to exchange information bilaterally or multilaterally depends on different factors, including equity.[577] These factors may vary according to the type of instrument under which information is exchanged, the purpose for which information can be used, the extent to which information can be collected, protection of taxpayers' confidentiality or industrial secrets, and so on.

The OECD has been playing a key role in spreading exchange of information worldwide as a tool to combat international tax avoidance and tax evasion. By way of soft law instruments, namely black lists and reports, the OECD's campaign on tax havens has become the instrument to establish a general obligation upon all States to exchange information in tax matter when requested. Not compelling with such an obligation would trigger a sanction hitting States' reputation.

Not only the scope of information exchange in tax matters has been notably widened in the course of last decades, but exchange of information has become the minimum form of cooperation required by high-tax countries for establishing good relationship with foreign jurisdictions.[578] Whereas States are required to exchange information, bilateral or multilateral treaties are the instruments through which such an obligation is fulfilled, as they define scope and limit of the content of such an obligation. The international community of States requires such a commitment to exchange information from "uncooperative tax havens". Once the commitment is publicly made, the single (cooperative) jurisdiction is free to choose its treaty partners to enter into negotiations with.

[577] United Nations, *Coopération Internationale en matière fiscale. Rapport du Group spécial d'experts de la coopération internationale en matière fiscale sur les travaux de sa deuxième réunion*, New York, 1984, 13.

[578] It is worth recalling that the OECD provided for several countermeasures to apply towards tax havens and uncooperative jurisdictions.

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To use OECD's words, effective exchange of information requires a jurisdiction to establish a legal mechanism that allows information to be given to a tax authority of another country in response to a request for information that may be relevant to a specific tax inquiry.[579] An effective exchange of information system in addition requires the implementation of appropriate safeguards aimed at adequately protect taxpayers' privacy and the confidentiality of their tax and business affairs.

Furthermore, in order to avoid that exchange of information be limited by domestic provisions of the States involved, the OECD requires that in the case of information requested for the investigation and prosecution of a criminal tax matter, the information should be provided without a requirement that the conduct being investigated would constitute a crime under the laws of the requested jurisdiction if it occurred in that jurisdiction.[580] In the case of information requested in the context of a civil tax matter, the requested jurisdiction should provide information without regard to whether or not the requested jurisdiction has an interest in obtaining the information for its own domestic tax purposes. A commitment to effective exchange of information requires administrative practices to be put in place so that the legal mechanism for exchange of information will function effectively and can be monitored.

5. The Joint OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters

On 25 January 1988 the member States of the Council of Europe and the OECD member countries signed the Convention on Mutual Administrative Assistance in Tax Matter (hereinafter referred to as "the Convention"), which entered into force on 1 April 1995, when the requirement of the ratifications of a minimum of five countries was met.[581] The object of the Convention was to promote international cooperation for a better operation of national tax laws.[582] Although a broad discussion of this instrument if out of the scope of the present work, it is worth highlighting some of its important features, as well as pointing out that it is a multilateral instrument dealing with exchange of information in tax matters.

[579] Paragraph 38 of the 2001 Progress Report. This limitation was previously provided in the first version of the Model TIEA. See X. Oberson, *The OECD Model Agreement on Exchange of Information – A Shift to the Applicant State*, Bulletin for International Taxation, 1/2003, 14-17.

[580] Paragraph 38 of the 2001 Progress Report.

[581] The Parties to the Convention are presently Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Sweden, the Ukraine, the United Kingdom and the United States. Canada, Germany and Spain have signed the Convention and are awaiting ratification.

[582] Comments on the relationship between the Convention and European Community law, as well as on its interpretation in accordance with the Vienna Convention on the Law of the Treaties can be found at M.A. Grau Ruiz, *Convention on mutual administrative assistance in tax matters and Community rules: how to improve their interaction?*, EC Tax Review, 4/2006, 196-202.

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The scope of the Convention is much broader than that of Article 26 of the OECD Model and of TIEAs, as it covers a wide range of forms of cooperation, such as exchange of information, simultaneous tax examinations and participations in tax examinations abroad, as well as assistance in recovery and service of documents. It applies to taxes on income or profits, taxes on capital gains, and taxes on net wealth, social security contributions, estate taxes, inheritance or gift taxes, taxes on immovable property, general consumption taxes, excise taxes, taxes on the use or ownership of motor vehicles, and any other taxes imposed on behalf of a contracting State.

Exchange of information can take the three typical forms dealt with in the OECD Commentary on Article 26, i.e. on request, automatic and spontaneous. The Contracting States can, in fact, exchange information that is foreseeably relevant to the assessment and collection of tax, the recovery and enforcement of tax claims, and the prosecution before an administrative authority or the initiation of a prosecution before a judicial body.

A Protocol amending the Convention[583] should abolish the provision currently contained in Article 19, according to which the requested State shall not be obliged to accede to a request if the applicant State has not pursued all means available in its own territory, except where recourse to such means would give rise to disproportionate difficulty. Such an amendment is due to the agreement recently reached on the internationally agree standard to exchange of information in tax matters.[584]

Similarly, the protection of persons and limits to the obligation to provide assistance in the current version should be amended in a way more analogous to limits to exchange of information contained in Article 7 of the TIEA. Consequently, according to the Convention, cooperation will not take place whether the request of information would impose upon the requested State an obligation to: (i) carry out measures at variance with its own laws or administrative practice or the laws or administrative practice of the applicant State or measures contrary to public policy; (ii) supply information which is not obtainable under its own laws or its administrative practice or under the laws of the applicant State or its administrative practice, or which would disclose any trade, business, industrial, commercial or professional secret, or trade process, or information, the disclosure of which would be contrary to public policy; (iii) provide administrative assistance if and insofar as it considers the taxation in the applicant State to be contrary to generally accepted taxation principles or to the provisions of a convention for the avoidance of double taxation, or of any other convention which the requested State has concluded with the applicant State; (iv) provide administrative assistance for the purpose of administering or enforcing a

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[583] The Protocol was opened for signature on the occasion of the OECD's annual Ministerial Meeting in Paris on 27-28 May 2010. Currently it is available in a Provisional Edition.

[584] See in this sense the Preamble of the Protocol.

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provision of the tax law of the applicant State, or any requirement connected therewith, which discriminates against a national of the requested State as compared with a national of the applicant State in the same circumstances; (v) provide administrative assistance if the applicant State has not pursued all reasonable measures available under its laws or administrative practice, except where recourse to such measures would give rise to disproportionate difficulty; (vi) provide assistance in recovery in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the applicant State.

The requested State is also obligated to use its information gathering measures to obtain the requested information, even though the requested State may not need such information for its own tax purposes. Banking secrecy does not constitute a valid reason to decline a request of information.

Information obtained must be treated as secret and protected in the same manner as information obtained under the domestic law of the requesting State and can be disclosed in any case only to persons or authorities (including courts and administrative or supervisory bodies) concerned with the assessment, collection or recovery of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes of that requesting State.

As above mentioned, this Convention can be appreciated for being a multilateral instrument facing a matter which by definition would require a very broad cooperation by more than two States. International tax evasion and tax avoidance can involve a large number of countries, and a multilateral instrument offers small countries greater protection from possible unilateral actions by rich large countries during negotiations. It also avoids the enormous spreading of an infinite number of bilateral treaties, which may grant different levels of taxpayers' protection or different degrees of tax authorities' intervention.

6. The Mutual Assistance Directive

Exchange of information has been a matter of interest also at the European Union level, which has experienced this form of cooperation on the grounds of some principles developed by the OECD and consolidated in the Model Convention,[585] particularly in respect of the different types of exchange of information (i.e. upon request, automatic and spontaneous).

Although already in 1962 the Neumark Report recommended the creation of a Community service to provide information for tax controls purposes, the first EU document dealing with exchange of information for tax avoidance and tax evasion are the Council Resolution of 10 February 1975.[586] Such Resolution emphasised the

[585] M.A. Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims*, London, 2003, 125.

[586] Resolution of the Council of the 10 of February 1975, concerning measures to be adopted to tackle international tax fraud and evasion. Official Journal C 35/1 of 14 February 1975.

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need to deepen and broaden cooperation between national administrations in tax matters and provided an original bulk of concrete initiatives in the field of mutual assistance between Member Countries. The main tool to ensure an effective cooperation was exchange of information, aimed at correctly calculating tax liabilities as well as at tackling cases of tax fraud taking place on a cross-border basis.

In order to fulfil these objectives, the following acts were subsequently adopted:

- Council Directive no. 76/308/EC of 15 March 1976 on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the EU agricultural and guarantee fund and of agricultural levies and customs duties;[587]
- Council Directive no. 77/799/EEC of 19 December 1977 concerning Mutual Assistance in the field of Direct Taxation, subsequently extended also to Value Added Tax (with Directive no. 79/107/EC of 6 December 1979 and to excise duties with Directive no. 92/12/EC of the 25 February 1992).[588] These amendments have resulted in a final version, Directive no. 2004/56/EC of 21 April 2004[589] concerning Mutual Assistance between Tax Administrations in the field of Direct Taxation and of some excise duties and insurance premiums, in force since 29 April 2004.
- Council Regulation no. 218/92/EC of 27 January 1992 concerning administrative assistance in the field of Value Added Tax, in force since 1 January 1 2004.[590]
- Council Directive no. 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments. [591]
- EU Commission's Communications no. 28 and 29 of 2 February 2009 containing two Proposals for Council Directives concerning respectively (*i*) mutual assistance for the recovery of claims relating to taxes, duties and other measures and (*ii*) administrative cooperation in the field of taxation.[592]

The pillar of the whole European system of mutual assistance in direct tax matters is undoubtedly Directive no. 77/799/EEC (hereinafter referred to as "the Mutual Assistance Directive"), as amended by Directive 2004/56/EC, which establishes a common framework for exchange of information aimed at enabling EU Member

[587] Official Journal L 73, of 19 March 1976, 18-23.

[588] Official Journal L 336, 27 December 1977, 15-20.

[589] Council Directive 2004/56/EC, amending Directive 77/799/EEC, Official Journal L 127, 29 April 2004, 70-72.

[590] Official Journal L 24, 1 February 1992, 1-5.

[591] Official Journal L 157, 26 June 2003, 38-48.

[592] COM(2009) 28 final, and COM(2009) 29 final.

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States to carry out correct assessments of taxes on income and on capital, evoking the same structure as Article 26 of the OECD Model. The direct result of the cooperation and of information exchange is a substantial legal equalisation of pieces of evidences. Administrative acts coming from the competent authority of the requested State are enforceable as they were issued by local authority of the requesting State. The Mutual Assistance Directive is applicable to direct taxation and taxation of insurance premiums, but not to VAT and excise duties which are respectively dealt with in Council Regulation No. 1798/2003 of 7 October 2003 and in Council Regulation No. 2073/2004 of 16 November 2004.[593]

Articles 2, 3 and 4 of the Mutual Assistance Directive envisage the three forms of information exchange already illustrated and contained in the commentary on Article 26 of the OECD Model Convention, i.e. on request, automatic and spontaneous. It must be remarked that differently from Article 26 of the OECD Model, under the Mutual Assistance Directive exchange of information upon request may not take place if it appears that the requesting State has not previously exhausted its own usual sources of information. In addition, in order to obtain the information sought, the requested authority or the administrative authority to which it has recourse shall proceed as though acting on its own account or at the request of another authority in its own Member State.

Spontaneous exchange of information is particularly used whether: (i) the Competent Authority of a Member State has grounds for supposing that there may be a loss of tax in the other Member State; (ii) a person liable to tax obtains a reduction in or an exemption from tax in the one Member State which would give rise to an increase in tax or to liability to tax in the other Member State; (iii) business dealings between a person liable to tax in a Member State and a person liable to tax in another Member State are conducted through one or more countries in such a way that a saving in tax may result in one or the other Member State or in both; (iv) the competent authority of a Member State has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises; and (v) information forwarded to the one Member State by the competent authority of the other Member State has enabled information to be obtained which may be relevant in assessing liability to tax in the latter Member State. The competent authorities may extend such exchange of information to cases other than those above specified.

As far as the limit for forwarding information is concerned, Article 5 of the Mutual Assistance Directive establishes that the competent authority of the requested

[593] Official Journal L 264, 15 October 2003, 1-11 and Official Journal L 359, 4 December 2004, 1-10 respectively. From 1979 until 1992, VAT was part of the scope of Directive 77/799/EEC. Excise duties were also part of the scope of that Directive from 1992 to 2004. However, due to the conclusions of the high-level Council Working Party on fraud in May 2000 report, which identified the incapacity of this Directive to fulfil its objectives, the Commission presented two separated draft Regulations aiming at creating an entirely new environment for administrative cooperation for VAT and excise duties, which were subsequently adopted as indicated above. VAT and excise duties were therefore withdrawn from the scope of Directive 77/799/EEC.

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Member State shall forward it as swiftly as possible and that if it encounters obstacles in furnishing the information or if it refuses to furnish the information, it shall forthwith inform the requesting authority to this effect, indicating the nature of the obstacles or the reasons for its refusal. In addition, and differently from Article 26 of the OECD Model Convention, the Mutual Assistance Directive provides for the possibility for the competent authorities to agree a closer form of cooperation, consisting in the authorisation of the presence in one Member State of officials of the tax administration of another Member State. Paragraph 4 of Article 7 establishes that where a competent authority of a Member State considers that information which it has received from the competent authority of another Member State is likely to be useful to the competent authority of a third Member State, it may transmit it to the latter competent authority with the agreement of the competent authority which supplied the information. Such a provision on third States is inserted in Article 7, which deals with secrecy. In this respect it is worth highlighting that like Article 26, the Mutual Assistance Directive establishes an obligation to keep information received secret in the same manner as information received under its domestic legislation. In any case, such information may be made available only to the persons directly involved in the assessment of the tax or in the administrative control of this assessment, in connection with judicial proceedings or administrative proceedings involving sanctions and cannot be used for purposes other than taxation.

Limits to exchange of information are addressed in Article 8 of the Mutual Assistance Directive, which establishes that the Mutual Assistance Directive does not impose any obligation upon a requested Member State to carry out inquiries or to communicate information, if it would be contrary to its legislation or administrative practices. The provision of information may be refused where it would lead to the disclosure of a commercial, industrial or professional secret or of a commercial process, or of information whose disclosure would be contrary to public policy. According to the principle of reciprocity, the requested State may decline transmission of information when the Member State requesting it is unable, for reasons of fact or law, to provide the same type of information.

An interesting provision that is worth mentioning and which is not contained in Article 26 of the OECD Model is Article 10 of the Mutual Assistance Directive, regarding pooling of experience. Under this latter Article, in fact, Member States shall, together with the Commission, constantly monitor the cooperation procedure provided for in the Mutual Assistance Directive and shall pool their experience, especially in the field of transfer pricing within groups of enterprises, with a view to improving such cooperation and, where appropriate, drawing up a body of rules in the fields concerned.

The wording of the Mutual Assistance Directive does not specify whether exchange of information should regard only residents or also non-residents. The quite broad formulation of Article 1 regarding the scope of the Directive seems that exchange of information can regard both categories of taxpayers. Member States' domestic

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legislations of implementation of the Directive seem to have been orientated in this sense.

With a view to simplifying the existing legislation and administrative procedures for both public authorities and private parties, on 2 February 2009 the EU Commission issued two Proposals for Council Directives concerning respectively (*i*) mutual assistance for the recovery of claims relating to taxes, duties and other measures and (*ii*) administrative cooperation in the field of taxation.[594] More particularly, the two Directives, whether adopted by the Council, should repeal existing legislation in this matter and should provide public authorities with common tools and instruments in a predefined organisational framework, in order to simplify recourse to international administrative cooperation. The aim is to create a legal instrument of high quality for enhancing the smooth functioning of the internal market and circumventing the negative effects of harmful tax practices.

As a detailed exam of the single provisions contained in the two Proposals is out of the scope of the present work, only the main innovative features will be pointed out as follows. Both Proposals broaden the scope of the existing forms of assistance within the EU, by covering all taxes of any kind, irrespective of the manner in which they are levied, the non-payment of any kind of tax or duty, compulsory social security contributions. Only indirect taxes remain out of the scope of the Proposals, being already covered by Community legislation on administrative cooperation between Member States.[595]

Exchange of information can be on request, automatic and spontaneous and it should be possible for tax officials to be present in administrative offices and to participate actively in administrative enquiries in another Member State or to have simultaneous controls. A new provision is that on administrative notification, according to which the competent authority of the requested Member State, under its own domestic law, should notify the addressee of any instruments and decisions which emanate from the administrative authorities of the requesting State.

With a view to strengthening the Member States' obligation to share their experience, the competent authorities should send each other feedback on exchange of information and, together with the Commission, Member States should monitor administrative cooperation to share their experience and improving such cooperation. Disproportionate administrative burden and exhaustiveness principles provide grounds for refusal to cooperate, but neither tax purposes nor domestic interest can constitute bases for refusal to provide cooperation. Similarly to paragraph 5 of Article 26 of the OECD Model Convention, exchange of information cannot be denied solely because the information sought is held by banks and other financial institutions.

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[594] COM(2009) 28 final, and COM(2009) 29 final.

[595] Regulation 1798/2003 of 7 October 2003 for VAT and Regulation 2073/2004 of 16 November 2004 for excise duties.

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A very innovative provision is the introduction of the most favoured nation principle, according to which a Member State has to provide cooperation to other Member State under the same conditions as to a third country. Furthermore, common forms and computerised formats will be preferred to others for the exchange of information.

As far as relations with third countries is concerned, and bearing in mind the recent fraud cases where an EU Member State and a third country were involved, a compulsory sharing of information from outside the EU is provided for, in so far as not excluded by international agreements with the third country at hand.

It is worth briefly mentioning another initiative at the European level which is commonly known under the name of Fiscalis 2013. Among its objectives preeminent role is played by that of enhancing the fight against tax fraud, as well as by that of ensuring the exchange of information between national tax administrations and with traders through projects such as trans-European tax IT systems. The project was established under Decision No. 1482/2007/EC of the European Parliament and of the Council of 11 December 2007 and it aims at improving the operation of taxation systems in the internal market. This programme is not new, dating the first one back to 1998, and consists of a five-year period project aimed at improving the functioning of tax systems in the internal market by strengthening cooperation between participating countries, their administrations and any other bodies. The participating countries are Member States, but the programme is also open to candidate countries benefiting from a pre-accession strategy, potential candidate countries and partner countries. Its scope regards both direct and indirect taxes.

Under the supervision of the European Commission, participating countries will establish communication and information-exchange systems, drawing manuals and guides in this respect and establishing common software and network connection to ensure that systems are compatible. The Commission and the Member States will organise exchanges of officials for periods of no longer than six months, seminars and, on a pilot basis, bilateral and multilateral control exercises within the Community legal framework for cooperation.

7. The EU Savings Directive

The most effective EU instrument aimed at information exchange is the so called EU Savings Directive.[596] This Directive, effective as of 1 July 2005, is one part of the major tax reform package launched by the Commission in 1997.[597] With a view to

[596] Council Directive 2003/48/EC cited above.

[597] The very first proposal by the Commission dates back to 10 February 1989 (COM(89) 60 final, Official Journal C 141, 7 June 1989, 5) and was replaced by a new one in May 1998 (COM(1998) 295 final, Official Journal C 212, 8 July 1998, 13) which was part of the Monti Package, already discussed in Chapter 4. This latter proposal was based on the principle of “coexistence”, under which Member States would be free either to implement a withholding tax on interest paid to residents of other Member States or to provide information on savings income to these States. However, neither of the

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introducing a form of coordination in direct tax matters within the European Union, the Directive has settled a common automatic exchange of information regime, which applies across the European Union in respect of interest income paid by paying agents established in one Member State to beneficial owners established in another Member States and which involves the mentioned paying agents and domestic tax authorities. Such an automatic and compulsory exchange of information system aims at curbing harmful tax competition and tax evasion, which typically takes place in cross-border interest.[598]

The ultimate aim of the Directive, enshrined in Article 1, is "to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the national laws of the latter Member States". In other words, the Directive has a twofold goal: (1) effective taxation, and (2) taxation in the State of residence. However, owing to their strict bank secrecy traditions, Austria, Belgium and Luxembourg were allowed to replace the automatic exchange of information system with the application of a withholding tax for a transitional period. Income so collected must be shared with the State of residence of the beneficial owner.

In order to prevent capital outflows towards more attractive jurisdictions outside the EU, the full implementation of the EU Savings Directive required the involvement of third countries, which were called to bind themselves under international treaties to introduce measures equivalent to those contained in the Directive.

The EU Savings Directive represents an unprecedented form of coordination at European level in respect to direct tax matters. Coordination of taxation of savings income eliminates the risk that resident individuals avoid taxation in their Member State of residence, but no form of coordinated taxation within the Community is provided for.

This paragraph will provide a brief summary of the mechanism of the Directive. Detailed rules and its implication for non-EU countries have been dealt with in many

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two proposals encountered the unanimous consent of the Council. A new proposal was submitted to the Council in July 20001 (COM (2001) 400 final, 18 July 2001, Official Journal C 270E, 25 September 2001, 259-265) and was finally approved.

[598] It must be pointed out that interest income is normally taxed in the State of residence of the taxpayer. Interest arising in another jurisdiction is often subject to a limited withholding tax, which can be relieved through a tax credit granted by the State of residence. Whereas business enterprises are normally obliged to keep accounts and therefore report interest received from both domestic and cross-border sources, among individuals tax evasion related to cross-border interest payments is much more common. Due to divergent tax rates within the European Union and to the liberalisation of capital movements, individual investors started putting their savings in countries with no or low tax on interest for non-resident taxpayers or in countries with a strong bank secrecy, in order to escape tax in their home States. These are the main reasons inducing the European Commission to propose a system based on automatic exchange of information between Member States to curb tax evasion on cross-border interest payments.

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articles and will not be repeated here.[599] The provisions of the Directive apply in the case of savings income in the form of interest paid within the Community by a paying agent established in one Member State to an individual beneficial owner established in another Member State. Automatic exchange of information allows the State of residence of the beneficial owner to be informed about the payment and tax income received accordingly. The exchange of information is between tax authorities and is based on the information reported by paying agents to tax authorities of their State of residence, where the interest normally has source.

One of the key concepts introduced by the Directive is that of beneficial owner, which is actually not new in international tax law.[600] It is worth recalling that the notion of beneficial owner contained in Articles 10, 11, 12 and 17(2) of double tax treaties based on the OECD Model has a clear anti-tax avoidance purpose,[601] as it aims at preventing the use of conduit companies with a view of benefiting from the most advantageous conventional tax regime. Without providing an exhaustive definition, according to the OECD Commentary, such concept aims at denying conventional tax benefits to those persons receiving income acting in the capacity of agent or nominee. Differently from the OECD Model, the Directive provides a "positive" definition of beneficial owner, establishing at Article 2 that it means any individual who receives an interest payment or any individual for whom an interest payment is secured, unless he provides evidence that it was not received or secured for his own benefit. A recipient of the interest payment is not considered as the beneficial owner, when such a recipient is: (i) a paying agent; (ii) a legal person; (iii) an entity that is subject to business taxation; (iv) a collective investment fund as defined in the UCITS Directive (85/611/EEC); (v) an individual acting on behalf of a "paying agent on receipt"[602] as defined in Article 4, paragraph 2 of the Directive whose name and address are disclosed to the economic operator marking the interest payment and to the tax authorities of the source State; or (vi) an individual who acts on behalf of

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[599] F. Vanistendael, *The interest-savings directive: European hide and seek*, in H. van Arendonk, F. Engelen, S. Jansen (Eds), *A Tax Globalist: Essays in honour of Maarten J. Ellis*, Amsterdam, 2005, 326; X. Oberson, *Agreement between Switzerland and the European Union on the Taxation of Savings – A Balanced "Compromis Helvétique"*, Bulletin for International Fiscal Documentation, 3/2005, 108-115; S. Bell, *EU Directive on taxation of savings income*, Derivatives and Financial Instruments, 5/2003, 201-211; S. Bell, *Updated proposal for a Council Directive on the taxation of savings income*, British Tax Review, 1/2002, 32-41; S. Mohamed, *A Critical assessment of the proposed directive on taxation of cross-border savings income*, EC Tax Journal, 1/2002, 45-68.

[600] See J.D.B. Oliver, J.B. Libin, S. van Weeghel, C. Du Toit, *Beneficial Ownership*, Bulletin for International Fiscal Documentation, 7/2000, 310-325; A.P. Dourado, *The EC draft directive on interest from savings from a perspective of International Tax Law*, EC Tax Review, 9/2000, 144-152.

[601] This is primarily an anti-abuse or anti-treaty shopping measure aimed at preventing individuals or legal persons resident in a State other than the Contracting States from taking advantage of the Convention, by using another person or a company.

[602] On the problems raised by the definition of "paying agent upon receipt", which involves only entities, not individuals, see F. Vanistendael, *The European Interest Savings Directive – An Appraisal and Proposals for Reform*, Bulletin for International Taxation, 4/2009, 152-162.

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another individual who is the beneficial owner and discloses the beneficial owner's identity to the economic operator.

Where a paying agent has information suggesting that the individual who receives an interest payment or for whom an interest payment is secured may not be the beneficial owner, it shall take reasonable steps to establish the identity of the beneficial owner. If the paying agent is unable to identify the beneficial owner, it shall treat the individual in question as the beneficial owner and collect information accordingly.

Article 4 of the Directive defines as "paying agent" any economic operator who pays interest to or secures the payment of interest for the immediate benefit of the beneficial owner, whether the operator is the debtor of the debt claim which produces the interest or the operator charged by the debtor or the beneficial owner with paying interest or securing the payment of interest. A paying agent can be any individual or a legal entity that pays interest within its profession or business[603] and it is the subject in charge of the disclosure obligations established in the Directive. The paying agent can therefore be (i) the debtor, if this directly pays interest to the beneficial owner, or (ii) the intermediary in charge of paying interest on behalf of the debtor for the benefit of the beneficial owner.

Accordingly, the Directive applies in the following cases: (i) the paying agent (who is also the debtor) resides in one Member State and the beneficial owner resides in another Member States; (ii) both the debtor and the paying agent reside in the same Member State, which is however different from that in which the beneficial owner resides; (iii) both the debtor and the beneficial owner reside in the same Member State (domestic interest payment), but the paying agent is established in another Member State; (iv) the debtor resides in a non-EU country, but the beneficial owner and the paying agent reside in two different Member States.

As far as interest payment is concerned, Article 6 of the Directive distinguishes the relevant income into the four following groups: (i) interest paid or credited to an account, relating to debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payments shall not be regarded as interest payments; (ii) interest accrued or capitalised at the sale, refund or redemption of the debt claims referred to in (i); (iii) income deriving from interest payments either directly or through an entity referred to in Article 4(2), distributed by: an UCITS authorised in accordance with Directive 85/611/EEC, entities which qualify for the option under Article 4(3),

[603] See article 4, paragraph 1 of the Commentary on the Directive. The fact that the paying agent must act within its profession or business may also be inferred from the expression "any economic operator", which has been preferred to "any person", certainly more vague and likely to cover a much broader range of paying agents, including those which make payments of interest outside of their profession or business.

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undertakings for collective investment established outside the territory referred to in Article 7; (iv) income realised upon the sale, refund or redemption of shares or units in the following undertakings and entities, if they invest directly or indirectly, via other undertakings for collective investment or entities referred to below, more than 40 % of their assets in debt claims as referred to in (i): an UCITS authorised in accordance with Directive 85/611/EEC, entities which qualify for the option under Article 4(3), undertakings for collective investment established outside the territory referred to in Article 7.

Automatic exchange of information is the instrument by which the Directive ultimate objective of monitoring can be achieved, i.e. to obtain an effective taxation in the State of the beneficial owner. It works on two levels: (i) information that the paying agent must collect on the identity and the residence of the beneficial owner, as well as on the amount paid; (ii) information that the competent authority of the State of the paying agent shall exchange to the Member of the beneficial owner.

As far as the first level is concerned (i.e. information that the paying agent must collect on the identity and the residence of the beneficial owner, as well as on the amount paid), according to Article 8 any paying agent should collect: (i) the identity and residence of the beneficial owner; (ii) the name and address of the paying agent; (iii) the account number of the beneficial owner or, where there is none, identification of the debt claim giving rise to the interest; (iv) information concerning the interest payment.

As far as the second level is concerned (i.e. information that the competent authority of the State of the paying agent shall exchange to the Member of the beneficial owner), Article 9 provides for a system of automatic exchange that takes place at least once a year, within six months following the end of the fiscal year of the Member State of the paying agent for all interest payments made during the year.

Paragraph 3 of Article 9 of the Directive refers to the provisions of Directive 77/799/EEC, provided that these are not expressly waived. It is worth stressing, however, that differently from Directive 77/799/EEC the exchange of information under the EU Savings Directive is not based on reciprocity, because this would risk undermining the goals of the Savings Directive itself. For a transitional period, Austria, Belgium and Luxembourg are allowed to replace exchange of information with the application of a withholding tax levied by paying agents established within their territories.[604] They are allowed to keep for themselves the 25% of the revenue so collected and should transfer the remaining 75% to the State of residence of the beneficial owner.

The withholding tax does not prevent the State of residence of the beneficial owner from taxing interest according to its domestic legislation, provided that a double taxation relief is granted. Article 13 of the Directive, however, permits derogation from

[604] The withholding tax was first set at 15%, increased to 20% on 1 July 2008 and to 35% on 1 July 2011.

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the mentioned procedure: beneficial owners may require the paying agent not to levy the withholding tax but to exchange information with their home State tax authority.

8. Application problems of the EU Savings Directive

The EU Savings Directive can be appreciated for the introduction of a compulsory system of automatic exchange of information which is more effective than a one upon request. Such a system necessarily involves not only a form of cooperation between competent authorities of the different Member States concerned, but also private sector, i.e. intermediaries intervening in the payment chain and falling within the definition of paying agent, as above illustrated. In addition, from a strict theoretical perspective, the EU Savings Directive has indirectly introduced a quite new principle in international taxation according to which each Member State is somehow responsible for the correct enforcement of the tax law of another Member State, by automatically providing the latter with information.[605]

Moreover, the EU Savings Directive provides an opportunity for Member States to adopt a new perspective on the abolition of double taxation. In fact, if the State of residence has all the necessary information to tax its residents even with reference to foreign savings income, it could be clearly established that only States of residence shall tax this type of income.

Political discussions, the literature and practical experiences have highlighted different problems in the application of the EU Savings Directive,[606] such as its limited subjective and objective scope, which is easily exposed to tax avoidance by individuals through the use of intermediary structures. As a result, on 15 September 2008, under the provisions contained in Article 18 of the EU Savings Directive, the Commission released a Report on the application of the EU Savings Directive addressed to the Council[607] and on 13 November 2008 it issued a Proposal for amending the Directive itself.[608] The Report identifies all the major problems related to the application of the Directive and the amendment proposed aim at closing existing loopholes and better preventing tax evasion. A comprehensive discussion of all of them is out of the scope of the present work. However, it is worth highlighting the major issues, which can be grouped in the following categories:

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[605] In this sense F. Vanistendael, *Guidelines for Answers to the Questionnaire and Special Reports on the Interest Savings Directive*, in *EATLP Annual Conference Materials*, Budapest, 2006, 1.

[606] For a comprehensive discussion about these problems, see more broadly F. Vanistendael, *The European Interest Savings Directive – An Appraisal and Proposals for Reform*, Bulletin for International Taxation, 4/2009, 152-162.

[607] COM (2008)552 final, Council Document 13124/08 FISC 117.

[608] COM(2008) 727 final, Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments.

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1. The use of intermediary structures not covered by the present scope of the EU Savings Directive, notably some legal arrangements which cannot be legally classified as entities, such as partnerships, associations and trusts, gave rise to abuse and to uncertainties as to the application of the "paying agent upon receipt" rule;
2. Collective investment funds falling within the scope of the UCIT Directive 85/611/EEC and those not included by this latter gave problems of different treatment;
3. The development of the financial markets has created new structured products and life insurance contracts which fall out of the scope of the EU Savings Directive, even if they have a flow of income, a risk and a liquidity almost identical to debt claims;
4. Rules established for the determination of the beneficial owner's residence for tax purposes are quite weak;
5. The use of conduit vehicles established in third countries to avoid the disclosure obligations should be eliminated in a way consistent with the free movement of capital.

The most important proposed amendment refers to the definition of savings income, which should be broadened in order to include not only interest payments according to its original definition, but also other substantially equivalent income from some innovative financial products and from certain life insurance products, as well as interest payments obtained by some entities and legal arrangements for the ultimate benefit of individual beneficial owners.

In order to discourage the interposition of legal entities or other arrangements aimed at circumventing the application of the EU Savings Directive, the Commission proposes to use a "look-through" approach. Paying agents subject to the anti-money laundering obligations would be asked to use the information collected under these obligations to identify the actual beneficial owner(s) of a payment and fulfil the disclosure obligations set forth by the EU Savings Directive accordingly. A list annexed to the EU Savings Directive would be inserted in order to facilitate paying agents' tasks and will include the categories of entities and legal arrangements resident in non-EU jurisdictions which are used to escape taxation of income.

The Commission proposes three different wordings to refine the definition of residence of the beneficial owner.[609] The first proposed wording aims at ensuring regular updating of the information on the permanent address of the beneficial owner and it requires paying agents to refer to the "best information available to them at a payment date", even under anti-money laundering obligations. The second proposed wording intends to replace the "permanent address" approach that is currently used to establish the residence of the beneficial owner with a new approach based on an

[609] Paragraph 2.1., page 4, regarding Article 3 of the Directive.

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official proof of tax residence that the paying agent must be provided with by the beneficial owner (i.e. a valid tax residence certificate issued within the last three years). The third proposed wording provides that when the paying agent has official documentation proving that the residence for tax purposes of the beneficial owner is in a Member State different from the one of the permanent address because of diplomatic privileges or other international rules, the residence for the purpose of the Directive shall be the tax residence according to that official documentation.

Due to the uncertainties regarding the interpretation of the concept of "paying agent upon receipt" and to the massive use by beneficial owners of untaxed intermediate structures to escape the disclosure obligations, the Commission proposes the adoption of a "positive" definition based on substantive elements. This should include all entities and legal arrangements, such as certain kinds of trusts and partnerships, investment funds, pension funds and assets relating to life insurance contracts, entities and arrangements set up exclusively for charitable purposes, and cases of shared beneficial ownership, irrespective of whether this operator is established inside or outside the EU. Those entities and legal arrangements to whose assets or income no beneficial owner is immediately entitled at the moment of receipt of the payment will be obliged to act as "paying agent upon receipt", unless they opt for being treated as an investment fund.

The scope of the EU Savings Directive would be also amended in order to cover interest and substantially equivalent income deriving from securities that can be regarded as equivalent to debt claims. With reference to investment funds, the reference to the UCITS Directive should be replaced with a reference to the registration of the undertaking or investment fund or scheme in accordance with the domestic rules of any of the Member States. This would apply the same rules to UCITS and non-UCITS, irrespective of their legal form. Moreover, the definition of "undertakings for collective investment established outside the territory", which currently refers to all investment funds irrespective of the regulation applicable and of how they are marketed to investors should be refined according to the existing OECD definition of "collective investment fund or scheme", in order to ensure that interest income channelled through these vehicles is treated appropriately.

A number of proposed amendments regard the quality of the information reported. First, the paying agents would be requested to provide not only the identity and residence of all the beneficial owners concerned, but also details on whether the amount reported for each beneficial owner is the full amount, the actual share due to the beneficial owner, or an equal share. This would allow solving current uncertainties concerning the treatment of income from joint accounts and other cases of shared beneficial ownership. Second, the paying agent and the reporting Member State should distinguish between amounts referring to the interest component of a payment and those referring to the full proceeds from a sale, redemption or refund of a security.

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Finally, as far as the withholding tax is concerned, the Commission proposes to abolish the option granted to beneficial owners to avoid the application of the said withholding tax through the submission of a tax certificate and to only leave the voluntary disclosure system. The procedure based on the tax certificate is, in fact, less practical, raises extra burden upon the tax administration of the State of the paying agent and risks infringing the free movement of capital, as it makes it difficult for an EU citizen who is tax resident outside the EU to avoid a withholding tax for which he cannot obtain a credit or reimbursement.

9. The EU Commission's Communication on "good governance in tax matters"

In 2009 when the OECD decided to start a peer review process aimed at verifying the application of the OECD standard on information exchange and transparency, the European Commission issued a Communication dealing with the introduction of good governance in tax matters.[610] Such Communication was then adopted by resolution of the European Parliament.[611] The European Commission encourages transparency and exchange of information not only for the EU member States and potential candidates, but also for third countries that require EU development aid or countries that conclude agreements with the EU or with EU member States. Protection of the financial system from uncooperative jurisdictions and tax havens requires actions to achieve international good governance in the tax area, i.e. the principles of transparency, exchange of information, and fair tax competition. Promoting good governance in tax matters, in fact, not only can address problems related to tax fraud and tax evasion, but also those related to money laundering, corruption and terrorism.

The goals of the Communication are to consider the tools to improve and promote good governance within and outside the EU and to increase coordinated actions by EU member States in order to reinforce the efforts aimed at promoting transparency and exchange of information. The European Commission acknowledges the OECD's efforts on harmful tax competition, as well as the importance of the standard on transparency and information exchange, and proposes a series of actions. In brief, the European Commission calls on the Council to adopt as soon as possible the Commission proposals in this respect. In particular, the Commission presented a proposal to replace the current Mutual Assistance Directive,[612] which, as previously mentioned, aims at reinforcing EU action at the international level against tax fraud

[610] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *Promoting Good Governance in Tax Matters*", COM(2009) 201 final, Brussels, 28 April 2009.

[611] European Parliament Resolution, 10 February 2010, on Promoting Good Governance in Tax Matters, P7 TA 2010 (0020).

[612] COM(2009) 29 final, 2 February 2009.

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and evasion through the introduction of a most favoured national clause and a prohibition upon Member States from invoking bank secrecy for non-resident taxpayers.

The Commission presented also a proposal to replace the existing Directive on recovery tax claims,[613] with a view to increasing the efficiency of assistance between tax administration, and one to amend the Savings Directive, which has been already examined.[614] The Commission, moreover, proposes the application of the Code of Conduct for Business Taxation to all member States and their dependent and associated territories, to strengthen cooperation and relationship with the European Economic Area (Iceland, Liechtenstein and Norway) and with Switzerland, and to include principles of good governance as one of the areas to be address at an early stage of the pre-accession process for EU candidates and potential candidates countries.

At the international level, the Commission intends to promote good governance in the tax area through actions aimed at third countries, and urges action by the Council and dialogue with third countries to accelerate the process of implementing commitments to greater transparency and exchange of information, and to tackle distortive practices unduly detrimental to EU Member States' budgets and businesses.

The EU Parliament, adopting the Commission's Communication, condemned the role played by tax havens in encouraging and profiteering from tax avoidance, tax evasion, and capital flight, and urged member States to fight against tax havens, tax evasion, and illicit capital flight. Regarding good governance, the lack of which encourages tax fraud and tax evasion, the EU Parliament shares the opinion that it is a key element in rebuilding the world economy. In order to achieve it, the Institution proposes that instead of bank secrecy, automatic exchange of information must take place and this is to be extended to cover taxes of any kind. The EU Parliament suggests to adopt the proposed amendment to the Savings Directive (thus ending the temporary derogations granted to Austria, Belgium and Luxembourg and extending the scope to cover private companies, trusts, and other forms of investment income), to accelerate the conclusion of the antifraud agreement with Liechtenstein, and the negotiation of similar agreements with Andorra, Monaco, San Marino and Switzerland. The Parliament, furthermore, recommends the increase of cooperation, the introduction of automatic exchange of information, as well as the implementation of the Code of Conduct for Business Taxation in relations with third countries. Regarding third countries, the Parliament considers that EU aid funds for development should be made conditional on the compliance of such country with good governance standards, welcomes the work in the area of good governance

[613] COM(2009) 28 final, 2 February 2009.

[614] COM(2008) 727 final, 13 November 2008. See paragraph 8 above.

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from the G-20, G-8, the UN and the OECD, and introduces the possibility to establish coercive measures to promote good tax governance.

In spite of the lack of any binding effects, both the Commission's Communication and the Parliament Resolution denote the firm political intention of EU Institution to address the issue of tax havens and tax base erosion through exchange of information and transparency.

10. Qualified Intermediary and FATCA regulations in the US.

Among the various initiatives undertaken by individual States the most remarkable are those implemented by the US, initially in 1999 with the so called "Qualified Intermediary" regulation, and subsequently in 2010 with the "Foreign Account Tax Compliance Act" ("FATCA"). An in-depth analysis of all the domestic initiatives undertaken by single States is out of the scope of the present work. The example of the US is however provided, because it is considered as one of the most relevant.

The Qualified Intermediaries ("QI") Regulations are basically grounded on the application of a withholding tax, whether the identity of the beneficial owner cannot be disclosed. Differently from the system introduced by the EU Savings Directive, the QI Regulations are based on an agreement entered into by financial intermediaries and the Internal Revenue Service (IRS), i.e. US tax administration.[615] The first initiative of implementation of such a system dates back to 1996 and the whole QI regime can be considered as a creation of the Clinton Administration.[616] The Regulation was finalised in 1999 and it represents something quite unique. According to the QI Regulation, dividends, interest payments and royalties (unless some specific exceptions apply, such as bank deposit interest), short term obligations and portfolio debt are subject to a 31% withholding tax. Such withholding tax is reduced to 0% for non-US residents with reference to US bank deposit interest and portfolio interest or up to the amount established in the applicable Convention on US dividends and other interests, whether documentation concerning the actual beneficial owner of the income in question is provided. For US residents, a 0% tax rate on all income payments and sale proceeds is applied.

A QI is a non-US financial institutions or a foreign branch of any US financial institutions that, having entered into such an agreement with the IRS, is allowed not

[615] Due to the difficulties to meet the favour of US treaty partners' governments and to the impossibilities to impose legal obligations on foreign subjects, the IRS thought of introducing an agreement featuring a contractual nature. This instrument does not mean extraterritorial enforcement of domestic tax law, but rather the exercise of domestic power extraterritorially. Rather than having a sole counterpart, the objectives could be reached by way of signing an agreement with all financial institutions incorporated under the laws of another State without previously consulting with the latter State. In this respect, see R. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, The Hague, 1999, 98.

[616] S.C. Ruchelman, S. Shapiro, *Exchange of Information*, *Intertax*, 11/2002, 411.

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to levy such a withholding tax and to provide information on the beneficial owner. The advantages of the QI system can be summarised as follows: bank secrecy does not need to be waived, as confidential information concerning clients does not need to be disclosed; reduced withholding taxes deriving from double tax treaties can also be applied and even more easily and correctly; in the case of primary withholding responsibility, namely when the QI should directly apply the withholding tax to the prescribed income, no disclosure is necessary, as the withholding tax is levied directly by the QI. On the contrary, where not assuming such a primary withholding responsibility, the QI has to transfer the withholding payer the information necessary to apply the correct withholding tax rate. Such system makes sure that the US tax regime on classes of income such as dividends and interests is applied with reference to US persons living abroad, it ensures that all US persons are correctly identified for tax purposes wherever they may be, and non-resident aliens benefit for a correct application of withholding tax rates established in the double tax conventions.

The players in a QI agreement basically consist of either US investors or non-US investors dealing with US sourced income (e.g. US securities), foreign financial intermediaries that have signed an agreement with the IRS, and, in the majority of cases a US bank acting as a custodian on behalf of the foreign bank and the IRS. For the purpose of these regulations, “intermediary” can be any custodian, broker or nominee who holds investments on the account of other purposes and is not the beneficial owner. A foreign intermediary can enter into an agreement with the IRS and therefore opt for being a QI only whether its State of residence has concluded a double tax treaty with the US or whether its home State enforces adequate anti-money laundering rules. These latter need to be first scrutinised and approved by the IRS.[617]

The most original feature of the whole QI system is the contractual nature of the agreement entered by the IRS and the financial intermediary. Each agreement, which is valid for a six-year period and renewable, establishes some advantages for the intermediary signing it and some penalties in the case of non-compliance. Accordingly, the intermediary signing the agreement (i.e. the QI) is bound to identify all the taxable forms of income deriving from US securities, collect the documentation it is asked for and disclose it. The Agreement normally provides for the participation of subjects other than the investor, the QI and the IRS, such as the withholding agent in the form of the US Custodian and auditor in charge of monitoring on a periodical basis that the QI carries out correctly what it is required to do, according to the type of responsibility assumed.

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[617] This approach has impacted those small banking States not being part of the US Treaty Network. For instance, Monaco financial intermediaries have the chance to become Q.I. because the anti-money laundering provisions of the *Principauté* have been judged sufficient by the IRS, while the same did not happen with Liechtenstein.

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As far as the information disclosure is concerned, any QI has to satisfy the requirement of the so called "know your client" documentation. This includes an affirmative statement and the required documental proof, such as a passport, a national identity card, a residence permit, a driving licence with a photograph or a licence to carry weapons. Documentation has to be provided either in its original for or in an authenticated copy.

QI Regulations have proven to be useful instruments to properly balance interests of preserving tax base from evasion with bank secrecy. Owing to the QI system, the US has become one of the first countries in the world to set their sight on taxpayers' assets deposited abroad, in order for these to be disclosed and consequently subject to tax. However, the QI rules do have a limited objective scope, covering only certain financial assets held directly by US persons. Past experience has shown that the QI regime still leaves room to abuse and interposing foreign companies is one of the example through which US taxpayers avoided the reporting obligation.[618] As a result, on 18 March 2010 US President Obama enacted the "Foreign Account Tax Compliance Act" (hereinafter referred to as "FATCA"), i.e. a set of rules similar to the QI regime (which does not replace this latter), but which significantly extends and intensifies the requirements imposed on financial institutions. FATCA should be effective as of 1 January 2013. FATCA is meant to address perceived abuses of US tax law via the use of foreign accounts, investments and structures,[619] to establish a more transparent international financial world through magnified due diligence, reporting and record-keeping requirements,[620] as well as to increase US tax revenues via a broadened tax base and enhanced penalties. FATCA "invites" foreign financial institutions (such banks, brokers, investment companies and fund structures) to enter into an agreement of a contractual nature with the IRS, under which the institutions agree to identify US customers and report their assets.

In order to induce (or force) foreign financial institutions to cooperate, it is provided that withholding agents are required to deduct a 30% tax from any withholdable payment to a foreign financial institution which is considered as non-cooperative institutions. A withholdable payment is any payment of any compensation or passive income from sources in the US other than effectively connected to US trade or

[618] The notorious UBS case also demonstrated the weakness of the Q.I. regime wherein the ultimate US beneficiary account holders hid financial assets behind trust and corporate structures without apparent responsibility of the foreign entities to report. It is worth noting that rather than improving the existing Q.I. regime, US preferred to add a new regulation, whose objective is to impede the evasion of US income tax through the use of offshore accounts and entities.

[619] FATCA has been described as "the most controversial piece of U.S. tax legislation to have been introduced because it imposes new registration and U.S. withholding tax requirements on all financial institutions worldwide". D. Treitel, *The Americans are leaving America*, Taxation, 1 July 2010, issue 4261, 14-15.

[620] D. Hart, G. Dean, V. Tzotchev, *Through the looking glass: The new FATCA reporting and compliance obligations are anything but illusion*, Tax Planning International Review, 8/2010, 4.

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business and proceeds sale of assets capable of producing interest or dividends from US sources.

The definition of foreign financial institutions is very broad and includes any entity that accepts deposits such as traditional banks, entities that hold financial assets for the account of other, or are “engaged (or hold themselves out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or any derivative financial products such as futures, forward contract or option in such securities, partnership internship, or commodities”.[621]

Foreign financial institutions signing this agreement (and thus becoming “cooperative”) undertake to identify all accounts held directly or indirectly by a US person. Differently from the QI regime, which is generally limited to direct account holders (i.e. both individuals and legal entities), FATCA applies to US persons who directly or indirectly control more than 10% of a foreign company or complex structures like foundations or trusts. Then they undertake to prove that they have no US customers, should the withholding tax not apply on the financial intermediary (burden of proof reversed) and obtain a waiver from each account holder, so that the required data on the customer can be reported to the IRS.

When a waiver is obtained, then an account holder’s banking secrecy is lifted for the US tax authority and the exchange of information is approved. Where the holder of an account declines to reveal the identity of the recipient or to certify that it does not have a substantial US owner (a “recalcitrant account”), the foreign financial institution should deduct and withhold the 30% tax on any payment to recalcitrant account or to elect to have the 30% tax withheld upon such accounts by the withholding agent. If the customer refuses the waiver request, the foreign financial institution will close the corresponding account or will refrain from entering into business relationship with this customer.[622]

The identification of customers is probably the most complex task foreign financial institutions are called for. In fact the definition of US persons that fall within the scope of FATCA includes not only US citizens and persons residing in the US, but also green card holders or persons who have stayed in the US for several consecutive days during the past three years, thus meeting the “substantial presence test”.

FATCA does not apply to US persons who hold less than a total of USD 50,000 in a foreign financial institution or in its affiliated companies. However, in such cases, it is questionable as to whether a foreign financial institution is at all capable of accessing the required information on its affiliates without breaching the applicable local laws.

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[621] US Internal Revenue Code, s 1471(d)(5). This latter group of foreign financial institutions catches an extremely large number of small to medium size registered investment advisers, hedge funds, private equity funds, family offices, etc.

[622] It is still doubtful what happens in the case that local law does not allow a bank to unilaterally terminate its business relationship with a customer.

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The information on US accounts to be reported by the foreign financial institution to IRS includes: name of the account holder or the US persons with holdings in companies and trusts; address, taxpayer identification number and (in the case of indirect relationships) those of intermediary companies; account and custody numbers; account balance and custody holdings; gross receipts and gross withdrawals according to the definition yet to be provided by the treasury; further information as requested by the IRS (follow-up requests). The reporting should occur on an annual basis and generally in electronic form, requiring major adjustments to the internal systems of banks and financial services providers. It is an automatic exchange of information, which differ from that of the OECD because it does not involve two competent authorities of two different Contracting States, but one tax administration and financial institutions.

The 30% withholding tax applies to interest, dividends and sales returns paid to uncooperative institutions and customers from US source. It remains unclear whether FATCA also applies to certain insurance products (e.g. insurance wrappers). The withholding tax is deducted from payments to foreign financial intermediaries who do not enter into a contract with the IRS and to recalcitrant account holders who do not sign a waiver.

The withholding tax is not applied as a final one and thus does not primarily serve as a new source of income. Its purpose is rather that of providing a strong incentive for financial institutions to enter into the agreement with the IRS, in such a way that all assets of US persons held worldwide will be reported to IRS. Differently from the EU Savings Directive system, the withholding tax deduction does not represent an alternative to compliance with the disclosure obligations. As above underlined, if a customer does not adhere to the new information regulations, the business relationship with that customer is to be terminated.

Instead of deducting the withholding tax for uncooperative institutions or account holders not signing the waiver, foreign financial institution can decide that an upstream foreign financial institution shall deduct the withholding tax. In this alternative case, the upstream custodian requires all information on account holders and the corresponding payments (“pass-through payments”), so that the withholding tax can be deducted in advance.

If a financial intermediary is part of a group of companies that includes at least one other foreign financial intermediary which has signed the agreement with the IRS, it is obliged too to adhere to the requirements of FATCA. However, this financial intermediary is free to enter into its agreement with the IRS. Such a contract would bind the financial intermediary to implement the requirements of FATCA and to adhere to the corresponding provisions. In principle, membership of an expanded affiliated group is assumed if at least 50% of a company is controlled directly or indirectly. In order to enable adherence to these requirements, the flow of information between the various companies in a group must be expanded considerably and the processes must be harmonised.

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It is worth underlining that FATCA represents a powerful instrument to curb international tax evasion which does not involve competent authorities from other countries, but rather financial institutions. The withholding tax serves an important function of incentive to compliance and reporting and is not conceived as an instrument to collect tax revenue. It is clear that FATCA, once effective, will have considerable effects on the financial sectors and introduces a new model of exchange of information which departs from that developed at the international level, but involves different players. It must also be noted that although FATCA is an improvement of existing legislation against international tax evasion, it seems that this exchange of information will be unilateral. In fact, while the IRS will receive relevant information about its citizens, the US is not obliged to exchange information with tax authorities of other countries about foreigners investing in the US.

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CHAPTER 6

CONCLUSIONS

This Chapter draws the conclusions of the analysis developed in the present work. It first critically discusses about the reputational use of the term “tax havens” in the OECD’s campaign and highlights the existence of some very favourable tax regimes in some high-tax countries which are never been included in any black list (paragraph 1). Then, the attention is focused on the concept of tax competition proposed by the OECD (paragraph 2) and it is pointed out that there are some theoretical contradictions in the OECD stance: whereas modern economic theories favour free competition as opposed to monopoly, high-tax countries intend to limit tax competition for reducing their tax base erosion. Probably due to this implicit asymmetry, the international community and the OECD have shifted their attention from “tax havens” to “uncooperative jurisdictions”. A subsequent discussion leads to the conclusions that non-governmental institutions, such as the OECD, may not be the proper institutions, endowed with the proper legal binding instruments, to develop an international regime for dealing with harmful tax practices.

In this Chapter the attention is also focused on whether the uncooperative attitude of targeted jurisdictions and their refusal to exchange information can be regarded as a form of internationally wrongful act (paragraph 3). Such an issue is addressed in the light of the Project of Articles on the Responsibility of States for internationally wrongful act and the analysis draws the conclusion that there is no international obligation imposing a cooperative attitude upon sovereign States. Finally, an exam of the role of exchange of information in the harmful tax competition project is developed (paragraph 5). It is noted in this respect that exchange of information is in fact currently regarded as the most effective instrument to curb international tax evasion and international tax avoidance, but automatic exchange of information is more effective and should be therefore preferred to exchange upon request.

1. The reputational use of the term “tax havens”: a few remarks

The present analysis has shown that the expression “tax havens” (which is often interchangeably replaced with “offshore jurisdictions”, “secrecy jurisdictions” or “uncooperative jurisdictions” and similar ones) is not endowed with any unequivocal technical legal meaning shared at the international level. These terms are used with a view to exerting political pressure on targeted jurisdictions that erode other

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countries' tax bases, and thus these definitions imply a significant cost of reputation for the targeted jurisdictions.

Over the last decade and especially in the last two years, the use of the terms "tax haven" has been replaced thanks to the work of the OECD, which has increasingly focused on exchange of information. Secrecy and confidentiality are currently perceived as the main obstacles to the proper application of domestic tax legislation and high-tax countries claim information from what they now call "uncooperative jurisdictions".

The very reason why the term "tax haven" has a quite ambiguous meaning is the fact that such a term is manipulated according to the political goals and biases that the users of the expression intend to pursuit. In this respect, it is interesting to note that certain well-reputed high-tax countries provide for some favourable tax regimes, aimed at clearly attracting foreign investors.[623] Although these regimes do appear to meet the requirement of the "ring-fencing regime", which according to the OECD is harmful, these jurisdictions have never been labelled as "tax havens" nor has ever their reputation been harmed with black lists. This lack of attention towards these tax regimes confirms that black lists may be politically biased. This is evidence of the biased usage of the term "tax haven". The most notable example of low tax regimes embedded within the system are, among the other, Ireland, the Netherlands, the US, the UK, New Zealand, and Canada, and a brief review of these will follow here.

Between the late 1990s and the early 2000s, Ireland experienced high growth rates, largely dependent on the success of Irish government in attracting foreign direct investment through a very favourable corporate tax regime.

Ireland is an island located on the periphery of Europe, not well endowed with natural resources and up to 1960s largely dependent on agriculture and fishing. After the efforts in late 1960s and 1970s to attract manufacturing industry, in the 1980s Ireland concentrated on the development and the attraction of high-value industries, mainly software and pharmaceuticals.[624] A very favourable corporate tax rate and an extensive network of double tax treaties undoubtedly represented the strength points of its success.

[623] The same view is shared by a number of authors in literature. For instance, M.J. Langer, *Harmful Tax Competition: Who Are the Real Tax Havens?*, Tax Notes International, 25/2000, 2832 argues: "Many of the countries attacked by the OECD as tax havens probably are tax havens by any reasonable definition. But so are many non-member countries of the OECD that have not been attacked by the OECD because it was not politically prudent for the OECD to do so. Moreover, most OECD countries are themselves tax havens". In this sense see also R. Bisvas, *International Tax Competition: globalisation and fiscal sovereignty*, London, 2002, 27. See also J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress, 9 July 2009, which identifies as tax havens the United States (with particular attention to three States: Delaware, Nevada, and Wyoming), the United Kingdom, the Netherlands, Denmark, Hungary, Iceland, Israel, Portugal, and Canada.

[624] S. Killian, *Where's the harm in tax competition? Lessons from US multinationals in Ireland*, Critical Perspectives on Accounting, 17/2006, 1074.

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Ireland's original strategy consisted in refraining completely from taxing foreign investment, to the extent that the goods produced locally were exported rather than sold domestically. This export sales relief came to an end in April 1990, but was immediately followed by a wide application of manufacturing relief, under which manufacturing profits were subject to a 10% tax. Manufacturing is not defined in Irish tax legislation, so that any irreversible process leading to a commercially different product resulted to benefit from this favourable tax regime. The 10% rate also applied to companies operating in a tax free zone around Shannon airport, and to financial services companies in a Financial Services Centre in Dublin, both schemes requiring licensing from the government.

Starting from 2000, these favourable tax regimes were subject to renewal, owing to their inclusion in the 2000 OECD Report, which Ireland contributed to draft. In order to avoid being labelled as a tax haven, with clear impacts on flows of investment attracted, the Irish strategy consisted in increasing to 12.5% the tax rate on manufacturing firms and on firms located in the Shannon Free Zone and the Financial Services Centre in Dublin. In order to also satisfy the European Union, this corporate tax rate was then extended to trading income generated within the State by all firms, both manufacturing and not. Based on the previous strategy, which consisted in offering an attractive tax regime to foreign multinational, Ireland ended up offering a 12.5% tax to all indigenous industry. In other words, the same low corporate tax rate is provided for all local and multinational companies, therefore avoiding falling within the ring-fencing test cited in the OECD's project.

As a result, without being included in any international black list,[625] Ireland has become one of the most profitable locations for multinational firms, as it attracted the establishment of companies, such as Coca Cola, Google, Microsoft, Apple, Pfeizer, and Hewlett Packard.

The main tax advantages provided by Irish corporate tax law consists of: no withholding tax on dividend,[626] interest and royalties payments; exemption from capital gain tax on gains arising from the disposal of shares held by an Irish company;[627] and relief for the capital cost of acquiring intellectual property.[628]

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[625] See M.A. Sullivan, *U.S. Multinationals Move More Profits to Tax Havens*, Tax Notes International, 7/2004, 589-593 who reports Ireland to be the most profitable global location for US firms and incidentally describes the country as a tax haven.

[626] Ireland levies a 20% withholding tax on dividends paid by Irish resident companies. However an exemption from this withholding tax is granted where: (*i*) dividends are paid to companies entitled to the benefit of the EU Parent-Subsidiary Directive; (*ii*) dividends are paid to companies resident in a treaty country or another EU Member State, and that are not under the control of Irish residents; (*iii*) dividends are paid to companies in any jurisdiction and ultimately controlled by residents of tax treaty countries or other EU member States; (*iv*) dividends are paid to certain quoted companies; (*v*) dividends are paid to individuals who are residents of a treaty country or another EU Member State.

[627] Such an exemption is subject to the following requirements: (*i*) the Irish holding company has held at least 5% of the shares in the subsidiary for a continuous period of 12 months in the previous 24 months; and (*ii*) the subsidiary company is tax resident in the EU or in a country with which a double

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Another country which is often considered a tax haven, but which was never included in the OECD's black lists is the Netherlands, in particular due to its corporate tax law.[629] The Netherlands is a very attractive jurisdiction for those investors seeking to maximise their after-tax return of investment, mainly owing to the following factors: the participation exemption regime, which exempts from Dutch corporate tax almost all dividends and capital gains from subsidiaries established abroad; a very wide tax treaty network, which substantially reduces to zero almost all withholding taxes on dividend, interest and royalty payments; and the advance tax ruling system, which gives certainty to multinationals about how the income of their Dutch subsidiaries will be subject to tax.[630] In addition, the Netherlands allows firms to reduce taxes on dividends and capital gains from subsidiaries and has a wide range of treaties that reduce taxes.

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tax treaty is in force with Ireland at the time of the disposal; and (*iii*) the subsidiary itself carries on a trade or is part of a trading group.

[628] Capital expenditure incurred on or after 7 May 2009 on certain intangible assets used for the purposes of a trade will be available for offset against a company's taxable income. Capital allowances (or tax depreciation) are given on qualifying expenditure so as to reduce a company's profits that are liable to corporation tax. In certain cases this may reduce the company's tax rate to 2.5% of its profits. The type of expenditure that qualifies for the relief is quite broad and includes capital expenditure on patents, trademarks, licences, copyrights, brands, industrial know-how, and goodwill directly attributable to any of these intangible assets. The tax relief will be the same as the amount of depreciation or amortisation on the intangible asset charged to the profit and loss account of the company. However the company may decide to claim the relief over 14 years at 7% per annum and 2% in year 15. The use or exploitation of the intangible asset is deemed to be a separate trade of the company, and certain restrictions apply to the amount of the relief that may be claimed against income of that separate trade. The total relief that may be claimed is 80% of the trading income arising from the relevant intangible asset. Thus 20% of the income will always be taxable, however where the company pays tax at the standard rate of corporation tax, an effective rate of 2.5% on the total income of the trade results. Excess relief may be carried forward for use against future income from the separate trade. The relief applies to capital expenditure on intangible assets acquired from group companies, but this is capped at an arm's length price. The relief does not apply unless the expenditure was incurred wholly and exclusively for bona fide commercial reasons, and was not incurred as part of tax avoidance arrangements. It must be pointed out that according to the Jurisdiction Report prepared during the "Mapping the Faultlines Project" of the Tax Justice Network and available at http://www.secrecyjurisdictions.com/PDF/Ireland.pdf, Ireland does not put details of trusts on public record, does not require that beneficial ownership of companies is recorded on public record, does not maintain company ownership details in official records, does not have adequate access to banking information and allows company redomiciliation.

[629] In this sense, see, for example, J. G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress, 9 July 2009.

[630] Owing to the pressure exerted by both the OECD and the EU, the Netherlands had to revise the tax ruling system in 2001 and eliminate its harmful characteristics.

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All this factors have rendered the Netherlands one of the most preferred location of "mailbox companies" and "paper headquarters", which do not have any substantial commercial presence.[631]

Similarly, the US has been broadly defined as an "offshore banking tax haven",[632] because of the very attractive tax regime it provides to non-US investors. Not only the US exempts interest on bank deposits of non-resident aliens, but it also provides a very favourable regime for carrying out business activity on non-US markets. By correctly structuring and managing certain business vehicles in some specific States, non-US investors can in fact minimise their overall tax burden on their international investments.

Limited liability companies (LLCs) formed in Georgia, Delaware and New York are the typical structures allowing maximisation of after-tax profits. In fact, although LLCs are normally treated similarly for both State and federal taxes, these three States provide for a very favourable tax regime. By maintaining its registered office and registered agents within the State in question, the only document kept in the records is the certificate of incorporation. There is no obligation to declare the identity of beneficial owners, nor is any federal tax levied whether certain requirements are met.

Certain LLCs can benefit from a federal taxes exemption if they are treated as a "disregarded" entity or sole proprietorship.[633] Tax filing requirements are governed by the classification of a LLC. All the three States do not provide for requirements for an annual audit, unless mandated by the LLC members, or obligations to hold an annual meeting, unless it is stipulated in the agreement.

The United States policy in the matter of exchange of information is quite aggressive: the QI Program set up in 2001 and the most recent FATCA regulations, for example, have revealed the US government's firm intention to collect tax owed by US citizens.

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[631] M. van Dijk, F. Weyzig, R. Murphy, *The Netherlands: a Tax Haven?*, SOMO, November 2006, 5, available at http://somo.nl/html/paginas/pdf/netherlands_tax_haven_2006_NL.pdf, found that out of the 42,072 financial holding companies registered in the Netherlands for which information on the (ultimate) parent was available, 5,830 are managed by trust companies. Of these mailbox companies, 43% have a parent in a tax haven jurisdiction such as the Netherlands Antilles, Switzerland, Cyprus, the British Virgin Islands or the Cayman Islands. Hence there is a clear link to tax havens for conduit structures. It must be pointed out that according to the Jurisdiction Report prepared during the "Mapping the Faultlines Project" of the Tax Justice Network available at available at http://www.secrecyjurisdictions.com/PDF/Netherlands.pdf, the Netherlands does not put details of trust on public record, does not require that company accounts be available on public record, does not require that beneficial ownership of companies is recorded on public record, does not maintain company ownership details in official records, and does not have adequate access to banking information

[632] C.E. McLure, *US Tax Laws and Capital Flight from Latin America*, Inter-American Law Review, 20/1989, 321-357.

[633] In the case of Georgia, the rules include that the LLC has: (i) no members from either Georgia or the US; (ii) not engaged in business in the State or the US; (iii) no permanent establishment there; (iv) no income from the State or the US.

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As it has been highlighted in Chapter 5, both programs required foreign financial institutions to disclose the US authorities the identity of US persons with funds invested in the US, but the other way round was not provided for.[634] The US, however, chose to avail itself of an agreement with foreign financial institutions rather than of an international treaty, as this allows the US government to receive information about US persons with foreign financial accounts, but not to be bound to disclose information on foreigners to their home countries' administration in return.[635] The US provides bank secrecy to foreign persons making passive investment in the US and thus can be qualified as a classical "uncooperative jurisdiction's" behaviour, to use one of the OECD's expressions. However, the US has never been included in any black list.

The US, by establishing an obligation of disclosure upon financial institutions, is in a position to obtain relevant information regarding US citizens, but it is not required to collect information regarding foreign investors to exchange under international agreements with foreign jurisdictions.[636]

Another jurisdiction that has a strong tradition of attracting international business is the UK.[637] Thanks to one of the most extensive treaty network in the world and to the

[634] According to the blog of the Tax Justice Network: "The U.S. wants to ferret out U.S. tax cheats. Yet the U.S. does not want to pass on information about foreign tax cheats to their home governments: if it did, then foreign tax evaders would take their money out of the U.S. and put it in another jurisdiction that would keep their information secret; among other things, this transparency would exacerbate U.S. balance of payments deficits. This is how secrecy jurisdictions work". See http://taxjustice.blogspot.com/2010/05/fatca-new-automatic-info-exchange-tool.html.

[635] In this respect D. Spencer, *Atmosphere is changing for exchange of information*, International Tax Review, 5/2010, 42 points out: "The U.S. provides de facto and de jure bank secrecy in tax matters for foreign persons making financial investments in the U.S., thereby facilitating the country to be an international financial centre. […] The QI programme limits – intentionally – the ability of the U.S. government to exchange tax information with foreign governments".

[636] According to the Jurisdiction Report prepared during the "Mapping the Faultlines Project" of the Tax Justice Network available at http://www.secrecyjurisdictions.com/PDF/USA_Delaware.pdf, the US (Delaware) provides banking secrecy, does not put details of trusts on public record, does not require that company accounts be available on public record, does not require beneficial ownership of companies be recorded on public records, does not have adequate access to banking information, allows company redomiciliation, and allows protected cell companies.

[637] According to S. Picciotto, *Offshore: The State as Legal Fiction*, in M.P. Hampton, J.P. Abbott (Eds.), *Offshore Finance Centres and Tax Havens: the Rise of Global Capital*, Basingstoke, 1999, 58, London was especially attractive since the Bank of England, keen to boost the balance of payments and encourage the rebirth of the City as a global financial centre, applied its informal but strict monetary controls differentially as between the clearing banks and secondary banks. The City of London was established as the leading "onshore" financial centre, and it benefited further from exploiting the facilities of the related "offshore" centres. The features which made them tax havens were also convenient for a broader role as financial centres, and could be further developed. The commercial secrecy provided by company and trust laws could be enhanced by bank secrecy, which was already substantial in English common law as "received" in British dependencies, but could be augmented by statute and by prescribing criminal penalties for disclosure of confidential information. See also on this topic M.K. Lewis, *International Banking and Offshore Finance: London and the Major*

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progressive reduction of tax rates over the past decades, the UK provides foreign investors wishing to establish business in its jurisdiction with a very favourable tax environment, whose main features are the following: no withholding tax on dividends, irrespective of where the shareholder is resident; tax exemption on qualifying foreign dividends; capital gains exemption where a UK resident company sells shares, if certain conditions apply; a standard tax rate of 28%, which can be cut to 21%, again if certain conditions are met; double tax relief for foreign tax paid on dividends; tax depreciation available for purchased intangible assets, including goodwill and trademarks; reduction or elimination of withholding tax on interest and royalties paid to residents in tax treaty countries, under certain conditions.

The UK legislation offers a special business vehicle for professional or international trading partnerships, which is extremely effective for planning international trading arrangements where the members are not UK residents. The Limited Liability Partnership (LLP) is, in fact, a flexible partnership vehicle, which offers separate legal status, limited liability protection for its members and provides for an extremely attractive onshore, zero tax structure. If the LLP carries a trade or profession, it is treated as transparent for tax purposes (i.e. each member will be assessed on their share of any income or gains of the LLP). The LLP is not subject to UK tax where the members are non-resident of the UK and the income of the LLP is from a non-UK source.

Each LLP is required to file an annual Partnership Tax Return with the UK Revenue showing each member's share of the profits or losses, irrespective of whether or not the partners are subject to UK taxation on them. This document is not accessible to the public. By contrast, the LLP is required to keep records of their financial transactions to enable the financial position of the LLP to be determined at any time, as well as an Annual Return to be submitted to Companies House. These documents are available for public inspection.[638]

Another country that offers a number of important tax planning opportunities is New Zealand. Although New Zealand adopts the worldwide taxation principle and a 30% corporate income tax, it is possible to eliminate taxation exposure by creating and properly managing structures involving a locally-registered company, in conjunction with a New Zealand trust. New Zealand trusts have in fact become one of the most preferred tools to implement tax minimisation strategies, mainly because of the non-

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Centres in M.P. Hampton, J.P. Abbott (Eds.), *Offshore Finance Centres and Tax Havens: the Rise of Global Capital*, Basingstoke, 1999, 80-116; M. Blanden, *Foreign Banks in London*, The Banker, 11/1995, 37-42; M. Collins, *Money and Banking in the UK – A History*, London, 1988.

[638] According to the Jurisdiction Report prepared during the "Mapping the Faultlines Project" of the Tax Justice Network available at http://www.secrecyjurisdictions.com/PDF/UnitedKingdom_CityLondon.pdf, the UK (City of London) does not put details of trust on public record, does not require that beneficial ownership of companies is recorded on public record, does not maintain company ownership details in official records, and does not have adequate access to banking information.

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inclusion of such jurisdiction in the OECD's black lists, which normally means that the application of domestic anti-tax haven legislation does not trigger. A New Zealand trust is not subject to any tax if the settlor is non-resident and income is originated from non-New Zealand sources.

As far as reporting requirements are concerned, domestic legislation provides that companies' financial statements must be filed only if more than 25% of the shares are held by non-nationals. Consequently, foreign investors can easily appoint a New Zealand (fiduciary) shareholder to escape such obligation.

In May 2008 a new partnership vehicle was introduced, i.e. the Limited Partnership (LP). It offers separate legal personality, limited liability protection for the limited partner(s), zero tax where its activities do not generate any income of New Zealand source, and, above all, strict confidentiality over the limited partner's identity and details. LPs are often used by passive investors, whose liability is restricted to the equity invested only provided that they do not engage in any management functions. Although the identity of the limited partner(s) must be disclosed to the New Zealand Company House for registration purposes, this information is secret and is not open to public inspection. Similarly, any partnership agreement is confidential and the LP is not required to file annual accounts. Domestic tax legislation only provides for an obligation to fill an annual tax return of the LP, a record of financial transactions and a joint tax return of the partners (irrespective of whether or not they are liable to New Zealand tax). Such documentation is however not accessible for public inspection.

Like the previously mentioned jurisdictions, Canada applies the worldwide income taxation principle, i.e. resident companies are subject to tax on income wherever produced. However, it is possible to significantly reduce taxation exposure by creating and properly managing a structure that involves the use of a locally-registered company, in conjunction with an overseas principal. Thanks to a specific business vehicle, a total exemption from Canadian tax can arise where income is derived from non-Canadian sources and no activities in connection with the trading or overseas asset(s) held have taken place in Canada. Such vehicle is the British Columbia Limited Liability Partnership (LLP) which provides a separate legal personality, partnership tax treatment and limited liability.

An LLP can be formed by two or more individuals or corporate entities, to carry on a business activity, and its registered office must be situated in the State of British Columbia. Whether a LLP carries on a trade or profession, it is transparent for tax purposes, i.e. partners are assessed on their share of any income or gains generated by the LLP. Where the partners of the LLP are non-resident of Canada and the income of the LLP is derived from non-Canadian source, the LLP is not subject to Canadian taxation at all. An LLP is required to keep records of financial transactions in sufficient detail. However, accounts are not required to be publicly filed or disclosed unless it is a public issuer subject to securities legislation.

In addition, Canadian law distinguishes between legal and beneficial ownership, which means that a Canadian company can hold legal title to assets and conduct

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certain trading activities, while beneficial ownership of the assets or trading income belongs to someone else.

A Canadian company can enter into a private nominee agreement with an overseas Principal, which must be managed and controlled outside of Canada and which would be the beneficial owner of non-Canadian asset(s) or non-Canadian source trading income. According to the nominee agreement, a Canadian company can hold the assets or perform the trading activity on behalf of the beneficial owner, as a bare nominee, in return for an agreed fee ("nominee fee"). From a third party perspective, the Canadian company will appear as the Principal in all dealings associated with these activities. The Canadian company will not perform active asset management or conduct trading or other activities in Canada, in order to ensure that the Principal Company itself is not found to be carrying on business in Canada, via the Canadian company nominee. Provided that the nominee agreement establishes a true nominee arrangement, then the overseas Principal would be treated for Canadian tax purposes as the beneficial owner of assets held and income generated by the Canadian company.

Since Canada taxes on the basis of beneficial ownership, and not legal ownership, a Canadian company would not be liable to taxation regarding its legal ownership of the assets or trading income. The only tax that would be levied is on the nominee fee which it receives from the Principal, which must abide by the arm's length principle.

When used in an asset holding capacity, any gains realised by a Canadian company on disposal of the assets would not give rise to a Canadian capital gains tax charge as it is only holding legal title. As is common in such arrangements, the value of asset(s) held or income received as nominee will not appear in the Canadian company accounts. Although the financial statements of the Canadian company must be filed with the Canadian Revenue Agency in support of the Company's corporation tax return, these are not open to public inspection. Such a favourable tax regime makes Canadian company in a nominee capacity an extremely suitable vehicle for both asset holding and trading activities.

2. A critical analysis of the concept of tax competition as promoted by the OECD

The present paragraph intends to develop a critical analysis of the concept of tax competition promoted by the OECD as opposed to that of free competition, as opposed to monopoly, favoured by other economic theories. Probably owing to some asymmetries of the two concepts, the international community and the OECD have shifted their attention from "tax havens" to "uncooperative jurisdictions". A subsequent discussion developed here leads to the conclusions that the OECD is not the proper institution, endowed with the proper legal binding instruments to develop an international regime for dealing with harmful tax practices.

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The present work has highlighted that the tax haven problem has always been dealt with in terms of tax competition. The mobility of capital reached in the modern economies raised the inevitable consequence that sovereign countries lowered their tax rates on income earned by foreigners within their borders in order to attract portfolio and direct investment with a view to stimulating domestic growth. Tax competition exists when governments feel pressure to lower tax rates, because they are concerned that jobs and investment may cross borders and offer a more attractive environment to make them stay at home. As a result, they compete with each other to offer taxpayers the most favourable investment opportunities.

As highlighted in Chapter 3, the different economic theories that have been developed on the effects of tax competition show that tax competition is approached mainly from the high-tax countries' perspective. Tax competition is generally defined as "harmful" because it constitutes a serious threat to the government's expected level of taxation. Chapters 4 and 5 showed that the OECD has basically assumed the perspective of the governments of high-tax countries and it has been playing a key role in (and has gained much of its authority from) the tax competition campaign. The OECD basic view is that tax competition brought forth by "tax havens" (first period 1998-2001) or "uncooperative jurisdictions" (second period 2002-2011) is harmful and as a result must be curbed through coordinated measures. The 1998 Report and the 2000 Progress Report however fail to adequately define harmful tax competition or to distinguish it from beneficial tax competition. Such acknowledgment appears in the 2001 Progress Report, where in paragraph 1 the OECD states: "The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterised tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces which have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs". Jeffrey Owens, head of OECD Fiscal Affairs, has on several occasions emphasised that the OECD recognises that there are also benefits to be derived from tax competition and is only opposed to certain types of tax competition.[639]

The analysis conducted here (and specifically in Chapter 5) leads to the hard fact that in the OECD's view nil or low tax rate of one country means damage for another country, provided that some other indicators exist. It can be thus reasonably concluded that the OECD views as "harmful" those forms of tax competition that the OECD and its member countries consider to be harmful to them. This is clearly a circular definition (i.e. it is harmful what is perceived as such), and it is used according to the interest of high-tax countries represented at the OECD level.

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[639] J. Owens, *Curbing harmful tax practices*, OECD Observer, January 1999, 13 and *Jeffrey Owens Discusses Details of the OECD Harmful Tax Practices Report*, Tax Notes International, 10 July 2000, 94.

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However, in more general economic terms, one has to bear in mind that competition is not necessarily harmful.[640] Prominent economists have defined tax competition as "a liberalising force in the world economy, something that should be celebrated rather than persecuted. It forces governments to be more fiscally responsible lest they drive economic activity to lower-tax environments".[641] Modern economic theory shows that monopoly is bad, and competition is good. Consumers benefit when all producers compete for their business, likewise taxpayers benefit when governments compete for taxes. Like monopolists, high-tax countries have no interest in competing to be efficient and claim a general reduction of welfare as a result of tax havens. Desai, Foley and Hines have shown that tax havens do not in all cases divert economic activity and they even stimulate investment and high-tax countries.[642]

It must be pointed out that in this respect the 1998 Report stated that "there are no particular reasons why any two countries should have the same level of structure of taxation",[643] and that "it is not intended to explicitly or implicitly suggest that there is some general minimum effective rate of tax to be imposed on income below which a country would be considered to be engaging in harmful tax competition".[644] Similarly, the Executive Summary of the 2000 Progress Report repeated that "it is important to note at the outset that the project is not primarily about collecting taxes and is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates". The 2001 Progress Report emphasised that "the OECD project does not seek to dictate to any country what its tax rate should be, or how its tax system should be structured".[645] In other words, the OECD formally made it clear that there is no intention to dispel tax competition at large and to harmonise taxes or impose minimum tax rates.[646]

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[640] As pointed out by R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, 2008, 132, "Limiting (tax) competition means introducing serious market failures (cartels), so presumably there must exist strong reasons for doing so".

[641] This definition is by prof. Milton Friedman, quoted by B. Zagaris, *Increasing Cooperation of International Tax Enforcement and Anti-Money-Laundering Enforcement*, Tax Notes International, 7/2003, 649.

[642] See Chapter 3 in this respect and M.A. Desai, C.F. Foley, J.R. Hines, *Do tax havens divert economic activity?*, Economic Letters, 90/2006, 219.

[643] Paragraph 26 of the 1998 Report.

[644] Paragraph 41 of the 1998 Report.

[645] Paragraph 3 of the 2001 Progress Report. The same words are repeated in paragraph 1 of the 2004 Progress Report.

[646] J. Owens, *Curbing harmful tax practices*, OECD Observer, January 1999, 13 affirmed: "The OECD's position on preferential taxes is unambiguous. The existence of low or no income taxes is not in itself enough to constitute harmful tax competition (…). Accordingly, harmonising tax rates across countries or installing minimum tax levels is not the aim".

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The point is that governments, on the one hand, welcome globalisation and, on the other hand, claim that tax competition leads to a fiscal crisis. They resent being forced to lower tax rates, claiming that tax competition results in less social insurance to their citizens, increased income inequality, job insecurity, and income volatility. The result is that countermeasures enacted at the international level and urged by the OECD aim at preventing the flow of jobs and capital from high-tax countries to low-tax ones. It is therefore clear that enacting anti-tax haven measures and discouraging resident taxpayers to invest where higher returns of investment can be achieved may indirectly constitute a restriction to international flows of capital, which threats economic freedom. Thus, restricting tax competition can easily have consequences contrary to the reported OECD's intended view not to constraint tax competition. As one of the critics to the OECD has pointed out, if tax competition leads to reduced taxes, then the natural result of restricting tax competition or persecuting taxpayers' privacy would be higher taxation.[647]

This contradiction between defence of the free market and restriction on tax competition has probably led the international community and the OECD to shift the paradigm from "tax havens" to "uncooperative jurisdictions". In this new paradigm, cooperation is held to be the remedy to harmful tax competition, as it allows high-tax countries to reduce tax avoidance and evasion phenomena. In the new OECD view, tax havens should therefore stop favouring investors' tax minimisation strategies and they should rather support high-tax countries, by providing these latter with the information they need.

Exchange of information has thus become the current main goal of the whole OECD's project, but it shows a kind of asymmetrical bias. The OECD and its member countries are demanding targeted jurisdictions to abolish their settled principles of bank secrecy and client confidentiality and to exchange relevant information to high-tax countries' authorities, but, tax havens (or uncooperative jurisdictions) do not need to be provided with the same information claimed by OECD member countries. Tax havens are thus indeed required to comply with an international standard that would only benefit the tax authorities in the OECD member countries, as it seems unlikely that tax havens will request information about their resident taxpayers to high-tax countries. Exchange of information is expensive and costs risk being high especially for small economies.

It can be questioned whether the OECD is indeed the appropriate institution deputed to develop an international regime for dealing with harmful tax practices. To that purpose, it is worth recalling that the OECD originated in 1948 as the Organisation for European Economic Co-operation (OEEC), led by Robert Marjolin of France, to help administer the "European Recovery Program", better known as "Marshall Plan", wholly financed by the US, for the reconstruction of Europe after World War II.

[647] D.J. Mitchell, *OECD War on Low-tax Countries*, Washington Time, 20 August 2000, B1 argues: "Higher tax burdens are both the theoretical goal and the practical result" of the OECD initiative.

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Two were the main goals of this Program. First, the US government intended to politically stabilise countries of Western Europe in order to reduce the expansion of Soviet influence in Europe. Second, the US economy sought new market areas in order to absorb its remarkable production potentialities no longer involved in the war. The US intention was to shape European economy according to the principles of economic liberalism in order to enhance trade, monetary and financial movements. The role of the organisation, at its very beginning, was to establish a bridge between Europe. However, between 1957 and 1959, the failure of the Maudling Committee negotiations aimed at establishing a free trade area among the OEEC member States made it clear that equilibrium among industrialised countries had changed and a radical renewal of the organisation was necessary. The Convention establishing the Organisation for Economic Co-operation and Development, signed in Paris on 14 December 1960 and entered into force on 30 September 1961, transformed the OEEC into a renewed organisation endowed with new aims, a broader participation and wider possibilities of action.[648] The OECD's goals is to develop the world economy, by favouring sustainable economic growth not only of member States but also of third-party jurisdictions, with particular attention to developing countries.

Article 1 of the OECD Convention states that the aims of the OECD shall be to promote policies designed:

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

b) to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and

c) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

OECD tax policy has become one of the major areas of the OECD's activity, but the attempts to affirm its member countries' tax policy over the rest of the world (and particularly over targeted countries) seem to be outside of its mandate. The differential ways in which harmful tax practices are regarded, in which consultative processes take place, and in which sanctions are applied denote a basic weakness and inequity in the approach, which can raise serious concerns of establishing a precarious equilibrium.

The compliance with these non-binding principles is ensured through some mechanisms enacted with a view to verifying whether States have actually enforced

[648] For a discussion about the continuity of the subjectivity *ratione materiae* of the two organisations see F. Salerno, *L'Organizzazione per la cooperazione e lo sviluppo economici*, Enciclopedia del diritto, 1981, XXXI, 382; H. Hahn, *Organisation for Economic Co-operation and Development*, Encyclopedia of Public International Law, 1997, III, 790. The view according to which the two organisations constitutes two different subjects of international law is held by S. Marchisio, *Organizzazione per la cooperazione e lo sviluppo economici*, Enciclopedia Giuridica, 1990, XXII, 1.

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domestic rules according to them. Such mechanisms are not of a jurisdictional nature, but are based on a multilateral supervision, i.e. the so called “peer review process”. Peer review processes consist of the analysis and the systematic evaluation of one State by other States, with a view to inducing the State under examination to conform its behaviour to rules and principles established by the organisation.[649]

The examination is performed periodically by other States identified as examiners, on the grounds of a rotation system. The main weakness of the system is that examiners should not be influenced by national interests, but since they actually act as formal representatives of their own States, they risk compromising the credibility of the instrument. At the end of the discussion, which quite often consists of negotiations with the State under examination, a report containing progresses made, conclusions and recommendations is approved *per consensus*. Differently from a jurisdictional approach, the final result is not a binding decision or the application of sanctions upon the defaulting State. However, such a “soft” instrument is the most effective in encouraging the fulfilment of precise goals by States and imposes common values and convergent opinions, as its effectiveness largely depend on the circumstance that the results of the process are made public and have a wide echo in national and international press.

The present work has highlighted that harmful tax competition is regarded as an illicit behaviour of some States which enact domestic regulation harming tax interests of other States. In fact, harmful tax competition can never exist without the State’s participation in the avoidance or evasion committed by resident taxpayers of other jurisdictions.

It cannot be denied that the OECD has been playing a key role in developing principles concerning international taxation. Besides the OECD Model Convention, which is broadly used as a base for bilateral agreements aimed at avoiding or eliminating international double taxation, the initiative taken by the organisation has been having a relevant echo in domestic tax legislations, which have been amended according to such new international trends. The whole OECD’s campaign against tax havens and uncooperative jurisdictions indeed achieved many positive results. As stated by J.M. Barroso, former president of the European Commission, “progresses made in the last months in fighting tax havens are higher than in the last thirty years”.[650] However, the project against tax competition launched by the OECD and its member States (most of which – it is worth recalling – are EU Member States) has been considered by many vocal critics as an attack on taxpayers, as creating a cartel of high-tax countries leading to both higher taxes and restrictions to outflows of

[649] In this sense, F. Pagani, *L’examen par les pairs. Un instrument de coopération et de changement: analyse d’une méthode de travail de l’OCDE*, Paris, 2002, 4.

[650] E. Brivio, *Mister Euro attacca gli Usa: ospitano paradisi fiscali*, Il Sole 24 ore, 1 April 2009, 8.

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factors of production according to economical evaluations.[651] It has been reputed as leading to fiscal protectionism, as economic countermeasures urged by the OECD against low-tax jurisdictions attack free trade and global commerce. Similarly, the OECD's action has been considered as an attack on privacy in business relationship, which is a must for economic growth and freedom.

In the literature the OECD's initiative against harmful tax competition has been criticised for several weaknesses. Sharman,[652] for example, argued that the OECD labelled the small States as "tax poachers", while such targeted jurisdictions insisted on the legitimacy of their behaviour and claimed that the OECD itself was violating not only their sovereignty by seeking to dictate and impose foreign tax laws upon them, but also the basic norms of a debate between equals. Sharman also highlighted that from the 1998 Report almost all OECD member countries employed some offending activities in order to maintain policy competitiveness. Blacklisting as an instrument to curb harmful tax competition was criticised by Rawlings and Sharman,[653] according to whom blacklisting was inaccurate, arbitrary, punitive and discriminatory.

Avi-Yonah[654] criticised the failure of the 1998 Report to distinguish satisfactorily between healthy and harmful tax competition and expressed disappointment that the OECD had restricted its project to the mobile services sector only, without discussing the problem of production tax havens. A criticism in this sense also comes from Roin,[655] who remarked the inadequate discussion of the nature of tax competition in the 1998 Report.

Kudrle[656] pointed out that the OECD failed to properly define the "substantial activity" criterion for the tax havens. The Author, in fact, remarked that paragraph 52 of the 1998 Report described this criteria as "the absence of a requirement that the activity be substantial is important since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven", while in paragraph 7 of the 2000 Progress Report this criteria is described as the behaviour of a jurisdiction that "facilitates the establishment of foreign owned entities without the need for a local substantive presence or prohibits these entities from having any

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[651] See for example, T. Dwyer, *'Harmful' Tax Competition and the Future of Offshore Financial Centres, such as Vanuatu*, Pacific Economic Bulletin, 1/2000, 55.

[652] J.C. Sharman, *Havens in a Storm. The Struggle for Global Tax Regulation*, New York, 2006.

[653] G. Rawlings, J.C. Sharman, *National Tax Blacklists: A Comparative Analysis*, Journal of International Taxation, 9/2006, 64

[654] R. Avi-Yonah, *Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State*, Harvard Law Review, 113, 2000, 1563.

[655] J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, Georgetown Law Journal, 89, 2001, 543.

[656] R.T. Kudrle, *The OECD's Harmful Tax Competition Initiative and the Tax Havens: From Bombshell to Damp Squib*, Global Economy Journal, 1/2008, Article 1, 7

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commercial impact on the local economy". According to Kudrle, if the OECD had attempted to pursue the criterion seriously, a definition of "substantial" would have posed lots of difficulties and many tax havens could have claimed different degrees of non-negligible value-added relative to organisation of comparable activity and similar size in high-tax countries.

Wright[657] defined the Global Forum established within the OECD as an "international tax crimes tribunal" that "would not only monitor and expose 'harmful' international tax preferences, but would also oversee enforcement steps to bring offending member governments into conformity with the report's guidelines by the end of the year 2005. The Author[658] also argued that the OECD Report proposed a "cartel" to "permit national governments to regain their clout in defining and enforcing tax bases, setting rates, and favouring the deserving".

Easson[659] affirmed that "the OECD aims to restrict tax competition and can thus be likened to a cartel. Tax competition, like other forms of competition, is a good thing, and cartels are a bad thing. Therefore, the OECD initiative is a bad thing". According to Langer,[660] "the OECD is essentially a cartel consisting of the world's richest countries, most of which are high-tax jurisdictions" and "the OECD's policies are clearly designed to assist its member countries, rather than the world at large. No one other than its own members has ever given it a mandate to tell other countries how to behave. It functions to help its members even if that means harming other countries whose policies are detrimental to those of OECD members". Nobel Prize winner Milton Friedman[661] defined the OECD as "a bunch of Paris-based bureaucrats", a "tax cartel" whose "ill-conceived project" and "unwise proposal" boosts the underground economy by inducing taxpayers to hide, shelter, and underreport income.

Zagaris[662] pointed out that those countries that are targets of the OECD's policy have been excluded from most of the decision-making process, which in addition lacks of transparency; the private sector was not adequately included in the policymaking; a different and more favourable treatment was granted to OECD members, which were

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[657] A. Wright, *Harmful Tax Competition: an Emerging Global Issue*, Tax Notes International, 17 August 1998, 461.

[658] A.W. Wright, *Harmful Tax Competition: an Emerging Global Issue*, Tax Notes International, 17 August 1998, 461.

[659] A. Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, Tax Notes International, 7 June 2004, 1054.

[660] M.J. Langer, *Harmful Tax Competition: Who Are the Real Tax Havens?*, Tax Notes International, 18 December 2000, 1.

[661] M. Friedman, *Economists Urge U.S. President to Reject OECD Initiative*, World Tax Daily, 2001, 107.

[662] B. Zagaris, *Issues Low-Tax Regimes Should Raise When Negotiating With the OECD*, Tax Notes International, 5/2001, 523-532.

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not included in any blacklist, albeit the inadequacies of their tax regimes; the application of economic sanctions and coercion was threatened through blacklisting without any binding hard law. In addition, Zagaris criticised the OECD's initiative for consisting of an effort to usurp policymaking from democratically elected governments, without adequate participation by such governments. Biswas[663] opposed that the international regime being developed at the OECD level was driven and controlled by a group of countries, which are themselves the major perpetrators of the "offending" actions. Mitchell[664] accused the OECD of being "a taxpayer-funded international bureaucracy that receives tax-exempt salaries, jets around the world in business class and maintains a private wine cellar".

3. Uncooperative behaviour is not a violation of international law

The present paragraph intends to scrutinise whether the uncooperative attitude of targeted jurisdictions and their refusal to exchange information for tax purposes can be considered as a violation of international law, in terms of internationally wrongful acts. To that purpose an analysis of the main provisions contained in the Project of Articles on the Responsibility of States for internationally wrongful act will be first provided. Subsequently, the exam will be focused on the sources of international law, in order to define the sources of international obligations, the breach of which might give rise to international State responsibility. Finally, the analysis will be addressed in respect of exchange of information for tax purposes and will conclude that there is no international obligation imposing a cooperative attitude upon States, giving rise to international State responsibility.

3.1. States responsibility for internationally wrongful act

Harmful tax competition is perceived as a phenomenon whose existence strictly depends on the participation of some jurisdictions in the avoidance or evasion of revenue by residents of other countries. Either providing a more favourable tax regime, or by refusing to exchange information, tax haven jurisdictions provide for a form of "cooperation" to investors, rather than to their home States, resulting in a negative fiscal externality for governments of high-tax countries (i.e. tax base erosion). Similarly, the OECD's and its members' campaign has been considered as an attack on targeted States' sovereignty, as the OECD is forcing low-tax or uncooperative jurisdictions, on the ground of political pressure rather than economic constraints, to shape their tax system at high-tax countries' convenience and to eliminate financial privacy. In this respect, it can be questioned whether and to what

[663] R. Biswas, *International Tax Competition: Globalisation and Fiscal Sovereignty*, London, 2002, 23.

[664] D.J. Mitchell, *OECD War on Low-tax Countries*, Washington Times, 20 August 2000, B1.

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extent the claimed harm caused to high-tax countries can be regarded as a form of international wrongful act, resulting from the breach of an international obligation of cooperation with high-tax countries. More specifically, the issue is whether tax havens are bound by international law (i) to provide a minimum level of taxation in line with the OECD standards and (ii) to exchange information concerning tax situations of taxpayers residing in OECD member countries.

In order to address these two issues it is worth reviewing here the concepts of State responsibility in international law and then the scope and binding effects of international law rules as applied to the matter under consideration.

Broadly speaking, in direct tax matter breaches of international law by States can occur in relation to bilateral treaties, when, for instance, one of the contracting States fails to implement certain rules into its domestic legislation in order to actually apply the treaty provisions. Similarly, and at the European Union level, breaches of international law by States can occur whether their domestic tax legislation or their bilateral tax treaties are in breach of one of the fundamental freedoms.

The harmful tax competition issue and the uncooperative attitude of tax havens have never been approached in terms of State responsibility, although the current tax competition campaign is mainly based on an alleged “harm” caused to high-tax countries.

State responsibility is a fundamental principle in international law, arising out of the nature of the international legal system and the doctrines of State sovereignty and equality of States and which plays a key role in international taxation.[665]

According to international law, whenever a State commits an internationally unlawful act against another State, international responsibility is established between the two. A breach of an international obligation involves a requirement to make reparation in an adequate form.[666] As a result, State responsibility requires the existence of an international obligation, the recognition of a breach of such an obligation, and acknowledges some consequences to wrongful behaviour.

The United Nations Commission on international law dealt with a Project of Articles on the Responsibility of States for internationally wrongful acts (hereinafter referred to as “Project”),[667] with a view to establishing the origins of such responsibility, as

[665] Breach of international obligations is a relevant matter of a number of international organisations. In the field of taxation, the World Trade Organisation case law and the European Court of Justice can be mentioned. State responsibility is also dealt with the European Court of Human Rights, the Permanent Court of International Justice, and the International Court of Justice.

[666] *Chorzow Factory*, Permanent Court of International Justice Series A (1927), No. 9, 21.

[667] Text adopted by the United Nations Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission’s report covering the work of that session. The report, which also contains commentaries on the draft articles, appears in Yearbook of the International Law Commission, 2001, vol. II (Part Two). Text reproduced as it appears in the annex to

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well as the elements of international wrongful act and its consequences. The fifty-nine articles contained in the Project are considered as applicable to the infringement of any international obligation.[668] Article 1 of the Project provides that "every internationally wrongful act of a State entails the international responsibility of that State", so reflecting that the principle of responsibility of States is part of the international law. Article 1, thus, provides that a wrongful act automatically leads to State responsibility.

The relevance of State responsibility is also reflected in Article 36(2)(d) of the Statute of the International Court of Justice, which allows a State to make a declaration recognising the International Court of Justice's jurisdiction in all legal disputes concerning the nature or extent of the reparation to be made for the breach of an international obligation.

Article 2 of the Project establishes the elements of an internationally wrongful act of a State, by providing that this latter occurs when the two following requirements are both met:

i. the conduct must consist of an action or omission is attributable to the State under international law; and

ii. it constitutes a breach of an international obligation of the State.

The two requirements are respectively dealt with in Chapter II (attribution of a conduct to a State) and in Chapter III (breach of an international obligation) of the Project.[669]

To the purposes of the present analysis, it is worth emphasising that under Article 12 of the Project a breach of an international obligation by a State occurs when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character. In other words, the obligation which is assumed infringed must be established by international law, such as a treaty, a customary law, a decision of an international court or a binding unilateral act.[670] Consequently, taxation

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General Assembly resolution 56/83 of 12 December 2001, and corrected by document A/56/49(Vol. I)/Corr.4.

[668] In this respect, see B. Conforti, *Diritto Internazionale*, Naples, 2002, 353, who points out that previous attempts to regulate this matter was only limited to responsibility of States in respect of the treatment of foreigners.

[669] A broad analysis of these matters is out of the scope of the present work. However, it is worth briefly highlighting here that Paragraph 1 of Article 4 of the Project of Articles establishes that the conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organisation of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State. Paragraph 2 of the same Article provides that an organ includes any person or entity which has that status in accordance with the internal law of the State. On the notion of organ see more broadly B. Conforti, *Diritto Internazionale*, Naples, 2002, 354-357.

[670] *Nuclear Tests (Australia v. France)*, International Court of Justice Reports 1974, 253.

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not in accordance with an international obligation established, for instance, in a double tax treaty can give rise to State responsibility. A tax audit on the territory of another State without this latter State's permission, for example, is in contravention with a customary rule, as it violates States' sovereignty.[671] By contrast, taxation not in accordance with domestic law alone is not an international wrongful act, as the obligation assumed infringed must be established by international law.

3.2. Sources of binding international law

In this respect, it is worth briefly recalling the sources of international law, where such a binding international obligation might be found. To the purpose of the present analysis, decisions of international courts or binding unilateral acts will not be considered, as not relevant to the matter under examination. Sources of international law are the materials and processes out of which the rules and principles regulating the international community are developed. A definitive statement of the said sources is contained in Article 38(1) of the 1946 Statute of the International Court of Justice, which requires the Court to apply, among the other things:

a) international conventions, whether general or particular, establishing rules expressly recognised by the contesting States;

b) international custom, as evidence of a general practice accepted as law;

c) the general principles of the law recognised by civilised nations; and

d) subject to the provisions of Article 59, judicial decisions and the teaching of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

In the following paragraphs, the exam will focus on the sources listed in a), b) and c). Sources mentioned in d) are out of the scope of the present work and therefore will not be analysed.

International treaties or conventions are sources of international law,[672] which play the role of contracts between two or more parties. Treaties are subject to customary law and find their binding force over the contracting parties on the grounds of the customary rule "*pacta sunt servanda*". They can regulate a particular aspect of international relations, or form the constitution of international organisations. For a treaty-based rule to be a source of law, rather than simply a source of obligation, it must either be capable of affecting non-parties or have consequences for parties more extensive than those specifically imposed by the treaty itself.

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[671] H. Pijl, *State Responsibility in Taxation Matters*, Bulletin for International Taxation, 1/2006, 42.

[672] International treaties are also referred to as conventions, agreements, pacts, general acts, charters, declarations, and covenants and describe a similar transaction, i.e. a written agreement whereby the States legally bind themselves to act in a particular way or to set up particular relations between themselves. They are a more modern and more deliberate method to create international obligations.

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Some treaties are the codification of existing customary law[673] and aim at establishing a code of general application. Their effectiveness depends upon the number of States that ratify or accede to the particular convention, but, representing customary international law, they are binding also upon non-parties. This might occur when the treaty rule reproduces an existing rule of customary law, which is only clarified in terms of the treaty provision.[674] The incorporation in a multilateral treaty of a customary rule, which is in the process of development, may result in its consolidation or crystallisation. A new rule, drafted in a treaty provision might induce States to adopt it as a practice and, whether the *opinion juris* requirement is also met, the subsequent acceptance of that rule might renders this latter part of customary law.[675]

In tax matter, main sources of international tax law of this type are bilateral double tax conventions, which are based on domestic tax laws of the contracting States and establish rules for States' taxing powers' conflict resolutions. In this respect a key role is played by Model Conventions formulated by international organisations (i.e. OECD, and UN), which are recommendations and are not endowed with binding effects. Model Conventions only serve the purpose to provide some guidelines for bilateral negotiations of single treaties and for interpretations of these latter. Although Model Conventions are not sources of international law, they play a key role in the identification of principles and customary rules of international tax law.

The primary source of international law is international custom,[676] which requires both an objective and a subjective element:[677] State practice (*usus*) and acceptance of that practice as obligatory (*opinio juris sive necessitatis*).[678]

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[673] Examples are laws governing the global commons, and *jus ad bellum*.

[674] A relevant example is the Vienna Convention on the Law of Treaties 1969, which was considered by the International Court of Justice to be law even before it had been brought into force. Legal Consequences for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276 (1970) (Advisory Opinion), 1971, International Court of Justice Reports 16, 47.

[675] *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, note 6, 41. See also Trial of the Major War Criminals before the International Military Tribunal, Vol. 1, Judgment, 171, 253-4.

[676] M.N. Shaw, *International law*, Cambridge, 2003, 69 refers to customs as an authentic expression of the needs and values of the community at any given time and in international law they are a dynamic source of law in the light of the nature of the international system and its lack of centralised government organs. On international customs, see generally A. D'Amato, *The Concept of Custom in International Law*, New York, 1971; M.H. Mendelson, *The Formation of Customary International Law*, Recueil des cours, 272, 1998, 155-410.

[677] In literature there are indeed disagreements as to the value of a customary system in international law. W. Friedmann, *The Changing Structure of International Law*, New York, 1964, 121, as well as I. De Lupis, *The Concept of International Law*, Adelrshot, 1987, 112-116 deny that customs can be significant as a source of law, noting that it is too clumsy and slow-moving to accommodate the evolution of international law. A. D'Amato, *The Concept of Custom in International Law*, New York, 1971, 12 recognises that custom is of value since it is activated by spontaneous behaviour and thus

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In order to ascertain whether a State practice is a relevant rule of international customary law, it is necessary to consider every relevant activity of States' bodies and officials. The practice must be followed regularly, or must be "common, consistent and concordant".[679] Due to the size of the international community of State, such practice does not have to be completely uniform, nor has it to be followed by all States.[680] Indeed it is only necessary a sufficient degree of participation of those States whose interests are mainly affected,[681] and an absence of substantial dissent.[682]

A dissenting State is entitled to deny the opposability of a rule at hand if it can demonstrate its persistent objection to that rule,[683] either as a member of a regional group[684] or by virtue of its membership of the international community.[685] It is not

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mirrors the contemporary concerns of society. Modern theories do acknowledge its primary source in the international law system. M.N. Shaw, *International law*, Cambridge, 2003, 69, highlights the "democratic value" of customs, as they reflect the consensus approach to decision-making with the ability of the majority to create new law binding upon all, while the very participation of States encourages the compliance with customary rules.

[678] Customary international law can be distinguished by acts of comity by the presence of the *opinion juris*, even if some acts of comity, such as diplomatic immunity, have developed into customary international law. Some treaties, in addition, have gradually "codified" some rules of customary international law.

[679] *Fisheries Jurisdiction Case (United Kingdom v Iceland)* (Merits), 1974, International Court of Justice Reports 3, 50.

[680] The problem of the identification of the customary rule can be of difficult solution, as hardly ever there exists complete and total consent in the international community of States. To that purpose, general customary rules (applying to all States) are commonly distinguished from special customary rules (followed by some States). As far as taxation is concerned, no tax customary law exists in respect of source taxation, as States can apply different criteria. In addition, customary law pertains to facts and behaviour internationally relevant, whereas criteria of taxation are normally established by domestic legislation. For a broader discussion on this matter, as well as for the evidence in identifying customary rules, see C. Garbarino, *La tassazione del reddito transnazionale*, Padua, 1990, 38.

[681] *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, note 6, 42.

[682] *Case Concerning Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America) (Merits)*, 1986, International Court of Justice Reports 14, note 4, 98. In a number of occasions the International Court of Justice rejected claims that a customary rule existed because of a lack of consistency in the practice. See *Asylum Case (Colombia v Peru)*, 1950, International Court of Justice Reports 266 at 277; Advisory Opinion on the Legality of the Threat or Use by a State of Nuclear Weapons in Armed Conflict, 1996, International Court of Justice Reports 226.

[683] *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, 232 per Judge Lachs.

[684] *Asylum Case (Colombia v Peru)*, 1950, International Court of Justice Reports 266, 277-3.

[685] *Fisheries Case (United Kingdom v Norway) (Judgment)*, 1951, International Court of Justice Reports 116, 131.

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easy for a single State to maintain its dissent.[686] In order for a State practice to become a new customary rule, it is not necessary a minimum period of time, being a process that might occur with great rapidity.[687]

As mentioned above, a State practice can become a rule of customary international law if there is a presumption of the *opinio juris sive necessitatis*.[688] The acts concerned not only must amount to a settled practice, but also they must be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it.[689] Such a requirement more specifically attains to the psychological element in the creation of customary law,[690] and the International Court of Justice frequently referred to it as being an equal footing with State practice.[691] In those cases where practice (of which evidence is given) comprises abstentions from acting, consistency of conduct might not establish the existence of a rule of customary international law.

In tax matters, examples of principles of customary law are: taxation on the effective source of income (which is applied by all States in respect of non-resident taxpayers and, albeit codified in tax treaties, serves as a criterion for resolutions of conflicts

[686] In this sense also rules of the *jus cogens* have a universal character and apply to all States, irrespective of their wishes. In this sense, see *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, note 6, 229 per Judge Lachs. *Jus cogens* (Latin for “compelling law”, “strong law”, or “peremptory law”) is a principle of international law considered so fundamental that it overrides all other sources of international law, including even the Charter of the United Nations. The principle of *jus cogens* is enshrined in Article 53 of the Vienna Convention on the Law of Treaties, which establishes: “For the purposes of the present Convention, a peremptory norm of general international law is a norm accepted and recognised by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character”. Rules of *jus cogens* generally require or forbid the State to do particular acts or respect certain rights. However, some define criminal offences which the State must enforce against individuals. Generally included on lists of such norms are prohibitions of such crimes and internationally wrongful acts as waging aggressive war, war crimes, crimes against humanity, piracy, genocide, apartheid, slavery and torture. *Jus cogens* could be regarded as a special principle of custom with a superadded *opinio juris*.

[687] *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, 43.

[688] While the objective factor (*usus*) is understandable since customary law is founded upon the performance of State activities and the convergence of practices, namely what States actually do, the subjective or psychological element (*opinion juris*) is required to separate international law from principles of morality or social usage, because States do not restrict their behaviour to what is legally required. In this sense M.N. Shaw, *International law*, Cambridge, 2003, 73.

[689] *North Sea Continental Shelf Cases (Federal Republic of Germany v Denmark; Federal Republic of Germany v Netherlands)*, 1969, International Court of Justice Reports 4, 44.

[690] In this sense, C. Garbarino, *La tassazione del reddito transnazionale*, Padua, 1990, 37.

[691] *Case Concerning the Continental Shelf (Libyan Arab Jamahiriya v Malta) (Judgment)*, 1985, International Court of Justice Reports 13, 29; Legality of Nuclear Weapons Advisory Opinion (GA), 16.

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between States' taxing powers on international income),[692] worldwide income taxation on the grounds of a personal criterion, non-discrimination in the treatment of non-resident taxpayers (also contained in tax treaties),[693] the territoriality principle (in terms of the effectiveness of administrative and judicial acts of one State within its territory only, and the prohibition to perform tax audits on the territory of another State, without this latter's previous permission), and diplomatic tax immunities.[694]

As mentioned above, Article 38(1)(c) of the Statute of the International Court of Justice refers to the "general principles of law recognised by civilised nations". There are various diverging opinions about the substance and content of these "general principles", as well as on their legal scope and relationship with the other main sources, namely treaties and customary law. It is even doubtful whether their unclear and controversial nature might render them as a source of international law.[695]

Some authors consider these principles as an affirmation of Natural Law concepts,[696] which are deemed to underlie the system of international law and constitute the method for testing the validity of the positive (i.e. man-made) rules.[697] Some others, basing their views on arbitral compromises from the 19th century, connect them with equity,[698] or departing from Grotius' theories consider these principles as deduced from the fundamental principles of morality and justice, together with the more specific principles from civil law codes and from Anglo-Saxon Common Law of

[692] In this sense C. Garbarino, *La tassazione del reddito transnazionale*, Padua, 1990, 40. The same view is shared by R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, Bulletin for International Taxation, 4/2007, 132, who more generally refers to this customary rule as "jurisdiction to tax".

[693] In this respect, see more broadly K. Van Raad, *Non Discrimination in International Tax Law*, Deventer, 1986, 7-17.

[694] R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, Bulletin for International Taxation, 4/2007, 132 also identifies, as customary rules, the arm's length standard (which is applied in all tax treaties to the transfer pricing problems), and foreign tax credits and deductions (which are provided both in tax treaties and in domestic legislations in order to curb double taxation).

[695] C. Garbarino, *La tassazione del reddito transnazionale*, Padua, 1990, 39. According to T. Rosembuj, *Harmful Tax Competition*, Intertax, 10/1999, 317, general principles are a specific source of international law, together with treaties and their uses, although they are subordinated to these latter. V.D. Degan, *Sources of International Law*, The Hague, 1997, 15 notes that the denial of their obligatory character if not embodied either in treaties or in customary law was the view of the official doctrine in the former Soviet Union, which saw in this source almost without exception the general principles of international law.

[696] L. Le Fur, *Précis de droit international public*, Paris, 1931, paras 372, 387 and 545. See also the Dissenting Opinio by Judge Tanaka on the 1966 Judgment on the Hague Court in the Second Phase of *South West Africa Cases*, International Court of Justice Report 1966, 297-299.

[697] H. Lauterpacht, *Private Law Sources and Analogies of International Law*, London, 1927, 56.

[698] V.D. Degan, *Sources of International Law*, The Hague, 1997, 14.

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judicial precedents.[699] Positivist positions treat these principles as a sub-heading under treaty and customary law,[700] because of their being "recognised by civilised nations", and being rules in force in municipal legal system of States.[701]

Another group of writers reduces the application of these principles to the private law analogy[702] and prefer the definition according to which they serve the purpose to authorise the Court to apply the general principles of municipal jurisprudence, in particular of private law, in so far as they are applicable to relations to States.[703] Likewise any situation arising before a national judge and not falling within the scope of a parliamentary regulation or judicial precedent, the judge should deduce a relevant rule by analogy from already existing rules or directly from the principles governing and guiding the legal system, whether they are referred to as deriving from justice, equity or considerations of public policy. Such a situation is more likely to arise in international law, due to the relative underdevelopment of the system in relation to the needs it is faced with. The "general principles of law" should therefore aim at filling the gap that might be uncovered in international law and at solving the problem of giving any international situation a solution determined as a matter of law.

They may also include legal principles common to a large number of systems of municipal law, as an international tribunal which uses these principles "chooses, edits, and adapts elements from better developed systems: the result is a new element of international law the content of which is influenced historically and logically by domestic law".[704] In order to identify them, it is necessary to develop a comparative analysis of the general principles governing every domestic legal system, from which the general principles of international law should be derived.

The significance of general principles has undoubtedly been lessened by the increased intensity of treaty and institutional relations between States, so that Article 38(1) may be looked upon as a directive to the Court to fill any gap in the law by referring to the general principles. It must be pointed out that if such principles are

[699] C. Fenwick, *International Law*, New York, 1965, 87. A similar view that the general principles of law are an explication of the idea of justice is also shared by A. Favre, *Les principes généraux du droit, fonds commun du droit des gens*, Recueil d'études de droit international en homage à Paul Guggenheim, Geneva, 1968, 375-390.

[700] M.N. Shaw, *International law*, Cambridge, 2003, 94.

[701] C. De Visscher, *Theory and Reality in Public International Law*, Princetown, 1968, 400.

[702] H. Lauterpacht, *Private Law Sources and Analogies of International Law*, London, 1927, 56.

[703] I. Brownlie, *Principles of Public International Law*, Oxford, 2003, 16, highlights that the terms "general principles of law recognised by civilised nations" are a source which comes after those depending more immediately on the consent of States and yet escapes classification as a "subsidiary means" in paragraph (d). According to the Author, the formulation appeared in the *compromise* of arbitral tribunals in the 19th century, and similar *formulae* appear in draft instruments concerned with the functioning of tribunals.

[704] I. Brownlie, *Principles of Public International Law*, Oxford, 2003, 16.

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constantly affirmed and regularly followed by States, they can well become customary law, provided that the requirement of the *opinio juris* is also met.

Finally, it is worth mentioning recommendations of international organisations, as the whole OECD's campaign on harmful tax competition has developed through these acts. Recommendations are typical acts issued by international organisations, not endowed with legally-binding effects upon addressee States. They are quite often referred to as "soft law" instruments, as opposed to "hard law" ones, and due to their lack of establishing obligations are not rated among the sources of international law.

However, recommendations are assessed to produce the so called "lawfulness effects",[705] namely States do not commit any international wrongful act, both infringing a treaty or a customary law obligation, if they comply with recommendations. Such an effect can be only admitted in the relationships between States and as long as recommendations are legitimate, i.e. those recommendations in accordance with the scope of powers of the international organisation and with the limits established in the Statute of this latter. Due to the lack of an international body in charge of deliberating upon the legitimacy of recommendations, the lawfulness effect can only occur towards those States in favour of the recommendation at hand or not having expressly made any reservation on it.

Turning back to the issue of State responsibility, once a violation of an international obligation established in a source of international law occurred, it is necessary to further verify the absence of circumstances precluding wrongfulness,[706] the presence of the subjective element and the damage. Although these mentioned elements will not be object of discussion here, it is worth pointing out that a violation of an international obligation can be referred to as internationally wrongful act, whether all these elements are present. If an internationally wrongful act takes place, then the responsible State is under an obligation to make full reparation for the injury caused by that act,[707] whereas the injured State is allowed to react.

As far as the obligation upon the responsible State is concerned, this is full reparation, which under Article 34 shall take the form of restitution, compensation and satisfaction, either singly or in combination. Restitution consists of re-establishing the situation which existed before the wrongful act was committed, provided and to the extent that restitution is not materially impossible and that it does not involve a burden out of all proportion to the benefit deriving from restitution

[705] B. Conforti, *Diritto internazionale*, Naples, 2002, 181.

[706] They are dealt with in Chapter V of the Project and are the following: consent (Article 20), self-defence (Article 21), countermeasures in respect of an internationally wrongful act (Article 22), force majeure (Article 23), distress (Article 24), necessity (Article 25), and compliance with peremptory norms (Article 26).

[707] Article 31 of the Project. Article 30 indeed also establishes that the State responsible for the internationally wrongful act is under an obligation: (a) to cease that act, if it is continuing; and (b) to offer appropriate assurances and guarantees of non-repetition, if circumstances so require.

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instead of compensation. Compensation shall cover any financially assessable damage including loss of profits insofar as it is established, insofar as such damage is not made good by restitution. Finally, satisfaction may consist of an acknowledgement of the breach, an expression of regret, a formal apology or another appropriate modality, insofar as it cannot be made good by restitution or compensation. In addition, satisfaction shall not be out of proportion to the injury and may not take a form humiliating to the responsible State.

As far as reaction by the injured State is concerned, the most typical one is countermeasure (also called sanctions, reactions, reprisals, self-protection or self-help), which is dealt with in Chapter II of Part Three of the Project. According to Article 49, countermeasures might be taken by injured State (being a form of reaction) against the responsible State in order to induce this latter to comply with its obligation. Countermeasures are a form of legitimate answer to an illegitimate act and despite satisfying the conditions of a breach, they are not wrongful.[708] In other words, their legitimacy derives in being a form of response to an illegitimate act, as countermeasures alone would be illegitimate themselves. Countermeasures are limited to the non-performance for the time being of international obligations of the State taking the measures towards the responsible State, and shall, as far as possible, be taken in such a way as to permit the resumption of performance of the obligations in question.

Different limits to countermeasures exist, the major of which consisting in proportionality between the injury suffered and the gravity of the internationally wrongful act.[709] Such a principle of proportionality is also contained in Article 51, which establishes that countermeasures must be commensurate with the injury suffered, taking into account the gravity of the internationally wrongful act and the rights in question. According to some authors,[710] the principle of proportionality in international law requires that there be no excessive disproportion between the two violations. If disproportion exists, the countermeasure becomes illicit for its exceeding part.[711]

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[708] According to E. Blumenstein, *Sistema del diritto delle imposte*, Milan, 1954, 109, countermeasure in taxation is a certain type of fiscal treatment of taxpayers which, because of their nationality or territory or residence, are in fact members of a foreign State, and bearing in mind the treatment that the latter provides those taxpayers, who because nationality or territory of residence must be considered as compatriots.

[709] *Gabcikovo-Nagymaros Project (Hungary/Slovakia)*, 1997, International Court of Justice Reports, 49-57

[710] B. Conforti, *Diritto Internazionale*, Naples, 2002, 380.

[711] B. Conforti, *Ib.*, points out that other limits to countermeasures are: *jus cogens* and human rights principles, especially in respect of obligations towards foreigners. Article 50 sets forth a list of obligations which shall not be affected by countermeasures, which are: (a) the obligation to refrain from the threat or use of force as embodied in the Charter of the United Nations; (b) obligations for the protection of fundamental human rights; (c) obligations of a humanitarian character prohibiting reprisals; and (d) other obligations under peremptory norms of general international law. Article 52,

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3.3. Uncooperative behaviour and State responsibility

In order to ascertain whether the behaviour of tax havens or uncooperative jurisdictions can be regarded as wrongful and thus as giving rise to State responsibility, a first question arises: is there any international obligation of States to provide for a minimum level of taxation or to exchange information? If the answer is affirmative, then it must be scrutinised whether the infringement of such obligation is an international wrongful act (under the requirements shown above) and, whether, on the one hand, the responsible State shall make full reparation and, on the other hand, the injured States can react by way of countermeasures.

As far as the first question is concerned, it must be pointed out that the establishment of the level of taxation, albeit minimal or non-existent, is a form of exercise of national sovereignty, which hardly ever finds any regulation at the international level. The most typical example in this respect is the European Union, where the European Institutions do not have competence in direct taxation, which is considered to be a jealous prerogative of member States. Similarly, double tax treaties simply reallocate the (already existing) taxing powers of contracting States, but do not establish any international obligation to set up taxes which are not already provided for in domestic legislation. By contrast, in indirect taxation matters (at the WTO or EU VAT level), where an international obligation upon States is established, any tax treatment not in conformity with such an obligation might well constitute a breach of international law, giving thus rise to States responsibility.

Harmful tax competition strictly deals with a more favourable (or non-existing) direct taxation, but no international obligation under customary law or international treaty exists in respect to a minimum level of taxation that each State should levy on taxpayers. As a result, jurisdictions providing for low or no tax regimes cannot be regarded as a form of internationally wrongful act giving rise to State responsibility.

Similarly, no international obligation to exchange information for tax purposes exists,[712] unless a State has entered into an international treaty in this respect. The lack of such obligation under customary law can be confirmed by the international organisations' efforts to spread bilateral instruments for information exchange purposes. Thus, States not having concluded any international treaty in this respect might legitimately decline requests of information by other States. Such uncooperative attitude does not constitute any breach of international law.

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paragraph 3, establishes that countermeasures may not be taken, and if already taken must be suspended without undue delay if (a) the internationally wrongful act has ceased; and (b) the dispute is pending before a court or tribunal which has the authority to make decisions binding on the parties.

[712] In this sense, P. Levine, *La lutte contre l'évasion fiscale de caractère international en l'absence et en présence de conventions internationales*, Paris, 1988, 142.

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It must be pointed out that the OECD cannot be denied to have created, through soft law instruments, a set of principles of international taxation which, although not endowed with a binding force, are widely accepted worldwide. The lack of any binding force of the OECD's recommendations should not induce one to conclude that they are not capable to influence economic international relationships. Recommendations are in fact endowed with a very high political value, as they are issued by an organisation considered authoritative and they are unanimously approved by its members. In practice, member States adapt their national legislation to the OECD's non-binding principles and apply them to their economic relations not only with other member countries but also with non-members. However, the fact that national domestic laws and international tax treaties converge towards common policies, common definitions and common models denotes that at the international level there are similar trends and common values, but it does not mean that the OECD has established a binding international tax regime.

Unless such principles are transposed into a bilateral or multilateral treaty, they cannot be regarded alone either as customary law or as a *corpus* of international principles, giving rise to international obligations. As previously pointed out, customary rules must meet the psychological requirement of the *opinio juris*, namely there must be evidence of a "belief" that this practice is rendered obligatory by the existence of a rule of law requiring it. As far as the general principles are concerned, as already highlighted, their characterisation as a source of international law is not unanimously acknowledged, since they should rather been regarded as instruments filling *lacunae legis*. In this sense, the OECD's principles on harmful tax competition do not seem to fill any *lacunae legis*.

Tax policies are exclusive prerogatives of national parliaments (in accordance with the "no taxation without representation" principle) and every jurisdiction has the right to choose whether exchanging information or not. There is no international law rule prohibiting financial capital diversion from high-tax to low-tax countries, nor are there any public international law grounds for one State to demand from another State a particular type of tax system. As a result, it seems there is no ground to hold that any jurisdiction refusing to cooperate or to comply with the OECD's and its members' desire commits any internationally wrongful act.

In conclusion, there is no international obligation (unless an international treaty expressly establishes so) to provide for a minimum level of taxation or to exchange information for tax purposes. It is, indeed, an established rule of international customary law that sovereign States enjoy almost unlimited jurisdiction over their resident taxpayers.[713]

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[713] See more generally R.S.J. Martha, *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction*, Deventer, 1989. See also M. Orlov, *The Concept of Tax Haven: A Legal Analysis*, Intertax, 2/2004, 104, who points out that this automatically include the right to provide for special rules concerning the application of the national tax system to resident taxpayers.

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4. The role of exchange of information in the harmful tax competition project

This paragraph intends to scrutinise the role played by exchange of information in the harmful tax competition project. As the OECD shifted its attention from “tax havens” to “uncooperative jurisdictions”, a discussion about the nature of the principles developed by the OECD on transparency and exchange of information in the international tax order will be provided. The results of the analysis lead to following conclusions: (i) there is no international obligation upon States to exchange information; (ii) exchange of information is also accepted at the EU level but it is not settled law yet; (iii) a more effective instrument to curb international tax avoidance and international tax evasion might be possible through automatic exchange of information, rather than through an exchange upon request; and (iv) a provision of a different level of secrecy and confidentiality between resident and non-resident investors might lead to a situation of discrimination according to the Bilateral Investment Treaties.

As shown in Chapters 4 and 5, the OECD’s harmful tax competition project evolved from a project targeting jurisdictions meeting the no-substantial activity criterion to those not exchanging information. The lack of exchange of information is in fact one factor stimulating tax competition and thus hampering its “harmful” effects.

As it has been pointed out in this work, the lack of exchange of information allows taxpayers to escape from their home State’s taxation and to choose to become subject to tax where they are provided with a more attractive tax regime. By contrast, governments of high-tax countries adhering to the capital export neutrality principle, collect income from their resident taxpayers, irrespective of where it is sourced, and to actually enforce their claims they need to receive information about activities established by their taxpayers in low-tax jurisdictions.[714] Thus, exchange of information is currently conceived as the instrument curbing the effects of harmful tax competition and constitutes a focal part of the OECD’s efforts to combat harmful tax practices.[715]

As already highlighted in the present work, the OECD’s tax competition project has focused on exchange of information as a policy measure to limit such competition. Thanks to its strong authoritative power, the message that can be read from the organisation’s action is that governments not engaged in tax information exchange are to be regarded as “bad” and the absence of mechanisms enacting such

[714] In this respect, it is worth recalling the OECD’s view in paragraph 54 of the 1998 Report: “Lack of effective exchange of information is one of the key factors […] since it limits the access by tax authorities to the information required for the correct and timely application of tax laws”.

[715] D. Kaur, R. Saw, *The EOI Standard – Past, Present and Future*, Asia-Pacific Tax Bulletin, 1/2010, 14.

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information exchange represents “harmful tax competition”.[716] It cannot be denied that the OECD’s project has achieved its desired results,[717] as currently no jurisdiction figures on the OECD’s black list. Under the “peer review process”, it is possible to assess whether or not the modifications to legislations and procedures adopted by each jurisdiction, together with the bilateral agreements concluded, effectively achieve the desired transparency targets.[718]

However, as pointed out above, exchange of information as an instrument to curb what high-tax countries call “harmful” tax competition cannot be considered as a legal obligation established by international law. As long as a sovereign State does not enter into an international instrument providing an obligation in this sense, States are free to decide whether and with whom to exchange information.

Through soft law instruments and the threat of black lists, the OECD has been capable to set politically, rather than legally, binding principles on transparency and exchange of information, which now play a key role in international taxation. Governments are modifying their attitudes and their tax policies in order to adapt their tax laws to the international environment modified by such principles. This phenomenon seems to be perfectly in line with one of Avi-Yonah’s arguments,[719] i.e. that countries are not free to adopt any international tax rule they please, but rather they must operate in the context of the regime. Avi-Yonah argued that a coherent international tax regime exists, embodied in both the tax treaty network and in domestic laws, and that it forms a significant part of international law. The “norms” of this international regime would be the “single tax principle” and the “benefit principle”.[720] States, in fact, are not free to adopt any international tax rules they wish, but they are obliged to operate in the context of the regime, which changes in the same ways international law changes over time. The Author’s idea is based on the observation that tax laws of various jurisdictions interact with each other, and cases of direct influence can be documented. For example, developed countries now tend to tax currently passive income earned by resident taxpayers overseas, and to exempt or defer active business income. Bilateral tax treaties are remarkably similar,

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[716] R. Höijer, *Tax competitions and tax cartels*, in A. Bergh, R. Höijer (Eds.), *Institutional Competition*, Bodmin, Cornwall, 2008, 151.

[717] According to Jeffrey Owens, Director of the Centre for Tax Policy Administration of the OECD, “More than a decade of work led by the OECD, together with the political leadership of the G20, has permitted unprecedented progress towards better transparency and exchange of information”. See J. Owens, *Moving Towards Better Transparency and Exchange of Information on Tax Matters*, Bulletin for International Taxation, 11/2009, 557-558.

[718] E. Martino, *The Future of International Tax Cooperation in a Barrier-Free Market: Recent Developments Regarding Italian Tax Treaties*, Bulletin for International Taxation, 8-9/2010, 438.

[719] R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, Bulletin for International Taxation, 4/2007, 130-139.

[720] See R.S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, Bulletin for International Taxation, 4/2007, 133 discussed above.

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quite often they have a higher status than domestic law and thus constrain domestic tax jurisdiction and override contrary domestic law. Consequently, these similarities of principles, rules, policies and even language would constitute an international tax regime.[721]

It is worth mentioning that the OECD's principles on exchange of information have been also acknowledged at the EU level. According to settled ECJ's jurisprudence on the free movement of capital between member and non-member States, there exists a distinction between taxpayers resident in EU member States and resident in third countries. Such distinction is based on a different degree of legal integration which characterises member States of the European Union, and in particular the reason of the presence of Community legislation which seeks to ensure cooperation between national tax authorities, such as Directive 77/799/EEC.[722] Economic cross-border activities taking place within the Community are not always comparable to those involving EU member States and third countries. Consequently, although under Article 56(1) of the EC Treaty all restrictions on the movement of capital between member States and between member and non-member States are prohibited, the lack of exchange of information with third countries constitutes a valid justification for a restriction on capital movements to or from non-member States, resulting from an overriding reason in the public interest regarding the fight against tax evasion.[723]

It can thus be concluded that the extreme importance of guaranteeing the effectiveness of fiscal supervision and the possibility to verify whether the exercise of a fundamental freedom is aimed or not at circumventing domestic tax legislation

[721] Contrary to Avi-Yonah's view, M.J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, Tax Law Review, 3/2001, 261-336; H.D. Rosenbloom, *International Tax Arbitrage and the 'International Tax System'*, Tax Law Review, 2000, available at SSRN: http://ssrn.com/abstract=222451; J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, Georgetown Law Journal, 3/2001, 543-604; T. Dagan, *The Tax Treaties Myth*, Journal of International Law and Politics, 939/2000 available at SSRN: http://ssrn.com/abstract=379181 or doi:10.2139/ssrn.379181 argued that an international tax regime does not exist, and countries are free to adopt any tax rules according to their own interests. According to H.D. Rosenbloom, *Cross-Border Arbitrage: The Good, The Bad and The Ugly*, Taxes, 3/2007, 115, although there exist various similarities of domestic tax system and double tax treaties, there is no mechanism for enforcing, or even attempting to enforce, an international tax regime. International obligations established in double tax treaties broadly supplement domestic laws, in the task of eliminating or mitigating double taxation. In the lack of a domestic provision establishing for a tax upon a specific case, a tax treaty would be useless. This can prove that an international tax regime necessary relies on domestic tax legislation and cannot be parted or even isolated from it.

[722] ECJ Judgment of 12 December 2006, *Test Claimants in the FII Group Litigation*, C-446/04, ECR 2006 p. I-11753, paragraph 170; ECJ Order of 23 April 2008, *Test Claimants in the CFC and Dividend Group Litigation*, C-201/05, ECR 2008 p. I-2875, paragraph 92; ECJ Judgment of 18 December 2007, *Skatteverket A*, C-101/05, ECR 2007 p. I-11531, paragraph 37.

[723] ECJ Judgment of 19 November 2009, *Commission / Italy*, C-540/07, ECR 2009 p. I-10983, paragraph 68.

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induces the ECJ to consider member States which exchange information differently from third countries which do not.

One should also note, however, that this is not very settled European Community case-law. In fact, in the *Skatteverket A* case, the European Commission[724] opposed the lack of proportionality between the restriction and the purposes of securing the objective pursued, since the tax authorities of the member State involved could require the taxpayer to furnish proof that the requirements for entitlement to the exemption provided for by that legislation were satisfied.[725] By contrast, according to Advocate General Bot, who delivered his Opinion on the case at hand, the European Community is allowed to adopt measures that restrict the free movement of capital in respect of one or more third countries, which gives the Community a means of exerting pressure in negotiations with the country or countries concerned.[726] In the Advocate General's view,[727] third countries "must still undertake the commitments necessary to ensure that such limitations are removed from conventions or associations agreements concluded with the Community".

Consequently, whereas the Commission supports the lack of proportionality to a restriction based on the lack of exchange of information (therefore emphasising a higher value of fundamental freedoms), the Advocate General favours exchange of information even referring to the need to encourage third countries to conclude conventions on information exchange with the Community or at least with Member States, and claims that, by accepting the disproportionate measures argument, "the Community and the Member States would inevitable be deprived of a means of exerting pressure that might encourage third countries to make such commitments".[728] In fact, "this method of exerting pressure is necessary in order to combat tax evasion and tax avoidance" and "Article 56 EC must be interpreted as providing for liberalisation subject to conditions".[729]

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[724] ECJ Judgment of 18 December 2007, *Skatteverket A*, C-101/05, ECR 2007 p. I-11531, paragraphs 57 and 58.

[725] As pointed out in paragraph 58, the Commission pointed out that "even if it proves difficult to verify the information provided by the taxpayer, in particular due to the limited nature of the exchange of information provided for by Article 8 of the Directive 77/799, there is no reason why the tax authorities concerned should not request from the taxpayer the evidence that they consider they need to effect a correct assessment of the taxes and duties concerned and, where appropriate, refuse the exemption applied for if that evidence is not supplied". Such argument was nevertheless accepted by the Court in other cases, such as ECJ Judgment of 25 October 2007, *Geurts and Vogten*, C-464/05, ECR 2007 p. I-9325 and ECJ Judgment of 11 October 2007, *ELISA*, C-451/05, ECR 2007 p. I-8251.

[726] Paragraph 83 of the Opinion of Advocate General.

[727] Paragraph 88 of the Opinion of Advocate General.

[728] Paragraph 150 of the Opinion of Advocate General.

[729] Paragraph 151 of the Opinion of Advocate General.

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The ECJ does not acknowledge the Advocate General's arguments, which risk being too compromising, and does not explore the issue of the pressure that the Community can exert on third countries to exchange information. The ECJ rather concludes that the lack of exchange of information makes the legal context within which free movement of capital takes place so different that restrictions can be justified. The lack of exchange of information is therefore conceived as deserving a higher degree of protection even compared to fundamental freedoms.

It is interesting to note that the Advocate General's Opinion seems to actually acknowledge the OECD's policy aimed at curbing international tax avoidance and evasion. In spite of the lack of any binding effect of his Opinion, as well as the lack of any value in the context of international law, his arguments seem to denote the absence of a clear common view on the role that information exchange plays on international taxation. Exchange of information is undoubtedly a means to curb international tax evasion and tax avoidance, but political pressure rather than an existing legal obligation is the only way to achieve it.

Further evidence to such an assumption can be found in the following argument. As it has been highlighted in the present work, whereas some countries labelled as "uncooperative" entered into agreements on tax information exchange under the political pressure of high-tax countries (and some of them have even signed treaties between each others), some high-tax jurisdictions more simply have been going their own way. The US FATCA regulation evidences the willingness of the US government to collect relevant information from abroad for its own purposes only, rather than conforming to international trends and abide by reciprocal obligations.

The OECD's standard on information exchange has been broadly criticised by Sheppard,[730] who judged the OECD Model TIEA as being weakly drafted and as being "more a public relations document than a tool of tax administration". According to his view, a treaty on exchange of information should be a contract, the parties of which agree to abide by a reciprocal obligation and to receive some benefits in return. Considering high-tax countries vs. uncooperative jurisdictions, it clearly emerges that there is no mutual interest in exchange of information. In addition, States can well agree to comply with certain obligations to exchange information, but there are no instruments dealing with the consequences of failures to (partly or fully) provide the information requested. Moreover, a bilateral instrument cannot properly deal with those problems of tax and financial crimes which often take place through more than two jurisdictions, nor can information upon request be an efficient remedy.

[730] L.A. Sheppard, *News Analysis: Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, Tax Notes International, 13/2009, 1140. The Author at 1141 also argues that a serious limitation is article 2, which states that no party is required to turn over information that it does not routinely collect or have in its possession. There is no affirmative obligation to collect information. Article 2 of the Model TIEA, in fact, states: "obligated to provide information which is neither held by its authorities nor in the possession or control of persons who are within its territorial jurisdiction". Article 4 does not cover, among definitions, transparent entities, which are often used for tax avoidance purposes.

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An effective exchange of information aimed at seriously hindering problems of tax evasion and avoidance would require information be exchanged automatically and under multilateral instruments. Nevertheless, due to the political pressure of the Bush Administration in 2001, aimed at preserving US bank secrecy, the US signalled that it would not support an aggressive OECD policy of exchange of information in tax matters. The result was that the OECD opted for a policy of exchange of information upon request, rather than automatic one.[731]

There is another issue which does not seem to receive much attention in the literature and which is worth mentioning. As highlighted in Chapter 5, one of the most serious obstacles to exchange of information which the OECD targeted at is banking secrecy. The era of fiscal transparency should mark the end of refusal to information exchange between tax authorities based on the existence of banking confidentiality.[732] However, if uncooperative jurisdictions provided a different level of protection of secrecy within their jurisdictions, in response to high-tax countries' claims, a problem of discrimination in the following terms might arise. High-tax countries are interested in receiving information about their resident taxpayers investing in uncooperative jurisdictions, but they should not feel concerned about the level of secrecy provided to taxpayers residing in such uncooperative jurisdictions by these latter. As a result, uncooperative jurisdictions might grant their residents secrecy and confidentiality and conversely exchange information upon non-residents. Although, a discrimination normally occurs both when similar situations are treated differently and when different situations are treated similarly, and although resident and non-resident taxpayers are normally not considered in similar circumstances, the principle of national treatment enshrined in most Bilateral Investment Treaties imposes that investments made by investors of one contracting Party in the territory of the other contracting Party, as well as returns therefrom, shall be accorded treatment no less favourable than that accorded to investment made by national investors. If a foreign investor doing business in one country is subject to access to its business privacy under a request of information exchange from its home State, whereas a local investor does not suffer from such interference by local tax authority in its business affairs, the principle of national treatment is clearly violated.

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[731] In this respect, see D. Spencer, *Atmosphere is changing for exchange of information*, International Tax Review, 5/2010, 42.

[732] See in this respect Article 26 paragraph 5 of the OECD Model Convention and Article 5, paragraph 4 of the OECD Model TIEA.

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